

Current Federal Tax Developments

By William R. Pomierski and Menna Eltaki

Cross-Border Equity Swap Withholding: Impact of Proposed NPC Regulations and Other Developments

The final step in the phased-in implementation of Code Sec. 871(m) will occur on March 18, 2012, after which *dividend equivalent payments* made with respect to any notional principal contract that is contingent on or determined by reference to the payment of a dividend from sources within the United States will be considered U.S. source income.¹ Although Congress authorized regulations under Code Sec. 871(m) exempting notional principal contracts (NPCs) determined to be of a type that “do not have the potential for tax avoidance,” no such regulations have been issued or proposed as of late December, 2011.²

In a related development, on September 16, 2011, the IRS issued proposed regulations under Reg. §1.446-3 (the “Proposed NPC Regulations”).³ If adopted, the “deemed payment rule” set out in the Proposed NPC Regulations, which are described below, could significantly expand the definition of an NPC, and potentially subject an additional class of equity derivative transactions, namely bullet equity swaps, to the sourcing rules of Code Sec. 871(m).

This column summarizes the application of Code Sec. 871(m) in light of its full implementation on and after March 18, 2012. This column then discusses the Proposed NPC Regulations and the impact of the expanded definition of an NPC under Code Sec. 871(m), including a look at the potentially disparate treatment of bullet equity swaps and cash-settled forward contracts.

Dividend Equivalent Payments Under HIRE

In general, U.S. source dividends paid to a non-U.S. person are subject to a 30-percent withholding tax,



William R. Pomierski is a Partner in the international law firm of McDermott Will & Emery LLP, resident in the Chicago office. He is a former editor-in-chief of the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS.

Menna Eltaki is a member of McDermott's tax department resident in the New York office.

unless the rate is reduced by treaty.⁴ Dividends are considered U.S. source if paid with respect to the stock of a U.S. corporation.⁵ Except as otherwise provided under Code Sec. 871(m), as described below, dividend equivalent payments made pursuant to equity-based NPCs are generally sourced to the residence of the recipient, as long as the payments are not effectively connected with the recipient's conduct of a U.S. trade or business.⁶ As such, prior to the adoption of Code Sec. 871(m), a non-U.S. investor that entered into a notional principal contract relating to U.S. stock was generally eligible to receive dividend equivalent payments under the contract without such payments being subjected to the 30-percent U.S. withholding tax.⁷

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act ("HIRE") into law. HIRE added new Code Sec. 871(m) which provides that, for purposes of the U.S. withholding tax rules, a *dividend equivalent payment* will be treated as a payment of U.S. source income. In relevant part, a dividend equivalent payment is defined as a payment made pursuant to a *specified* NPC that (directly or indirectly) is contingent on, or determined by reference to, the payment of a dividend from sources within the United States.⁸

The application of Code Sec. 871(m) is being phased in. First, the rules did not apply at all prior to the six-month anniversary of the effective date of the HIRE Act (September 14, 2010). Second, after September 14, 2010, Code Sec. 871(m) applies only to dividend equivalent payments made with respect to *specified* NPCs, defined as NPCs falling within one of the following categories: (1) in connection with entering into such contract, any long party transfers the underlying security to any short party to the contract⁹; (2) 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; (3) the underlying security is not readily tradable on an established securities market; (4) 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 (5) such contract is identified by the Service as a specified NPC.¹⁰ As of the time this article was written in late December 2011, the IRS had not identified any additional contracts as specified NPCs under category (5), above.

For the final step in its implementation, Congress provided that Code Sec. 871(m) will apply to divi-

dent equivalent payments made after March 18, 2012, with respect to *any notional principal contract* unless the IRS determines that such contract is of a type which does not have the potential for tax avoidance.¹¹ Thus, absent future guidance establishing exemptions for certain NPCs, after March 18, 2012, dividend equivalent payments made with respect to *any* NPC will be considered U.S. source income under Code Sec. 871(m).

We note that the 2011-2012 Priority Guidance Plan includes a Code Sec. 871(m) regulations project.¹² It is unclear, however, whether this project will result in exceptions being established for certain NPCs, or will go in the other direction and expand the categories of equity-based derivative transactions that are subject to the sourcing regime of Code Sec. 871(m). In this regard, Code Sec. 871(m)(2)(C), authorizes regulations extending (as opposed to limiting) the application of this sourcing rule to "any other payments determined ... to be substantially similar to a [dividend equivalent] payment described in subparagraph (A) or (B) [of Code Sec. 871(m)(2)]." Accordingly, taxpayers that have entered into equity-based NPCs relating to U.S. equity securities on which dividend equivalent payments may be made after March 18, 2012, are cautioned to consider the impact of Code Sec. 871(m) on the particular transaction, including but not limited to tax gross-up and related implications under the terms of the transaction or under a related master agreement.¹³

Proposed NPC Regulations

As noted above, the Proposed NPC Regulations were released on September 15, 2011. Contrary to current Proposed Reg. §1.1234A-1(c),¹⁴ the Proposed NPC Regulations include a deemed payment rule that would, if adopted, significantly expand the definition of an NPC under Reg. §1.446-3. By potentially redefining what an NPC is, the Proposed Regulations will impact the definition of a dividend equivalent payment under Code Sec. 871(m).¹⁵

As described in detail in another article in the JOURNAL,¹⁶ the Proposed NPC Regulations would redefine an NPC "payment" to include an amount that is fixed during the term of a derivative contract even if the amount is paid or otherwise taken into account at a later date.¹⁷ By treating amounts that are fixed as "payments," such amounts would then count toward

the NPC classification requirement that one party to a contract must make at least two payments to the other during the term of the contract. The deemed payment rule could extend NPC classification to bullet equity swaps, which are not NPCs under the current version of Reg. §1.446-3, thus extending the reach of Code Sec. 871(m).

The Proposed NPC Regulations include two examples of the application of the deemed payment rule to bullet swaps. Example 1 involves a forward rate agreement between A and B that provides for a single payment at maturity equal to the product of (x) the notional amount of \$10 million multiplied by (y) the difference between a floating rate (three-month LIBOR) measured at maturity of the contract and a specified fixed rate (six percent). The Proposed NPC Regulations conclude that this contract is *not* an NPC because it provides for a single net payment between A and B at maturity, and the amount of the payment is determined by reference to changes in interest rates measured solely on the settlement date of the contract.

Example 2 involves a fairly typical total return equity swap (TRS), often referred to also as a bullet equity swap, that provides for a single payment at maturity. Under the terms of the TRS in Example 2, A (the long party) is entitled to receive a payment from B at maturity equal to the appreciation in the value of one million shares of XYZ stock, plus an amount equal to any dividends or other distributions that are *actually paid* on the reference shares during the term of the TRS. B (the short party) is entitled to receive a payment from A at maturity equal to any depreciation in value of the XYZ shares, plus an amount equal to the three-month LIBOR (compounded over the term of the contract) multiplied by the notional value of the shares. No payments are to be made in Example 2 prior to the maturity of the contract. All payments between A and B due at maturity are netted, resulting in a single net payment from one party to the other. Example 2 concludes that this TRS is an NPC under the Proposed Regulations as a result of the fixing of amounts (the amounts based on actual dividend payments on XYZ shares and the LIBOR-based cost of capital amounts) that are taken into account in determining the net settlement payment due at maturity.¹⁸

Based on Example 1, above, the Proposed NPC Regulations apparently will not apply to cash-settled forward contracts where no amounts payable by one party to the other (or taken into account for netting purposes) are fixed or computed during the term of the contract.¹⁹ For example, assume an investor enters into a cash-settled forward contract with a term to maturity of one year that relates to a specified number of shares of ABC corporation stock. Assume ABC stock is currently trading at \$50 per share, and that the terms of the forward contract provide that, at maturity, the settlement amount will be based solely on the appreciation or depreciation in the market value of a share of ABC measured at maturity relative to the forward price of \$55 per share (assuming for purposes of this simple illustration that the forward price incorporates estimated—as opposed to actual—dividends on ABC shares and an implicit (fixed) cost of capital over the term of the contract).²⁰ Based on Example 1 of the Proposed NPC Regulations, it appears that this contract would not be considered an NPC because no amounts are fixed or computed during the term of the contract and paid or otherwise taken into account at a later date. Accordingly, the contract would not be subjected to Code Sec. 871(m)'s sourcing rule unless the Service exercises its regulating authority under Code Sec. 871(m)(2)(C).

Finally, it should be noted that the Service has indicated the Proposed NPC Regulations are a component of a larger guidance project that is expected to include regulations addressing forward contracts.²¹ Proposed regulations addressing forward contracts have not yet been issued, however, and there is no indication as to whether or to what extent such regulations may address exceptions from or additions to the definition of a dividend equivalent payment for purposes of Code Sec. 871(m).²² Accordingly, any such future guidance will need to be carefully monitored to determine the impact, if any, on the application of Code Sec. 871(m) to notional principal contracts and other forms of derivatives relating to U.S. equity securities.

ENDNOTES

¹ Unless otherwise indicated, all references to "Code Sec." and "\$" are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury Regulations pro-

mulgated thereunder.

² See Code Sec. 871(m)(3)(B). It should be noted that there is a guidance project under Code Sec. 871(m) set out in the 2011-2012

Priority Guidance Plan, dated September 2, 2011. According to a representative of the Treasury Department, however, regulations under Code Sec. 871(m) could be released

by mid-January, 2012. See *Derivatives Withholding Rules 'Imminent,' Treasury Official Says*, 2011 TNT 243-6 (Dec. 19, 2011).

³ Notice of Proposed Rulemaking, 76 FR 57684 (Sept. 16, 2011).

⁴ Code Sec. 871(a)(1).

⁵ See Code Secs. 861(a)(2) and 862(a)(2).

⁶ Reg. §1.863-7(b)(1).

⁷ For a more detailed discussion of the history of the U.S. withholding tax treatment of equity-based notional principal contracts, see William R. Pomierski and Menna A. Eltaki, *Cross-Border Equity Swaps: 'Change in Tax Law' Implications*, J. TAX'N FIN'L PRODS., Vol. 8 No. 3 (2009) ("Change in Tax Law"); see also William R. Pomierski and Menna A. Eltaki, *Cross-Border Equity Swaps Revisited: Latest Developments Create New Round of Uncertainties*, J. TAX'N FIN'L PRODS., Vol. 8 No. 4 (2010).

⁸ The focus of this column is on the withholding tax implications for equity-based notional principal contracts. Accordingly, the implications of HIRE for substitute dividends made pursuant to securities lending and sale-repurchase (repo) agreements, which are also governed by Code Sec. 871(m), are not discussed.

⁹ For these purposes, a "long party" is defined as any party to the contract which is entitled to receive any payment which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to the underlying security, and the "short party" is defined simply as any party to a contract that is not a long party. See Code Secs. 871(m)(4)(A) and (B).

¹⁰ Code Sec. 871(m)(3)(A).

¹¹ Code Sec. 871(m)(3)(B).

¹² See *supra* note 2.

¹³ See Pomierski and Eltaki, *Change in Tax Law*, *supra* note 7.

¹⁴ See Proposed Reg. §1.1234A-1(c)(2004):
(c) Bullets swaps and forward contracts.

(1) Any gain or loss arising from the settlement of obligations under a bullet swap or forward contract (including a payment pursuant to the terms of the obligations) is treated as gain or loss from a termination of the bullet swap or forward contract.

(2) *Definition of bullet swap.* A bullet swap is a financial instrument that is not an excluded contract as defined in

§1.446-3(c)(1)(ii), that provides for the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount, and that provides for settlement of all the parties' obligations at or close to maturity of the contract.

(Emphasis added.)

¹⁵ The Proposed Regulations would make conforming amendments to current Reg. §1.863-7 by defining a notional principal contract therein by cross-reference to Reg. §1.446-3(c).

¹⁶ Dale S. Collinson and Liz Dyor, *IRS Issues Proposed Regulations Implementing the Swap Exclusion from Code Sec. 1256 and Broadening the Definition of a Notional Principal Contract*, J. TAX'N FIN'L PRODS., Vol. 10, No. 1 (2012).

¹⁷ Proposed Reg. §1.446-3(c)(1)(ii).

¹⁸ See Proposed Reg. §1.446-3(c)(6), Example 2, subparagraph (ii) ("Because both legs of this contract provide for payments that become fixed during the term of the contract (the dividend payments and the LIBOR-based payments), each leg of the contract is treated as providing for more than one payment. In addition, since the indices referenced in the contract are specified indices described in paragraph (c)(2)(i) of this section, and the 1 million shares of XYZ common stock are a notional principal amount described in paragraph (c)(3) of this section, the contract is a notional principal contract defined in § 1.446-3(c)(1)(i).")

¹⁹ See *Proposed Derivatives Regulations Shouldn't Change Position on Bullet Swaps*, 2011 TNT 210-2 (Oct. 31, 2011):

Larson responded that the factor differentiating forward contracts from NPCs is whether the final price is known at the outset of the contract. "There is no better way to differentiate" the two types of contracts, he argued.

Hence, under the proposed regulations, a contract calling for accrued interest at LIBOR would be an NPC, while a similar contract calling for a fixed rate of interest could be a forward contract, because the final price is known when the contract is made. "If you don't know when you start out today what the price is that you

will pay in two years" -- because it may be tied to LIBOR and LIBOR is changing -- "then it would fall under these rules," he said. "Forward contracts under that regime would have to be contracts in which final price is known."

See also *Proposed Derivatives Regs Only First Piece of Guidance Framework*, 2011 TNT 222-1 (Nov. 17, 2011) ("Asked why single-payment credit default swaps were not considered to fall within the NPC definition, Walli said the traditional rules associated with options and forward contracts limited the government's ability to change course. 'We don't feel as though we have free license to go in and declare anything to be anything,' he said. For example, because options contracts have been subject to over 50 years' worth of past rules, the government can't 'by administrative fiat' declare them to be something else, he said."), and *Proposed Derivatives Regulations Defended*, 2011 TNT 220-2 (Nov. 15, 2011) ("Forward contracts are still excluded from the NPC definition. Some practitioners like to think of swaps as a series of little forward contracts and wanted regulations to accommodate that treatment. Walli was not empathetic. 'If you want to write a series of forward contracts, then do that,' he said. 'A forward contract is 1.446-3(c)(1)(iii), traditionally understood as an executory contract with pricing fixed on day one. You can't go changing the rules.'")

²⁰ This example is for simple illustrative purposes only and does not reflect the exact manner in which pricing of a similar contract would be determined.

²¹ See *Proposed Derivatives Regs Only First Piece of Guidance Framework*, *supra* note 19 ("Speaking at a District of Columbia Bar Taxation Section program sponsored by the bar's Financial Products Committee, Karl Walli, senior counsel (financial products) in Treasury's Office of Tax Legislative Counsel, noted the interwoven nature of the rules governing financial products and said the proposed regs are only one piece "of an elaborate jigsaw puzzle." He added that guidance on the timing rules for swaps could come by the end of the current guidance plan year.")

²² See *Derivatives Withholding Rules 'Imminent,' Treasury Official Says*, *supra* note 2.

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