US Treasury proposal clarifies withholding on dividend-linked payments

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On 4 December 2013, the IRS issued proposed regulations clarifying the circumstances under which certain payments linked to US-source dividends under a notional principal contract or an equity-linked instrument will be subject to US withholding tax. At the same time, the IRS issued final regulations that provide a two-year transitional relief period for parties adapting to this new withholding regime, which is due to become effective in 2016.

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Background

Enacted in 2010 as part of the US Hiring Incentives to Restore Employment (HIRE) Act, Section 871(m) of the Internal Revenue Code of 1986 (Code) imposes US withholding tax on dividend equivalent payments (DEPs) received by non-US persons. For these purposes, DEPs are generally defined as payments under:

- ***Securities loans (www.practicallaw.com/7-503-0989)*** (see *Practice note, Stock lending (www.practicallaw.com/2-201-9445)*).
- Sales and repurchase transactions (see *Practice notes, Repos: Overview (US) (www.practicallaw.com/7-518-8989)* and *Repos: overview (UK) (www.practicallaw.com/6-202-0649)*).
- Notional principal contracts (NPCs) that are specified NPCs (SNPCs).
- Similar transactions identified by the US Treasury Department (Treasury).

In each case, the payments must be contingent upon or determined by reference to the payment of a US-source dividend. Section 871(m) lists four categories of NPC that will be considered SNPCs. This statutory definition was scheduled to expire on 18 March 2012, after which the Code provided that an SNPC would include any NPC unless the US Internal Revenue Service (IRS) and the Treasury were to determine that the instrument did not have the potential for tax avoidance.

On 19 January 2012, the IRS proposed regulations under Section 871(m) (2012 Proposed Regulations), which provided a complex seven-factor approach to defining an SNPC. The 2012 Proposed Regulations also treated as NPCs equity-linked instruments (ELIs) that provide for a payment that is "substantially similar" to a DEP. For more detail, see *Legal update, IRS Issues Regulations on Dividend Equivalent Payments (www.practicallaw.com/0-517-3793)*.

2013 proposed regulations

Notional principal contracts and equity-linked instruments

As noted above (see *Background*), Section 871(m) of the Code imposes withholding tax on DEPs made pursuant to an SNPC. Under the 2012 Proposed Regulations, an NPC or an ELI would be an SNPC if it fell within one of seven categories of transaction. On 4 December 2013, the IRS issued proposed regulations (2013 Proposed Regulations) that clarify the circumstances under which certain payments linked to US-source dividends under an NPC or ELI will be subject to US withholding tax under Section 871(m).

The 2013 Proposed Regulations, which supersede the 2012 Proposed Regulations, have replaced the seven-factor test with a single test based solely on the objective measurement of an NPC's or ELI's "delta" to determine whether an instrument may be subject to tax under Section 871(m). For these purposes, the delta of an NPC or ELI is the ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of the underlying securities. If an NPC or ELI has a delta that is not reasonably expected to vary during the term of the transaction, the NPC or ELI is generally treated as having a delta of 1.0.

The 2013 Proposed Regulations provide that an NPC with a delta of 0.70 or greater when the long party enters into the transaction will be an SNPC and, therefore, subject to Section 871(m) withholding on any DEPs. Similarly, the 2013 Proposed Regulations provide that an ELI with a delta of 0.70 or greater when the long party acquires the instrument will be a specified ELI (SELI) and, therefore, subject to Section 871(m) withholding on any DEPs.

If a transaction references more than one underlying security, the taxpayer must determine whether the transaction is a Section 871(m) transaction with respect to each underlying security. A transaction, therefore, may be a Section 871(m) transaction with respect to one or more underlying securities referenced in the transaction, but may not be a Section 871(m) transaction with respect to other underlying securities referenced by that same transaction.

Finally, in contrast to the 2012 Proposed Regulations, the 2013 Proposed Regulations do not apply on a retroactive basis. In other words, an instrument whose delta increases above the 0.70 threshold during the term of the instrument will not be an SNPC or SELI, provided that the delta was below 0.70 on the date the long party acquired the instrument.

Dividend equivalent payments

Any DEPs made pursuant to an instrument that falls within the scope of Section 871(m) of the Code generally will be subject to US withholding tax. The 2012 Proposed Regulations defined DEPs as payments contingent upon or determined by reference to actual US-source dividend payments and specifically excluded payments determined by reference solely to an estimate of an expected dividend payment (see *Legal update, IRS Issues Regulations on Dividend Equivalent Payments (www.practicallaw.com/0-517-3793)*).

Due to the potential for abuse, the 2013 Proposed Regulations do not include this exception. Instead, the definition of DEPs has been broadened to include estimated dividends as well as certain indirect dividend payments that are intended to reflect actual or estimated dividends, such as adjustments to the interest rate on a price return swap or to the purchase price set in a forward contract.

The 2013 Proposed Regulations also clarify that a DEP is deemed to be paid when the amount is fixed, even if the actual payment of that amount is deferred under the terms of the instrument. Finally, the 2013 Proposed Regulations include the rule from the 2012 Proposed Regulations that any payment of a long party's tax liability with respect to a DEP made by the withholding agent is treated as a DEP. As such, under SNPCs and SELIs that follow a standard allocation of withholding tax risk to the payer, any additional amounts payable are themselves treated as DEPs.

Effective dates

The 2013 Proposed Regulations are scheduled to apply to DEPs pursuant to SNPCs and SELIs if the payments are made on or after 1 January 2016. Further, the 2013 Proposed Regulations include grandfathering relief for ELIs that are acquired before 5 March 2014.

Before publishing the 2013 Proposed Regulations in the Federal Register as final and, therefore, effective, the US Treasury will consider any comments received by 5 March 2014, and will hold a public hearing on 11 April 2014.

Final regulations: transitional relief

In connection with the issuance of the 2013 Proposed Regulations, the IRS also issued final regulations under Section 871(m) that provide a two-year transitional relief period for parties adapting to the new withholding regime. These final regulations extend the applicability of the four-factor definition from the Code to payments made before 1 January 2016.

The IRS stated that an extension of the statutory definition of SNPC is necessary because the 2013 Proposed Regulations adopt a different approach from the approach taken in the 2012 Proposed Regulations for determining whether an NPC is an SNPC. Therefore, this extension will allow the financial services industry time to establish necessary systems and other operating procedures to comply with the rules in the 2013 Proposed Regulations.

Resource information

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