

**MEMO# 27888**

February 12, 2014

# IRS Releases New Proposed Regulations Regarding U.S. Withholding Tax on Dividend Equivalent Payments

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TO: ICI GLOBAL TAX COMMITTEE No. 1-14 RE: IRS RELEASES NEW PROPOSED REGULATIONS REGARDING U.S. WITHHOLDING TAX ON DIVIDEND EQUIVALENT PAYMENTS

The Internal Revenue Service (“IRS”) recently released final and new proposed regulations regarding dividend equivalent payments under U.S. Internal Revenue Code section 871(m). [\[1\]](#) The new and proposed regulations impose withholding tax on certain payments made to foreign parties pursuant to notional principal contracts (“NPCs”), or swaps, and other “equity-linked instruments” (“ELIs”).

## Background

Prior to the enactment of section 871(m) in 2010, U.S. withholding tax generally was not imposed on dividend equivalent payments made with respect to equity swaps. Rather, income under an NPC generally was sourced by reference to the residence of the recipient. Congress enacted section 871(m) in response to concerns that foreign parties were using equity swaps to avoid U.S. withholding tax on dividends. Section 871(m) thus treats certain “dividend equivalent” payments as U.S. source dividend income for U.S. withholding tax purposes.

Section 871(m) defines “dividend equivalent payments” as (i) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that, directly or indirectly, is contingent upon, or determined by reference to, the payment of dividends on U.S. securities; (ii) any payment made on a “Specified NPC” that is contingent upon, or determined by reference to, the payment of dividends on U.S. securities, and (iii) any payment that the U.S. Treasury Department (“Treasury”) determines to be “substantially similar” to the payments in (i) and (ii). A “Specified NPC” is defined under the statute as any NPC if:

- The long party transfers the underlying security to the short party in connection with entering into the contract (i.e., “crossing in”);
- The short party transfers the underlying security to the long party in connection with the termination of the contract (i.e., “crossing out”);

- The underlying security is not readily tradable on an established securities market;
- The underlying security is posted as collateral by the short party to the long party in connection with entering into the contract; or
- The contract is identified by the U.S. Treasury Department as a Specified NPC.

Further, with respect to any payments made after March 18, 2012, any NPC will be treated as a Specified NPC unless the U.S. Treasury Department determines that an NPC does not have the potential for tax avoidance.

## **Original Temporary and Proposed Regulations**

The U.S. Treasury Department and the IRS issued temporary and proposed regulations under section 871(m) in 2012. The temporary regulations maintained the four categories of Specified NPCs listed in the Code for payments made through December 31, 2012. The original proposed regulations were scheduled to become effective for payments made on or after January 1, 2013. The original proposed regulations set forth seven categories of Specified NPCs and expanded the scope of section 871(m) to cover ELIs, including futures, forwards, options, and convertible debt instruments. The original proposed regulations were widely criticized by the financial industry, in part because of numerous compliance difficulties. Thus, the effective date of the temporary regulations was later extended to December 31, 2013, and the effective date of the proposed regulations was extended to January 1, 2014.

## **Final Regulations and New Proposed Regulations**

In December, 2013, Treasury and the IRS issued final regulations and new proposed regulations under section 871(m). The final regulations apply the four categories of Specified NPCs set forth in section 871(m) to payments made through December 31, 2015. The new proposed regulations, if finalized, would apply to all payments made on a Specified NPC beginning on January 1, 2016, regardless of when the NPC is executed. The proposed regulations also would apply to all payments made on a "Specified ELI" on or after January 1, 2016, but only with respect to an ELI acquired on or after March 5, 2014.

The new proposed regulations eliminate the seven categories of Specified NPCs set forth in the original proposed regulations. Instead, the new proposed regulations provide that NPCs and ELIs will be treated as Specified NPCs or Specified ELIs if the instrument has a delta of 0.7 or more on the date the instrument is acquired. For this purpose, "delta" is the ratio of (i) the change in the fair market value of the NPC or ELI to (ii) the change in the fair market value of the property referenced by the NPC or ELI. The proposed regulations provide that the delta is deemed to be 1.0 if the ratio is not reasonably expected to vary during the term of the transaction.

### **Dividend Equivalent Amounts**

The proposed regulations define a dividend equivalent payment as any gross amount with respect to a Specified NPC or Specified ELI that references the payment of a dividend on an underlying security, and such payment is used in computing any net amount transferred to or from a long party, even if that party does not actually receive payment. An "underlying security" generally is the stock of a U.S. Subchapter C corporation. A payment includes any amount that explicitly or implicitly references an actual or estimated amount of dividends in computing one or more of the terms of the transaction, such as purchase price, premium, or upfront payments.

The amount of the dividend equivalent payment equals: (1) the actual dividends on the

underlying security, multiplied by (2) the delta of the transaction at the time the amount of the dividend equivalent is determined. If the Specified NPC or Specified ELI has a term of one year or less, the amount of the dividend equivalent is determined when the long party disposes of the transaction. For this purpose, the delta of an option when it lapses is treated as zero, and the delta of an option when it is exercised is treated as one. For transactions with a term of more than one year, the amount of a dividend equivalent payment is determined on the earlier of the ex-dividend date or the record date for the dividend.

## Index-Linked Instruments

The proposed regulations provide that a “qualified index” is not treated as an underlying security for purposes of section 871(m). Thus, instruments linked to a qualified index are not subject to the sourcing rule of section 871(m). An index is a “qualified index” if it:

- References 25 or more component underlying securities;
- References only long positions in the underlying securities;
- Contains no component representing more than 10 percent of the weighting of the securities in the index;
- Is modified or rebalanced only according to predefined objective rules at set intervals;
- Does not provide a dividend yield that is 1.5 times the dividend yield of the S&P 500 Index for the prior month; and
- Futures or options on the index trade on a national securities exchange that is registered with the U.S. Securities and Exchange Commission (SEC) or a domestic board of trade designated as a contract market by the U.S. Commodities Futures Trading Commission (CFTC).

A transaction referencing a qualified index will not qualify for this exception, however, if, in connection with the transaction, the taxpayer reduces its exposure to any component of the index. The proposed regulations also provide a safe harbor, under which an index will be a qualified index if it is comprised solely of long positions in assets other than underlying securities, and the referenced underlying securities in the aggregate comprise 10 percent or less of the index’s weighting.

## Exceptions

The proposed regulations contain two exceptions to the sourcing rules in section 871(m). The first applies to “qualified dealers” who enter into a transaction as a long party in their capacity as a dealer in securities. A qualified dealer is defined as a dealer that is subject to regulatory supervision by the government where it was organized and that provides a written certification that it is a qualified dealer. This exception does not apply with respect to any proprietary position held by a dealer.

The second exception applies to certain corporate acquisitions, in which the long party is obligated to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons are obligated to acquire more than 50 percent of the issuing entity’s value.

## Other Rules

The proposed regulations contain special rules to prevent avoidance of section 871(m). Specifically, in certain circumstances, two or more transactions referencing the same underlying security will be treated as a single transaction. For example, if a purchased call

option and a written put option each have a delta of less than 0.7, the two may be treated as a combined transaction with a delta in excess of 0.7, and thus subject to section 871(m), if one option was acquired in connection with the other.

Another rule provides that a transaction that references an interest in an entity that is not a U.S. C corporation, such as a partnership, may be treated as referencing the underlying securities held by such entity. This rule will not apply if the underlying securities represent 10 percent or less of the value of the referenced interest in the entity.

The proposed regulations give the IRS the authority to treat any payment with respect to a transaction as a dividend equivalent if a taxpayer or related person acquires a transaction with a principal purpose of avoiding the application of section 871(m). The IRS can do so by, among other things, adjusting the delta of a transaction, the timing of payments, or the components of an index.

### Reporting Requirements

A short party or a broker or dealer that is party to a potential section 871(m) transaction must determine whether the transaction is subject to section 871(m) and report to the counterparty or customer the amount and timing of any dividend equivalents. Brokers and dealers thus generally must calculate the delta of each transaction entered into by its customers or counterparties at the time of acquisition and, for each section 871(m) transaction, on the date of each underlying dividend.

### Withholding Agents

A withholding agent must withhold on a dividend equivalent payment upon the later of (i) the time that the amount of the dividend equivalent is determined, and (ii) the time at which the withholding agent is deemed to have control over property of the long party. A withholding agent will not be liable for under-withholding if it reasonably relies on information it receives from the party determining the delta of the transaction. Further, the withholding agent is not required to withhold on a dividend equivalent payment made pursuant to a transaction that is subject to section 871(m) only because it has been combined with one or more other transactions, unless the withholding agent knows that the long party or a related person entered into the transactions in connection with one another.

## Comments Requested

Treasury and the IRS have requested comments on the new proposed regulations by March 5, 2014. A public hearing has been scheduled for April 11, 2014. The Institute may submit written comments on the proposed regulations if there are specific concerns for funds. Therefore, please provide any comments to me ([kgibian@ici.org](mailto:kgibian@ici.org) or 202-371-5432) no later than Thursday, February 20, 2014.

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### endnotes

[1] The final and proposed regulations can be found on the website of the Federal Register [here](#) and [here](#), respectively. Hereinafter, all section references are to the U.S. Internal Revenue Code, unless otherwise specified.

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