US

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US dividend equivalent regulations

On September 17 2015, the Internal Revenue Service (IRS) released final and temporary regulations under section 871(m) of the US Internal Revenue Code. This is the provision that treats dividend equivalents paid under certain derivative contracts as dividends from sources within the US and therefore subject to US withholding tax if paid to a non-US person. The regulations finalise regulations proposed in 2013 (2013 Proposed Regulations), with some important changes.

The new regulations generally adopt the delta approach introduced in the 2013 Proposed Regulations, which treat payments on notional principal contracts (NPCs) and equity-linked instruments (ELIs) as dividend equivalents if they have a delta above a threshold. The final regulations increase the delta threshold to 0.80 from 0.70. Generally, if an NPC or ELI has a delta of 0.80 or greater, the NPC or ELI is a section 871 transaction, and payments on the instrument that reference dividends paid on a US corporation's stock are dividend equivalents.

The final regulations provide that the delta of an instrument is determined when the instrument is issued and is not re-tested when the instrument is acquired in the secondary market. This is a change from the 2013 Proposed Regulations, which required determining delta in the hands of each taxpayer on the relevant acquisition date. The new regulations retain the provisions of the 2013 Proposed Regulations that include estimated and implicit dividends as dividend equivalents. For example, a price return only instrument can give rise to dividend equivalent payments if the expected dividends on the underlying security are taken into account in pricing the instrument or setting its terms. As in the 2013 Proposed Regulations, instruments linked to qualified indices are carved out from the dividend equivalent rules. However, the definition of a qualified index has been modified.

The delta approach is limited to simple NPCs and ELIs, and a new framework has been designed for complex NPCs and ELIs. A complex NPC or ELI is any NPC or ELI that is not a simple contract; a simple contract is an NPC or ELI that has a fixed term and references a fixed number of underlying shares. Complex NPCs and ELIs are not subject to the delta test; instead, a complex NPC or ELI gives rise to dividend equivalents if it passes a substantial equivalence test. The IRS has requested comments regarding the administrability of the substantial equivalence test.

Because the new regulations look to the underlying reference asset of a transaction and not the identities of the transaction participants, it is possible for US withholding tax to apply to transactions between two non-US parties. As a result, market participants worldwide will need to familiarise themselves with these rules.

The new regulations generally apply to NPCs and ELIs issued on or after January 1 2017. NPCs and ELIs issued on or after January 1 2016, and before January 1 2017, are also subject to the new regulations, with a delayed effective date of January 1 2018.

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