

January 23, 2012

Temporary and Proposed Regulations Regarding US Withholding Tax on Certain Equity Swap Payments

On January 19, 2012, the Treasury Department and the Internal Revenue Service (the “IRS”) released temporary and proposed regulations under section 871(m) of the Internal Revenue Code regarding the imposition of US federal withholding tax on certain equity swap payments. Under the temporary regulations, swap payments made after March 18, 2012, but prior to January 1, 2013, will continue to be subject to the existing sourcing rules contained in section 871(m). Beginning January 1, 2013, however, payments contingent on or determined by reference to dividends on US equities made under swaps and certain other financial instruments that fall within any one of seven categories of “specified notional principal contracts” set forth in the proposed regulations would generally be treated as US source income under section 871(m) and thus potentially subject to US withholding tax. This would include payments made in 2013 and thereafter on swaps that are currently in place, as well as swaps executed during the remainder of 2012.

Background

US withholding tax generally is imposed on certain types of US source income, including dividends, paid to foreign persons.¹ In general, swap payments are not subject to US withholding tax because payments made to a foreign person under a notional principal contract (“NPC”) are treated as foreign source income.² Prior to the enactment of section 871(m), as discussed in detail below, treatment of swap payments made to a foreign person as foreign source income applied even where the swap payments were based on US source dividends.

¹ I.R.C. §§ 871 and 881.

² Treas. Reg. § 1.863-7(b)(1). This sourcing rule has been in effect since 1991.

In contrast, dividends are generally sourced by reference to the residence of the payor corporation.³ Consequently, dividends paid by US corporations to foreign holders generally are treated as US source income and subject to US withholding tax at a 30% rate (subject to reduction pursuant to an applicable tax treaty).

In recent years, the IRS has increasingly focused on the enforcement of US withholding tax on dividends by examining both financial institutions and foreign persons. Specifically, the IRS has targeted transactions such as total return swaps on US equities that it believes have the potential for withholding tax avoidance. As part of this enforcement effort, the IRS issued an industry directive (the “Directive”) in January 2010.⁴ The Directive was issued to assist revenue agents in developing the facts necessary to determine whether a transaction that is in the form of a swap will be respected as an NPC or will be recast as some other arrangement. The Directive indicated that the IRS may take the position that the long party on certain types of equity swaps should be treated as the owner of the underlying equity, in which case dividend equivalent payments received pursuant to such swaps would be treated as actual dividends and thus potentially be subject to US withholding tax. Among other things, the Directive instructed revenue agents to examine any swap where (i) the swap involved both a “cross-in” and a “cross-out” (as described in more detail below), (ii) the referenced securities with respect to the swap were issued by a privately held US corporation or (iii) the foreign person entered into the swap by using an electronic trading program offered by a US financial institution. In each of these cases, the Directive suggested that the foreign person may be considered the beneficial owner of the referenced securities.⁵

Section 871(m)

Section 871(m) was enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act.⁶ Under section 871(m), “dividend equivalent” payments are treated as US source income. The term “dividend equivalent” is defined to include payments made on a “specified notional principal contract” (a “specified NPC”) on or after September 14, 2010 that are contingent upon, or determined by reference to, the payment of dividends on US securities.⁷ Accordingly, such

³ I.R.C. § 861(a)(2).

⁴ Internal Revenue Service, Industry Directive on Total Return Swaps (“TRSs”) Used to Avoid Dividend Withholding Tax, LMSB-4-1209-044 (January 14, 2010). See our prior memorandum dated January 26, 2010 entitled “IRS Industry Directive on Total Return Swaps Used to Avoid Dividend Withholding Tax” available at www.shearman.com in the Tax practice area. See also Staff of the S. Comm. on the Permanent Subcommittee on Investigations, 110th Cong., Dividend Tax Abuse: How Offshore Entities Dodge Taxes on US Stock Dividends (Comm. Print 2008).

⁵ Under section 871(m) and the proposed regulations, the first two of these situations (*i.e.*, cross-in/cross-out and referenced securities that are not readily tradable) would now result in a “specified NPC” (as defined below). As described below, however, the proposed regulations make clear that the fact that a US equity swap is executed on an electronic trading platform will not cause payments on such swap to be subject to US withholding tax.

⁶ The relevant provision was enacted as section 871(l), but was subsequently redesignated as section 871(m) pursuant to the HIRE Act, P.L. 111-147, § 541(a).

⁷ I.R.C. § 871(m)(2)(B). Section 871(m) also applies to substitute dividend payments made under certain securities lending and sale-repurchase transactions. I.R.C. § 871(m)(2)(A).

payments when made to a foreign person are generally subject to US withholding tax at a 30% rate (subject to reduction pursuant to an applicable tax treaty).⁸

Pursuant to section 871(m)(3)(A), an NPC is considered a specified NPC if:

- in connection with entering into the contract, any “long party” to the contract transfers the underlying security to any “short party”⁹ (*i.e.*, there is a “crossing-in”);
- in connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party (*i.e.*, there is a “crossing-out”);
- the underlying security is not “readily tradable on an established securities market”;
- in connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract; or
- the contract is identified by the Treasury Department as a specified NPC.

An underlying security means, for any NPC, the security with respect to which the relevant dividend is paid. While the categories of specified NPCs enumerated in the statute is relatively narrow, section 871(m)(3)(B) provided that any payment made after March 18, 2012 on an NPC that is contingent upon, or determined by reference to, US source dividends would be treated as a payment made on a specified NPC unless the Treasury Department determined that the swap is of a type that lacks tax avoidance potential.

On January 19, 2012, the Treasury Department and the IRS issued: (1) temporary regulations that apply to swap payments made after March 18, 2012 and before January 1, 2013, and (2) proposed regulations that would apply to swap payments made on or after January 1, 2013.¹⁰ Presumably with the intention of avoiding market disruption, the temporary regulations extend the current rules in section 871(m)(3)(A) to swap payments made on or before December 31, 2012, thus preventing the application of the draconian rule that otherwise would have been in effect beginning on March 19, 2012 (*i.e.*, the treatment of all swaps on US equities as specified NPCs). After December 31, 2012, however, the proposed regulations would significantly expand the types of NPCs that are considered specified NPCs.

Temporary Regulations (Applicable to Payments Made on or Before December 31, 2012)

Under the temporary regulations, the current categories of specified NPCs in section 871(m)(3)(A) will be extended until December 31, 2012 to allow taxpayers and withholding agents time to comply with the proposed regulations’ more expansive

⁸ Unlike the Directive, the statutory provision does not treat the party with long exposure under the swap as the owner of the underlying equity for US federal income tax purposes, but instead changes the source of income derived from the swap.

⁹ The term “long party” refers to any party to the contract which is entitled to receive any payment pursuant to such contract which is contingent upon, or determined with reference to, the payment of a dividend from sources within the US with respect to the underlying security. *See* I.R.C. § 871(m)(4)(A). The term “short party” refers to any party to the contract which is not a long party with respect to the underlying security. *See* I.R.C. § 871(m)(4)(B).

¹⁰ T.D. 9572, 26 C.F.R. Part 1; REG-120282-10, 26 C.F.R. Part 1.

categories of specified NPCs.¹¹ This provides some relief to taxpayers and withholding agents that will need to implement procedures to fulfill their new withholding obligations. It is far from clear, however, that this time period will be sufficient to allow taxpayers and withholding agents to put in place appropriate systems and make other adjustments needed for the new rules, particularly in light of the numerous substantive and interpretive issues raised by the proposed regulations.

As discussed below, the temporary regulations do not effectively “grandfather” any swaps, but instead simply continue the existing statutory regime for any payments made on or prior to December 31, 2012.¹²

Proposed Regulations (Applicable to Payments Made on or After January 1, 2013)

The proposed regulations are proposed to apply to payments made on or after January 1, 2013. Of course, the proposed regulations will not be effective until the rules are finalized.¹³ In light of the importance of these rules and some of the ambiguities discussed below, there certainly could be changes to the proposed regulations before they are finalized.

If finalized in their current form, the proposed regulations would apply to payments made on or after January 1, 2013, even with respect to swaps executed before January 1, 2013 (including swaps executed before the date on which the regulations were proposed). Accordingly, taxpayers should both (i) monitor swaps executed during the remainder of 2012 and (ii) evaluate existing swap portfolios (to the extent such swaps are expected to continue into 2013) to determine whether any of such swaps would be considered specified NPCs under the proposed regulations.

As described in greater detail below, the proposed regulations make several important changes and clarifications to the existing statutory regime, including:

broadening the definition of specified NPCs, including adding several categories of NPCs that were not contained in the existing statutory regime;

- expanding section 871(m) to apply to payments under certain non swap derivatives (such as futures, forwards and options) to the extent that payments on such derivatives are contingent upon or determined by reference to US source dividends; and
- clarifying that NPCs will not be considered specified NPCs simply because they are executed on an electronic trading platform.

Categories of Specified NPCs

The single biggest change made by the proposed regulations is the broadening and expansion of the categories of NPCs that will constitute specified NPCs. Under the proposed regulations, an NPC will be considered a specified NPC

¹¹ Temp. Treas. Reg. § 1.871-16T(b); T.D. 9572, 26 C.F.R. Part 1.

¹² In addition, the temporary regulations clarify that the general sourcing rule for swap payments in Treas. Reg. § 1.863-7 does not apply to a dividend equivalent under section 871(m). See Temp. Treas. Reg. § 1.863-7T; T.D. 9572, 26 C.F.R. Part 1.

¹³ There will be a hearing on the proposed regulations on April 27, 2012 and comments on the proposed regulations may be submitted in advance of the hearing.

with respect to payments made on or after January 1, 2013 if it falls into one of the following seven categories (explained in more detail below):

- the long party to the NPC is “in the market” with respect to the underlying security on the same day or days that the parties price the NPC or on the same day or days that the NPC terminates (“contemporaneous transfers of the underlying securities”);
- the underlying security in the NPC is not regularly traded (“underlying security is not regularly traded”);
- the short party to the NPC posts the underlying security with the long party as collateral and the underlying security posted as collateral represents more than 10% of the total fair market value of all the collateral posted by the short party on any date that the NPC is outstanding (“underlying security posted as collateral”);
- the NPC has a term of fewer than 90 days (“NPC term of fewer than 90 days”);
- either (1) the long party controls contractually or by conduct the short party’s hedge of the short position or (2) the long party enters into an NPC using an “underlying equity control program” (“long party controls short party’s hedge”);
- the notional principal amount of the underlying security in the NPC is greater than (1) 5% of the total public float of that class of security or (2) 20% of the 30-day average daily trading volume determined as of the close of the business day immediately preceding the first day in the term of an NPC (“notional principal amount represents a significant percentage of trading volume”); or
- the NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date (“NPC provides for the payment of a special dividend”).¹⁴

With respect to each of the above categories, the term “underlying security” refers to the US security referenced by the NPC. If an NPC references more than one security or a “customized index,” each security or component of such customized index is treated as an underlying security of a separate NPC.¹⁵ A customized index refers to any index, as determined on the date that the parties enter into an NPC, that is a narrow-based index¹⁶ or any other index unless futures contracts or option contracts on such index trade on a qualified board or exchange, as defined in section 1256(g)(7).

¹⁴ Prop. Reg. § 1.871-16(c).

¹⁵ Prop. Reg. § 1.871-16(f)(1).

¹⁶ A “narrow-based index” is an index (1) that has 9 or fewer component securities; (2) in which a component security comprises more than 30% of the index’s weighting; (3) in which the 5 highest weighted component securities in the aggregate comprise more than 60% of the index’s weighting; or (4) in which the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting have an aggregate dollar value of average daily trading volume of less than \$50,000,000 (or in the case of an index with 15 or more component securities, \$30,000,000) except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security. Prop. Reg. § 1.871-16(f)(3)(ii).

Where an NPC references an index other than a customized index (a “broad-based index”), the proposed regulations do not treat the NPC as a separate NPC with respect to each component of the index. Thus, if the long party to an NPC on a broad-based index sells one or more of the underlying components on the same date the NPC is priced, such sales would not cause the long party to be treated as “in the market” with respect to the underlying security (thus causing an NPC to be a specified NPC) because the underlying security would be the index itself and not each of the components. Similarly, where an NPC is executed with respect to a broad-based index on a date that is after a special dividend had been announced for one of the index components but before the ex-dividend date for such special dividend, the special dividend category for specified NPCs would not apply because, again, there would be no special dividend with respect to the index itself. While not entirely clear, notwithstanding the special rule for broad-based indices, it appears that section 871(m) may still apply to an NPC with respect to a broad-based index. For example, an NPC on a broad-based index that has (or is treated as having) an actual term of less than 90 days may be considered a specified NPC.

Each category of specified NPC is addressed in greater detail below.

1. *Contemporaneous Transfers of the Underlying Securities*

This category applies where the long party to the NPC is “in the market” on certain dates with respect to the underlying security.¹⁷ Specifically, the proposed regulations explain that the long party is “in the market” with respect to the underlying security if the long party either:

- sells or otherwise disposes of the underlying security on the same day or days that the parties price the NPC; or
- purchases or otherwise acquires the underlying security on the same day or days that the NPC terminates.

The long party will also be “in the market” under this rule if the long party sells or purchases the underlying security on a day other than the pricing date or the settlement date of the NPC, but sets the price to align with the price of the NPC (such as with a forward contract).

The “in the market” category contained in the proposed regulations is broader than the cross-in/cross-out categories in section 871(m)(3)(A)(i) and (ii) in two critical respects.

First, a cross-in (or cross-out) can occur under section 871(m) and the temporary regulations only if the long party sells (or is treated as selling) the underlying security to (or buys (or is treated as buying) the underlying security from) the short party. In contrast, the “in the market” standard does not require that the short party acquire the underlying security from (or sell the underlying security to) the long party. In fact, an NPC may be treated as a specified NPC under this category even where the short party never holds the underlying physical position (*e.g.*, where the short party hedges its swap exposure through derivative positions).

Second, a cross-in or cross-out occurs under the terms of the statute only if the relevant sale or purchase transaction was undertaken “in connection with” the execution or termination of the swap. The “in the market”

¹⁷ Prop. Reg. § 1.871-16(c)(1).

standard requires no such connection. Presumably, this means that a long party could inadvertently cause a swap to be treated as a specified NPC under this category because of an entirely unrelated transaction that it (or, as described below, a related person) undertakes with respect to the same underlying security.

This category in general, and in particular the fact that it could apply even where there is no connection between the NPC executed by a taxpayer and the “in the market” transaction undertaken by the taxpayer or a related person, could create substantial problems for taxpayers engaged in various, separate trading strategies (such as multi-strategy hedge funds). For example, one investment manager for a multi-strategy hedge fund may execute an NPC giving it long exposure to a US equity security, while on the same date, but in a completely unrelated transaction, another investment manager for the same fund may dispose of the same security. It is difficult to see what abuse would otherwise be present in such a case that would justify imposing US withholding tax on dividend equivalents paid on the NPC executed by the first investment manager.

The preamble to the proposed regulations (the “preamble”) indicates that there may be multiple testing dates for determining if the long party is in the market. Specifically, the preamble states that “an NPC is sometimes entered into in tranches that spread the execution over more than one day; in that case, the proposed regulations consider each day that a tranche is executed or settled as a testing date.”¹⁸

A *de minimis* exception provides that the long party is not treated as in the market when the amount of the underlying securities disposed of on a pricing date or acquired on a termination date is less than 10% of the notional amount of the NPC.

2. *Underlying Security Is Not Regularly Traded*

This category treats as a specified NPC any NPC that references an underlying security that is not regularly traded.¹⁹ The proposed regulations treat a security as “regularly traded” if:

- the security is listed on one or more qualified exchanges at the time the NPC is priced, and
- the underlying security was traded on at least 15 trading days during the 30 trading days prior to the date the parties price the NPC.²⁰

For this purpose, securities are considered traded only on days when the quantity of the underlying securities traded exceeds 10% of the 30-day average daily trading volume.

A “qualified exchange” refers to a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established under section 11A of the Securities Exchange Act of 1934. Thus, securities that trade only on an over the-counter market are not considered regularly traded for purposes of this category.

¹⁸ Preamble at 5-6.

¹⁹ Prop. Reg. § 1.871-16(c)(2).

²⁰ A special rule for securities during the first 30 days following a public offering considers a security to be regularly traded if it is traded on at least 15 trading days on one or more qualified exchanges during the 30 trading days subsequent to the initial offering.

Practically speaking, most securities underlying normal commercial swaps will be considered regularly traded for this purpose, but there could be significant issues under this new standard for swaps where preferred stock or convertible preferred stock is the underlying security.

3. *Underlying Security Is Posted as Collateral*

Under this category, an NPC will be considered a specified NPC if the short party to the NPC posts the underlying security with the long party as collateral.²¹ A *de minimis* exception is provided for a pledge of the underlying security where the underlying security represents no more than 10% of the total fair market value of all the collateral posted by the short party on any date that the NPC is outstanding. The *de minimis* exception (which was not contained in the statutory provision) was included presumably in recognition of the fact that a short party may pledge a pool of non cash collateral as security for its obligations under a swap, and the existence of a small amount of the underlying security in such pool should not, by itself, cause an NPC to be treated as a specified NPC.

4. *NPC Term of Fewer than 90 Days*

This category provides that an NPC with a term of fewer than 90 days will be considered a specified NPC.²² Importantly, for this purpose, the term of an NPC is the number of days that the contract is actually outstanding (including the date the NPC is terminated, but excluding the date the NPC was entered into). Thus, if a taxpayer enters into a long term swap, but the swap is terminated within 90 days of its commencement, the swap becomes a specified NPC.

The proposed regulations further provide that an NPC is considered terminated, in whole or in part, for purposes of determining its term if the long party enters into any position (within the meaning of Treas. Reg. § 1.246-5(b)(3)) to the extent that the position offsets a portion of the long party's position with respect to an underlying security in the NPC. This rule does not specifically provide any standard regarding when a position would be treated as offsetting an NPC (such as by providing that the offsetting position must be with respect to "substantially similar or related property" within the meaning of Treas. Reg. § 1.246-5(b)(3)). We believe that the government should clarify this rule and provide more specific guidance regarding when a position would be treated as offsetting an NPC for this purpose.

The preamble indicates that the 90-day term rule is intended to prevent potentially abusive situations such as short term equity swaps around ex-dividend dates in an attempt to avoid US withholding tax on dividends.²³ It is not entirely clear why, as a conceptual or policy matter, there should be any minimum term requirement and, if such a term requirement is imposed, why the minimum term should be as long as 90 days. The need for a 90-day term is particularly surprising because the first category effectively prevents a long party from avoiding US

²¹ Prop. Reg. § 1.871-16(c)(3).

²² Prop. Reg. § 1.871-16(c)(4).

²³ Preamble at 7.

withholding tax by replacing a physical equity position with a swap position. That is, the potential for abuse in the case of a short-term swap would appear to be present only where there is a cross-in or a cross-out of the underlying shares (or both), such that the long party has substituted, at execution or termination of the swap, physical exposure for derivative exposure or derivative exposure for physical exposure, as the case may be.

For example, long parties who enter into NPCs as part of a high-frequency trading strategy typically trade in and out of positions without regard to whether a dividend will be declared during the short period in which they have exposure to the underlying security, and do not enter into short-term transactions in an attempt to avoid US withholding tax. If this category is finalized in its current form, many short-term traders may simply re-design their trading strategies to avoid trading in and out of NPCs on US equities around their ex-dividend dates. It is hard to see what policy objective is advanced by changing taxpayers' behavior in this manner.

5. *Long Party Controls Short Party's Hedge*

This category covers situations in which the long party controls the short party's hedge of its short position by controlling the short party's acquisition of stock or directing the short party to sell its hedge to a particular purchaser at a specific price and date.²⁴ The long party may be treated as exercising control over the short party's hedge pursuant to the terms of a written agreement or through course of conduct.

An NPC also will be considered a specified NPC under this category where the long party enters into the NPC using an underlying equity control program. The term "underlying equity control program" refers to any system that allows a long party to direct a short party's hedge of an NPC or that allows a long party to acquire (or cause the short party to acquire) an underlying security in a transaction with a short party and determine the form of the transaction later.²⁵

Importantly, an underlying equity control program does not include an electronic trading platform that allows customers to electronically place an order to enter into an NPC with a dealer, which allows the dealer to determine whether and how to hedge its position.

6. *Notional Principal Amount Represents a Significant Percentage of Trading Volume*

Under this category, an NPC will be considered a specified NPC if the notional principal amount of the underlying security in the NPC is greater than either:

- 5% of the total public float of that class of security; or
- 20% of the 30-day average daily trading volume determined as of the close of the business day immediately preceding the first day in the term of an NPC.²⁶

²⁴ Prop. Reg. § 1.871-16(c)(5).

²⁵ Prop. Reg. § 1.871-16(f)(2).

²⁶ Prop. Reg. § 1.871-16(c)(6).

The proposed regulations provide an aggregation rule under which a long party that has multiple NPCs that reference the same underlying security must aggregate the notional principal amounts of those NPCs. The aggregation rule appears to apply even where the long party's NPCs are executed with two or more different short parties and even where the NPCs are executed on different dates. In addition, the long party must also consider any NPCs held by its affiliates because, for purposes of the proposed regulations as described more fully below, any related party is considered a party to the NPC.

This aggregation rule is extremely broad and could be difficult to implement for many taxpayers. In any event, this category serves no apparent purpose given that the "in the market" category effectively prevents long parties from replacing physical equity exposure with a swap position on the same underlying security without triggering the re-sourcing rule of section 871(m). Even if a volume limitation were thought to be necessary to prevent abuse, it is difficult to see what policy is advanced by aggregating for this purpose NPC positions initiated on different days. If finalized in its current form, this category would place an artificial limit on taxpayer's ability to gain derivative exposure to a particular security, potentially reducing the liquidity of that particular security.

7. *NPC Provides for the Payment of a Special Dividend*

An NPC will be considered a specified NPC under the final category if the NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date for such dividend.²⁷ The announcement of the special dividend is treated as occurring on the earliest date on which the corporation declares, announces or agrees to the amount or payment of such special dividend. The term "special dividend" refers to a nonrecurring payment to shareholders that is in addition to any recurring dividend payment, even if paid in conjunction with a recurring dividend.²⁸

We would note that treatment of an NPC as a specified NPC under this category causes all dividend equivalent payments on the swap to be subject to withholding tax, not only the special dividend that caused the NPC to be treated as a specified NPC.

Expanded Definition of Dividend Equivalent

Significantly, the proposed regulations expand the definition of "dividend equivalent" for purposes of section 871 by adding a third category of "substantially similar" payments, which treats as US source income payments made under certain futures contracts, forward contracts and options. The proposed regulations provide that a "dividend equivalent" is: (1) any substitute dividend made pursuant to a securities lending transaction, a sale-repurchase transaction "or a substantially similar transaction" that is contingent upon or determined by reference to the payment

²⁷ Prop. Reg. § 1.871-16(c)(7).

²⁸ Prop. Reg. § 1.871-16(f)(6).

of a US source dividend, (2) any payment made pursuant to a specified NPC that is contingent upon or determined by reference to the payment of a US source dividend, and (3) “any substantially similar payment” (as defined below).²⁹

A payment is not a dividend equivalent if it is determined by reference to an estimate of an expected (but not yet announced) dividend without reference to or adjustment for the amount of any actual dividend.³⁰ When determining the amount of a dividend equivalent payment, the payment includes any gross amount used in computing any net amount transferred to or from the taxpayer.³¹

Substantially similar payments include: (1) any payment of a beneficial owner’s tax liability with respect to a dividend equivalent made by a withholding agent in an amount determined under the gross-up formula in Prop. Reg. § 1.1441-3(f)(1), and (2) any payment (including the payment of the purchase price) made pursuant to an equity-linked instrument that is contingent upon or determined by reference to a US source dividend.³²

The proposed regulations define an “equity-linked instrument” as a financial instrument (or combination of financial instruments) that references one or more underlying securities to determine its value, including a futures contract, forward contract, option or other contractual arrangement.³³ An equity-linked instrument that provides for a substantially similar payment is treated as an NPC for purposes of section 871(m) and the proposed regulations thereunder. While not entirely clear, by treating such an equity-linked instrument as an NPC for purposes of the proposed regulations, this provision appears to cause an equity-linked instrument to be subject to the re-sourcing rule of section 871(m) only if it would have been described in one of the seven categories of specified NPCs had it been an NPC. The application of section 871(m) to equity-linked instruments raises significant substantive and administrative issues for market-makers in such instruments and other similar parties.

Look-Back Rule

The proposed regulations contain a special rule that applies when an NPC that was not a specified NPC upon its execution becomes a specified NPC during its term. Under this rule, if an NPC is not considered a specified NPC on the date the parties enter into the contract, but later becomes a specified NPC, any payment made during the term of the contract that is contingent upon or made by reference to a US source dividend is considered a dividend equivalent.³⁴ Nevertheless, because the proposed regulations apply only to payments made on or after January 1, 2013, the look-back rule will not cause pre-2013 payments to be re-characterized as US-source income (assuming they would not be so treated under the existing statutory regime), even if such rule causes an NPC to be treated as a specified NPC for periods prior to January 1, 2013.

²⁹ Prop. Reg. § 1.871-15(b)(1).

³⁰ Prop. Reg. § 1.871-15(b)(2).

³¹ Prop. Reg. § 1.871-15(c).

³² Prop. Reg. § 1.871-15(d).

³³ Prop. Reg. § 1.871-15(d)(2).

³⁴ Prop. Reg. § 1.871-16(d).

This rule further provides that when the NPC becomes a specified NPC during the term of the contract, any tax owed on dividend equivalent payments made before the NPC became a specified NPC must be paid when the next payment (including a termination payment) is made under the contract. When computing the amount of tax owed upon the next payment that occurs after the contract becomes a specified NPC, “the dividend equivalent equals the sum of all the dividend equivalents with respect to the NPC arising before the date the NPC became a specified NPC and the amount of any dividend equivalent arising upon the termination or payment.”³⁵

The look-back rule creates obvious practical difficulties for withholding agents, particularly because (as described below) such parties may be unaware that an NPC that was not a specified NPC when executed subsequently became a specified NPC.

Treatment of Related Parties

For purposes of determining whether an NPC is a specified NPC under the proposed regulations, a related person (within the meaning of sections 267(b) and 707(b)(1)) is treated as a party to the NPC.³⁶

Importantly, an NPC entered into between two related dealers is not a specified NPC if the NPC hedges risk associated with another NPC entered into with a third party.³⁷ This related dealer exception applies, however, only where the dealers entered into the NPCs in the ordinary course of their businesses as dealers in securities or commodities derivatives. Read literally, however, the related dealer exception appears not to provide relief where the related-party NPC hedges exposure on a derivative (such as a forward contract) that is not an NPC.

Withholding Agent Concerns

Withholding agents generally are liable for their failure to withhold on payments they make that are subject to US withholding tax. The regime set forth in the proposed regulations presents particular problems for withholding agents with respect to swap payments made to foreign persons because an NPC may be considered a specified NPC due to circumstances that the withholding agent does not know (or have reason to know) exist. These circumstances include (but are not limited to):

- The long party to the NPC sells the underlying security on the same day that the parties price the NPC or purchases the underlying security on the same day that the NPC terminates, but the short party is unaware that such sale or purchase occurred;
- The NPC’s actual term is at least 90 days, but the long party enters into an offsetting position with respect to the NPC within 90 days of its execution and the short party does not know that such offsetting position exists; and

³⁵ Prop. Reg. § 1.871-16(d)(2)(ii). The proposed regulations provide an example to demonstrate the mechanics of the look-back rule in Prop. Reg. § 1.871-16(d)(3).

³⁶ Prop. Reg. § 1.871-16(e)(1).

³⁷ Prop. Reg. § 1.871-16(e)(2).

- The notional principal amount of the NPC does not exceed the applicable trading volume limitation (*i.e.*, 20% of the 30-day average daily trading volume of the underlying security), even when taken together with other NPCs with the same short party, but the long party has engaged in other NPCs on the same underlying security with other short parties that cause the NPC to violate the trading volume limitation.

As a technical matter, it would appear that the withholding agent would have strict liability for its failure to withhold in each of these cases, notwithstanding that it might not know or have reason to know that withholding was required. The practical effect of this strict liability remains to be seen, but withholding agents could simply decide to treat all NPCs as specified NPCs, and withhold accordingly, in order to avoid the open-ended exposure that otherwise would arise (in which case the long party would be eligible for a refund of the withheld tax to the extent it can demonstrate that the NPC is not considered a specified NPC under any of the seven categories discussed above).

A recent statement by a Treasury Department official involved in the drafting of the proposed regulations, however, suggests that the government may believe that withholding agents will not be held liable for failing to withhold on a swap where they determine, to the best of their knowledge, that such swap is not a specified NPC.³⁸ In light of the serious nature of a failure to withhold and the potential chilling effect that strict liability for a failure to withhold in the case of a specified NPC would have on the swap market, we expect commentators on the proposed regulations to urge the IRS to clarify that withholding agents will not be held liable for failure to withhold where they do not have access to certain information that could cause an NPC to be treated as a specified NPC. Alternatively, the IRS could provide that a withholding agent will not be held liable for failure to withhold on a specified NPC where it receives certain representations from the payee that, if true, would allow the withholding agent to determine that the NPC was not a specified NPC.

Applicability of Judicial Doctrines to NPCs Other than Specified NPCs

The preamble makes clear that the proposed regulations do not supplant common law principles that might otherwise cause payments under an NPC to be subject to US withholding tax. In this regard, the preamble states that notwithstanding the proposed regulations, “the Commissioner may challenge transactions that are designed to avoid the application of these rules under applicable judicial doctrines. Nothing in these rules precludes the Commissioner 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.”³⁹

While it is at least theoretically possible, we think it is highly unlikely that an NPC that was not treated as a specified NPC under any of the seven categories enumerated in the proposed regulations would nevertheless provide the long

³⁸ Responding to concerns regarding the inability of withholding agents to know whether the long party is “in the market,” an attorney-advisor in the Treasury Department’s Office of International Tax Counsel stated: “When that is the case, we are not imposing on the withholding agent the requirement to know things that they can’t know. People are required to act to the best of their knowledge, not play detective. Just like withholding agents responsibilities generally.” Marie Sapirie and David D. Stewart, “Treasury Releases Dividend Equivalent Guidance,” *Tax Notes Today*, Jan. 20, 2012, at 2.

³⁹ Preamble at 9.

party with sufficient incidents of ownership that it would be considered the owner of the underlying security under common law principles.

Anti-Abuse Rule

Under the proposed regulations, if a taxpayer enters into a transaction or transactions with a principal purpose of avoiding the application of the proposed regulations, payments made under such transactions may be treated as dividend equivalents to the extent necessary to prevent the avoidance of the provisions.⁴⁰

Other Rules

1. *Treatment of Dividend Equivalents Under Tax Treaties*

The proposed regulations would treat dividend equivalents under section 871(m) as dividends for purposes of tax treaties.⁴¹ Accordingly, dividend equivalent payments would be subject to US withholding tax at the rate provided under the dividend article of an applicable tax treaty if the foreign person satisfies the requirements contained in that treaty (which could be advantageous or disadvantageous depending on the relevant treaty's "other income" article).

2. *Treatment of Dividend Equivalents Received by Foreign Governments*

The proposed regulations also clarify that dividend equivalents under section 871(m) received by foreign governments are considered income from investments in stocks for purposes of section 892.⁴² Unusually, the preamble provides that taxpayers may rely on this provision immediately notwithstanding that the regulation is in proposed form (though the only relevance of this interim reliance rule is in the case of dividend equivalents under the currently applicable definition).

⁴⁰ Prop. Reg. § 1.871-15(e).

⁴¹ Prop. Reg. § 1.894-1(c)(2).

⁴² Prop. Reg. § 1.892-3(a)(6).

Circular 230 Disclosure

Any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties and is not intended to be used or referred to in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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