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Preventing End Runs around the Dividend Withholding Regime: Treasury's Revised Regulations under Section 871(m) and the New Delta Test

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Highlight

Until recently, foreign persons could enter into transactions that were economically similar to investment in U.S. stocks or securities but avoid the U.S. withholding tax that would have been owed on any payment of dividends or interest had such persons actually acquired U.S. stock or securities. Section 871(m) removed this loophole by requiring withholding tax to be paid on any notional principal contract (NPC) or similar transaction. After receiving comments on a proposed seven-factor test to determine whether a contract or transaction fell within the ambit of Section 871(m), the IRS and Treasury issued new proposed regulations that instead adopt an objective "delta" test. Under these proposed regulations, if the delta test is satisfied, then the specified NPC or transaction falls within Section 871(m)'s ambit and is subject to withholding. This article describes the new proposed regulations and provides examples of how the test would be applied

Text

Generally, payments of dividends are sourced based on the payor's residence, while payments on swaps are sourced based on the recipient's residence.¹ This created a disparity: Dividends paid to foreign persons were subject to a U.S. withholding tax² while dividend-equivalent payments made pursuant to a swap might not be. The potential benefits to foreign recipients (and costs to the U.S. fisc) from this disparity are illustrated in the examples provided in Exhibits 1 and 2. As detailed in the exhibits, two foreign persons ("David" and "Angela") who, economically, are both in the same place before taxes, might find themselves in very different after-tax positions--in our examples one (Angela) received \$ 100, while the other (David) ended up with only \$ 70.

Angela, a foreign person, enters into a total return swap with Joe, a U.S. person. Joe, as the long party,³ agrees to pay any appreciation plus any dividends paid on 10 shares of Acme Corp. stock during the term of the agreement while Angela, as the short party, agrees to pay any depreciation on those same 10 shares. Acme Corp. is a U.S. corporation. During the term of the swap, Acme Corp. pays a dividend of \$ 10 per share. Pursuant to the agreement, Joe pays Angela \$ 100; this payment is sourced to Angela's residence and not subject to any U.S. withholding tax.

[SEE Exhibit 1: Total Return Swap IN ORIGINAL]

¹ IRC § 861(a)(2); Treas. Reg. § 1.863-7(b)(1).

² With a possible reduction pursuant to an income tax treaty.

³ For purposes of Section 871(m), (1) the long party means any party entitled to receive any payment contingent upon or determined by reference to the payment of a dividend from U.S. sources with respect to an underlying security, (2) the short party means any party other than the long party, and (3) the underlying security is any security with respect to which the dividend is paid. For this purpose, any index or fixed basket of securities is treated as a single security. IRC § 871(m)(4).

[SEE Exhibit 2: Stock Ownership IN ORIGINAL]

By contrast, David, a foreign person acquires 10 shares of Acme Corp. While he owns the stock, Acme pays a dividend of \$ 10 a share. This dividend is U.S.-source income and subject to a 30 percent U.S. withholding tax. Shortly, thereafter, David sells the stock for no gain or loss.

SECTION 871(m)

Congress felt this disparity in tax treatment (and perhaps the lost revenue) was improper. In response, it enacted Section 871(m),⁴ which treats a dividend-equivalent payment as a dividend for certain purposes, including withholding.⁵

In particular, Section 871(m) treats a dividend-equivalent payment as a dividend from sources within the United States for purposes of Sections 871(a), 881, 4948(a), and Chapters 3 and 4 of the Code. A dividend equivalent payment is:

- . Any substitute dividend made pursuant to a securities lending or 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 (NPC) 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 that the Secretary determines is "substantially similar" to a specified notional principal contract or substitute dividend payment.⁶

For payments made after March 18, 2012, a specified NPC is any NPC unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance.⁷ A payment is any gross amount used in computing any net amount transferred to or from the taxpayer.⁸

THE 2012 PROPOSED REGULATIONS

In 2012, the IRS issued proposed regulations (the "2012 Proposed Regulations") defining specified NPCs, substantially similar payments, and other rules. Under these 2012 Proposed Regulations, a dividend-equivalent includes any gross amount used to compute any net amount transferred to or from the taxpayer, even if the net amount transferred was zero.⁹

A specified notional principal contract was a contract that satisfied one of the following seven factors:

1. The long party is in the market on the same day the parties priced or terminated the notional principal contract;
2. The underlying security is not regularly traded on a qualified exchange;
3. The short party posts the underlying security as collateral and the underlying security represents more than 10 percent of the collateral posted by the short party;

⁴ Unless otherwise indicated, all references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the IRC or "Code"), and references to regulations refer to the Treasury Regulations promulgated thereunder.

⁵ Section 871(m) was enacted as part of the Hiring Incentives to Restore Employment Act, P.L. 111-147, 124 Stat. 71 (2010), which is commonly referred to as the HIRE Act. The Foreign Account Tax Compliance Act, or FATCA, was also enacted as part of the HIRE Act. While FATCA is focused on preventing U.S. persons from avoiding U.S. taxes, Section 871 (m) is focused on preventing foreign persons from avoiding U.S. taxes.

⁶ IRC § 871(m)(2).

⁷ IRC § 871(m)(3)(B). For payments made on or after September 14, 2010, and on or before March 18, 2012, a specified NPC is any NPC if (1) the long party transferred the underlying security to the short party in connection with entering into the NPC, (2) the short party transferred the underlying security to the long party in connection with the termination of the NPC, (3) the underlying security is not readily tradable on an established securities market, (4) the short party posted the underlying security as collateral with the long party, or (5) the NPC is identified by the Secretary as a specified NPC. IRC § 871(m)(3)(A).

⁸ IRC § 871(m)(5).

⁹ 2012 Prop. Reg. § 1.871-15(c).

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4. The actual term of the NPC is less than 90 days;
5. The long party controls the short party's hedge;
6. The notional principal amount is greater than 5 percent of the total public float of the underlying security or greater than 20 percent of the 30-day daily average trading volume; or
7. The NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.¹⁰

A payment was substantially similar to a substitute dividend if the payment was any gross-up amount paid by a short party in anticipation of the long party's tax liability with respect to a dividend-equivalent or any payment made pursuant to an equity linked instrument that was calculated by reference to a dividend from sources with the U.S. and the equity linked instrument met one of the seven requirements to be a specified NPC.¹¹

Among other things, commentators felt, and the IRS agreed, that this seven-factor test would be difficult to administer, would not accurately identify tax avoidance transactions, and the definition of equity linked instrument was overly broad.¹² Accordingly, on December 5, 2013, Treasury and the IRS withdrew the 2012 Proposed Regulations and recently issued new proposed regulations (the "2013 Proposed Regulations").¹³

THE 2013 PROPOSED REGULATIONS

Under the 2013 Proposed Regulations, a securities lending, sale-repurchase transaction, specified NPC, or specified equity linked instrument (ELI) may be subject to Section 871(m).

The Delta-Based Standard. These regulations replace the previously proposed seven-factor test to determine whether an instrument is a specified NPC or a specified ELI with a new delta-based standard.¹⁴ This delta-based standard compares the change in fair market value of the contract to the change in the fair market value of the property referenced by that contract.¹⁵ When measuring, multiple contracts referencing the same underlying security entered into by the same taxpayer (or a related party) and in connection with each other are combined and treated as a single contract.¹⁶ However, for all other purposes of Section 871(m), including to determine the amount of the dividend-equivalent payment, such contracts are treated separately unless the withholding agent knows the contracts were entered into in connection with each other.¹⁷

A specified NPC or specified ELI is any NPC or ELI that has a delta of 0.70 or greater at the time the long party acquires the NPC or ELI.¹⁸ However, an NPC or ELI is deemed to have a constant delta of 1.0 if the delta is not expected to vary

¹⁰ 2012 Prop. Reg. § 1.871-16.

¹¹ 2012 Prop. Reg. § 1.871-15(d).

¹² Preamble to 2013 Proposed Regulations; 2012 Prop. Reg. § 1.871-16.

¹³ REG-120282-10.

¹⁴ The 2013 Proposed Regulations provide exceptions to this definition for two types of transactions that have little potential for tax avoidance. The first exception is for when a qualified dealer enters into a transaction as a long party in its capacity as a dealer. A qualified dealer is any dealer in securities within the meaning of Section 475 that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized. The second exception is for when a taxpayer enters into a transaction as part of a plan where one or more persons (including the taxpayer) are obligated to acquire 50 percent or more of the entity issuing the underlying security.

¹⁵ 2013 Prop. Reg. § 1.871-15(g).

¹⁶ 2013 Prop. Reg. § 1.871-15(1).

¹⁷ 2013 Prop. Reg. § 1.871-15(1)(5).

¹⁸ 2013 Prop. Reg. § 1.871-15(d)(2), (e).

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during the term of the transaction.¹⁹ This is to prevent taxpayers from artificially reducing delta. For this purpose, the delta may be determined using any commercially reasonable method.²⁰

Delta Calculation Examples. The following two examples illustrate how delta is calculated when changes in fair market value are expected.

Example 1: An NPC requires the long party to pay the short party an amount equal to all of the depreciation in value of 100 shares of X stock plus an interest-based return. In return, the short party is required to pay the long party an amount equal to all of the appreciation in the value of 100 shares of X stock plus any dividends paid on such stock. The value of the NPC will change by \$ 1 for each \$ 0.01 change in price of a share of X stock. Therefore, the notional principal contract has a delta of 1.0--i.e., $\$ 1.00 / (\$ 0.01 \times 100)$.²¹

Example 2: The long party acquires a call option that references 100 shares of X stock. At the time the long party acquires the call option, its value is expected to change by \$ 0.30 for a \$ 0.01 change in the price of X stock. Therefore, the call option has a delta of 0.3--i.e., $\$ 0.30 / (\$ 0.01 \times 100)$.²²

As noted earlier, the general delta calculation is ignored when a constant delta is expected, as shown in Example 3.

Example 3: The long party acquires an NPC that entitles it to receive 50 percent of the appreciation and dividends on 100 shares of X stock in return for an obligation to pay the short party 50 percent of the depreciation on 100 shares of X stock and an interest-based return. The value of the NPC is expected to change by \$ 0.50 for each \$ 0.01 change in the price of a share of X stock. Therefore, this NPC has a delta of 0.5 ($\$ 0.50 / (\$ 0.01 \times 100)$). However, the delta is not expected to vary during the term of the transaction. Therefore, one forgoes the usual calculation; the NPC has a constant delta and is treated as having a delta equal to 1.0 on 50 shares of X stock.²³

Determining the Dividend-Equivalent Amount. The 2013 Proposed Regulations provide that a dividend equivalent is any amount that references the payment of a U.S. source dividend or is calculated based on an actual or estimated dividend.²⁴ As a result, an NPC that provides for a payment based on the appreciation but not payments based on any regular dividends is still treated as a dividend-equivalent payment because the anticipated dividends are presumed to have been taken into account in determining the other terms of the NPC, including the price.²⁵

The method used to calculate the dividend-equivalent amount depends on the type of contract and whether the contract includes a reasonable estimate of future dividends. For security lending or a sale-repurchase contract, the dividend-equivalent amount is equal to the actual per share dividend amounts paid on the underlying security multiplied by the number of shares transferred.²⁶ For a specified NPC or specified ELI, the dividend-equivalent amount equals the per share dividend amount with respect to the underlying security multiplied by the number of shares of the underlying security referenced in the contract (subject to adjustments) multiplied by the delta of the transaction with respect to the underlying security at the time that the amount of the dividend equivalent is determined.²⁷ The delta used to calculate the dividend-equivalent amount may

¹⁹ 2013 Prop. Reg. § 1.871-15(g)(2).

²⁰ 2013 Prop. Reg. § 1.871-15(g)(1).

²¹ 2013 Prop. Reg. § 1.871-15(g)(3) Ex. 1.

²² 2013 Prop. Reg. § 1.871-15(g)(3) Ex. 2.

²³ 2013 Prop. Reg. § 1.871-15(g)(3) Ex. 3.

²⁴ 2013 Prop. Reg. § 1.871-15(h).

²⁵ 2013 Prop. Reg. § 1.871-15(h)(2).

²⁶ 2013 Prop. Reg. § 1.871-15(i)(1)(i).

²⁷ 2013 Prop. Reg. § 1.871-15(i)(1)(ii).

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differ from the delta used to determine whether a transaction is subject to Section 871(m).²⁸ Examples 4 and 5 illustrate how the dividend-equivalent amount is calculated.

Example 4: When stock in Acme Inc. is trading at \$ 50 a share, a foreign investor enters into a forward contract to purchase 100 shares of Acme stock in a year. The transaction documents include reasonable estimates of the dividends to be paid on Acme stock during that period and the price is determined by (1) multiplying the number of shares referenced in the contract by the current price of the shares and an interest rate but then (2) subtracting out the future value of dividends expected to be paid on the Acme stock during the contract term. Assume the interest rate in the contract is 4 percent and Acme is expected to pay dividends with a future value of \$ 1 per share. The purchase price set in the forward contract in this case will be \$ 5,100--i.e., 100 shares x \$ 50 per share x 1.04 - (\$ 1 x 100). Accordingly, the estimated dividend amount in the contract is considered a dividend equivalent.²⁹

Example 5: A foreign investor enters into a contract that entitles her to receive payments based on the appreciation in the value of 100 shares of Acme stock and pay an amount based on LIBOR plus any depreciation in the value of Acme stock. The contract does not explicitly entitle her to payments based on dividends paid on Acme stock. However, the LIBOR rate in the contract is reduced to reflect expected annual dividends. Because the LIBOR rate is reduced to reflect estimated dividends but the estimated dividend amount is not specified, the foreign investor is treated as receiving the actual dividend amount and these actual per share dividend amounts are dividend equivalents.³⁰

Effective Date. The 2013 Proposed Regulations generally will apply to payments made on or after the date the final regulations are published. However, the definition of a specified NPC will apply to payments made pursuant to a specified NPC on or after January 1, 2016, and the definition of specified ELI will apply to payments made on or after January 1, 2016, on an ELI that was issued on or after 90 days after the date of publication of the final regulations.³¹

CONCLUSION

The delta-based standard of the 2013 Proposed Regulations uses an objective test to determine whether an NPC or ELI will be subject to Section 871(m). This should provide greater certainty for financial institutions and should be easier to apply than the seven-factor standard of the 2012 Proposed Regulations. While some have criticized the delta-based standard as being unfriendly to taxpayers, its simplicity and certainty have their own benefits.

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²⁸ 2013 Prop. Reg. § 1.871-15(i)(1)(ii)(C).

²⁹ 2013 Prop. Reg. § 1.871-15(h)(4) Ex. 1.

³⁰ 2013 Prop. Reg. § 1.871-15(h)(4) Ex. 2.

³¹ [Notice 2014-14](#).