Clients&FriendsMemo

On Thursday, August 30, 2012, the IRS issued temporary regulations that extend the current U.S. federal withholding tax regime under section 871(m). The temporary regulations extend the current section 871(m) withholding tax rules until January 1, 2014, instead of January 1, 2013, as indicated in this memorandum. The text of the temporary regulations is available here.

New Proposed and Temporary Regulations Address U.S. Withholding Tax on Cross-Border Equity Derivatives

January 25, 2012

I. Introduction

On Thursday, January 19, the Internal Revenue Service (the "**IRS**") and the Treasury Department issued proposed and temporary regulations under section 871(m) of the Internal Revenue Code. These regulations provide guidance on cross-border swaps and other equity-linked instruments whose dividend equivalent payments will be subject to U.S. withholding tax.

II. Background

Section 871(m) was enacted in March 2010 as part of the Hiring Incentives to Restore Employment Act (the "**HIRE Act**"). Under section 871(m), starting on September 14, 2010, any payment to a foreign party on an equity swap (or any substantially similar payment on another financial instrument) that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source dividend is subject to a 30% U.S. withholding tax if:

- the foreign party transfers the underlying stock to its counterparty in connection with the transaction (i.e., the underlying stock "crosses in"),
- the counterparty transfers the underlying stock to the foreign party at the termination of the transaction (i.e., the underlying stock "crosses out"),
- the underlying stock is not readily tradable on an established securities market,
- the underlying stock is posted as collateral to the foreign party in connection with the transaction, or

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- the equity swap or other transaction is otherwise identified by the IRS as subject to withholding.[1]

In addition, any dividend equivalent payment made to a foreign party pursuant to a securities lending or sale-repurchase transaction with respect to a U.S. equity security (or any substantially similar payment on another financial instrument) is treated as a U.S.-source dividend subject to 30% withholding.

Finally, section 871(m) provides that, starting on March 18, 2012, a 30% U.S. withholding tax will be imposed on any dividend equivalent payment made to any foreign party on every equity swap (or any substantially similar financial instrument), except to the extent that regulations are issued that provide that the equity swap (or other financial instrument) does not have the potential for tax avoidance.

III. Discussion of the Temporary and Proposed Regulations

A. Deferral of Effective Date

The temporary regulations delay the March 18, 2012 effective date of section 871(m) until January 1, 2013. Accordingly, equity swaps that are not subject to withholding under current law will continue to be exempt from withholding until January 1, 2013.

B. Equity Swaps Subject to Section 871(m) Withholding Under the Proposed Regulations

The proposed regulations describe the equity swaps whose dividend equivalent payments will not be subject to U.S. withholding tax on and after January 1, 2013. Under the proposed regulations, only swaps that satisfy each of the seven conditions described below will be exempt from withholding under section 871(m); dividend equivalent payments on all other equity swaps will be subject to withholding tax beginning January 1, 2013.

Moreover, the proposed regulations would expand the scope of section 871(m) to any equity-linked instrument (and not only a swap) that provides for a payment that is determined by reference to, or is contingent on, the payment of a dividend (or a redemption that is treated as a dividend) from sources within the United States. Thus, an option, forward, or futures contract whose settlement price adjusts for dividends, or a debt instrument that pays contingent interest linked to U.S. dividends, is subject to these rules, and their dividend equivalent payments may be subject to withholding if any of the seven conditions are violated.

[1] For purposes of this memorandum, any payment to a foreign counterparty that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source dividend is referred to as a “dividend equivalent payment”.

1. Long Party Must Not Be "In The Market" on the Pricing or Termination Date of the Derivative

The long party must not be "in the market" with respect to 10% or more of the notional amount of the securities that are the subject of the derivative on the same day or days that the parties price the derivative, or on the day or days that the derivative terminates. In other words, the long party must not sell or otherwise dispose of 10% or more of the notional amount of the underlying securities on the same day or days the parties price the derivative, and must not purchase or otherwise acquire 10% or more of the notional amount of the underlying securities on the same day or days the derivative terminates. Moreover, neither the purchase nor sale of the underlying securities may be at a price that is set or calculated in a way that is substantially identical to or determined by reference to an amount used to price or terminate the derivative (regardless of the day on which the purchase or sale occurs). Thus, a foreign hedge fund that holds shares of a U.S. stock and wishes to replace those shares with an equity swap could not sell 10% or more of the shares it holds into the market at any price on the same day that it enters into (or prices) the swap and escape withholding on dividend equivalent payments on the swap.

The same prohibition applies on exit. Thus, under the proposed regulations, if a foreign hedge fund that is long a U.S. equity security pursuant to a derivative terminates the derivative, and on the same day buys 10% or more of the underlying equity security, all prior dividend equivalent payments on the derivative will be subject to U.S. withholding tax. An IRS official has indicated publicly that if a withholding agent obtains a representation from the foreign long party that the foreign long party will not violate this prohibition, the withholding agent will not be liable for penalties for failure to withhold absent knowledge or reason to know that the representation is violated (although the foreign counterparty will still be liable for the tax).

Under the proposed regulations, there does not need to be any connection between the sale or purchase of the underlying securities and the derivative. Further, any violation of the prohibition against being "in the market" with respect to the underlying security will cause all dividend equivalent payments on the derivative to be subject to withholding. Thus, under the proposed regulations, if a foreign hedge fund owns 100 shares of IBM, and sells 10 of its IBM shares into the market on the same day it prices a long swap with respect to 100 shares of IBM (so that the fund is now long 190 shares of IBM), the fund will be subject to 30% withholding tax on all dividend equivalent payments on the swap (even though the fund was not "in the market" with respect to 90 of the 100 long swap shares). Likewise, if a fund that does not own any physical shares of IBM enters into a swap on 100 shares of IBM and, on the same day that it exits the swap, buys 10 IBM shares in the market, the fund will be subject to tax on all dividend equivalent payments on the swap during the swap's entire term (even though the fund was not "in the market" with respect to 90 of the 100 long swap shares). This aspect of the proposed regulations is particularly punitive and

significantly broader than the scope of withholding under section 871(m) as it currently applies (as extended by the temporary regulations).

2. Underlying Security Must Be Listed on an SEC-Registered National Securities Exchange or a Section 11A National Market System

The underlying security must be listed on a national securities exchange that is registered with the Securities and Exchange Commission or on the national market system established pursuant to section 11A of the Securities Exchange Act of 1934,[2] and must be traded on at least 15 of the 30 trading days before the derivative was priced (or, in the case of an initial offering, during at least 15 of the 30 trading days after the initial offering) at a volume that exceeds 10% of the 30-day average daily trading value.

3. No More Than 10% of the Collateral May Consist of the Underlying Security

No more than 10% of the fair market value of the collateral posted by the short party may consist of the underlying security on any date that the derivative is outstanding. An IRS official has indicated publicly that changes in value of collateral after the date the derivative was entered into will not cause this provision to be violated.

4. Derivative Must Remain Outstanding (and Not Offset) for At Least 90 Days

The derivative must actually be outstanding for at least 90 days (not counting the date the derivative was entered into).

Thus, under the proposed regulations, any dividend equivalent payments on a U.S. equity derivative that is outstanding for less than 90 days are subject to U.S. withholding tax, even if the derivative had an initial term of more than 90 days and was terminated early. Moreover, for this purpose, a derivative is considered terminated if the long party enters into any offsetting position with respect to the derivative.

This rule will effectively prevent quantative statistical arbitrage funds from qualifying under the proposed regulations (because they rarely retain their long positions for 90 days).

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[2] These exchanges include: NYSE Amex LLC; BATS Exchange, Inc.; BATS Y-Exchange, Inc.; NASDAQ OMX BX, Inc.; C2 Options Exchange, Incorporated; Chicago Board Options Exchange, Incorporated; Chicago Stock Exchange, Inc.; EDGA Exchange, Inc.; EDGX Exchange, Inc.; International Securities Exchange, LLC; The Nasdaq Stock Market LLC; National Stock Exchange, Inc.; New York Stock Exchange LLC; NYSE Arca, Inc.; and NASDAQ OMX PHLX, Inc. See http://www.sec.gov/divisions/marketreg/mrexchanges.shtml.

As with the other conditions, an IRS official has indicated that penalties will not be imposed on withholding agents that receive a representation from the foreign long party to the effect that the foreign long party will comply with the condition (so long as the withholding agent does not know or have reason to know of a violation).

5. Long Party Must Not Control the Short Party's Hedge

The long party must not control (by contract or otherwise) the short party's hedge of the short position.

Thus, the long party may not direct that the short party purchase its hedge from a particular market maker or on a particular exchange.[3]

6. Liquidity Limits on the Size of the Notional Amount

The notional principal amount of the underlying security must not be greater than (i) 5% of the total public float of that class of security or (ii) 20% of the 30-day average daily trading volume, determined as the close of the business day immediately preceding the first day in the term of the derivative. For purposes of this rule, the long party must aggregate the notional principal amounts for all derivatives for which it is a long party.

U.S. withholding agents will likely seek to obtain representations from their foreign counterparties with respect to this prohibition.

7. Derivative Must Not Be Entered Into After the Announcement of a Special Dividend and Before the Ex-Dividend Date

The derivative must not be entered into between the announcement of a special dividend and the ex-dividend date.[4]

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[3] The proposed regulations provide that an electronic trading platform that allows customers electronically to place an order to enter into a derivative with a dealer and through which the dealer determines whether and how to hedge its position does not violate this condition.

[4] The proposed regulations define a "special dividend" as a nonrecurring payment to shareholders that is in addition to a recurring dividend payment, if any (and that may be paid in conjunction with a recurring dividend).

C. Additional Rules Under the Proposed Regulations

(i) The proposed regulations make clear that the withholding tax under section 871(m) applies to the gross amount of dividend equivalent payments to the foreign long party, even if the withholding agent does not make a net payment. Thus, assume that in a particular year, the U.S. short party owes a gross dividend equivalent payment of $100 on a swap that failed one of the seven conditions and is owed a gross payment of $200. Even though the U.S. short party makes no net payment (and, in fact, receives a net payment), the U.S. short party must remit $30 (30% of $100) to the IRS.

(ii) The proposed regulations provide that if a derivative is not subject to section 871(m) at inception and subsequently becomes subject to section 871(m) withholding during the term of the derivative (e.g., because it is terminated before 90 days, or the foreign long party is "in the market" on the date the derivative terminates), then all dividend equivalent payments paid during the term of the derivative become subject to section 871(m) withholding. Amounts owed with respect to any dividend equivalent payments made prior to the date the derivative becomes subject to section 871(m) withholding are payable when the next dividend equivalent payment is made under the derivative (determined on a gross basis), but the withholding agent and foreign counterparty are not subject to any penalties or interest for periods before the date of that dividend equivalent payment. If the net payment to be made by the short party to the long party is not sufficient to pay the withholding tax, the short party is still obligated to remit to the IRS the full amount of withholding tax that is owed.

(iii) The proposed regulations provide that dividend equivalent payments are treated as dividends for purposes of U.S. tax treaties, and therefore may qualify for reduced rates of withholding.

(iv) The proposed regulations provide that dividend equivalent payments are treated as income from investments in stocks under section 892 and therefore generally will not be taxable to sovereign wealth funds. Moreover, although the proposed regulations are proposed only, the preamble indicates that sovereign wealth funds may rely on this rule before the regulations become final.

(v) The proposed regulations provide that if related persons (under sections 267(b) or 707(b)(1) of the Code) enter into a derivative that hedges another derivative entered into between one of the parties and an unrelated party, and both derivatives were entered into by the related parties in the ordinary course of their dealer activities, then the derivative between the related parties is not subject to section 871(m) withholding.

Thus, the proposed regulations prevent multiple (or "cascading") withholding under section 871(m) in the limited context of related parties entering into back-to-back derivatives in the ordinary course of their dealer activities. The proposed regulations do not otherwise address cascading withholding, although the IRS has requested comments on this issue.

(vi) The proposed regulations contain an anti-abuse rule that provides that if a taxpayer enters into a transaction or transactions with a principal purpose of avoiding the application of the regulations, payments with respect to the transaction or transactions may be treated as dividend equivalent payments subject to withholding.

(vii) The proposed regulations are proposed to apply to payments made on or after the date the regulations are finalized. Thus, derivatives entered into today (and in the past) may be subject to withholding under these proposed regulations when they are finalized.

(viii) The proposed regulations provide that for all purposes of the proposed regulations any person that is "related" to a party to a derivative is also treated as a party to the derivative.[5] Thus, if a trader enters into an equity swap that provides for a dividend equivalent payment, and on the same day a trader in a related entity coincidentally sells 10% of the underlying security into the market, the dividend equivalent payments would be subject to 30% withholding. Similarly, if an individual owns more than 50% of a hedge fund, foreigners own the balance of the fund, the hedge fund enters into an equity swap that provides for a dividend equivalent payment, and on the same day the individual coincidentally sells 10% of the underlying security into the market, the dividend equivalent payments with respect to the foreign investors would be subject to 30% withholding. This would be the case even if the parties have no knowledge as to trades put on by the related party (and may even have information barriers established between them for securities laws or other purposes).

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If you have any questions about the foregoing, please contact David S. Miller, Mark Howe, Daniel J. Mulcahy, Shlomo Boehm, Jason Schwartz, Harley Raff or any other member of our Tax Department.

[5] For these purposes, "related" is defined by reference to sections 267(b) and 707(b)(1) of the Internal Revenue Code, and very generally includes certain family members, persons and entities that are more than 50% owned by such persons, and entities that are 50% or more commonly owned.