United States
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Dividend equivalents

On March 18 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (the Hire Act). The Hire Act includes provisions that effectively shut down certain dividend washing transactions. As discussed in our prior columns, the US imposes a 30% (or lower treaty rate) tax on US source dividends paid to foreign persons. Historically, it appears that foreign counterparties attempted to avoid US withholding tax on dividends paid on US stock through certain equity swap or securities-lending transactions entered into with investment banks. These transactions were perceived abusive by US authorities because, according to the US Senate report on this issue, the counterparties had no purpose for entering into the transactions other than to avoid US withholding taxes on dividends. The merit of the tax positions of the parties involved in these transactions is under scrutiny by the US Treasury and Internal Revenue Service.

The Hire Act treats as a US-source dividend any dividend equivalent for purposes of US withholding tax provisions. Under the Hire Act, a "dividend equivalent" is (i) any substitute dividend (made pursuant to a securities-lending or repo transaction), (ii) any amount paid pursuant to a "specified notional principal contract," and that is contingent on, or determined by reference to, the payment of a US-source dividend, and (iii) any amount that the Treasury determines is substantially similar to a payment described in (i) and (ii) (the "catch-all clause").

A specified notional principal contract is any notional principal contract if (i) in connection with entering into the contract, any long party (ie, the party entitled to receive the dividend related payment) transfers the underlying security to any short party to the contract (so-called crossing-in), (ii) in connection with the termination of the contract, any short party (ie, any party that is not a long party) transfers the underlying securities to any long party (so-called "crossing out"), (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral, or (v) the Treasury identifies the contract as a specified notional principal contact. In addition, unless the Treasury determines that a notional principal contract does not have the potential for tax avoidance, any notional principal contract pursuant to which payments are made after March 18 2012, will be a specified notional principal contract.

To alleviate the potential for the cascading effect of dividend withholding taxes for derivative transactions (ie, if the same US securities are the subject of multiple derivative transactions and therefore multiple dividend equivalent payments), the Hire Act includes a provision pursuant to which the Treasury may reduce the tax if one or more of the dividend equivalents is subject to tax and to the extent the taxpayer establishes that the tax has been paid on another dividend equivalent in the chain or if Treasury determines such reduction is appropriate to address the role of financial intermediaries. For purposes of this provision, an actual dividend payment is treated as a dividend equivalent.

This provision applies to payments of dividend equivalents made on or after September 14 2010. Therefore these provisions apply to existing swaps.

While this provision's enactment is no surprise, of particular interest is the scope of the catch-all-clause. For example, the Joint Committee of Taxation report on this provision states that the catch-all-clause gives the Treasury the authority to conclude that "payments under certain forward contracts or other financial contracts that reference stock of US corporations are dividend equivalents." We wait to see how the Treasury will use this authority, if at all, to ensnare other derivative transactions.

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