Tax Alert

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New guidance on US withholding on dividend equivalent payments on swaps over US equities

On December 5, 2013, new guidance was released regarding derivatives over US equities that call for “dividend equivalent payments” that can be subject to up to 30 percent gross US withholding tax. Final regulations extend (to December 31, 2015) the current “four factor scheme” in section 871(m)(3)(A) for determining whether dividend equivalent payments on swaps are subject to US withholding tax.

Newly issued proposed regulations (“the 2013 proposed regulations”) revoke the previously issued proposed regulations (the “2012 proposed regulations”) and their “seven deadly sins” standard, proposing instead a seemingly objective, delta based standard applicable to a broad class of equity derivatives after January 1, 2016.

If finalized, the 2013 proposed regulations would implement what at first blush appears to be a more precise standard – a delta of 0.7 of the instrument when acquired by the long party – to apply to dividend equivalent “payments” on or after January 1, 2016 for determining whether an instrument is potentially subjected to withholding tax.

PwC insights

- The extension of the statutory regime until December 31, 2015 is welcome. There is no mad rush to eliminate trades or revise systems by 2013 year end. The two year period should give markets time to respond to the new proposal with comments, and (if the government is prompt in implementing final regulations) give sufficient time to implement necessary systems.

- The 2013 proposed regulations are sweeping in their scope. Dividend equivalent payments on all total return derivatives (whatever their form or manner of execution) will be subject to withholding tax. The application of the provision to a broad class of “equity linked instruments” (“ELI”) that do not generate total returns (i.e., a delta of 1.0) goes far beyond the statutory standard. Market participants will need to sensitize their clients; and the tax and operations departments of dealers as well as the traders of the investors will need to familiarize themselves on the calculation of “delta” in order to build the systems required to comply with the .7 delta standard if this becomes the ultimate standard adopted by final regulations.

- The ability of the IRS to administer the 2013 proposed regulations, including delta calculations, may be a cause of future concern. Short parties (the dealer community) do not have a single method to calculate delta, so variances in the 0.7 standard will exist.

- Clearing houses and exchanges are identified as potential withholding agents. A request to exempt these organizations of they were not a principal to an 871(m) transaction was rejected by Treasury and IRS.

- The 2013 proposed regulations reverse the 2012 proposed regulations by treating an estimate of expected dividend as a dividend equivalent, with a narrow exception.[1]

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[1]Prop. Treas. Reg. 1.871-15(h)(2)(i), (ii).

Background

Section 871(m)

If a foreign person 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 person 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 were treated as foreign source income under Treas. Reg. Sec. 1.863-7, and were not subject to US withholding tax.

Under 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 certain swaps over US equities, "specified notional principal contracts" ("SNPCs") are treated as US source (and subject to US withholding). Specifically, the statute defines a swap as an SNPC if:

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

The 4-factor statutory test for identifying an SNPC was initially stated to apply through March 19, 2012, but has been extended 3 separate occasions through December 31, 2015.

The 2012 regulations

The 2012 proposed regulations would have expanded the statutory definition of a SNPC beyond the 4 factor test to seven characteristics regarding specific terms of the contract or its manner of execution.

In addition to the definition of a SNPC, the 2012 regulations also coordinated the principals of section 871(m) with sourcing rules, withholding rules, related party rules, anti-abuse rules, estimated dividend payment rule, and a "customized index" rule in line with section 1256, among other operational rules.

Effective now – Extending application of statutory effective date until January 1, 2016

In final regulations released December 5, 2013, the IRS and Treasury Department extended the applicability of the current statutory standards (described above) for determining which swaps generate payments subject to US withholding tax. Thus, until January 1, 2016, payments on swaps over US equities are subject to withholding only if one of the four factors above is "failed".

The final regulations not only confirm that a US-resident bank is a withholding agent with respect to payments on the US equity to a foreign party, but also that, if the bank fails to withhold, the foreign party is required to file a Form 1120-F (US Income Tax Return of a Foreign Corporation).[2] In addition, the final regulations confirm that a financial intermediary or custodian that meets the withholding agent definition under Treas. Reg. Sec. 1.1441-7(a)(3) would be considered a withholding agent on dividend equivalent payments.

[2] Treas. Reg. 1.1441-7(a)(3), Example 6.

The final regulations also eliminate the previous temporary provision allowing a withholding agent to use a distributing corporation's estimates to determine the amount of a dividend equivalent, and opt instead for the existing rule under Treas. Reg. Sec. 1.1441-3(d)(1).

In addition to reinserting an inadvertently deleted example under the withholding regulations, the final regulations also adopt the coordination provisions with section 892 and 894 with US tax treaties, which were previously in the 2012 proposed regulations.

Proposed guidance – Future scope of US sourcing for US dividend equivalents

The 2013 proposed regulations define a dividend equivalent as: 1) a substitute dividend payment under a securities lending or repo agreement, 2) a payment under a SNPC that references a US source dividend payment, 3) a payment under a specified ELI that references a US source dividend payment, and 4) a substantially similar payment. A payment is a US source dividend payment if it is directly or indirectly contingent upon or determined by reference to the US sourced dividend.

Of interest is the "delta" approach taken by these 2013 proposed regulations for defining a SNPC and specified ELIs ("SELI").

The delta test

The preamble to the 2013 proposed regulations indicate that Treasury and the IRS found economic correlation between a derivative and the physical underlying was a better tool than the "seven deadly sins" for identifying transactions with the potential for tax avoidance. As such, the proposed regulations adopt a "delta test."

The delta of an instrument is the ratio between the change in the fair market value of the instrument and the change in the fair market value of the underlying referenced property. Thus, an instrument with a delta of 1 indicates a derivative whose change in fair market value exactly corresponds with that of the underlying property. Delta 1 represents derivatives that lack any optionality and include ETFs, futures, forwards, same strike put – call option combinations, and total return swaps.

The 2013 proposed regulations adopt a delta of 0.7 as the threshold for defining an SNPC and a SELI. If more than one underlying security is referenced, the delta with respect to each underlying security is measured. The delta must be determined in a commercially reasonable manner.

In addition, instruments with a constant delta will be treated as having a delta of 1. The proposed regulations offer the example of a contract calling for 50% of the appreciation, dividends and depreciation of 200 shares of stock (and thus a delta of 0.5) as 100% of 100 shares of stock in order to prevent taxpayers from claiming the delta is not a delta of 1.[3] At lapse, the delta of an option is zero, at exercise 1.

The proposed regulations also adopt a set of aggregation rules[4], in which two or more instruments entered into in connection with each other referencing the same underlying security will have their delta's aggregated when the taxpayer is the long party in those transactions. This may prove difficult if a long party uses different counterparties and each position has a delta under of 0.7 but when the positions are aggregated, they are over.

[3] Prop. Treas. Reg. 1.871-15(g)(3), Example 3.
[4] Prop. Treas. Reg. 1.871-15(l)(1) through (6).

Related operational rules

Dealer exceptions

Two exceptions are provided.[5] First, payments to "qualified dealers" that enter into transactions as the long party in their capacity as a dealer are excluded from the regime. This is long desired relief. The section 475 definition of "dealer" will apply, and the dealer must be subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized. The dealer must also certify to the short party that it is a qualified dealer acting in its capacity as a dealer in securities and that it will withhold and deposit any tax imposed by section 871(m) with respect to a section 871(m) transaction that it enters into as a short party in its capacity as a dealer. This exception does NOT apply to proprietary positions of the dealer.

The 2013 proposed regulations with respect to "qualified dealers" rules are similar to the "qualified securities lender" regime of Notice 2010-46. Qualified Securities Lenders ("QSL") can also receive dividend equivalent payments "gross" of withholding. QSLs must satisfy all of the following conditions: (i) it is a bank, custodian, broker-dealer, or clearing organization that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized, and (ii) is regularly engaged in a trade or business that includes the borrowing of securities of domestic corporations (as defined in § 7701(a)(4)) from, and lending of securities of domestic corporations to, its unrelated customers; and (iii) it is subject to audit by the Service under § 7602 or, in the case of a Qualified Intermediary (QI) that appropriately amends its QI agreement with the Service, by an external auditor. It seems likely that entities that currently hold themselves out to by QSLs for securities lending of US equities will be the same entities that utilize the "qualified dealer" rule in the 2013 proposed regulations.

Second, when a taxpayer enters into a transaction as part of a plan pursuant to which one or more persons (including the taxpayer) are obligated to acquire 50 percent or more of the entity issuing the underlying securities, it is also excepted.

Portfolios held in a partnership

The 2013 proposed regulations will also treat a transaction that references an interest in an entity that is not a C corporation for Federal tax purposes as referencing the allocable portion of any underlying securities and potential section 871(m) contracts held directly or indirectly by that entity. The 2013 proposed regulations provide an exception for a transaction that references an interest in an entity that is not a C corporation if underlying securities and potential section 871(m) transactions represent, in the aggregate, 10 percent or less of the value of the interest in the referenced entity at the time the transaction is entered into.

Indexes

A "qualified index"[6] is treated as a single security that falls outside of the regime. The determination of whether an index is a qualified index is made at the time that a long party acquires a potential section 871(m) transaction and is determinative only with respect to that transaction. Therefore, an index can be a qualified index with respect to a transaction entered into on one day and not be a qualified index with respect to a transaction entered into on another day.

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[5] Prop. Treas. Reg. 1.871-15(j).

[6] Prop. Treas. Reg. 1.871-15(k)(1), (2).

A qualified index means an index that:

- References 25 or more component underlying securities;
- References only long positions in component underlying securities;
- Contains no component underlying security that represents more than 10 percent of the weighting of the underlying securities in the index;
- Is modified or rebalanced only according to predefined objective rules at set dates or intervals;
- Does not provide a dividend yield from component underlying securities that is greater than 1.5 times the current dividend yield of the S&P 500 Index as reported for the month immediately preceding the date the long party acquires the potential section 871(m) transaction; and
- Futures contracts or option contracts on the index (whether the contracts provide price only or total return exposure to the index) trade on a national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission.

An index is a qualified index if the index is comprised solely of long positions in assets and the referenced component underlying securities in the aggregate comprise 10 percent or less of the index's weighting.

Anti-abuse and use of judicial doctrines

The Commissioner may treat any payment made with respect to a transaction as a dividend equivalent if the taxpayer acquires a transaction with a principal purpose of avoiding the application of these rules.

The 2013 proposed regulations indicate the IRS will continue to scrutinize instruments for potential tax avoidance. In addition, the IRS may challenge taxpayers using all available statutory provisions and judicial doctrines (including the substance over form doctrine, the economic substance doctrine under section 7701(o), the step transaction doctrine, and tax ownership principles) as appropriate. Specifically, the 2013 regulations use the example that nothing in section 871(m) precludes the IRS from asserting that a contract labeled as an NPC or other equity derivative is in fact an ownership interest in the equity referenced in the contract.

Clearing houses as withholding agents

Example 7 is added to Treas. Reg. Sec. 1441-7(a)(3) indicating a clearing organization in a trade may be a withholding agent.

US short parties as responsible withholding agents and certification

Indicating that financial institutions are usually in the best position to undertake the responsibility to report the tax consequences of a potential section 871(m) transaction, the 2013 proposed regulations provide that when a broker or dealer is a party to a potential section 871(m) transaction, the broker or dealer is the party required to determine whether the transaction is a section 871(m) transaction, and if so, the amounts of the dividend equivalents.

If a broker or dealer is not a party to the transaction or both parties are brokers or dealers, the short party must determine whether the transaction is a section 871(m) transaction and the amounts of the dividend equivalents.

Determinations made by the broker, dealer, or short party are binding on the parties to the section 871(m) transaction unless the other person knows or has reason to know that the information is incorrect; the determinations are not binding on the IRS.

Long parties may have positions with different short parties that in and of themselves have a delta less than 0.7, but given the aggregation rule, the long party may have a position that has a delta over 0.7.

In addition, certain persons are permitted to request information from certain parties to a potential section 871(m) transaction when the information is necessary to satisfy their withholding or information reporting obligations, or to determine their tax liability. If a withholding agent reasonably relies on information received, it will not be liable for underwithholding; however, the party to the transaction who failed to properly determine the amount will be liable for the underwithholding.

The 2013 proposed regulations describe how the exception to withholding where no money or property is paid applies to a dividend equivalent.

Additionally, the 2013 proposed regulations provide that a withholding agent is not obligated to withhold on a dividend equivalent until the later of:

- The time that the amount of the dividend equivalent is determined, and
- The time at which any of the following has occurred:
    - Money or other property is paid pursuant to a section 871(m) transaction,
    - The withholding agent has custody or control of money or other property of the long party at any time on or after the amount of the dividend equivalent is determined, or
    - There is an upfront payment or a prepayment of the purchase price.

As expected, while the 2013 proposed regulations relieve a withholding agent of the liability to withhold when the withholding agent does not have control of money or other property of the long party, the long party remains liable for US tax on the dividend equivalent.

Contingent debt

The proposed regulations indicate that most contingent debt instruments are either referenced to a qualified index, have an embedded option with a delta below 0.7, or both, and can be used for tax avoidance under section 871(m). The 2013 proposed regulations provide that any contingent interest will not qualify for the portfolio interest exemption to the extent that the contingent interest payment is a dividend equivalent.

PwC summary

Overall, the extension of the statutory regime through 2015 is a welcome development; whereas the sweeping scope of the 2013 proposed regulations is sure to stir controversy. In the preamble to the proposed regulations, Treasury and IRS have taken the view that all equity swaps and other derivatives with a delta over 0.7 have “the potential for tax avoidance”. A wide range of equity based instruments will be affected by the 2013 proposed regulations. While the dealer exceptions are welcome, systems will still need to be developed for implementing certification and reporting requirements, and to comply with the aggregation rules.

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