International Tax ADVISORY ■

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Treasury Issues New Final and Proposed Regulations on Dividend Equivalent Transactions

On December 4, 2013, the U.S. Treasury issued final and proposed regulations under Section 871(m) of the Code. The final rules extend the current definition of "notional principal contracts" (NPCs) to payments made before January 1, 2016, while the proposed regulations introduce rules that may modify the scope and application of Section 871(m)'s resourcing rule for "dividend equivalent" payments. In general, these new regulations are a positive development in this complex area, offering the financial services sector and affected investors some present certainty and additional time to digest the new proposals.

Background

Regulations under Section 863 provide that income from an NPC is sourced to the residence of the recipient. An NPC is a financial instrument providing for payments calculated by reference to a specified index on a notional principal amount in exchange for specific consideration or a promise to pay similar amounts (e.g., interest rate and equity swaps). Non-U.S. investors would enter these contracts, which paid them "dividend equivalent" amounts instead of holding the securities directly, to avoid U.S. tax. Section 871(m), added by the 2010 HIRE Act and effective for payments made after September 14, 2010, re-sources "dividend equivalent" payments as U.S. source income. A dividend equivalent includes a payment that is directly or indirectly contingent upon or determined by reference to payment of a U.S. source dividend and made pursuant to a securities lending transaction, sale-repurchase transaction or a "specified NPC," as well as "substantially similar" payments.

Under Section 871(m)(3)(A), an NPC is a specified NPC if (i) in entering the contract, any long party transfers the underlying security to any short party ("cross in"); (ii) in terminating the contract, any short party transfers the underlying security to any long party ("cross out"); (iii) the underlying security is not readily tradable on an established securities market; or (iv) in entering the contract, the underlying security is posted as collateral by any short party with any long party. For payments made after March 18, 2012, Section 871(m)(3)(B) states

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that all NPCs are specified NPCs unless the IRS determines the contract is a type that does not have the potential for tax avoidance.

Treasury previously issued, in January 2012 (and amended in September 2012), temporary and proposed regulations under Section 871(m). The 2012 temporary regulations, as amended, provided that Section 871(m)(3)(A)'s definition of specified NPC applied for payments made after March 18, 2012, and before January 1, 2014. The 2012 proposed regulations, to apply to payments on or after January 1, 2014, offered a seven-factor test to identify specified NPCs and addressed Section 1441 withholding issues for dividend equivalent payments.

2013 Final and Proposed Regulations

The final regulations essentially adopt, with little modification, the definition of specified NPC of the 2012 temporary regulations—i.e., the statutory definition in Section 871(m)(3)(A)—and extend its application to payments made before January 1, 2016.

The 2013 proposed regulations introduce several important changes. First, the new proposed regulations add to the definition of "dividend equivalent" any payments made pursuant to a "specified equity-linked instrument" ("specified ELI") that references a U.S. source dividend. An ELI is defined in the new proposed rules as any financial transaction (other than a securities lending or sale-repurchase or NPC) that references the value of one or more underlying securities. Second, the 2013 proposed rules do away with the formerly proposed seven-factor test, instead espousing a "delta test" to determine whether an NPC or ELI is specified. Delta is the ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of the referenced property. With respect to payments made on or after January 1, 2016, an NPC or ELI with a delta of 0.70 or greater at the time the long party acquires the transaction is a specified NPC or specified ELI. The rules also offer guidance for transactions referencing multiple securities and aggregating certain long positions for Section 871(m) purposes.

Other significant aspects of the 2013 proposed regulations include rules identifying the payment and computing the amount of a dividend equivalent and providing two exceptions to Section 871(m) for transactions where (1) a qualified dealer under Section 475 is the long party in its capacity as dealer or (2) a taxpayer enters a transaction as part of a plan to acquire 50 percent or more of the entity issuing the underlying securities. Anti-abuse provisions in the 2013 proposed regulations would allow the IRS to treat any payment as a dividend equivalent if a taxpayer acquires a transaction with the principal purpose of avoiding these rules and to challenge avoidance transactions using any and all statutory rules or judicial doctrines. Finally, the new proposed regulations also address reporting and withholding issues for potential Section 871(m) transactions.

Transfer Pricing Principles May Apply to Disregarded Transactions for Foreign Tax Credit Purposes

In Chief Counsel Advice 201349015 (CCA), released December 6, 2013, the IRS advised on the proper reporting of U.S. taxable income and the proper standard for determining the "compulsory amount" of creditable foreign taxes imposed on transactions between a U.S. corporation and its foreign disregarded entity (DRE) or branch.

A foreign DRE is generally treated as a foreign branch, and the income of a foreign DRE or branch is included in the taxable income of its owner as if they were a single person. As such, transactions between a foreign DRE or branch and its owner are typically ignored for tax purposes. The "arm's length standard" under Section 482 allows the IRS to allocate income, deductions, credits and allowances among commonly controlled (but separate) taxpayers to prevent tax evasion and clearly reflect income. The arm's length standard does not seem particularly meaningful for transactions between foreign DREs or branches and their owners that are non-events for tax purposes.

Although generally ignored for U.S tax purposes, transactions between a foreign DRE or branch and its owner can impact foreign taxes. In particular, the IRS' concern is that non-arm's length pricing may result in "too much income" being reported in the foreign country and thus an "overpayment" of foreign taxes. Consequently, the CCA opines that the arm's length standard may be relevant to determining whether non-arm's length transfer prices in transactions between a foreign DRE or branch and its owner result in noncompulsory foreign taxes that are ineligible for the U.S. foreign tax credit.

Under Section 1.901-2(e)(5) of the regulations, foreign taxes are not considered paid—and thus are not creditable under Section 901—if they exceed the liability under foreign tax law (the "noncompulsory rule"). Further, under the noncompulsory rule and Section 901 regulations, a taxpayer must substantiate that its or its foreign DRE's foreign tax return was prepared based on a reasonable interpretation of the substantive and procedural foreign tax law (including applicable tax treaties) and exhaust all effective and practical remedies to reduce and minimize its foreign tax liability.

Essentially, this CCA is a warning to U.S. corporations with foreign DREs or branches. Just because transactions between a foreign DRE or branch and its owner (or between a foreign DRE or branch and an affiliate of its owner) may be ignored (or produce offsetting amounts) for many U.S. tax purposes, taxpayers should not interpret this general treatment as a free pass to disregard arm's length principles. These transactions can still have significant, if incidental, consequences on U.S. taxable income—e.g., the foreign tax credit. While the CCA does not discuss in depth transactions between foreign corporations and their U.S. DREs or branches, the IRS counsels that these transactions may similarly be given effect for limited U.S. tax purposes—e.g., the income sourcing rules.

For more information, contact **Edward Tanenbaum** at (212) 210-9425 or **Heather Ripley** at (212) 210-9549.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Jennifer H. Weiss
404.881.7453
jennifer.weiss@alston.com

ALSTON & BIRD LLP

WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213-576-1100
NEW YORK: 90 Park Avenue ▪ 12th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 275 Middlefield Road ▪ Suite 150 ▪ Menlo Park, California, USA, 94025-4004 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333
VENTURA COUNTY: 2801 Townsgate Road ▪ Suite 215 ▪ Westlake Village, California, USA, 91361 ▪ 805.497.9474 ▪ Fax: 805.497.8804