

Asset Management Tax Alert



New Guidance on US Withholding on Dividend Equivalent Payments on Swaps over US Equities

On January 19, 2012, new guidance was released regarding swap contracts over US equities that call for “dividend equivalent payments” to be subject to up to 30 percent gross US withholding. The proposed rules provide a new, more expansive standard for defining the scope of swaps that are subject to US withholding. Although the expanded scope for swaps over US equities giving rise to gross US-source dividends is only proposed, the proposed regulations highlight key factors in assessing which total return derivatives over US equities may be subject to withholding in the future. Given the expanded scope of those payments subject to withholding, the new rules are proposed to be applicable for payments made after December 31, 2012, and the current rules will remain applicable until that date. Funds should carefully consider this pending guidance in structuring derivatives over US equities that extend past January 1, 2013.

PwC Insight: At the core of the proposed guidance is a decision between three primary paths. Funds will need to decide which of the three paths to take (in whole or on a transaction-by-transaction basis):

- The first path is to accept true dividend risk in contracts that historically have not contained dividend risk on the underlying equity (i.e., to either forgo the dividend entirely or receive only an estimate of futures dividends without a true-up). Under this approach, the fund should not suffer from US withholding.
- The second path requires market participants to adopt operational guidelines that address the seven requirements contained in the proposed guidance to ensure their contracts (equity swaps and other equity linked instruments) satisfy all seven requirements. Similarly, under this approach, the fund should not suffer from US withholding.
- The third path is to do nothing, and suffer up to 30 percent US withholding on gross dividend equivalents on certain equity-linked contracts. This path may make sense if the expected rate of return with gross US withholding is still economic for the Fund (including cases in which the fund currently holds the underlying name subject to withholding and is using the swap for leverage).

It is likely that funds will focus mostly on the second path, which will require changes to the existing terms and representations under standard ISDA Master Agreement and Schedule in order to ensure equity-linked derivatives avoid the “bad swap” definition of a specified notional principal contract for payments after December 31, 2012. Funds will need a mechanism to ensure compliance with any representations made. Some of the seven requirements to avoid “bad swap” status will create hurdles that may be too high for Funds to adopt, which may make one of the other two paths above more appealing.

Background – Section 871(m)

If a foreign fund directly owns stock in a US corporation, dividends paid on the stock generally are considered to be from US sources and are subject to US withholding tax. Prior to September 13, 2010, when a foreign fund entered into a properly structured total return swap over stock of a US corporation, all payments received by the foreigner (including dividend-equivalent amounts with respect to the US stock) generally are treated as foreign source income, and are not subject to US withholding tax.

As a result of section 871(m) (enacted in March 2010), “dividend equivalent payments” (i.e., the payments made by reference to the gross amount of dividend declared on the underlying stock) made with respect to swaps over US equities, made after September 14, 2010 and before March 19, 2012 are treated as US source (and subject to US withholding) if:

1. in connection with entering into the equity swap, the Long Party transfers the underlying security to the Short Party (“crosses-in”);
2. in connection with the termination of the equity swap, the Short Party transfers the underlying security to the Long Party (“crosses-out”);
3. in connection with entering into the equity swap, the Short Party posts the underlying security as collateral with the Long Party; or
4. the underlying security is not readily tradable on an established securities market.

Section 871(m) also provided that, after March 18, 2012, all swaps over US equities would produce US source dividend income subject to US withholding, unless the IRS and Treasury Department published guidance providing otherwise.

Effective Now – Extending Application of Statutory Effective Date until January 1, 2013

In temporary regulations released January 19, 2012, the IRS and Treasury Department extended the applicability of the current standards (described above) for determining which swaps generate payments subject to US withholding tax. Thus, until January 1, 2013, payments on swaps over US equities are subject to withholding only if one of the four factors above is satisfied.

The temporary regulations also provide an example illustrating a swap between a foreign corporation and a US-resident bank with respect to a US equity. Of particular note is that the example confirms not only that the US-resident bank is a withholding agent with respect to payments on the US equity, but also that if the bank fails to withhold, the foreign corporation is required to file a Form 1120-F (US Income Tax Return of a Foreign Corporation).

The proposed guidance also reminds taxpayers that the IRS may challenge transactions that are designed to avoid the application of section 871(m), or that are—in substance—properly characterized as direct ownership of the underlying asset (rather than as a derivative).

PwC Insight: The extension of the expiration of the effective date until January 1, 2013 is helpful to all market participants. That being said, given the new proposed regulations below, funds and their dealer counterparts may need this additional time to confirm that their swaps with a term continuing into 2013 fall outside of the seven requirements listed below. Although the same statutory rules apply to securities loans and sale-repurchase agreements (“repos”) in addition to certain specified notional principal contracts, the temporary regulations do not address securities loans or repos. Until regulations are proposed to cover securities loans and repos, the principles established by Notice 2010-46 continue to apply.

Proposed Guidance – Future Scope of US Sourcing for US Dividend Equivalents

On January 19, 2012, the IRS and Treasury Department also published proposed regulations intended to define the scope of swaps over US equities producing US source withholdable payments after January 1, 2013. The most significant portions of the proposed regulations, along with our observations, are provided below.

Seven “Bad Swap” Criteria

New Categories of “Bad” Swaps

In substitution for the four categories of swaps listed above, under the proposed regulations, the IRS and Treasury Department expand the categories of “bad” swaps (i.e., swaps that result in US source payments potentially subject to withholding) to include:

1. where the long party is “in the market” on the same day that the parties price the swap or the swap terminates (a refinement of the cross-in/cross-out standard above);
2. the underlying security is not traded on an exchange (a refinement of the “readily tradable” standard above);
3. the short party posts the underlying security as collateral and the underlying security represents more than 10 percent of the collateral posted by the short party (a refinement of the “collateral” standard above);
4. the term of the swap is less than 90 days;
5. the long party controls the short party’s hedge;
6. the notional amount is greater than 5 percent of the total public float of the underlying security or greater than 20 percent of the 30-day daily average trading volume; or
7. the swap is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

It can be expected that dealers will change their equity derivative guidelines to reflect the seven requirements in the proposed regulations. The seven requirements are discussed in more detail below.

“In the Market”

The IRS and Treasury Department consider a fund to be “in the market” if they either (1) sell the underlying security on the same day as the parties price the swap or (2) purchase the underlying security on the date the parties terminate the swap. If the swap is closed in multiple swaps, each day a portion of the swap closes is treated as day that the fund cannot be “in the market.” Similarly, if the fund “fixes” the price of its sale of the underlying security (through, for example, a forward contract) to align with the price of the swap, the IRS and Treasury Department treat this as the equivalent of the fund being “In the market.” The proposed regulations provide an exception for situations in which the amount of the fund’s sale is less than 10 percent of the notional amount of the swap.

PwC Insight: The standard in the proposed regulations is substantially narrower than even the standard in the proposed 2010 ISDA short form protocol on the HIRE Act. Specifically, for a multi-strategy fund, the fund would have to monitor whether any of its traders were in the market with respect to a security being put under swap on the date the swap is opened or closed, regardless of whether the transaction was entered into “in connection with” entering into the swap. The de minimis rule provided in the proposed regulations does provide some leeway in the case of an erroneous trade, but funds will still need a methodology to prevent larger trades on the date swaps are entered into or terminated. From the view of the dealer counterparties, it is likely that dealers will require additional representations from swap counterparties since dealers will lack the visibility to the funds activities.

Readily Tradable on an Established Market

The proposed regulations consider all securities as not readily tradable unless the security is traded on a “qualified exchange,” which is an exchange regulated by the Securities and Exchange Commission or under the Securities Exchange Act.

PwC Insight: This definition of “readily tradable” is substantially narrower than other definitions of the same term under other Code sections. Functionally, this means that any swap a fund executes over a non-exchange traded US stock results in a US-source dividend payment. We note, however, that many swaps over illiquid equity securities may have been at risk under current law that the IRS might attempt to recharacterize them as direct ownership of the underlying security under existing authorities.

Controlling the Short Party's Hedge

The proposed regulations provide that this covers any “system” (electronic or otherwise) that allows a long party to direct its counterparty’s manner of hedging its risk under the swap.

PwC Insight: Prior to section 871(m), it was not necessarily uncommon for a fund to assist its swap counterparty in sourcing its hedge (including determining the cost to acquire the hedge). This fact pattern presented challenges under substance-over-form authorities, as well as under the new proposed regulations. Under the proposed regulations, there is the risk that any direction or discussion of pricing with respect to counterparties hedging—which may affect the pricing of the swap itself—might cause the swap to be a “bad swap.” This heightens the need to separate—both in form and in substance—the counterparty’ hedge from the pricing on the swap.

Fewer than 90 Days

The proposed regulations require that a swap must stay open more than 90 days in order not to be per se a “bad swap.”

PwC Insight: This provision may pose a real challenge to traders that utilize short term derivatives (swaps, forwards, options, etc.) that rarely have swaps on 90 days. Funds may choose to suggest that the standard is more appropriately drafted as the “lesser of 90 days or the funds entire exposure to the underlying” standard. In the absence of a change in the rule, funds that utilize short-term derivatives should carefully review their use of such derivatives. Further, the regulations are not clear on how to evaluate whether the swap was “open” for 90 days. It is not outside the realm of possibility that a fund would open a swap with the intention of staying in the swap position long-term, but having or choosing to terminate the swap early in the case of a sharp market decline. From the dealer’s point of view, it is likely that dealers will require a representation from the counterparty relating to the 90 day rule since the dealer will have no visibility to the counterparty’s ability to enter into an offsetting swap with an unrelated dealer, thereby leaving the counterparty fund with a flat economic position. This shifts the risk to the fund to be compliant with this standard or suffer the up to 30 percent gross US withholding.

Related Operational Rules

Related Party Anti-Abuse Rule

To prevent taxpayers from avoiding the rules through related parties, the proposed regulations provide that each related person (as defined by sections 267(b) and 707(b)(1)) is treated as a party to the swap contract. This anti-abuse rule does not include a swap between dealers if the swap hedges risk associated with another swap entered into with a third party.

PwC Insight: This rule is beneficial to dealers that may enter into back-to-back swaps to move the exposure in the risk from the entity entering into the swap to another member of their affiliated group. This is a common fact pattern among dealers that operate a dual paradigm booking model for their equity finance division in order to effectively manage regulatory capital, with a significant booking site in Europe (often an FSA regulated dealer) and a US regulated dealer. On the non-dealer side of the transaction, this related party rule may raise operational questions for funds. For example, a fund may need to confirm that neither it, nor any related party, was “in the market” with respect to a particular name on the date a swap over that name was priced or terminated.

Estimates of Dividends Permitted

Under the preamble to the proposed regulations, a payment is not a “dividend equivalent payment” if it is determined by reference to an estimate of an expected (but not yet announced) dividend without adjustment for any actual dividend declared.

PwC Insight: This permits a foreign fund to gain some exposure to US source dividend amounts if the fund and the counterparty are willing to estimate the amount of the dividends to be declared, and therefore take dividend risk, rather than use the actual amounts of dividends declared.

Equity-Linked Derivatives other than Swaps

The IRS and Treasury Department provide that payments calculated by reference to a US source dividend on an “equity-linked instrument” other than a swap are also considered US source payments potentially subject to US withholding. Similarly, a “dividend equivalent payment” also includes any “gross up payment” made to the recipient of a swap payment subject to dividend equivalent withholding.

PwC Insight: This proposal has the potential to sweep a variety of transactions into the net of US withholding, including: futures, options, forward contracts and exchange traded notes that are not principal protected. Traditionally, income on these types of instruments has been considered to be capital gain that is exempt from US withholding tax, rather than “FDAP” that is subject to the withholding tax. The proposed regulations, however, appear to disregard the capital gain vs. FDAP distinction, and effectively reclass capital gains as dividends (a category of FDAP).

Basket Swaps versus Index Swaps

The proposed regulations provide that a “basket swap” that references more than one security is treated as a series of separate swaps, each over a single equity. The regulations treat a “customized index” the same as a basket swap (with each name representing a separate swap contract). The regulations define a “customized index” as a narrow-based index (as defined under the same standard as under section 1256) and any other index unless futures contracts or options contracts referencing the index trade on a qualified board or exchange (also defined under section 1256).

PwC Insight: The proposed regulations limit the ability to structure a swap that is not treated as a series of individual swaps to situations in which the index not only exists for use by more than one fund, but where it is a publicly-traded index. For many swaps, this was the appropriate characterization of the swap for other US tax purposes even prior to the regulations. This rule may not substantively affect the withholding tax consequence on a particular dividend, however, as withholding imposed on dividends treated as US source under section 871(m) is based on the gross amount of each dividend declared.

Becoming a “Bad” Swap after Payments Have Been Made

A number of the categories of “bad swaps” can create a real practical problem—the swap may start as a “good swap,” but evolve into a “bad swap.” Consider, for example a swap with a stated term of a year, which is terminated on day 89. It is quite possible that this swap called for a substitute dividend payment on day 75 (for example)—when the payment was made, there was no withholding as the swap was “good” at the time. The proposed regulations contemplate these types of scenarios, and require the withholding agent to withhold on the next payment date (in this example, on termination), with respect to prior payments.

PwC Insight: This provision is sure to cause more practical problems. “Good swap” status must constantly be tested to ensure that there are no problems.

Summary

Overall, the regulations provide a more objective bright line via the seven indicia of a “bad swap.” However, the subjectivity and difficulty in applying (and in the IRS ultimately auditing) some of these indicia will ensure significant comments from effected swap participants during the comment period, which ends April 6, 2012. Further, the nature of the seven indicia places the US withholding tax risk with the fund (rather than its dealer counterparties) based on the representations dealers will likely expect.

If you would like more information on these regulations or would like to discuss their impact on your existing contracts, or how to structure future contracts, please contact a member of our National Financial Transactions Team or your Asset Management engagement team.

Please reach out to any of the following members of PwC’s National Financial Transactions Team for more information:

Mike Gaffney

646 471 7135
mike.gaffney@us.pwc.com

L.G. “Chip” Harter

202 414 1308
chip.harter@us.pwc.com

Rebecca Lee

415 498 6271
rebecca.e.lee@us.pwc.com

Jeffrey Maddrey

202 414 4350
jeffrey.maddrey@us.pwc.com

David Schenck

202 346 5235
david.a.schenck@us.pwc.com

David Shapiro

202 414 1636
david.h.shapiro@us.pwc.com