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Final and new proposed dividend equivalent regulations issued under Section 871(m)

Contacts

Paul Epstein
pepstein@deloitte.com

Jeffrey O'Donnell
jodonnell@deloitte.com

Dustin Coscarart
dcoscarart@deloitte.com

Craig Gibian
cgibian@deloitte.com

On December 5, 2013, the U.S. Treasury and the Internal Revenue Service ("IRS") released final and new proposed regulations under section 871(m).[1] These new regulations replace temporary and proposed regulations issued on January 19, 2012. The highlights of the new regulations are:

- *Final regulations* - The existing temporary regulations are continued as final regulations for two years and sunset for all payments on or after January 1, 2016. These rules continue the statutory four-factor individual tests of Temp. Reg. §1.871-16T(b) adopted in the 2012 temporary regulations to determine specified notional principal contract ("specified NPC") status and U.S. source dividend treatment. For payments on or after January 1, 2016, the four statutory conditions for determining specified NPC status are permanently withdrawn. The final regulations are retroactive to the January 23, 2012 effective date of the temporary regulations they replace. Certain coordinating withholding provisions have been finalized.

- *New proposed specified NPC regulations* under Section 871(m) – For payments made on or after January 1, 2016, new proposed regulations are intended to replace the final regulations. The new proposed regulations replace the January 19, 2012 proposed seven-factor tests for determining specified NPC status with an objective delta measurement that is tested as of the NPC acquisition date. All NPCs with a delta of 0.70 or higher are treated as NPCs. All plain-vanilla total return equity NPCs that reference actively traded stocks (i.e. delta 1.0 instruments) are essentially treated as specified NPCs without regard to how the NPC was entered into, collateralized or terminated.

- *New proposed specified equity linked instrument regulations* - The same 0.70 delta measurement test applies to all equity linked instruments ("ELI") that are not NPCs as of the ELI acquisition date. ELIs include forwards, options, futures, convertible debt and debt that references underlying U.S.

[1] TD 9648, 78 *Fed. Reg.* 73079 (12/5/2013); REG-120282-10, 78 *Fed. Reg.* 73083 (12/5/2013).

equities. The rule that permitted equity linked instruments to escape dividend equivalent treatment when the dividends were estimated and not adjustable into the price of the contract is withdrawn and no longer available. The rules are applicable to payments made on or after January 1, 2016 with respect to ELIs acquired on or after March 5, 2016. The proposed regulations treat a dividend equivalent as a U.S. source dividend for purposes of sections 871(a), 881, 892, 894 and 4948(a).[2]

- *New proposed portfolio interest regulations under Section 871(h)* - New portfolio interest proposed regulations provide that contingent interest that is a dividend equivalent under Internal Revenue Code ("IRC" or "Code") section 871(m) does not qualify as portfolio interest.[3] Accordingly, contingent interest determined by reference to the appreciation or dividends of actively traded stocks is not portfolio interest to the extent such interest is treated as a dividend equivalent under the section 871(m) regulations.[4].The portfolio interest disqualification applies to all such interest payments made on or after the date the regulations are published as final rules in the Federal Register. Accordingly, such portfolio interest disqualification could predate the January 1, 2016 date applicable to specified NPC payments if the regulations are finalized sooner than that date.

Enacted in 2010 as part of the HIRE Act,[5] section 871(m) treats defined "dividend equivalents" on specified NPCs") as U.S. source dividends for the purpose of imposing U.S. gross basis tax on foreign persons under sections 871(a), 881 and 4948(a).[6] Thus, foreign taxpayers and their applicable withholding agents cannot rely on Treas. Reg. §1.863-7 to claim foreign source non-effectively connected income ("ECI") exemption from the tax on the dividend equivalents paid and received on specified NPCs. Moreover, sections 871(m)(3)(A)(v) and (B) provide the Secretary of the Treasury discretion, particularly in the case of payments made after March 18, 2012, to identify any NPC as a "specified NPC". Section 871(m)(5) treats a gross dividend amount that is used in computing any net amount transferred to or from the taxpayer as a "payment" for this purpose. Under section 871(m)(2)(A), a "dividend equivalent" includes substitute dividend payments made pursuant to a securities lending or a sale repurchase transaction which is already subject to and defined by final regulations issued in 1997.[7] Additional guidance was needed, however, to clarify dividend equivalent treatment for payments made with respect to specified NPCs or payments determined to be substantially similar to specified NPC payments. For a two-year period following enactment, Section 871(m)(3)(A)

[2] Prop. Reg. §1.871-15(b).
[3] Prop. Reg. §1.871-14(h).
[4] Section 871(h)(4)(C)(v)(I) provides exception to the disqualification of portfolio interest treatment with respect to non-U.S. real property interests that are actively traded under section 1092(d) criteria. However, section 871(h)(4)(A)(ii) grants the Secretary authority to identify by regulation contingent interest "where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of Federal income tax."
[5] See Section 541 of the Hiring Incentives to Restore Employment Act (HIRE Act), Public Law 111-147,124 Stat. 71 (3/18/2010).
[6] The term "gross basis tax" is used here to refer to the U.S. tax, if any, that is imposed on the income of a nonresident alien individual, a foreign corporation or a foreign organization that is a private foundation, by sections 871(a), 881, 1441 through 1464 or 4948(a) of the Code The tax is imposed at the rate of 30% of the gross amount, unless the rate is reduced by treaty or the income is exempted by internal law (e.g. section 892 for foreign governments) Where a treaty applies, it may reduce the rate on portfolio dividends to as low as 10%.
[7] Treas. Regs. §1.871-2(b)(2) and §1.881-2(b)(2).

provided four statutory factors for defining a specified NPC. By its terms, section 871(m) treated any NPC as a specified NPC through March 18, 2012,[8] if:

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

ii. In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;

iii. The underlying security is not readily tradable on an established securities market; or

iv. 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.[9]

Prior Temporary and Proposed Regulations

On January 19, 2012, prior to the statutory March 18, 2012 sunset date of the four-factor definition, Treasury and the IRS released temporary and proposed regulations under Code section 871(m) to address the definition of specified NPCs and substantially similar payments with respect to equity linked instruments.[10] The four factors were essentially adopted in temporary regulations and made effective as of January 23, 2012. The proposed regulations, issued on the same date, introduced more expansive definitions of specified NPCs, dividend equivalents and substantially similar payments and were to take effect when adopted as final rules. The January 2012 proposed regulations received great public criticism, particularly with respect to seven factors provided for the definition of a specified NPC. The controversy over the 2012 rules resulted in a one-year delay from their planned January 1, 2013 effective date to January 1, 2014, with a coinciding extension of the temporary regulations' adoption of the four statutory factors for the same period.[11] With the extended period about to expire, Treasury and the IRS have replaced the January 2012 temporary and proposed regulations with final and new proposed regulations. For a discussion of the 2012 Temporary and Proposed regulations, see United States Tax Alert dated February 13, 2012 ("Temporary and Proposed Dividend Equivalent Regulations Issued under Section 871(m)").

Final regulations and new proposed regulations issued December 5, 2013

The final regulations generally adopt without change the 2012 temporary regulations that incorporated the statutory four-factor definition of a specified NPC under section 871(m)(3)(A and extend the four-factor definition to payments made with respect to such contracts before January 1, 2016. The final regulations would sunset the definition of a specified NPC for payments made on or after January 1, 2016 (the date the new proposed regulations are intended to be effective as new final

[8] Under section 871(m)(3)(B), after March 18, 2012, any NPC would be treated as a specified NPCs unless the Secretary determined that such contract was of a type which did not have the potential for tax avoidance . Section 871(m)(3)(B).
[9] Section 871(m)(3)(A). Treas. Reg. § 1.871-15(d).
[10] TD 9572, 77 *Fed. Reg.* 3108 (Jan. 23, 2012); REG-120282-10, 77 *Fed. Reg.* 3202 (Jan. 23, 2012).
[11] These provisions were extended through December 31, 2013 by Announcement 2012-35, 2012-38 IRB 356 (August 23, 2012).

regulations). The final regulations issued December 5, 2013 adopt the January 2012 temporary regulations with minimal change and finalize without change three of the 2012 proposed provisions that coordinate the section 871(m) treatment with sections 892, 894 and 1441.[12]

- *Sections 892 and 894*. The final regulations adopt the provisions of the 2012 proposed regulations that coordinate the dividend equivalent payments treatment for purposes of sections 892 and 894. The amendment to the 892 regulations provides that, for purposes of determining the investment income of a foreign government eligible for section 892, dividend equivalents are treated as "income from investments in stocks."[13] The amendment to the 894 regulations generally adapts treaty entitlements to reduced rates of dividend taxation to dividend equivalent amounts derived by a foreign person described in section 871(m) and the regulations thereunder.[14]

- *Section 1441 withholding coordination*. Generally consistent with the 2012 temporary regulations, the final regulations also amend certain section 1441 provisions to require withholding on amounts owed with respect to a dividend equivalent amount, and reinstate the examples related to the definition of a withholding agent that were accidentally deleted by the 2012 temporary regulations.[15] Temporary regulation §1.1441-3T(i), which penalized a withholding agent for relying on a distributing corporation's estimates to determine the amount of a dividend equivalent, was withdrawn and not adopted in the final regulations.

In summary, the final regulations do not provide significant new guidance. In particular, the final rules do not address the meaning of "any other payment" that the Secretary may determine to be substantially similar to a payment made pursuant to a stock loan, sale-repurchase agreement or a specified NPC. The preamble to the final regulations states, however, that the IRS will continue to scrutinize payments with respect to contracts not expressly covered by the regulations under the substance over form doctrine, for economic substance under section 7701(o), under the step transaction doctrine and also under general tax ownership principles.

New proposed regulations

After a significant comment period the U.S. Treasury and the IRS have determined to withdraw the original proposed regulations. The new proposed regulations[16] withdraw the January 12, 2012 proposed regulations (with the exception of three provisions that coordinate section 871(m) with sections 892, 894 and 1441) and replace them with new rules defining, among other things, the term “specified

[12] Treas. Reg. §1.871-15(d).
[13] Treas. Reg. §1.892-3(a)(6).
[14] Treas. Reg. §1.894-1(c)(2).
[15] Treas. Reg. §1.1441-6(h).
[16] Prop. Reg. §1.871-15.

notional principal contract."

Below are the highlights of Treasury's and the IRS's new approach to regulating specified NPCs, equity linked instruments and dividend equivalent amounts:

- *Objective delta measurement test* - The new rules adopt an objective measurement of a derivative's delta risk to determine whether a contract is subject to tax under section 871(m). The delta is measured by the ratio of change in the fair market value of the contract to the change in the fair market value of the property referenced in the contract. The delta calculation must be determined in a commercially reasonable manner (e.g. in a manner that is used for non-tax business purposes).

    - Specified NPC - Defined as any NPC that has a delta of 0.70 or greater at the time the long party acquires the transaction - effective for payments made after January 1, 2016.

    - Specified ELI - Defined as any ELI that has a delta of 0.70 or greater at the time the long party acquires the transaction - effective for payments made after January 1, 2016 (but only for instruments acquired on or after March 5, 2014).

    - Specified treatment for constant expected delta - If a delta is not reasonably expected to vary during the contract term it has a constant delta, treated as 1.0 (which results in specified status).

- *Single standard for NPCs and other equity derivatives* – There will be a single standard for delta measurement for both specified NPCs and ELIs that will depend only on a single objective measurement at the time the contract is acquired.

- *Withdrawal of seven-factor test* - The seven-factor approach of the 2012 proposed regulations is not a suitable framework for evaluating whether an NPC "is of a type which does not have the potential for tax avoidance" and is permanently withdrawn with the remainder of the 2012 proposed regulations.

- *Equity linked instruments* - An ELI is defined as a financial transaction (other than a securities lending or sale-repurchase transaction or an NPC) that references the value of one or more underlying securities, including forwards, futures and option contracts, debt instruments convertible into underlying securities and debt instruments with payments linked to underlying securities.

- *Contingent Interest coordination* - Under new proposed regulation §1.871-14(h), contingent interest that is treated as a dividend equivalent under the proposed regulations does not qualify as portfolio interest. This would appear to disqualify contingent interest that is determined by reference to actively traded stocks and is otherwise qualified under section 871(h) when the contingent debt fails the 0.70 delta test limit on its acquisition date.

- *Underlying security* - Under this new definition, an underlying security is any interest in an entity taxable as a corporation for Federal tax purposes if a payment with respect to that interest may give rise to a U.S. source dividend. If a transaction references interests in multiple entities (including an index that is not a qualified index) or different interests in the same entity, each referenced interest is treated as a separate underlying security. A qualified index is treated as a single security that is not an underlying security.
    - Non-C Corporations and greater than 10% partnership interests - For a transaction that references an entity other than a C corporation (e.g. a partnership), the transaction is treated as referencing the allocable portion of an underlying security (or potential section 871(m) transactions) held directly or indirectly by the referenced entity, unless the securities (and the underlying securities referenced by any potential section 871(m) transactions) held directly or indirectly by the entity, in the aggregate, represent 10% or less of the value of the referenced interest in the entity at the time the long party acquires the transaction.
- *Qualified indices* - A qualified index is an index that:
    i. References 25 or more underlying securities that are only long positions;
    ii. Contains no underlying security that represents more than 10% of the index's weighting;
    iii. Is modified or rebalanced based only on predefined objective rules at set dates or intervals;
    iv. Does not provide for a high dividend yield; and.
    v. Is referenced by futures or options that trade on a national securities exchange or domestic board of trade.

Withholding responsibility - If a broker or dealer is a party to the transaction, the broker or dealer must determine whether withholding is required under section 871(m). If a broker or dealer is not a party to the transaction or both parties are brokers or dealers, then the short party must determine whether the contract is subject to withholding under section 871(m).

The chart below sets forth the various final and proposed regulations issued on December 5, 2013, their effective dates, and the regulations they replace:

2013 Final Regulations			
New Final Provision	**Old Provision**	**Description**	**Applicable Date**
Treas. Reg. §1.871-15(d)	Treas. Reg. §1.871-16T(b)	Definition of "Specified NPC"	January 23, 2012 (sunsets December 31, 2015)
Treas. Reg. §1.881-2(b)(3)	Treas. Reg. §1.871-16T(b)	Imposition of gross basis taxation of dividend equivalent amounts under section 871(m)	January 23, 2012
Treas. Reg. §1.892-3(a)(6)	Prop. Reg. §1.892-3(a)(6).	Modification of definition of income of foreign governments	December 5, 2013
Treas. Reg. §1.894-1(c)(2)	Prop. Reg. §1.894-1(c)(2)	Application of tax treaty rates for dividends to dividend equivalent amounts	December 5, 2013
Treas. Reg. §1.1441-2(b)(6) and 1.1441-3(h)	Treas. Reg. §1.1441-2T(a)(6), 1.1441-2T(e)(7) and 1.1441-3T(h)(1)	Amounts subject to withholding include the gross amount used in computing a net amount transferred in a transaction described in section 871(m)	January 23, 2012
Treas. Reg. §1.1441-6(h)	Prop. Reg. §1.1441-6(h)	Application of tax treaty rates for dividends to dividend equivalent amounts to withholding	December 5, 2013
Treas. Reg. §1.1441-7(a)(2)	Treas. Reg. §1.1441-7T	Definition of withholding agent as a person or party to a contract that provides for the payment of a dividend equivalent amount treated as having custody and control of such payment	January 23, 2012
2013 Proposed Regulations			
New Proposed Provision	**Proposed Superseded Provision**	**Description**	**Applicable Date**
Prop. Reg. §1.871-15(d)	Treas. Reg. §1.871-15(d) – removal of four-factor test in Dec. 5, 2013 final regulations; application of §871(m)(3)(A)(v) and (B)	Specified NPCs- Application of proposed regulations to the definition of specified NPCs	Payments made on or after January 1, 2016 with respect to specified NPCs
Prop. Reg. §1.871-15(e)	N/A - Supplemental provision pursuant to §871(m)(2)(C) ("other payment determined by the Secretary to be substantially similar to a payment pursuant to…§871(m)(2)(B)") (a specified NPC)	Specified ELIs - Application of proposed regulations to specified equity linked instruments	Payments made on or after January 1, 2016 with respect to ELIs acquired on or after March 5, 2014
Prop Reg. §1.871-14(h)	N/A – adopted under §871(h) and 871(m) authority	Contingent interest coordination with dividend equivalent amounts	Payments made on or after the date the regulation is published as final in the Federal Register