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Proposed IRS Regulations Will Impose U.S. Withholding Tax on Dividend-Linked Amounts under Many Equity Swaps and Other Equity-Linked Transactions on U.S. Equities

I. Overview

On January 23, 2012, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") published temporary and proposed regulations addressing cross-border equity-linked transactions, such as equity swaps, on U.S. equities. The proposed regulations can be expected to result in the imposition of U.S. withholding tax on many transactions of that kind, if adopted in the form proposed. The regulations implement changes to the law that were enacted in 2010 in response to concerns that certain taxpayers, such as offshore hedge funds, were exploiting the tax rules applicable to derivatives to earn substitute dividend income free of U.S. withholding tax in transactions that Congress believed should be taxed in a manner similar to holding the stock directly, or holding a long position in the stock under a securities loan, either of which would be subject to dividend withholding tax.

Some of the highlights of the proposed regulations are as follows:

- *30 Percent Withholding Tax on Dividend Equivalent Amounts.* The proposed regulations generally would impose U.S. withholding tax at a 30 percent rate (or lower rate provided by treaty) on any payment on an equity-linked transaction that is determined by reference to actual dividends on a U.S. equity (a "dividend equivalent"), if the transaction satisfies any of seven criteria. The criteria are generally intended to capture transactions similar to securities loans or nominee or agency arrangements, as well as short-term transactions, but do so through broadly drawn bright-line rules, some of which reach transactions that may not present the specific abuses that the statute was intended to address. It is likely that many transactions of a kind now common in the market will satisfy one of the criteria.

- *Broad Application to Equity-Linked Transactions.* The proposed regulations would apply potentially to *all* equity-linked transactions that satisfy one of the seven criteria, including futures, forward contracts, contracts for differences, options, structured notes, convertible bonds and mandatory convertible securities, and swaps and other derivatives on such instruments and on U.S. equities, including on preferred stock of U.S. corporations. The drafting of the regulations suggests that an exemption was intended for contracts based on broad-based indices that are traded through futures and options; for other portfolios or indices, the rules would apply on an equity-by-equity basis.

- *"Plain Vanilla" Transactions.* A dividend equivalent would not include a payment determined by reference to an *estimated* dividend, but dividends that have already been declared are not estimated dividends for this purpose. As a result, the proposed regulations would generally treat any equity-linked instrument entered into after a dividend has been declared as an instrument that provides for dividend equivalent payments, and therefore as subject to withholding tax with respect to that dividend if any of the seven criteria are satisfied. They would also treat any equity-linked instrument that is entered into after a special dividend has been declared and before the ex-dividend date for that dividend as subject to withholding tax with respect to all dividend equivalent payments on the transaction. Accordingly, as proposed, the regulations may impose withholding tax on payments made in respect of "plain vanilla" futures and options (other than contracts on traded broad-based indices) and other derivatives that happen to be entered into after a dividend declaration date.

- *Withholding on Gross Amounts.* A withholding agent is required to withhold on the gross amount of the underlying dividend, so the tax due might exceed the amount of the actual dividend equivalent payment owed to a foreign counterparty. It is not clear when withholding would be required for contracts in which a dividend is notionally reinvested or an increase in an expected dividend causes an adjustment to a strike price or conversion ratio.

- *Withholding on Prior Payments*. If a contract was not subject to withholding tax when entered into but later became subject to withholding, all dividend equivalent payments made under the contract would be subject to withholding, including payments that were made prior to the date on which the contract became subject to withholding tax.

- *Aggregation and Related Party Rules.* The proposed regulations include broad aggregation rules that would require taxpayers to take into account multiple transactions in the same equity and to take into account transactions by related parties – including related parties that are U.S. persons, whose positions might not otherwise be relevant – for many purposes of the rules. These aggregation rules are likely to pose challenges for taxpayers attempting to comply with the rules. The stakes for non-U.S. investors (and dealers) are high, because if a transaction is subject to withholding tax and a withholding agent does not in fact withhold the tax, the taxpayer would be obligated to file a U.S. tax return reporting the unpaid tax.

- *Withholding Agent Liability*. Some of the seven criteria that can cause an equity-linked transaction to become subject to U.S. withholding tax are based on transactions by a "long" party that will not be known to the "short" party that is the withholding agent, and that may take place after the contract has been entered into. As proposed, the regulations may require tax to be withheld by a "short" withholding agent even if it does not know of these transactions. An IRS official has informally suggested that a short party would not be liable for failing to withhold on a payment that it did not know or have reason to know was subject to withholding tax. The proposed regulations should be revised to state this explicitly.

- *Potential Double Taxation.* Unlike the current rules for cross-border securities loans, the proposed regulations would not provide any relief for transactions where U.S. withholding tax has already been withheld in a related transaction, for example on dividends on U.S. stock (or a long position in a securities loan) held by a non-U.S. dealer to hedge an equity swap or contract for differences. A non-U.S. dealer may be able to hedge instead with a U.S. affiliate without suffering dividend equivalent withholding tax on the intercompany swap, but only if both parties are swap dealers. Special purpose vehicles that issue U.S.-equity-linked structured notes and hedge with NPCs also may both suffer withholding tax on dividend equivalent amounts they receive and be required to withhold such tax a second time on dividend equivalent payments that they make.

- *Coordination with Section 892*. Dividend equivalents would be eligible for the section 892 exemption for foreign sovereigns (specifically, they would be treated as income derived from investments in stocks and securities). The preamble to the proposed regulations states that taxpayers may rely on this part of the proposed regulations.

- *Changes to Rules for Securities Loans.* The proposed regulations also modify rules for cross-border securities loans on U.S. equities, by providing that any payment that "grosses up" a long party for U.S. withholding tax on the payment, regardless of whether denominated as a substitute dividend or a fee, is itself treated as subject to U.S. withholding tax.

- *Application to Outstanding Transactions.* The proposed regulations are proposed to take effect for *payments* made on or after the date that final regulations are published, and therefore would apply to payments after that date on existing transactions. The temporary regulations extend the rules of current law, but will be removed when final regulations are adopted. The preamble to the regulations indicates that final regulations are intended to take effect for payments made on or after January 1, 2013.

II. Specified Notional Principal Contracts

The temporary and proposed regulations define the scope of section 871(m), the Internal Revenue Code provision that requires withholding on dividend-linked payments made on certain equity-linked transactions. Section 871(m) requires withholding in respect of "dividend equivalents" paid pursuant to "specified notional principal contracts" ("SNPCs") over U.S. equities, by treating such payments as if they were the actual underlying dividend. The currently effective statutory definition of "SNPC" is somewhat targeted (as discussed below) and generally applies to equity swaps (technically, notional principal contracts or "NPCs") that are linked in some identifiable way to a specific set of physical underlying equity securities. In the absence of guidance from Treasury and the IRS, however, that definition would have expanded under the terms of the statute to include potentially all NPCs for payments after March 18, 2012.

Under current law, SNPCs are limited to NPCs where the long party "crosses in" (transfers the underlying security to the short party in connection with the NPC) or "crosses out" (receives the underlying security from the short party), where the underlying security is not "readily tradable," or where a short party posts the underlying security as collateral. The proposed regulations would expand the definition of SNPCs to encompass other NPCs and other equity-linked transactions that satisfy specified criteria that we understand are intended to address concerns over (i) whether the transaction could be carried out in a manner similar to a securities loan (the "in the market" rule), (ii) whether the transaction could be viewed as similar to a nominee or agency arrangement (the "control of hedge" rule), (iii) whether the underlying stock is illiquid (the "regularly traded" rule, the "collateral posting" rule, and the "trading volume" rules), and (iv) additional potentially abusive characteristics (the "90 day" rule and rules relating to special dividends). We discuss these rules and certain additional rules below.

The Long Party is "in the Market." If the long party to an NPC is "in the market" with respect to the underlying security, the NPC would be a "SNPC."

- The long party is in the market if it sells or otherwise disposes of the underlying security *to any person* on the day the NPC prices, or purchases or acquires the underlying security *from any person* on the day the NPC terminates.

- A long party is also treated as in the market if it purchases or disposes of the underlying security at a price that is set or calculated to be “substantially identical” or “determined by reference” to any amount used to price or terminate the NPC. This language appears to be intended to capture transactions in which the long party agrees, for example, to sell stock based on a formula that matches a pricing term of the swap, and could also include stock sales in connection with swaps that use “market on open” or “market on close” pricing.

- In this respect, being “in the market” is broader than “crossing in” or “crossing out,” both of which involve transfers to and from the short party.

- A *de minimis* exception in the proposed regulations provides that a long party will not be “in the market” because of a disposition or acquisition of an amount of the underlying security that is less than 10% of the notional principal amount of the NPC.

- A short party to an NPC (or other withholding agent) would generally not independently know what trades the long party was engaging in contemporaneous with entering or terminating the NPC. Further, the long party may not be able to provide a representation on this point.

    - A number of market participants have expressed concern that some foreign counterparties, for example a multi-strategy hedge fund, do not have the systems in place to be able to represent at the time an NPC is entered into that its other trading activities will not involve buying or selling the underlying security on the relevant dates, and in any event may not wish to constrain their operations in this manner.

    - If the long party is a foreign swap dealer, it is likely that it will hedge its position by buying or selling the underlying stock when pricing or terminating an NPC. It appears from unofficial comments from an IRS official that the IRS is aware of this shortcoming in the rules and would be receptive to suggestions for alternatives. A possible solution to this issue, but not the issue noted above, would be for the “in the market” rule to be limited to long parties that are not swap dealers.

The Underlying Security is not Regularly Traded. Unlike current law, which looks to whether the underlying security is readily tradable, the proposed regulations would look to whether the underlying security is *actually* regularly traded.

- To be regularly traded, the underlying security would need to be listed on the New York Stock Exchange, the American Stock Exchange or NASDAQ or potentially other specified markets. It would also have to have been actually traded on at least 15 of the 30 trading days preceding the date the NPC is priced.[1]

- Because preferred stock generally is not traded on a qualifying exchange, equity swaps on preferred stock of a U.S. corporation generally would not satisfy the "regularly traded" criterion and therefore would be subject to dividend withholding tax.

The Underlying Security is Posted as Collateral. If the short party to an NPC posts the underlying security as collateral (and it represents more than 10% of the total fair market value of collateral at any time over the term of the NPC), the NPC would be a SNPC.

- It is unclear how the aggregation and related party rules would affect this criterion, for example if a U.S. related party enters into a transaction in which the underlying stock is posted as collateral and a non-U.S. related party enters into a NPC on the same stock but other securities or cash are posted as collateral.

Outstanding Fewer than 90 Days. If an NPC is outstanding for fewer than 90 days, it would be a SNPC.

- This rule applies by reference to the actual number of days the NPC is outstanding, not its stated term. Accordingly, a NPC that was not expected to be a SPNC when entered into could retroactively become a SNPC if it were terminated prior to 90 days.

- Importantly, an NPC would be considered terminated to the extent a long party enters into an offsetting position with respect to the underlying security. For example, if an offshore hedge fund purchased a convertible bond with market-standard terms and hedged it by selling the underlying stock short, the bond would be treated as having a term of less than 90 days. There is no *de minimis* rule. The preamble to the regulations does not explain why hedges are treated in this manner. It is possible that the IRS was concerned about direct or indirect hedges back to a counterparty.
    - It is unclear how hedges will be matched against long positions, for example where a taxpayer (or affiliate) has multiple long positions in

1 A security is only considered to be traded on a particular day if the trading volume for that date exceeds 10% of the 30-day average daily trading volume.

NPCs on a particular stock and a single offsetting short position in the stock.

- The potential withholding agent's lack of knowledge about the hedging activities of the long party will raise issues similar to those raised by the "in the market" rule discussed above. Likewise, a long party may not be able or willing to covenant that it will not enter into any offsetting positions prior to 90 days following the day the swap is entered into (or that is will inform the withholding agent if it does so).

- For dealers, this rule may require diligence in order to determine whether a customer and its affiliates have entered into hedges that would be treated as terminating a SNPC. Foreign dealers are likely to hedge their positions, so that unless this rule is modified when finalized, dividend equivalent payments to foreign dealers may generally be subject to U.S. withholding tax.

Long Party Controls Short Party's Hedge. If the long party directs (either customarily or contractually) how the short party hedges its position under an NPC, the NPC would be a SNPC.

- This rule appears primarily to be intended to apply to "give up" arrangements.

- This rule would also apply if the long party enters into an NPC using an "underlying equity control program." This would be any system or procedure that permits the long party to an NPC to direct how the short party hedges, or permits the 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."

- An "underlying equity control program" would not include an electronic trading platform that allows customers to place orders to enter into NPCs with a dealer, but allows the dealer to determine whether and how to hedge. It appears that conventional "direct market access" programs generally would not be treated as underlying equity control programs.

Represents a Significant Percentage of Trading Volume. If the notional principal amount of an NPC is greater than 5% of the total public float of the underlying security, or is greater than 20% of the 30-day average trading volume of the security (as determined at the end of the business day preceding the first day of the NPC's term), the NPC would be a SNPC.

- For purposes of this determination, all NPCs entered into by a long party in respect of the same underlying security would be aggregated. It seems likely, but is not certain, that if a later NPC caused the relevant threshold to be breached, that earlier NPCs on the same stock would become SNPCs.

- Because of the aggregation rule, short parties would not independently know whether an NPC represents a significant percentage of trading volume of the underlying security, and long parties will have to carefully monitor their positions.

Provides for the Payment of a Special Dividend. An NPC entered into on or after the announcement of a "special dividend" and before the ex-dividend date would be a SNPC. A special dividend is a nonrecurring payment to shareholders that is in addition to a normal recurring dividend.

- The application of this rule to conventional options, convertible bonds and other non-"delta one" transactions that typically adjust a strike price or conversion ratio to reflect the reduced value of the stock once a special dividend is paid, for *bona fide* economic reasons, may pose significant practical problems because there is no cash flow associated with the special dividend.

Swaps on a Portfolio or Index. Generally a NPC on a portfolio or index would be treated as if it were a bundle of NPCs on each underlying stock. The regulations are drafted in a manner that suggests that a NPC on a broad-based index that is traded through futures and options traded on commodity or securities exchanges are not intended to be treated in this manner. The regulations will need to be revised to make that clear, and to clarify whether NPCs on such broad-based indices are intended to be wholly outside the scope of these regulations.

Equity-Linked Instruments Other Than NPCs. As described above, the proposed regulations apply broadly to any financial instrument that references one or more underlying stocks and that provides for a dividend equivalent payment. Such transactions would be treated as NPCs for purposes of these rules, and therefore as SNPCs if they satisfy any of the seven criteria described above.[2]

III. NPCs that Become Specified Notional Principal Contracts

Under the proposed regulations, if an NPC is not a SNPC when entered into but later becomes one, all payments made on the NPC over its entire term that are contingent upon or

2 As drafted, the regulations would apply to such transactions even if they do not satisfy any of the seven criteria; this appears to be a drafting flaw rather than an intended consequence.

determined by reference to a U.S. source dividend would be treated as dividend equivalents and subject to withholding. Even if a payment is made on an NPC and properly not withheld on at the time it is made, if the NPC later becomes a SNPC, the earlier payment would be subject to withholding.

The withholding tax on such prior payments would be required to be withheld from the next payment due under the NPC. As the preamble to the proposed regulations makes clear, even if the tax due is greater than the amount of the next payment, the withholding agent would be responsible for reporting and depositing the entire amount due with the IRS. The withholding agent would be required to deposit the tax due even if it cannot collect the amount from the foreign counterparty.

The rule under the proposed regulations most likely to result in NPCs unexpectedly becoming SNPCs is the one governing NPCs outstanding for fewer than 90 days. Because a long party entering into any offsetting position during the first 90 days that an NPC is outstanding would cause it to be treated in whole or part as a SNPC, it may be difficult in practice for a U.S. withholding agent to be sure that an NPC has not become a SNPC.

IV. **Foreign Sovereign Counterparties and Counterparties Claiming Treaty Benefits**

For foreign sovereign investors eligible for the exemption under section 892, the proposed regulations would treat dividend equivalent payments made on SNPCs as income from investments in stock and securities and thus as generally exempt from U.S. withholding tax. Similarly, the proposed regulations would treat dividend equivalents as dividends for the purposes of applying tax treaties.

By their terms, both of these rules would be effective once the proposed regulations are finalized, but the preamble to the proposed regulations makes it clear that the proposed section 892 rule can be relied upon immediately. Under current law, therefore, it appears that a dividend equivalent would be treated as “Other Income” for treaty purposes rather than as a dividend.

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Please feel free to contact any of your regular contacts at the firm or any of our U.S. partners and counsel listed under Tax in the “Practices” section of our website (http://www.clearygottlieb.com) if you have any questions.

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