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IRS Releases Final and New Proposed Regulations That Define "Dividend Equivalent" for U.S. Withholding Tax Purposes

On December 5, 2013, the Internal Revenue Service ("IRS") finalized temporary regulations and issued new proposed regulations under Section 871(m),[1] the Internal Revenue Code provision that treats "dividend equivalents" paid under securities lending transactions, sale-repurchase transactions and certain notional principal contracts ("NPCs") as dividends from sources within the United States and therefore subject to U.S. withholding tax.

The final regulations under Section 871(m) adopt the prior temporary regulations with minimal changes. These regulations conform to the rules applicable to NPCs found in the Code and will continue to apply to payments under such NPCs until January 1, 2016.

More significant, however, are the new proposed regulations under Section 871(m), designed to broaden Section 871(m)'s scope beyond transactions specifically described in the statute. These new proposed regulations replace the seven factor test of the prior proposed regulations with a single factor test for determining when an instrument has the potential for tax avoidance through payment of dividend equivalent amounts.

The single factor test asks whether an NPC or equity-linked instrument ("ELI") has a "delta" of .70 or greater. If so, the proposed regulations treat payments on the instrument that reference dividends paid on a U.S. corporation's stock as "dividend equivalents" that are subject to U.S. withholding tax. An NPC's or ELI's delta is the ratio of the change in the fair market value of the instrument to the change in the fair market value of the underlying property referenced by the instrument. If adopted as final regulations, the proposed regulations would apply to payments on or after January 1, 2016 with respect to NPCs and ELIs that meet the new single factor test.

Further highlights of the proposed regulations include:

- ELIs include futures, forwards, options, debt instruments and other contractual arrangements (such as structured notes) that reference the value of underlying securities.
- The regulations will apply to payments made on or after January 1, 2016 on ELIs acquired by a long party on or after March 5, 2014. Accordingly, an ELI already outstanding or issued today will be subject to the new rules if it is acquired by a secondary market purchaser on or after March 5, 2014. This limited grandfather for instruments acquired before March 5, 2014, however, does not apply to NPCs.
- NPCs and ELIs with a delta that is "not reasonably expected to vary" during the term of the transaction are treated as having a delta of 1.0.
- For purposes of determining whether an NPC is subject to Section 871(m), the delta of an NPC or ELI is

[1] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

determined as of the date it is acquired and is not retested in the hands of the same holder.

- Secondary market purchasers test an NPC's or ELI's delta when the instrument is acquired. Accordingly, a single issue of instruments may include some instruments that carry dividend equivalents subject to U.S. withholding tax and others that are not.

- If an ELI references more than one underlying security, then it is subject to the new rules with respect to any underlying security for which it has a delta of .70 or greater. Thus, an ELI with multiple underlying securities will be "tainted" if any one of them has a delta of greater than .70 when it is acquired.

- The payment of a dividend equivalent includes any amount that references an actual or estimated payment of dividends, whether the reference is explicit or implicit, including actual or estimated dividend payments that are implicitly taken into account in computing one or more of the terms of the transaction (i.e., "price return" only instruments may be covered).[2] The prior regulations had carved out estimated dividends from "dividend equivalent" treatment.

- NPCs and ELIs that reference "qualified indices" are carved out from the dividend equivalent rules and should not give rise to dividend equivalent amounts.[3]

- Broker-dealers who are a party to a potential 871(m) transaction are required to determine whether the transaction is an 871(m) transaction and report the timing and amount of any dividend equivalent. If both parties to a potential 871(m) transaction are broker-dealers, or neither party is a broker-dealer, the short party is responsible for making these determinations.

- The proposed regulations mark the first time the government has used the objective "delta" standard to distinguish a financial derivative from an underlying. While this concept could be useful under other Code sections, the preamble to the proposed regulations provides that they should not be used as a basis for applying the delta standard elsewhere in the Code.

- Taxpayers that acquire a transaction with a principal purpose of avoiding the application of the proposed regulations would be subject to a general anti-abuse rule that allows the IRS to treat payments as dividend equivalents to the extent necessary to prevent the avoidance of the dividend equivalent rules.

[2] For example, suppose a price-return swap contract entitles the long party to receive appreciation in an underlying security (but does not entitle the long party to any dividends) and obligates the long party to pay a fixed rate of LIBOR to the short party. Also suppose that, had the long party entered into a total-return swap, the long party would be obligated to pay the short party LIBOR plus 100 basis points. Because the dividends are taken into account in determining the terms of the NPC (i.e., resulting in a reduced funding payment), the long party is treated as receiving a dividend equivalent on the price-return only swap despite the fact that the swap contract does not contain any reference to an estimated dividend amount. See Prop. Reg. Section 1.871-15(h)(4) Example 2.

[3] For these purposes, a qualified index is an index that (1) references 25 or more component underlying securities, (2) references only long positions in component underlying securities, (3) contains no components that represent more than 10 percent of the weighting of the index, (4) modifies or rebalances only according to predefined objective rules at set dates or intervals, (5) does not provide a dividend yield from component underlying securities that is greater than 1.5 times the current dividend yield of the S&P 500 Index as reported for the month immediately preceding the date the long party acquires the potential 871(m) transaction, and (6) futures contracts or option contracts on the index trade on a national securities exchange that is registered with the SEC or a domestic board of trade designated as a contract market by the CFTC.

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