

New Regulations Address Withholding on “Dividend Equivalents”

Section 871(m) of the Internal Revenue Code, enacted in 2010, imposes withholding tax on, among other things, “dividend equivalents” paid to foreign counterparties pursuant to “specified notional principal contracts” (“**specified NPCs**”). Temporary Treasury regulations released yesterday extend the currently operative definition of a specified NPC through the end of 2012. For payments beginning on January 1, 2013 (including on instruments entered into prior to that date), proposed Treasury regulations, also released yesterday, would among other things substantially revise the definition of a specified NPC and extend withholding under Section 871(m) to dividend-equivalent payments on a variety of equity-linked instruments other than swaps.

The proposed regulations for payments beginning on January 1, 2013 are described in more detail below. Very generally, these rules would exclude from the definition of a specified NPC (and therefore from withholding on dividend-equivalent payments) many typical equity swaps. However, the proposed regulations present a number of significant practical issues. First, a number of elements of the “specified NPC” definition – including whether the “long party” is “in the market,” or has aggregated positions in excess of specified thresholds, at the time of entry into the NPC – would not be within the control (and might not be within the knowledge) of the “short party.” In addition, many of the specified NPC criteria **cannot** be known until after an NPC has been entered into, including whether the long party is “in the market” on **termination** of the NPC, or has hedged its exposure within 90 days after entry into the NPC. Indeed, it may be quite difficult for some long parties (for example, financial institutions and investment entities, and members of their affiliated groups) to ascertain whether they are entering into instruments that are or might become specified NPCs. And as discussed in more detail below, the proposed regulations make clear that a contract (again, including one in existence today) may become a specified NPC during its term, with withholding tax becoming due with respect to **prior** dividend-equivalent payments (made or deemed made on or after January 1, 2013). Accordingly, short parties will likely find it necessary to seek a variety of protections (with respect to future and perhaps now-existing contracts), including representations, indemnities, and termination provisions. If short parties are to be permitted to rely on, for example, representations from long parties in order to avoid withholding obligations, clarification on the point is needed.

Under the proposed regulations, an NPC would be a specified NPC if one of the following seven conditions is met:

- the long party is “in the market” on the day (or in the case of tranches, the days) on which the NPC is priced or terminated (generally, by virtue of having sold the underlying security on the pricing date or for an amount set by reference to the price used in entering into the NPC, or having bought the underlying security on the termination date or for an amount set by reference to the price used in terminating the NPC, but with a *de minimis* exception for less than 10% of the notional amount);
- the underlier is not both (i) listed on a national securities exchange at the time the NPC is priced and (ii) generally, traded for at least 15 of the 30 trading days prior to the pricing of the NPC in quantities exceeding 10% of the 30-day average daily trading volume;
- the short party posts the underlying security as collateral, and that security represents more than 10% of the collateral posted on any day during the term of the NPC;

- the NPC's actual term (regardless of its stated term) is less than 90 days (for this purpose, termination would occur if and to the extent the long party enters into a "hedge" of its exposure, regardless of whether the hedge is entered into with the short party);
- the long party controls (whether contractually or by course of conduct) the short party's hedge of the NPC or enters into an NPC using an "underlying equity control program," defined as a system or procedure that permits the long party to (i) direct how the short party hedges its risk or (ii) cause the short party to acquire an underlying security and then execute the NPC (subject to an example excluding an electronic trading platform where the short party's computer system determines whether it has an internal hedge, automatically seeks to acquire the underlying security to the extent there is no internal hedge, and prices the NPC at the short party's execution price plus a market spread);
- the long party has NPC positions (in the aggregate, with any counterparties) representing more than 5% of the total public float of the underlying security or more than 20% of its 30-day average daily trading volume as of the day prior to the first day in the term of the NPC; or
- the NPC is entered into after the announcement of a "special" (non-recurring) dividend.

For purposes of testing whether any of the above conditions is met with respect to an NPC, the proposed regulations would treat every person related to a party to an NPC as a party to the NPC. Thus, for example, if an affiliate of the long party was "in the market" on the day the NPC was priced or terminated, and the *de minimis* exception was not met, the NPC would be a specified NPC.

An NPC that becomes a specified NPC during its term would be subject to withholding with respect to both subsequent and prior dividend-equivalent payments (again, if made or deemed made on or after January 1, 2013), with the tax on prior dividend-equivalent payments being due on the next payment date under the NPC. The preamble to the proposed regulations clarifies that the short party must remit the tax even where the amount of the tax exceeds the remaining amounts payable under the NPC.

Estimates of expected dividends, without adjustments, would not be considered dividend equivalents, unless these amounts were set after the declaration or announcement of the relevant dividend.

The proposed regulations would exclude from the scope of a specified NPC an NPC entered into with a related party that hedges an NPC entered into with an unrelated party, if these transactions are in the ordinary course of both related parties' dealer businesses.

The temporary and proposed regulations, like the statute, provide that a "payment" includes a gross amount used to determine a net amount payable under a contract (even if the net amount payable is zero or negative). However, the regulations do not make entirely clear whether the "fixing" of a dividend-equivalent amount, to be factored into a payment due at a later date (*e.g.*, at maturity), is subject to tax at that time (as opposed to at the time of the later payment). It is also not entirely clear whether "notional reinvestment" of a dividend-equivalent amount would constitute a "payment" for purposes of the proposed regulations. These results may well have been intended, however.

The proposed regulations would also apply to any "substantially similar" payment, which would mean (a) any payment of a beneficial owner's tax liability with respect to a dividend equivalent (*e.g.*, by way of a tax gross-up) and (b) any payment under an "equity-linked instrument" that is contingent on or determined by reference to a U.S.-source dividend. An "equity-linked instrument" would mean a financial instrument (or combination of instruments) that references one or more underlying securities to determine its value, including a futures contract, forward contract, option or other arrangement. Although not entirely clear, the proposed regulations would appear to apply to dividend-equivalent payments on instruments that provide the long party with less than a total-return exposure to an underlying security or securities. It is not clear whether this was intended, for example in the case of debt instruments providing for dividend-equivalent interest payments, which (if the underlying security is publicly traded) are specifically eligible for

exemption from withholding tax under the “portfolio interest exemption.” In addition, this provision as drafted appears to subject dividend-equivalent payments under **all** “equity-linked instruments” to withholding tax, regardless of whether the instrument would constitute a specified NPC. It seems very likely that this result was not intended.

If an instrument is linked to multiple underlying securities or to a “customized index,” the proposed regulations would treat each security in the “basket” or index as an underlying security in a separate NPC. Very generally, an index is a “customized index” unless (i) futures or option contracts are traded on the index and (ii) it is not “narrow-based” as defined (very generally, overly concentrated).

It is not clear how the proposed regulations would operate with respect to an instrument linked to an index that is not “customized.” While the proposed regulations do not treat each component of a non-customized index as a separate security subject to a separate NPC (which appears to have been intended to exclude instruments linked to such “broad-based indices” from the scope of a specified NPC), they also do not provide that the index **itself** would not constitute an underlying security (which the statute expressly does provide). In any event, the proposed definition of a specified NPC does not turn on the existence of any underlying security (although several prongs of that definition assume it). If an instrument linked to a broad-based index is intended to be within the scope of the proposed regulations, the application of several aspects of those regulations to such an instrument would be quite unclear.

The proposed regulations also would not affect the analysis under Section 1001 of whether and when a taxpayer is deemed to enter into a new instrument (and thus must “retest” the instrument’s specified NPC status) upon a modification of the instrument (which analysis would appear to be unaffected by the proposed regulations’ treatment of an instrument linked to multiple underlying securities as separate instruments). Any such retesting of a modified instrument would involve a variety of additional uncertainties and compliance burdens for the parties.

The preambles to both the temporary and proposed regulations state that the IRS may challenge transactions that are designed to avoid the application of those rules under applicable judicial doctrines, and may assert that a contract labeled as an NPC or other equity derivative is in fact an ownership interest in the underlying security. In addition, the proposed regulations would include an anti-abuse rule for cases where a taxpayer enters into one or more transactions with a principal purpose of avoiding the rules.

Finally, the proposed regulations would treat dividend equivalents as dividends for treaty purposes and for purposes of Section 892, which exempts from U.S. taxation payments to foreign governments and international organizations. The preamble provides that taxpayers may rely on the Section 892 rule prior to finalization, but does not permit similar reliance with respect to the treaty rule.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Samuel Dimon	212 450 4037	samuel.dimon@davispolk.com
Michael Farber	212 450 4704	michael.farber@davispolk.com
Lucy Farr	212 450 4026	lucy.farr@davispolk.com
Rachel Kleinberg	650 752 2054	rachel.kleinberg@davispolk.com
Po Sit	212 450 4571	po.sit@davispolk.com
Michael Bretholz	212 450 4130	michael.bretholz@davispolk.com
Yuliya Epifantseva	212 450 4771	yuliya.epifantseva@davispolk.com

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