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LEGAL ALERT

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Getting Specific: IRS Issues Guidance on Withholding for Specified Notional Principal Contracts Under Section 871(m), Delays Statutory Effective Date

Section 871(m) generally treats "dividend equivalent" payments on securities lending transactions, repos and "specified notional principal contracts" as dividends from U.S. sources, which potentially are subject to U.S. withholding tax. Under the statute, until March 18, 2012, a notional principal contract (NPC) is treated as a specified NPC in four specific situations, and after that date, <u>any</u> NPC is treated as a "specified NPC" subject to section 871(m) of the Internal Revenue Code, unless the IRS determines that it is of a type which does not have the potential for tax avoidance. On January 19, 2012, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued temporary and proposed regulations regarding the types of NPCs that are affected by section 871(m). The temporary regulations delay the March 18, 2012, effective date of this rule to January 1, 2013, and the proposed regulations provide rules for determining what types of NPCs will be specified NPCs after that date. Significantly, the proposed regulations:

- Provide bright-line tests for determining whether an NPC is a "specified NPC," recognizing that the volume of equity derivatives transactions traded in the market on a daily basis makes any other approach impractical; and
- Address the application of the withholding rules to the gross amount of the dividend equivalent payment notwithstanding that most NPCs contemplate only a net payment.

It will be important for parties to NPCs to consider the application of the proposed regulations to payments under their existing equity derivative transactions, and in the documentation of future equity derivative transactions.

Background

Section 871(m) generally treats dividend equivalent payments as dividends from U.S. sources, which potentially are subject to U.S. withholding tax. Dividend equivalent payments generally are:

- Substitute dividend payments on securities lending and repo transactions with respect to U.S. securities;
- Payments made on a "specified notional principal contract" that are contingent upon or determined by reference to the payment of a U.S. source dividend; and
- Substantially similar payments as specified in regulations.

When enacted, the statute identified four situations in which an NPC would be treated as a specified NPC because of its perceived potential for abuse. Those four situations include:

- In connection with entering into an NPC, any long party to the NPC transfers the underlying security to any short party to the NPC;
- In connection with the termination of an NPC, any short party to the NPC transfers the underlying security to any long party to the NPC;
- The underlying security with respect to an NPC is not readily tradable on an established securities market; or

- In connection with entering into an NPC, the underlying security is posted as collateral by any short party to the NPC with any long party to the NPC.

The statute further provided that, after March 18, 2012, any NPC would be treated as a specified NPC unless the IRS determines that it is of a type which does not have the potential for tax avoidance. The temporary regulations delay the effective date of the rule that would treat all NPCs as specified NPCs until January 1, 2013, which will provide time for the implementation of the rules under the proposed regulations. Consequently, until January 1, 2013, only in the above situations is an NPC treated as a specified NPC, the dividend equivalent payments on which are treated as U.S. source income.

Scope of "Specified Notional Principal Contract"

For payments made on or after January 1, 2013, the proposed regulations identify the seven types of specified NPCs, dividend equivalent payments with respect to which would be characterized as U.S. source income under section 871(m). The proposed regulations effectively retain the categories of NPCs that are treated as specified NPCs under the statute, with some modification, and add several new categories of contracts that are considered to be specified NPCs. As of January 1, 2013, specified NPCs include any NPC if:

- The long party is "in the market" on the day the parties price the NPC or when it terminates.
- The underlying security is not regularly traded on a qualified exchange.
- The short party posts the underlying security as collateral, and the underlying security represents more than 10% of the collateral posted by the short party.
- The term of the NPC has fewer than 90 days.
- The long party controls the short party's hedge.
- The notional principal amount is a significant percentage of the trading volume.
- The NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

These factors essentially build on the factors that are included in the statute and reflect Treasury and IRS concerns particularly with respect to short-term transactions; transactions where the long party has effectively hedged its position, either directly or indirectly, during the term of the NPC; and transactions where the underlying security is not liquid.

The proposed regulations generally would treat related persons as a single party to an NPC in order to prevent taxpayers from avoiding the rules. In addition, the regulations provide that in the case of a "customized index," each component security is considered to be an underlying security. A customized index is a "narrow-based index" as defined for securities law purposes, or any other index unless futures or options contracts referencing such index are traded on an exchange.

It is significant that the IRS recently proposed to modify the definition of "notional principal contract" for tax purposes, bringing certain transactions, such as credit default swaps, clearly within its scope. This expansion of the scope of contracts potentially treated as notional principal contracts should be considered in connection with determining the implications of the new proposed regulations. Note also that the regulations make clear that the Treasury and IRS still may seek to treat certain equity derivatives transactions as ownership of the underlying security under general tax principles.

Withholding Implications

The temporary and proposed regulations address the withholding tax consequences associated with treating dividend equivalent payments as U.S. source income. Prior to the enactment of section 871(m),

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all NPC payments were sourced to the jurisdiction of the recipient unless they were effectively connected income for U.S. tax purposes. This generally meant that there was no U.S. withholding tax imposed on swap payments. Section 871(m) therefore was a significant change that required amendments to the existing withholding and information reporting rules for NPCs.

As noted above, the temporary regulations make clear that withholding is imposed on the gross amount of the payment, regardless of whether the withholding agent actually makes a payment under the NPC. As a result, parties to swap agreements will need to ensure that the tax provisions contemplate not only the gross up of payments to reflect taxes, but also indemnification for taxes otherwise due on the gross obligation. In this regard, the International Swaps and Derivatives Association (ISDA) issued a "HIRE Act Protocol" that attempted to address the considerations with respect to withholding on gross payments under section 871(m). The period for adherence to that protocol has now passed, although parties may consider incorporating similar provisions into their negotiated agreements going forward. The ISDA tax committee is actively considering how to appropriately address the changes made by the proposed regulations.

"Substantially Similar" Payments

The proposed regulations would define the term "substantially similar" to include any payment of a beneficial owner's tax liability with respect to a dividend equivalent made by a withholding agent, and any payment, including payment of the purchase price or an adjustment to the purchase price, that is contingent upon or determined by reference to a dividend from sources within the United States.

Treasury and the IRS have scheduled a public hearing for April 27, 2012, and have requested written comments by April 6, 2012.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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