In *Et Tu Babe*, Mark Leyner's forward-looking hyperactive take on 1990s popular culture, the author created a complex and absurdist multi-dimensional view of each situation in which he placed his characters and, frequently, himself. To quote Mr. Leyner directly, "Imagine Chaim Potok collaborating with Amy Tan and Iceberg Slim."¹ The Internal Revenue Service (the “IRS”) has just issued new regulations that completely overhaul the U.S. withholding tax regime for dividend equivalents paid or accrued on derivatives. These new regulations create a level of complexity comparable to that of any *fin de siecle* novel. Certainly, Mr. Leyner would appreciate how the IRS intends the landscape to shift with these rules. This article describes the new Temporary and Proposed Regulations and their effect on certain popular capital markets products.

The IRS divided the new guidance into three sets of rules. First, a set of rules is
provided for payments on swaps made or credited on or after January 23, 2012 and before January 1, 2013. These rules generally follow the rules that have been in effect since 2010. Second, a set of new rules for dividend equivalents are proposed to be effective after final regulations are published. Third, rules are proposed to expand the categories of swaps affected by the dividend equivalent withholding rules (referred to as “specified notional principal contracts” or “specified NPCs”) beginning in 2013. The IRS has scheduled a hearing on April 27, 2012 on the latter two set rules.

I. The Briefest of Backgrounds

In 1991, the IRS promulgated a regulation providing that income from a swap (a notional principal contract or NPC in tax parlance) is sourced to the residence of the payee. This rule created the potential for a discontinuity with respect to equity swaps and total return swaps, on one hand, and actual stock ownership, on the other. Specifically, if a non-U.S. person held a stock directly, unless an income tax treaty provided for a total exemption from U.S. federal income tax, any dividends paid on a U.S. stock would be treated as U.S.-source income and subject to either 15% (most tax treaties) or 30% U.S. federal income tax withholding. In contrast, a dividend equivalent payment made to a non-U.S. person under a swap in respect of a dividend paid on a U.S. stock included in the specified index would be treated as non-U.S.-source income and not be subject to U.S. federal income tax withholding. Congress became dissatisfied with these results. The IRS perceived that banks and non-U.S. taxpayers abused this disparity through a variety of transactions and initiated an audit campaign to curtail these perceived abuses.

In March 2010, Congress addressed the perceived abuse through the passage of the HIRE Act. Specifically, Section 541 of the HIRE Act enacted Code § 871(m). Code § 871(m)(1) provides that a dividend equivalent “shall be treated as a dividend from sources within the United States.” For the period from the effective date of the HIRE Act through March 18, 2012, dividend equivalents paid or credited on certain swaps and in securities lending transactions could be subject to withholding. Accordingly, Code § 871(m) reverses the rule contained in the 1989 Treasury Regulation for dividend equivalents on certain swaps. As a result, on swaps covered under Code § 871(m) are generally subject to the same U.S., federal income tax withholding that an actual dividend would be subject to. Indeed, the very first Temporary Regulation released with the new regulation package amends the 1991 regulation to specifically state that it no longer applies to dividend equivalents.

II. Rules for Payments Made on Swaps Before January 1, 2013

The Temporary Regulations provide two sets of rules. First, they provide that the four categories of statute-specified swaps that can give rise to dividend equivalents remain the sole types of equity derivative transactions (apart from securities loans) that can give rise to U.S.-source dividend equivalents. Second, rules are provided for
withholding when a dividend equivalent is embedded in another payment.

A. The Existing Categories of Transactions That Can Give Rise to U.S.-Source Dividend Equivalents Remain Unchanged for Payments Before January 1, 2013

In Code § 871(m)(3)(B), Congress provided the IRS with the right to revise the statutory rules for the withholding of U.S. federal income tax on derivatives referencing U.S. stocks for payments made after March 18, 2012. The applicable tax rules also provide the IRS with the right to extend the withholding rules for dividend equivalents from swaps to financial contracts other than swaps. The legislative history accompanying the enactment of the statute provided, “under this rule, for example, the [IRS] may conclude that payments made under certain forward contracts . . . that reference stock of U.S. corporation are dividend equivalents.” In the new regulation package, the IRS chose not to exercise grants of authority for payments made prior to January 1, 2013.

Specifically, in new Temporary Regulation § 1.871-16T(b), the IRS spells out that only four types of swap transactions can give rise to dividend equivalents when paid or credited to the account of a non-U.S. person prior to January 1, 2013:

1. The non-U.S. person, in connection with entering into the swap, transfers the underlying security to the short party;
2. The short party, in connection with closing or terminating the swap, transfers the underlying security to the non-U.S. person;
3. The underlying security is not readily tradable on an established securities exchange; or
4. In connection with the opening of the swap, the short party posted the underlying security to the non-U.S. person.

These four transactions, known as “specified notional principal contracts” (or “specified NPCs”), dovetail with the four Congressional-specified transactions that give rise to dividend equivalents subject to withholding when paid or credited to a non-U.S. person for periods prior to March 18, 2012.

B. Withholding Rules for Embedded Dividend Equivalents

Code § 871(m)(5) provides that the word “payment” as used in Code § 871(m) includes any gross amount used to compute any net amount payable to or by a taxpayer. This rule ensures that a dividend equivalent subsumed in another payment retains its character as a U.S.-source income item, potentially subject to withholding. For example, assume that in a single stock equity swap over a U.S. Stock, the bank counterparty (“ShortCo”) has an obligation to make dividend equivalents payments to a non-U.S. person (“LongCo”). LongCo has an obligation to make funding payments to ShortCo. The funding payments equal the product of the value of the stock included in the specified index and an objective interest rate index. On a payment date, ShortCo’s obligation to make a dividend equivalent payment to LongCo is $500
and LongCo’s obligation to make a funding payment to ShortCo is also $500. As a result, no money passes hands between the counterparties. On these facts, even though the net payment was zero, ShortCo is considered to have made a $500 dividend equivalent payment to LongCo.

While it facially appears that ShortCo would not possess any funds received in respect of the equity swap with which to pay the U.S. federal income tax that is due on the crediting of the dividend equivalent to LongCo, this is unlikely to be the case in the majority of transactions. If ShortCo has hedged its position under the equity swap by acquiring shares of the stock referenced in the specified index, ShortCo would be able to use a portion of the cash dividend received on the hedge, that is, the actual stock, to pay over the withholding tax.

While not directly relevant to the discussion of the new rules, it is worth noting that the IRS has not provided relief from so-called cascading withholding taxes in this typical transaction. For example, if ShortCo were a non-U.S. person not acting through a United States trade or business, the issuer of the stock would have withheld U.S. income taxes when the actual dividend were paid to ShortCo. ShortCo would have an obligation to withhold taxes again when ShortCo made or credited the dividend equivalent to LongCo. There is no rule that would permit ShortCo to credit the tax that was withheld against it in computing the tax that it must withhold against LongCo. The Preamble to the Temporary Regulations states that future regulations may provide relief from these cascading withholding taxes.  

The Temporary Regulations do, however, elegantly impose the requirement on withholding agents to remit U.S. federal income tax on dividend equivalents paid or credited to a non-U.S. person pursuant to a specified notional principal contract. If the portion of a corporate distribution that is taxable as a dividend is uncertain, the short party may use the issuer’s estimate of the taxable portion of the distribution, but remains absolutely liable for remitting the correct amount of withheld taxes, interest and penalties. If the non-U.S. person’s U.S. federal income tax liability is not fully satisfied by withholding, the Temporary Regulations impose an obligation on the part of the non-U.S. person to file a return and pay the tax.

No guidance is offered on the payments of a dividend equivalent paid on a swap that is not a specified notional principal contract when the equivalent is paid, but becomes so thereafter. Such a rule would be very relevant to a swap that becomes a specified notional principal contract because there is a cross-out at the termination of the swap. Such rules were proposed for post-2012 payments.

III. The Proposed Regulations Affecting Dividend Equivalents Paid or Credited on Derivatives

At the outset of the discussion of the proposed changes to the definition of dividend equivalents and the categories of specified notional principal contracts, it is important to note that these rules are not just proposed to apply to transactions entered into after the proposed regulations become effective or in 2013 and thereafter, respectively. These rules are proposed to apply to transactions entered
into prior to such times, but which carry-over to these latter periods. In the case of
the changes to the dividend equivalent rules in particular, this could cause some
degree of havoc because so many outstanding financial products could be affected.
In addition, regulated investment companies (“RICs”) and exchange traded notes
(“ETNs”) tied to the performance of indices in which dividends are reinvested could
incur significant withholding tax responsibilities that could harm U.S. investors
because of the fact that the managers could be required to pay the U.S. withholding
tax from the entity itself.

A. Extension of Dividend Equivalent Status to Put-Call
Combos, Futures and Other Derivatives

The IRS has proposed to exercise its authority to expand the types of payments
treated as dividend equivalents to “substantially identical payments.” There are
two proposed categories of substantially identical payments. First, if the payer of a
dividend equivalent grosses up the payment to the non-U.S. person to account for
any U.S. dividend withholding tax, the gross-up payment itself is treated as a
dividend equivalent. Second, and likely more importantly, amounts paid on
“equity-linked instruments” that are contingent upon or determined by reference to a
dividend on a U.S. stock are proposed to be treated as dividend equivalents. An
equity linked instrument is a financial instrument or combination of financial
instruments that references one or more U.S. stocks. The Proposed Regulation
specifically includes futures, forward contracts and other contractual
arrangements. Although the rule potentially sweeps in virtually any conceivable
contract providing equity-linked returns, the IRS has added an anti-abuse rule to
capture transactions that provide an exposure to U.S. dividends but are not
encompassed by the definition of an equity-linked instrument.

It seems fairly clear that put-call combos could be encompassed by the new rule. In a
put-call combo, the non-bank counterparty purchases a call option on a U.S. stock. It
simultaneously sells a put option, with the same strike price, to the bank that sold it
the call option. The two options differ in certain respects so that the two options
should not be combined to create a synthetic forward contract. In both cases,
however, the strike price of the option is adjusted downwards for any dividends paid
on the underlying stock prior to the exercise of one or the other option. Under the
Proposed Regulation, it is likely that the adjustment to the put-call strike price
would be considered the payment of a dividend equivalent.

It is not entirely clear whether amounts paid or credited on equity-linked
instruments in respect of dividends paid or credited on the reference U.S. stock are
treated as per se dividend equivalents, as is the case with substitute dividend
payments paid in securities lending transactions, or whether such amounts are
treated as dividend equivalents only if the equity-linked instrument has features
that would cause it, if it were a swap, to be a specified NPC. The structure of the
Proposed Regulation seems to support the former interpretation.

The anti-abuse rule could have a chilling effect on the ability of non-U.S. persons to
enter into dividend swaps. A dividend swap is an “over-under” bet on the amount of a
dividend paid on a stock. Although the economic wager by the parties is only the
difference between an expected dividend and an actual dividend, it is possible that
the payment of an amount to a non-U.S. counterparty could be treated as the
payment of the full dividend with attendant withholding taxes imposed.

B. Single Stock Futures, Options and Self-Tenders

The Proposed Regulations provide an exception to amounts that otherwise would be
treated as dividend equivalents for “any payment . . . contingent upon or determined
by reference to an estimated of expected dividends [if] the estimate of an expected
dividend is not adjusted in any way for the amount of an actual dividend.”\(^{29}\) An
expected dividend is an unannounced dividend. A dividend announcement occurs on
the date on which the corporation announces or agrees to the payment of the
dividend.\(^{30}\)

The OneChicago Exchange (“OneChicago”) offers, \textit{inter alia}, two types of single stock
futures contracts: the “1-D” or NoDivRisk product and the “1-C” product. In both
products, the holder of the futures contract pays an amount equal to the current
stock price plus an interest factor minus the amount of anticipated dividends. In
return, at the termination of the future contract, the reference stock is delivered to
contract holder. If the amount of the anticipated ordinary dividends differs from the
actual ordinary dividends, the 1-D “trues up” the payment provided for in the futures
contract. The 1-C product does not provide for any adjustment. Both products true-up
the price for unanticipated extraordinary dividends.

The expected dividend rule should allow non-U.S. persons who enter into 1-C single
stock futures prior to the dividend announcement date to receive the economic
benefit of the embedded ordinary dividend without U.S. federal income tax
withholding. While this rule is beneficial, it is difficult to see how it will be
administered. Withholding agents will be required to determine whether the non-
U.S. person entered into the contract prior to the dividend announcement date.
Accordingly, there could be withholding on only a portion of identical futures
contracts expiring on the same date. It is not clear whether any futures clearing
agent would have sufficient systems capabilities to withhold based upon when the
futures contract was opened and in such a doubt, the agents may decide to withhold
on all contracts.

Many option contracts provide for an adjustment to the strike price for extraordinary
dividends and, in other cases, dividends that differ from historic dividends. It is
unclear as to whether withholding will be required in all cases in which the strike
price changes because of such event. For example, assume that a non-U.S. person
purchases a call option with a $100 strike price on USCo stock when USCo stock is
trading at $100. USCo stock falls to $50. After the trading price of USCo stock falls to
$50, USCo declares an extraordinary dividend of $7 and, as a result, the strike price
of the option is decreased to $93. The proposed rule could be interpreted as
requiring the option writer to withhold and remit tax on the $7 extraordinary
dividend even though it is difficult to see that the reduction in the strike price
economically passed the benefit of the extraordinary dividend to the non-U.S. holder
of the call option.

When a public company undertakes an open-market self-tender, the company does
not have an ability to determine whether persons who participate in the self-tender will be treated as receiving a dividend or should be treated as having sold a portion of their stock positions.\textsuperscript{31} The Proposed Regulations defining dividend equivalents specifically include amounts referencing redemption proceeds treated as dividends paid in self-tenders as dividend equivalents.\textsuperscript{32} The potential for dividend taxation of the entire amount paid in a self-tender likely would act as deterrent for dealers to write swaps over stocks the issuer of which is engaging in a self-tender.

IV. The Seven Deadly Sins: Swaps Proposed To Be Treated as Specified NPCs Beginning in 2013\textsuperscript{33}

The Proposed Regulations would increase the number of types of swap transactions treated as specified notional principal contracts from four to seven, beginning in 2013. In addition to expanding the number of types of swap transactions treated as specified NPCs, the proposed regulations would substantially change the existing four categories.

The Proposed Regulations contain a look-back rule that could be particular vexing to withholding agents. If a swap is not a specified NPC on the date that it is entered into, if it subsequently becomes a specified NPC, for example, because of early termination or the non-U.S. long party enters into additional swaps that cause its exposure to a particular underlying stock to exceed certain specified thresholds, dividend equivalents paid or credited to the account of the non-U.S. long party made before the swap became a specified NPC are retroactively treated as dividend equivalents and are subjected U.S. federal income tax withholding.\textsuperscript{34} When a swap becomes a specified NPC, the short party is required to withhold on the earlier of the next swap payment or termination date, even if the short party is not making a payment from which it could obtain the money to withhold.\textsuperscript{35}

The Proposed Regulations specifically provide that dividend equivalents paid or credited to the account of a non-U.S. party eligible for the benefits of an income tax treaty are subject to the withholding tax rate applicable to dividends under the treaty.\textsuperscript{36}

A. The Long Party Is In the Market

As described above, currently a specified NPC includes a swap in which there is a cross-in, that is, the long party transfers the underlying stock to the short party.\textsuperscript{37} Under the proposed regulations, a swap would be treated as a specified NPC if the long party sells (to anyone) the underlying security on the same date that a swap is priced.\textsuperscript{38} There is a \textit{de minimis} exception if the amount of stock sold by the long party is less than 10\% of the number of shares referenced in the swap.\textsuperscript{39} In order to prevent taxpayers from relying on an overly literal reading of this rule, a companion regulation specifies that if a long party sells stock on a date other than the date that the swap is priced, if the price references the price used in the swap, it is considered to have been sold on the date that the swap is opened.\textsuperscript{40}
A mirror rule replaces the category of specified NPCs if there is a cross-out. Specifically, the proposed regulations would treat a swap as a specified NPC if a non-U.S. long party is in the market buying the referenced stock on the date that the swap is terminated.\(^4\)\(^1\)

In both cases, if an affiliate of the non-U.S. long party is in the market selling (on the pricing of a swap) or buying (on the closing of a swap), the market activity of the affiliate is taken into account in determining whether the swap is a specified NPC.\(^4\)\(^2\)

If this proposed regulation is adopted in its current form, it is likely to have the effect of preventing non-U.S. financial institutions from becoming long parties under equity swaps unless the financial institution is acting from a United States permanent establishment. Large financial institutions are unlikely to have an ability to monitor whether one business unit is acquiring or selling a particular stock at the same time that another business unit is terminating or pricing a swap or other derivative on the same stock. Thus, it is unlikely that a non-U.S. financial institution could represent to its short counterparty that neither it nor any of its affiliates is in the market at the appropriate times, leaving the short counterparty with little choice but to withhold.

On the other side of this rule, a dealer could find itself under an obligation to withhold if its counterparty is in the market, but the dealer had no knowledge of such fact. While this could be problematic, Mr. Jesse Eggert, an attorney advisor in the Treasury office of Chief Counsel has stated that:

>[The IRS] is 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 to play detective. Just like withholding agents responsibilities generally.\(^4\)\(^3\)

**B. Thinly-Traded Stocks**

Code § 871(m)(3)(A)(iii) provides that a swap referencing a U.S. stock that is not readily tradable on established securities market is a specified NPC. Proposed Treasury Regulation § 1.871-16(c)(2) would change the parameters of this rule and treat a swap with reference index that includes a stock that is not “readily tradable” as a specified NPC. For this purpose, a stock would be considered to be readily tradable only if on at least 15 of the trading days during the 30 period prior to swap pricing date at least 10% of the 30-day average daily trading volume (“ADTV”) was traded on a qualified exchange.\(^4\)\(^4\) A qualified exchange means a national securities exchange that is registered with the Securities and Exchange Commission (the “SEC”) or the national market system established under section 11A of the Securities Exchange Act of 1934.

**C. Underlying Stock Is Posted as Collateral by the Short Party**

This form of specified NPC is proposed to be changed slightly from the rule contained in Code § 871(m)(3)(A)(iv). Specifically, the short counterparty may post 10% or less (by value) of the underlying stock as collateral with the long party
without causing the swap to become a specified NPC. The proposed regulation also differs from the statutory rule in that the posting of the underlying stock at any time by the short party will cause the swap to become a specified NPC whereas the statute only would cause a swap to be treated as a specified NPC if the underlying stock is posted as collateral at the opening of the swap.

**D. Swaps with Durations of Less Than 90 Days**

The proposed regulations would treat a swap with a duration of less than 90 days as a specified NPC. In performing the day count, the day the swap is opened is not counted, but the day on which the swap is terminated or closed is counted. In what will surely be an incredibly complex rule to administer, if the non-U.S. long party enters into an offsetting position, the swap will be considered to have been terminated on the day that such offsetting position is opened. It appears that there is an incorrect cross-reference in the proposed regulations, but it looks like the phrase “offsetting position” picks up a standard from the dividend received deduction holding period rules that tests whether “changes in the fair market value of the [swap] and the positions are reasonably expected to vary inversely.”

This offsetting position rule is likely to pose the same challenges to non-U.S. financial institutions that the proposed regulation regarding the short party being in the market is likely to pose. Specifically, it is unlikely that a non-U.S. financial institution that has a long position under a swap with a duration of 90 days or more would know if another division or an affiliate has entered into an offsetting position with respect to the long stock position. Accordingly, this could force non-U.S. financial institutions to cease to enter to swap transactions referencing U.S. stocks from branches located outside of the United States.

**E. Control Over the Short Party’s Hedges (Direct Market Access)**

If the non-U.S. long party can control how the short party hedges its position under a swap with U.S. stocks in the specified index, contractually, by contract or through an “underlying equity control program,” the swap will be treated as a specified NPC. An underlying equity control program includes an electronic trading platform that allows the long party to instruct the short party on the acquisition of a hedge. In example provided detailing when an electronic trading platform will be treated as an underlying equity control program, a non-U.S. person can enter a swap trade directly on the books of a dealer. The dealer’s computer system first searches the internal holdings of the dealer to determine if the dealer has a position that can hedge its obligations under the swap. If the computer system does not find a hedge internally, the computer acquires the underlying stock in a market transaction. The example concludes that because the computer, and not the non-U.S. long counterparty, has determined how to hedge the dealer’s short position under the swap, the non-U.S. long party to the swap acquired electronically does not control the dealer’s hedge.

**F. Swaps Over a Significant Percentage of the Public Float**
If a swap references more than 5% of the total public float of a particular stock or more than 20% of the 30-day ADTV (determined as of the close of the business day immediately preceding the opening of the swap), the swap is proposed to be treated as a specified NPC.\textsuperscript{52} Unfortunately for the dealer community, in determining whether a swap exceeds this threshold, the non-U.S. person must aggregate all of the swaps referencing the same underlying security, even if the swaps are not entered into with the same dealer.\textsuperscript{53} A dealer is unlikely to have knowledge as to whether the non-U.S. counterparty or its affiliates have entered into other swaps, that when aggregated with the swap entered into with that dealer, would cause these thresholds to be broken.

**G. The Swap Provides for a Special Dividend**

The seventh category treats swaps entered into after the announcement of a special dividend as a specified NPC.\textsuperscript{54}

**V. The Use of Stock Indices as Underlying Securities**

Code § 871(m)4)(C) provides that “any index or fixed basket of securities shall be treated as a single security." Notwithstanding this statutory rule, Proposed Treasury Regulation § 1.871-16(f)(1) would provide a contrary rule for a customized index. Under this contrary rule, “each security or component of [a] customized index is treated as an underlying security in a separate NPC.” A customized index is a narrow-based index or any index if futures contracts or option contracts do not trade on a qualified board or exchange.\textsuperscript{55} A narrow based index includes any index that meets one of four tests:

1. The index has nine or fewer components;

2. A single component of the index comprises more than 30% of the index’s weighting;

3. The five highest weighted components in the aggregate are more than 60% of the index’s weighting; or

4. The lowest weighted components comprising, in the aggregate, 25% of the index’s weighting have an aggregated dollar value of ADTV of less than $50 million. This test has other features and exceptions.

Presumably, the fact that narrow-based indices are not treated as single stocks mean that broad-based indices are treated as single stocks. It would be helpful, however, if the Proposed Regulations contained an explicit statement to this effect.

\textsuperscript{1}Mark Leyner, Et Tu Babe, p. 107. For readers not familiar with these pre-millennial celebrities, please substitute Paul Krugman (Nobel Prize winner and New York Time economic pundit), Amy Chua (Battle Hymn of the Tiger Mother) and Jay Z.
All references to non-U.S. persons who are subject to the withholding rules of Section 871(m) of the Internal Revenue Code of 1986, as amended (the “Code”) are to non-U.S. persons who did not enter into the swap or other transaction in connection with the conduct of a trade or business.

The phrase “dividend equivalent” as used in this article has the meaning assigned to such term in Code § 871(m)(2).


Mechanically, the proposed regulation operates by treating an equity-linked instrument as a swap for purposes of the tax and withholding rules. See Prop. Treas. Reg. § 1.871-15(d)(2)(ii).

A discussion of the rules relating to the taxation of redemptions is beyond the scope of this article. Please see Code § 302 for a list of the types of redemption transactions treated a sale or exchange.
The author thanks Robert Shapiro, the United States Tax Director at Societe Generale, for this clever designation of the proposed expanded categories of specified notional principal contracts. 


Prop. Treas. Reg. § 1.1441-6(h).


Prop. Treas. Reg. § 1.871-16(c)(1).


Sapire and Stewart, Treasury Releases Securities Lending Guidance, Tax Notes (January 20, 2012). It would very nice to have this thought in a more substantial form than a quote from a conference.


Prop. Treas. Reg. § 1.871-16(c)(3).


Id.

Id. The Proposed Regulation references Treasury Regulation § 1.246-5(b)(3). It is likely that the IRS meant to cross-reference Treasury Regulation § 1.246-5(b)(2).

Prop. Treas. Reg. § 1.871-16(c)(5).


Prop. Treas. Reg. § 1.871-16(c)(7).