

## *IRS Issues Temporary and Proposed Regulations on the Treatment of Dividend Equivalent Payments*

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On January 19, 2012, the IRS released temporary regulations (the "Temporary Regulations") and proposed regulations (the "Proposed Regulations") addressing the treatment of dividend equivalent payments for purposes of Section 871(m) of the Internal Revenue Code of 1986, as amended.

### **Background**

Non-US persons in receipt of US sourced dividend income are generally subject to withholding at a 30% rate unless reduced by treaty. Dividends are US sourced if paid by a US corporation. However, certain dividend equivalents paid on notional principal contracts and other transactions are sourced based by reference to the payee. Thus, these dividend equivalents paid to non-US persons could escape withholding.

Congress enacted Section 871(m) in 2010 to treat certain "dividend equivalents" as dividends from US sources and, thus, potentially subject to withholding. A dividend equivalent includes payments pursuant to certain securities loans, sale-repurchase transactions, certain specified notional principal contracts and any substantially similar transactions. Under the statute, a specified notional principal contract means any notional principal contract if: (i) in connection with entering into such contract, any long party (i.e., any party entitled to receive payments by reference to an underlying dividend) to the contract transfers the underlying security to any short party (i.e., any other party) to the contract, (ii) in connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract, (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract, or (v) such contract is identified by the Secretary of the Treasury as a specified notional principal contract. Under Section 871(m)(3)(B), after March 18, 2012, any notional principal contract is a specified notional principal contract unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance.

### **Explanation of the Temporary Regulations**

The Temporary Regulations extend the applicability of the definition of specified notional principal contract of Section 871(m)(3)(A) through December 31, 2012 to allow taxpayers and withholding agents to modify their systems and other operating procedures to comply with the Proposed Regulations which will apply to dividend equivalents beginning January 1, 2013.

The Temporary Regulations also amend other regulations to clarify the application of Section 871(m).

- Treasury Regulation § 1.863-7, which generally sources income from notional principal contracts by reference to the residence of the taxpayer, is amended to provide that it does not apply to a dividend equivalent as defined in Section 871(m).
- Treasury Regulation § 1.881-2 is amended to clarify that Section 871(m) applies to a foreign corporation's receipt of a dividend equivalent.
- Temporary Regulations under Section 1441 are also added to require a withholding agent to withhold tax owed with respect to a dividend equivalent.

The Temporary Regulations are effective January 23, 2012. The text of the Temporary Regulations also serves as the text of the Proposed Regulations.

### Explanation of the Proposed Regulations

Most significantly, the Proposed Regulations abandon the concept that all notional principal contracts other than those specifically enumerated will be specified notional principal contracts. Rather, the IRS and Treasury expand the types of contracts that are deemed to have a potential for tax avoidance providing taxpayers with much needed certainty in this area. However, the Proposed Regulations substantially expand the statute's definition of specified notional principal contracts. A notional principal contract will be a specified notional principal contract if one of the following seven factors is met: (1) the long party is "in the market" on the same day that the parties price the notional principal contract or when the notional principal contract terminates; (2) the underlying security is not regularly traded on a qualified exchange; (3) 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; (4) the term of the notional principal contract has fewer than 90 days; (5) the long party controls the short party's hedge; (6) the notional principal amount is greater than 5% of the total public float of the underlying security or greater than 20% of the 30-day daily average trading volume, as determined at the close of business on the day immediately preceding the first day of the term of the notional principal contract; or (7) the notional principal contract is entered into on or after the announcement of a special dividend and prior to the ex-dividend date. Although withholding agents may rely on these rules when deciding whether to withhold on payments made under notional principal contracts, the Proposed Regulations contain an anti-abuse rule that would treat as dividend equivalents any payments made under transactions entered into with a principal purpose of avoiding the application of these rules.

Under the Proposed Regulations, a withholding agent can be liable for failing to withhold on a payment made on a notional principal contract even if the withholding agent does not know or have reason to know that the contract was a specified notional principal contract. For example, a withholding agent may not know if the long party is in the market on the same day that the parties price the notional principal contract or when the notional principal contract terminates as required under the first factor above. To determine whether this factor has been met, the IRS recently stated informally that it expects withholding agents to ask for a representation from their counterparties that they are not in the market.<sup>1</sup> However, until this issue is officially clarified, some withholding agents may decide to treat all notional principal contracts as specified notional principal contracts to avoid any liability. We expect this to be an important issue to be raised in the public hearing that will be held to discuss the Proposed Regulations scheduled for April 27, 2012. Comments for this hearing must be submitted by April 6, 2012.

The Proposed Regulations clarify several other issues arising under the statute.

- A payment is not a dividend equivalent if it is determined by reference to an estimate of an expected (but not yet announced) dividend without reference to or adjustment for the amount of any actual dividend.

- For purposes of determining a dividend equivalent, the term payment includes any gross amount even if the contractual obligation is computed on a “net” basis that would reduce the gross payment by offsetting obligations to make payments.
- If a notional principal contract references more than one security or a customized index, each security or component security of that index is treated as an underlying security in a separate notional principal contract for purposes of Section 871(m).
- The withholding tax on a dividend equivalent may be reduced to the extent provided under a US income tax treaty.

If a notional principal contract that was not a specified notional principal contract on the date it was entered into becomes a specified notional principal contract during its term, it will be treated as though it had been a specified notional principal contract during the entire term of the contract and payments made under the notional principal contract by reference to the payment of a dividend from US sources will be recharacterized as dividend equivalents and all tax owed with respect to such dividend equivalents will be due at the time of the next payment made under the notional principal contract, including a termination payment. This rule applies even if there may not be any cash payment on which to withhold because of netting.



*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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<sup>1</sup> At the New York State Bar Association Tax Section’s annual meeting on January 24, 2012, Mark Perwien, special counsel at the IRS Office of Associate Chief Counsel, when asked how a withholding agent will know whether the long party is in the market, responded that the drafters expect that most withholding agents will ask for a representation from the counterparty that it is not in the market, and that should be good enough unless the former has reason to know otherwise. “Regulatory Update at NYSBA Looks at Cross-Border Equity Swap Withholding,” Tax Notes Today, January 25, 2012.