DIVIDEND EQUIVALENTS: PAST, PRESENT AND FUTURE

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Code §871(m) of the Code was enacted as part of the H.I.R.E. Act on March 18, 2010 and treats "dividend equivalents" as U.S. source dividends for withholding tax purposes. On January 23, 2012, Temporary Regulations (the "2012 Temporary Regulations") and a notice of proposed rulemaking (the "2012 Proposed Regulations") were published. The 2012 Proposed Regulations and Temporary Regulations provided guidance relating to U.S. source dividend equivalent payments made to nonresident individuals and foreign corporations. They also provided guidance to withholding agents. Correcting amendments to the 2012 Temporary Regulations were published on February 6, 2012, on March 8, 2012 and on August 31, 2012. On December 5, 2013 new proposed regulations (the "2013 Proposed Regulations") withdrew the 2012 Proposed Regulations. In addition and at the same date, final regulations ("2013 Final Regulations") were published that essentially adopted the 2012 Temporary Regulations.

BACKGROUND

Code §871(m) defines a dividend equivalent as one of the following:

- Any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States;
- Any payment made pursuant to a specified notional principal contract ("N.P.C.") that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; and
- Any other payment determined by the Secretary to be substantially similar to a payment described in the two previous categories (a substantially similar dividend).

For purposes of this definition, Code 871(m) defines a "specified notional principal contract" as one of the following if the payment was made during the period ranging from September 14, 2010 to March 18, 2012. A specified N.P.C. is any N.P.C. if:

- In connection with entering into such contract, any long party to the contract transfers the underlying security to any short party to the contract;
- 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;

- The underlying security is not readily tradable on an established securities market;

- 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

- Such contract is identified by the Secretary as a specified N.P.C.

For payments made after March 18, 2012, a “specified notional principal contract” is defined by Code §871(m) as any notional principal contract unless the Secretary determines that such contract is of a type not having the potential for tax avoidance.

A dividend equivalent is treated as a dividend from sources within the United States. It is so treated whether the recipient is a nonresident individual, a foreign corporation, or a foreign organization that is a private foundation. This sourcing rule also applies for purposes of F.A.T.C.A. As a consequence, when a payment is determined to be a U.S. source dividend equivalent, the payment is subject to a U.S. withholding tax, generally at the rate of 30%.

Among other things, the 2012 Proposed Regulations contained a seven-factor test approach to determine whether a payment made on or after January 1, 2014 constituted a specified notional principal contract. A specified notional principal contract was any notional principal contract if one or more of the following seven factors were met:

- The long party is “in the market” on the same day that the parties priced or terminated the N.P.C.;

- The underlying security is not regularly traded on a qualified exchange;

- 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;

- The actual term of the N.P.C. is fewer than 90 days;

- The long party controls the short party’s hedge;

- 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; or

- The N.P.C. is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

The 2012 Proposed Regulations also defined a substantially similar dividend. They defined this term as (i) any gross-up amount paid by a short party in satisfaction of the long party’s tax liability with respect to a dividend equivalent, or (ii) any payment made pursuant to an equity-linked instrument (“E.L.I.”) that was calculated by reference to a dividend from U.S. sources if the E.L.I. satisfied one or more of the seven aforementioned factors.

> *"The Proposed Regulations abandon the seven-factor test approach. The determination as to whether an N.P.C. or an E.L.I. will fall under the Code §871(m) sourcing rule will be determined exclusively by the objective measurement of a derivative's delta."*

The 2012 Proposed Regulations exclude from the definition of a dividend equivalent any payment determined by reference to an estimate of an expected but net yet announced dividend without reference to or adjustment for the amount of any actual dividend.

Under the 2012 Proposed Regulations, the provisions of an income tax treaty applying to dividends paid to or derived by a foreign person apply to dividend equivalents as defined under Code §871(m) and the regulations thereunder. This provision has been adopted in the 2013 Final Regulations.

2013 Final Regulations and 2013 Proposed Regulations

Key points of the 2013 Final Regulations and the 2013 Proposed Regulations are as follows:

1. The 2013 Final Regulations extend the definition of "specified notional principal contract" as defined for the period ranging from September 14, 2010 to March 18, 2012 under Code §871(m) to payments made before January 1, 2016. Under the 2012 Temporary Regulations this definition had only been extended until January 1, 2014.

2. The 2013 Proposed Regulations provide a similar but more precise definition of a dividend equivalent than already contained under Code §871(m) of the Code by adding an additional category to the definition. This additional category includes in the definition of a dividend equivalent any payment made pursuant to a specified E.L.I. that is directly or indirectly contingent upon or determined by reference to the payment of a dividend from U.S. sources. An E.L.I. is defined as any financial transaction (other than a securities lending or sale-repurchase transaction or an N.P.C.) that references the value of one or more underlying securities. As examples, the 2013 Proposed Regulations mention forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments with payments linked to underlying securities.

3. The definition of a specified N.P.C. as provided under the 2013 Proposed Regulations will apply to payments made pursuant to a specified N.P.C. on or after January 1, 2016. The 2013 Proposed Regulations will apply to payments made after January 1, 2016 pursuant to specified E.L.I.'s. However, the 2013 Proposed Regulations will only apply to the latter with respect to an E.L.I. that was acquired by the long party on or after March 5, 2014.

4. The 2013 Proposed Regulations abandon the seven-factor test approach. The determination as to whether an N.P.C. or an E.L.I. will fall under the Code §871(m) sourcing rule will be determined exclusively by the objective measurement of a derivative's delta. The delta of an N.P.C. or an E.L.I. is the ratio of the change in the fair market value of the contract to the change in the fair market value of the property referenced by the contract. The delta must be determined in a commercially reasonable manner. The underlying logic of this delta-based approach is to avoid any situation of potential tax avoidance existing when a transaction approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security. Under this "delta approach" a

specified N.P.C. is any N.P.C. that has a delta of 70% or greater when the long party acquires the transaction.

5. An equivalent definition is provided for specified E.L.I.'s.

6. When a transaction references more than one underlying security, the determination as to whether the transaction falls under Code §871(m) must be made on a security-by-security basis. The 2013 Proposed Regulations also include some anti-abuse rules regarding the delta determination.

7. Under the 2013 Proposed Regulations, a substantially similar payment is a dividend equivalent received by the long party in a gross-up amount when the payment is made in satisfaction of a tax liability with respect to a dividend equivalent made by a withholding agent.

8. A payment of a dividend equivalent is defined by the 2013 Proposed Regulations as any gross amount that references a U.S. source dividend and that is used to compute any net amount transferred to or from the long party even if the long party makes a net payment to the short party or the net payment is zero. The date of the payment is the date the amount of the dividend equivalent is determined. The fact that the payment occurs or is otherwise taken into account on a later date is not taken into account. A payment of a dividend equivalent also includes estimated dividend payments under the 2013 Proposed Regulations (as opposed to the 2012 Proposed Regulations), as well as any other contractual term of a potential Code §871(m) transaction that is calculated based on an actual or estimated dividend.

9. Under the 2013 Proposed Regulations, a transaction referencing an interest in an entity other than an entity treated as a C corporation for U.S. income tax purposes will be treated as referencing the allocable portion of any underlying security or Code §871(m) contracts that the entity holds directly or indirectly. A safe harbor exists where the underlying securities or section 871(m) contracts represent an aggregate amount of 10% or less of the value of the interest in the referenced entity at the time of the transaction.

10. The 2013 Proposed Regulations propose rules to calculate the amount of the dividend equivalent.

11. The 2013 Proposed Regulations propose two exceptions to transactions that may otherwise fall within the scope of Code §871(m) but that present a little potential for tax avoidance: i) a transaction into which a qualified dealer enters in its capacity as a dealer (see 2013 proposed regulations for more detailed guidance) and ii) a transaction into which a taxpayer enters as part of a plan pursuant to which one or more persons are obligated to acquire 50% or more of the entity issuing the underlying securities.

12. The 2013 Proposed Regulations exclude dividend equivalents from the definition of portfolio interest.

13. The 2013 Final Regulations also addressed the withholding obligations and reporting obligations entailed by the U.S. sourcing of dividend equivalent payments.

14. Finally, the 2013 Proposed Regulations clearly state that the Service reserves the right to treat any payment made with respect to a transaction as a dividend equivalent if the taxpayer’s principal purpose in entering into the transaction is to avoid the rules relating to dividend equivalent payments.