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New Rules Address Scope of U.S. Withholding on U.S. Equity-Linked Swap Payments

New Guidance Continues Status Quo Through 2012, But Proposes More Expansive Application Beginning 2013

The Foreign Account Tax Compliance Act (“FATCA”), which was signed into law on March 18, 2010, as part of the Hiring Incentives to Restore Employment Act (the “HIRE Act”), includes a number of revenue raising provisions affecting cross-border transactions. Among them are provisions that subject certain “dividend equivalent” payments to U.S. withholding tax by treating those payments as dividends from U.S. sources. Although generally effective for dividend equivalent payments made on or after September 14, 2010, the new withholding rules apply to U.S. equity-linked swap agreements in only limited circumstances through March 18, 2012. After such date, the rules would apply to any U.S. equity-linked swap in the absence of further action by the U.S. Department of the Treasury (“Treasury”). On January 19, 2012, Treasury issued temporary and proposed regulations (the “Temporary Regulations” and “Proposed Regulations”) addressing the application of these rules to dividend equivalent payments made after March 18, 2012.

Generally speaking, these provisions impact non-U.S. persons that seek to gain exposure to U.S. equities through derivative positions such as U.S. equity-based securities loans, repurchase agreements and, to the extent specified therein, swaps. Withholding tax may be imposed even in transactions between purely non-U.S. persons or, under certain circumstances, where neither party has hedged its exposure.

Current Withholding Tax Treatment of Dividend Equivalent Payments (Effective September 14, 2011 Through March 18, 2012)

As enacted, the FATCA provisions subject certain “dividend equivalent” payments to U.S. withholding tax by treating those payments as dividends from sources within the United States. A “dividend equivalent” is (i) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that is determined by reference to a dividend from sources within the United States, (ii) any payment made pursuant to a “specified notional principal contract” that is determined by reference to a dividend from sources within the United States, or (iii) any other substantially similar payment as determined by Treasury.

A “specified notional principal contract” is any notional principal contract¹ if:

- in connection with entering into the contract, any long party to the contract (*i.e.*, the party entitled to receive any payment pursuant to the contract that is determined by reference to a dividend

¹ Section 1.446-3 of the Treasury Regulations defines a “notional principal contract” as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Proposed regulations published on September 16, 2011, would broaden this definition.

from U.S. sources) transfers the underlying security (with an index or fixed basket of securities being treated as a single security) to any short party to the contract (*i.e.*, any party that is not a long party to the contract);

- in connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;
- the underlying security is not readily tradable on an established securities market;
- in connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract; or
- the contract is identified by Treasury as a specified notional principal contract.²

Furthermore, in the case of payments made after March 18, 2012, a “specified notional principal contract” includes any notional principal contract unless Treasury determines that the contract is of a type which does not have the potential for tax avoidance.

In the case of a chain of dividend and dividend equivalent payments that is subject to multiple levels of tax, Treasury may reduce the tax to the extent that the taxpayer can establish that the tax has been paid with respect to another dividend or dividend equivalent in the chain or is otherwise not due.

Withholding Tax Treatment of Dividend Equivalent Payments Made After March 18, 2012 and Before January 1, 2013

The Temporary Regulations extend the current definition of “specified notional principal contract” through 2012. Thus, for the remainder of 2012, the Temporary

² The current 2010 Short Form HIRE Act Protocol (the “Short Form HIRE Act Protocol”), published by the International Swaps and Derivatives Association, Inc., (“ISDA”) on November 30, 2010, was designed to assist parties in amending their ISDA documentation to reflect the dividend equivalent withholding provisions of FATCA that became effective on September 14, 2010. The Short Form HIRE Act Protocol places the risk of such withholding with the foreign dividend equivalent recipient by eliminating the payor’s gross-up obligation, and expands the payee representations so as to prevent trading in underlying reference securities in a manner that could trigger withholding.

Regulations do not alter the types of notional principal contracts that are treated as “specified notional principal contracts” and therefore subject to dividend equivalent withholding taxes.

Proposed Withholding Tax Treatment of Dividend Equivalent Payments Made On or After January 1, 2013

With respect to dividend equivalent payments made on or after January 1, 2013, the Proposed Regulations (i) redefine the term “specified notional principal contract,” (ii) broaden the definition of “dividend equivalent” to include certain payments that Treasury has identified as being substantially similar to the types of payments that currently are included in that definition, and (iii) address what constitutes a “payment” of a dividend equivalent (for example, where the parties to a swap have agreed to net offsetting payments). The Proposed Regulations also address the obligations of withholding agents and make certain conforming amendments. These proposed rules are discussed more fully below.

What Types of Transactions Would Be Considered “Specified Notional Principal Contracts”?

The Proposed Regulations identify seven categories of specified notional principal contracts. Accordingly, many swap transactions that currently do not attract withholding tax would become taxable beginning in 2013. The characteristics of the seven identified categories of specified notional principal contracts are as follows:

- the long party is “in the market”³ on the same day that the parties price the swap or when the swap terminates;

³ With certain exceptions for *de minimis* levels of trading, a long party is considered “in the market” if it sells the underlying security on the same day that the parties price the swap, or buys the underlying security on the day that the parties terminate the swap. Purchases and sales that occur on days other than the pricing or settlement date of a swap, but set the price to align with that of the swap (for example, through forward contracts), will cause a long party to be in the market.

- the underlying security⁴ is not regularly traded on a qualified exchange;⁵
- the short party posts collateral, more than 10 percent of which consists of the underlying security;⁶
- the term⁷ of the swap is less than 90 days;
- the long party controls the short party's hedge;⁸
- the notional principal amount⁹ is greater than 5 percent of the total public float of the underlying

security or greater than 20 percent of the 30-day average trading volume as of the close of business on the day immediately preceding the first day of the term of the swap; or the swap is entered into on or after the announcement of a special dividend¹⁰ and before the ex-dividend date.

The Proposed Regulations contain rules designed to prevent avoidance of dividend equivalent withholding through the use of related parties. Accordingly, certain affiliates of a party to a swap are also treated as parties to the swap. A swap entered into between two related dealers is not, however, treated as a specified notional principal contract if the swap hedges risk associated with another swap entered into with a third party. This carve-out for dealers is designed to avoid excessive withholding tax on back-to-back transactions commonly used by dealers to shift risk within their affiliated group. Regrettably, the Proposed Regulations do not otherwise limit the amount of tax that can be imposed on chains of dividend and dividend equivalent payments.

Notwithstanding these rules defining the term "specified notional principal contract," Treasury reserves its ability to challenge transactions that are designed to avoid withholding taxes under applicable judicial doctrines. Thus, nothing in the Proposed Regulations precludes Treasury from asserting, for example, that a long party to a total return swap is in fact the beneficial owner of the referenced security.

What Payments Would Be Considered "Substantially Similar" to Those Otherwise Treated as Dividend Equivalents, and Therefore Subject to Withholding?

The Proposed Regulations identify two categories of payments that would be considered "substantially similar" to those substitute dividends and other payments currently treated as dividend equivalents and therefore subject to withholding. These categories are (i) gross-up amounts paid by a short party to satisfy a long party's dividend equivalent withholding tax liability and (ii) payments, including purchase price payments

⁴ The Proposed Regulations define the term "underlying security" to include component securities of a "narrow-based index" (within the meaning of section 3(a)(55)(B) of the U.S. Securities Exchange Act of 1934) or any other index unless futures or options referencing the index trade on a qualified board or exchange.

⁵ An underlying security generally is "regularly traded" on a qualified exchange for this purpose if it was traded on at least 15 of the 30 trading days preceding the date that the parties entered into the swap. A "qualified exchange" is a national securities exchange that is registered with the U.S. Securities and Exchange Commission or the national market system established pursuant to section 11A of the U.S. Securities Exchange Act of 1934.

⁶ This category is intended to address Treasury's concern that the posting of the underlying security as collateral guarantees that the value of the collateral will move in tandem with the swap in the event of a short party default. This concern is alleviated if the underlying security is only a small portion of the total collateral.

⁷ The term is determined by including the date of termination of a swap but not the date that the swap is entered into. A swap may be deemed terminated in whole or in part on any date in which the long party enters into certain offsetting positions. This category reflects Treasury's concern that many transactions entered into to avoid U.S. withholding tax involve short-term equity swaps entered into around ex-dividend dates. As drafted, however, this category captures any short-duration swap, regardless of whether its term includes an ex-dividend date.

⁸ The long party may control the short party's hedge contractually or by course of conduct or by entering into the swap using an "underlying equity control program." Such a program generally includes any system or procedure that permits a long party to direct how a short party hedges its risk, or to acquire (or cause the short party to acquire) an underlying security in a transaction with a short party and to instruct the short party to execute such acquisition in the form of a swap after acquiring the underlying security. Such a program does not include, however, an electronic trading platform that allows customers electronically to place swap orders with dealers who, in turn, decide whether and how to hedge their positions.

⁹ If a long party has multiple swaps referencing the underlying security, the notional amounts must be aggregated in determining the total trading volume.

¹⁰ A "special dividend" is a non-recurring payment made in addition to any recurring dividend payment. This category reflects Treasury's belief that a swap that is entered into after the announcement of a special dividend and before the ex-dividend date is more likely to be motivated by U.S. tax avoidance purposes than one that references stock paying only recurring dividends.

or adjustments, that are made pursuant to an equity-linked instrument other than a swap (for example, a futures, forward or option contract) and reference a U.S. source dividend (including a redemption of stock that is treated as a dividend for U.S. federal income tax purposes). Treasury will continue to monitor equity-linked transactions and may identify other categories of “substantially similar” payments in separately issued guidance.

What Would Constitute a “Payment” of a Dividend Equivalent?

The Proposed Regulations specify that a “payment” of a dividend equivalent includes any gross amount used in computing a net amount transferred to or from a party. Thus, if a swap calls for netting of payments, a long party entitled to receive a dividend equivalent will be subject to withholding (and the short party will be required to withhold) on that gross amount. This is so even if the dividend equivalent payment is fully offset or the long party is required to make a net payment.

A payment made pursuant to a specified notional principal contract or a substantially similar payment is not treated as dividend equivalent if it is contingent upon or determined by reference to an estimate of expected dividends and that estimate is not adjusted in any way to reflect the actual dividend amount. An estimate of an expected dividend must be made before the earliest date on which the corporate issuer announces (such as by declaration) the dividend. Accordingly, the presence of dividend risk would eliminate the withholding risk.

What Withholding Obligations Would Apply?

The Proposed Regulations would alter the current rules applicable to withholding on U.S. source income to require a withholding agent to withhold tax owed with respect to dividend equivalents. If a swap were to become a specified notional principal contract after it was entered into, it would be treated as having been a specified notional principal contract throughout its entire term. All tax owed with respect to dividend equivalents as a result of such re-characterization would be due at the time of the next payment (including a termination payment). The withholding agent would be responsible for withholding and reporting the entire amount due at such time, even if the tax owed exceeded such payment. The mechanism by which the withholding agent would collect the amount due from a non-U.S. counterparty is not addressed by the Pro-

posed Regulations, and instead left to the parties to negotiate.

It should be noted that both the Temporary and the Proposed Regulations specify that any party (for example, long or short, U.S. or non-U.S.) to a transaction calling for a dividend equivalent payment is treated as a withholding agent, and therefore potentially liable for any unpaid tax and associated interest and penalties. If a short party fails to fully withhold, the long party must file a U.S. tax return to report and pay any remaining tax liability.

What Other Clarifications Would the Proposed Regulations Address?

The Proposed Regulations would confirm that dividend equivalents are eligible for reduced treaty rates of withholding in the same manner as dividends. The Proposed Regulations would also clarify that dividend equivalents are treated as income from investments in stock and therefore eligible for certain withholding tax exemptions available to foreign sovereigns pursuant to section 892 of the U.S. Internal Revenue Code.

What Practical Implications Would Need to Be Considered When Entering into U.S. Equity-Linked Derivative Transactions?

The Proposed Regulations would broaden substantially the reach of the dividend equivalent withholding tax, covering transactions that currently would not give rise to withholding. Accordingly, existing ISDA documentation would need to be revisited by both long and short parties. The term of a transaction, the make-up of the posted collateral, the liquidity of the underlying security, the trading policies of the long party, the size of the notional amount, the stated or unstated expectations as to the short party’s hedge, and the timing of the transaction *vis a vis* any special dividend announcements by the underlying issuer, all would become relevant. A short party typically would have no ability to control whether a long party is “in the market,” other than through the addition of a restrictive covenant to the documentation. A short party presumably would require assurances as to the long party’s ability to fund any tax liability that exceeded the amount of the corresponding payment (assuming no gross-up obligation).

Of particular concern is the possibility that the termination of a contract within 90 days would trigger withholding. The Proposed Regulations would impose withholding, for example, if two non-U.S. parties having no other

exposure to a U.S. equity security enter into a swap that references that security, and the swap terminates within 90 days. Given this possibility, all parties to a U.S. equity-linked contract would need to consider carefully any termination events, including the ability of after such date could cause the contract to have a term of less than 90 days.

The Proposed Regulations would apply to payments made on or after the date that final regulations are published. In the interim, Treasury and the U.S. Internal Revenue Service will consider written or electronic comments. Treasury has scheduled a public

a long party to enter into offsetting positions. The impact of the Proposed Regulations on any contracts that are or were entered into before January 1, 2013, and have terms extending beyond that date also would require attention, particularly if a termination on or hearing for April 27, 2012; any comments must be received by April 6, 2012.



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For further information and to learn more about how Dechert may help you to comment on or plan for the proposed U.S. tax law changes affecting U.S. equity-linked derivatives, please contact the author, one of the Dechert attorneys listed or any Dechert attorney with whom you regularly work.

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