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New Rules for U.S. Withholding on Dividend-Equivalent Payments

Newly issued temporary and proposed regulations indicate when U.S. withholding tax will be required in the case of "dividend-equivalent payments" made to non-U.S. persons under swap contracts on U.S. equities.

Under the HIRE Act, dividend-equivalent payments (that is, payments that are contingent upon or determined by reference to dividends paid on a U.S. equity) made after September 14, 2010, and before March 19, 2012, are subject to U.S. withholding tax only if the swap involves any of the following (and is therefore a "specified swap"):

- In connection with entering into the swap, the long party (defined as the party entitled to receive any dividend-equivalent payment under the swap) transfers the underlying security to the short party.
- Upon termination of the swap, the short party transfers the underlying security to the long party.
- The underlying security is not readily tradable on an established securities market.
- The short party posts the underlying security as collateral with the long party.

The regulations provide that dividend-equivalent payments made before January 1, 2013, are not subject to U.S. withholding tax unless the swap is a specified swap as defined above. For dividend-equivalent payments made to non-U.S. persons under equity swaps on U.S. equities after December 31, 2012, the definition of a "specified swap" (dividend-equivalent payments under which will be subject to U.S. withholding tax) is proposed to be expanded to include an equity swap that involves any of the following:

- The long party (i) sells the underlying U.S. equity on the date the swap is priced; (ii) purchases the U.S. equity on the date the swap is terminated; or (iii) purchases or sells the U.S. equity at a price that was fixed so as to be the same as the price used to price or terminate the swap, in each case unless the amount of U.S. equities purchased or sold is less than 10% of the notional amount of the swap contract.
- The underlying security is not regularly traded (i.e., is not traded on at least 15 trading days during the 30 trading days prior to the pricing of the swap) on a qualified exchange, which is an exchange regulated by the SEC or under the Securities Exchange Act.
- The short party posts collateral and the underlying U.S. equity represents more than 10% of the aggregate value of the posted collateral on any day that the swap is outstanding.
- The swap has a term of less than 90 days.

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- The long party controls (contractually, through an electronic system or otherwise) the short party's hedge of the short position.
- The notional principal amount of the U.S. equity being swapped is greater than either (x) 5% of the total public float of the U.S. equity (or the applicable class of the U.S. equity), or (y) 20% of the 30-day average daily trading volume (determined as of the close of the business day immediately preceding the first day of the swap term).
- The swap is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

If a swap is not a specified swap on the date it is entered into but later becomes one, withholding would be required as if the swap had been a specified swap since inception.

The proposed regulations also would broaden the withholding rules and make them applicable to dividend-equivalent payments made under any equity derivative instrument (including futures contracts, forward contracts, options or other contractual arrangements). However, if the applicable instrument (including an equity swap) provides for payments determined by "estimates" of expected (but not yet announced) future dividend payments without adjustment for dividends actually paid, such payments would not be treated as dividend-equivalent payments under the proposed regulations.

For equity swaps and other financial instruments covered by these rules, withholding would apply to the gross amount of each dividend-equivalent payment rather than to the net payments actually made under the swap. Accordingly, under the proposed regulations U.S. withholding tax could be due for a given year that exceeds the actual net payment made to the non-U.S. person for that year under the swap. The normal 30% withholding rate would be subject to reduction under an applicable income tax treaty (and provided that the non-U.S. person provides all required documentation, e.g., an IRS Form W-8BEN). A tax gross-up for withholding tax due on a dividend-equivalent payment would itself be treated as a dividend-equivalent payment that is subject to withholding tax.

The proposed regulations would treat a basket swap (referencing multiple securities) as separate swaps on each component of the basket. An index-based swap would not be treated as separate swaps on the index components as long as the index is not a narrow-based index (as defined for purposes of the 60/40 mark-to-market rules of Internal Revenue Code (IRC) section 1256) and futures or options on the index trade on a qualified board or exchange (also as defined under section 1256).

To prevent abuse, each related person (as defined under IRC sections 267(b) and 707(b)) would be treated as a party to the swap. However, an exception to this rule would allow dealers in securities or commodities derivatives to enter into back-to-back swaps with each other for the purpose of hedging other swaps entered into with their customers in the ordinary course of their business as a dealer.