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Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

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Enforcing Dividend Withholding on Derivatives

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and director of the International Tax LLM program at the University of Michigan. The author would like to thank Bob Dilworth, David Hariton, David Miller, Bob Roach, Mike Schler, and Phil West for their helpful comments.

The United States imposes a 30 percent withholding tax on dividends paid to nonresident aliens. However, this tax is rarely paid by portfolio investors because they can swap into U.S. securities, receiving payments to match both capital gain and dividends. Treasury has ruled that swap payments have an origin in the taxpayer's residence so there is no withholding obligation on payments that match dividends. The proposal would impose withholding tax on dividend equivalents on the ground that there is no policy justification for a distinction between dividends, substitute dividends under securities lending transaction (which are treated as dividends and are subject to withholding), and dividend equivalents paid under swaps.

The proposal is made as a part of the Shelf Project, a collaboration of tax professionals to develop and perfect proposals to strengthen the tax base. Shelf Project proposals are intended to raise revenue without raising rates — the best systems have the lowest feasible tax rates because the taxes are unavoidable. Shelf projects defend the tax base and improve the rationality and efficiency of the tax system. Given the current calls for tax stimulus, some shelf projects may stay on the shelf for awhile. A longer description of the Shelf Project can be found at "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, *2007 TNT 238-37*. Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

While the United States formally imposes a 30 percent withholding tax on dividends paid to nonresident aliens, the income statistics indicate that the tax is rarely paid. The reason is that a nonresident investor can swap into U.S. securities, receiving contract payments to match both capital gain and dividends. Treasury had ruled that swap payments have an origin in the taxpayer's residence so there is no withholding obligation on payments that match dividends. Later, Treasury determined that substitute dividends under securities loans should be treated as dividends, but this rule can be avoided by combining securities loans and swaps. The proposal would impose withholding on dividend equivalents on the grounds that there is no policy justification for a distinction between dividends, dividend substitutes, and dividend equivalents paid under swaps.

A. Current Law

1. Introduction. The United States levies a 30 percent withholding tax on fixed or determinable annual or periodic (FDAP) income paid from U.S. sources to nonresident taxpayers.[1] This withholding tax has been in place since the beginning of the income tax as a way of ensuring that nonresident taxpayers fulfill their tax obligation when earning U.S.-source income. Since the 1930s, the withholding tax on the gross amount of FDAP has been the final tax on such income, collected in lieu of the graduated income tax on net income that is levied on U.S. residents (and on nonresidents earning income that is effectively connected with a U.S. trade or business).

Several exemptions and treaty-based reductions apply to most forms of FDAP. For example, portfolio interest (interest paid to nonresidents who do not own 10 percent or more of the stock of a corporate payer) is typically exempt from withholding tax under the "portfolio interest exemption."[2] Royalties are likewise typically exempt from withholding tax because most of them are paid to countries with which we have treaties that follow the U.S. and OECD models and reduce withholding on royalties to zero.[3]

Thus, the main source of revenue from the withholding tax on FDAP is dividends. Dividends are subject to the full 30 percent withholding if not paid to a resident of a treaty jurisdiction, but even in the case of treaty partners, our treaties only reduce dividend withholding to 15 percent for portfolio dividends and 5 percent for direct dividends.[4] This represents a judgment of Treasury and Congress that it is appropriate for nonresident taxpayers to pay a withholding tax on dividends, even though the underlying corporate income has already been taxed once.[5]

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[1]Sections 871(a)(1) and 881(a)(1).

[2]Sections 871(h) and 881(c).

[3]*See* Reuven Avi-Yonah and Martin B. Tittle, *The Integrated 2006 United States Model Income Tax Treaty* (Vandeplas, 2008), Art. 12.

[4]*Id.* at Art. 10. Many recent treaties (for example, that with the United Kingdom) reduce the dividend rate to zero for some direct dividends, but never for portfolio dividends.

[5]While it may seem strange that dividends, which are not deductible, are subject to withholding tax while interest and

(Footnote continued on next page.)

But do dividends actually bear a withholding tax of 30 percent or 15 percent? In 2003, the latest year with reliable data, about $42 billion in U.S.-source dividends were paid to nonresident corporations, but only about $1.9 billion (or 4.5 percent) was withheld.[6] This suggests that the only dividends actually subject to withholding are direct dividends, that is, dividends paid to affiliated corporations within multinational enterprises, which are typically subject to the reduced treaty tax rate of 5 percent. What happened to all the portfolio dividends?

2. Equity swaps. Beginning in the 1980s, derivative financial instruments have been developed that potentially undermine the integrity of the income tax by, for example, converting equity into debt.[7] For present purposes, the relevant derivative is the total return equity swap (TRES).

In a TRES transaction, a foreign investor (who may or may not hold stock in a U.S. corporation) enters into an agreement with a U.S. financial institution. Under the TRES agreement, the investor pays an amount equal to the value of some amount of stock of a U.S. corporation (the underlying stock) to the financial institution. In return, the investor receives (a) the right to a dividend equivalent (DE) whenever the underlying stock pays an actual dividend, and (b) the right to any appreciation in the stock when the TRES expires, and undertakes to pay the financial institution for any decline in the stock's value when the TRES expires. Thus, for the period of the TRES, the holder of the TRES is in the same economic position as if it held the underlying stock, although it is not a stock owner for corporate governance purposes (for example, voting).

The financial institution then uses the funds received from the investor to purchase the underlying stock. During the period of the TRES, the financial institution pays a DE whenever the underlying stock pays a dividend. On expiration of the TRES, the financial institution sells the underlying stock, and the parties settle the TRES transaction by making a payment equal to the appreciation or depreciation of the stock.

What are the tax consequences of that transaction? For the financial institution, the actual dividends received on the underlying stock represent income, but that is offset by a deduction for the DE payment to the investor. The capital gain or loss on the underlying stock at the end of the TRES is likewise offset by the payment to settle the TRES. Thus, the U.S. financial institution is perfectly hedged and indifferent to the tax treatment of the DE (it pays tax on the fees received for undertaking the TRES).

For the foreign investor, the capital gain or loss at the end of the TRES is foreign-source income and thus not subject to U.S. taxation.[8] Before 1991, there was uncertainty about the tax treatment of the DE. It could be argued that the DE was equivalent to a dividend and therefore subject to U.S. withholding tax. However, in January 1991 Treasury issued a regulation stating that "the source of notional principal contract income" (which includes income from derivatives such as the TRES) "shall be determined by reference to the residence of the taxpayer."[9] Thus, because the recipient of the TRES is a foreign resident, the DE is foreign-source income and not subject to U.S. tax.

Why did Treasury adopt that rule? At the time, there was widespread concern that imposing withholding taxes on derivatives would kill a new and flourishing market in securities, which arguably benefited both Wall Street and U.S. issuers by harnessing billions of dollars of funds. There was extensive lobbying by the Securities Industry Association and expressions of concern that the uncertainty regarding the source of income on derivatives was harming the market.[10]

It was immediately understood that the effect of the new rule would be to exempt DEs from the withholding tax even if economically they are indistinguishable from dividends. Commentators expressed concern that the source rule for derivatives would result in widespread avoidance of the withholding tax on dividends because a TRES gives the foreign holder the same economic returns as an investment in the underlying stock, but enables it to avoid the withholding tax because of the source rule for DEs.[11]

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royalties are not, this reflects the reality that (a) royalties are tax free by treaty because the United States gains more from reducing foreign taxes on royalties than it loses by reducing its own, and (b) interest is tax free because it can easily be earned anywhere in the world and an attempt to impose withholding taxes on it would lead investors to go elsewhere and/or increase costs to U.S. borrowers. Dividends, on the other hand, arguably represent an investment in unique U.S. companies earning particular forms of rent, so the investment cannot easily be replicated elsewhere. For a proposal to impose withholding taxes on interest and royalties in coordination with other OECD members, see Reuven Avi-Yonah, "A Coordinated Withholding Tax on Deductible Payments," *Tax Notes*, June 2, 2008, p. 993, *Doc 2008-11497*, or *2008 TNT 107-35*.

[6]"Tax Compliance: Qualified Intermediary Program Provides Some Assurance That Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved," Government Accountability Office, Report No. GAO-08-99 (Dec. 2007), *Doc 2008-1666, 2008 TNT 18-47*, Table 3.

[7]Alvin C. Warren Jr., "Financial Contract Innovation and Income Tax Policy," 107 *Harv. L. Rev*. 460 (1993); for an argument that the threat posed by derivatives to the income tax has been exaggerated, see David M. Hasen, "A Realization-Based Approach to the Taxation of Financial Instruments," 57 *Tax L. Rev*. 397 (2004).

[8]Section 865(a)(2).

[9]Reg. section 1.863-7(b), adopted by T.D. 8330 (Jan. 11, 1991). For interest rate swaps, a similar rule was already adopted in 1987, Notice 87-4, 1987-1 C.B. 416.

[10]*See, generally*, H. David Rosenbloom, et al., "General Report, Tax Aspects of Derivative Financial Instruments," 80b *Cahiers de droit fiscal international* (1995); Reuven S. Avi-Yonah and Linda Z. Swartz, "U.S. International Tax Treatment of Financial Derivatives," *Tax Notes*, Mar. 31, 1997, p. 1703, *Doc 97-5985*, or *97 TNT 61-49*.

[11]*See, e.g.*, Oren Penn, "Withholding Tax in Cross-Border Equity Swaps: The Dividend Problem," *93 TNI 196-14*; Gregory May, "Flying on Instruments: Synthetic Investments and the Avoidance of Withholding Tax," *Tax Notes*, Dec. 9, 1996, p. 1225, *Doc 96-29690*, or *96 TNT 239-32*; Avi-Yonah and Swartz, *supra* note 10; Yaron Reich, "Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities," *Tax Notes*, June

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Treasury and the IRS were aware of those concerns. In January of 1992, in the context of issuing the new rule for securities lending (discussed below), Treasury and the IRS expressed concern that the derivative source rule could lead to avoidance of the dividend withholding tax by using a TRES, and suggested that a single stock TRES may be abusive.[12] However, no action was taken. In 1998, in the context of issuing new regulations governing the treatment of derivatives under section 446, Treasury and the IRS repeated their concern that a TRES could be used to avoid dividend withholding.[13] In response, the New York State Bar Association (NYSBA) Tax Section issued a report urging Treasury not to treat DEs as equivalent to actual dividends for withholding tax purposes.[14] Again, Treasury and the IRS took no action.

The market understood the inaction by Treasury and the IRS as a sign that using a TRES (even on a single stock, and even when the investor held the actual stock before and after entering into a TRES over the ex-dividend date) is an ''approved loophole.'' As a result, by 2008, only the hopelessly unsophisticated foreign portfolio investor would invest directly in the stock of U.S. corporations and incur the withholding tax on actual dividends.[15] Instead, everyone invests using TRESs and receives tax-free DEs. Thus, it is unsurprising that the Government Accountability Office report numbers suggest that no withholding tax is collected from foreign corporate investors in U.S. portfolio stock. The numbers indicate that the entire amount collected as withholding tax on dividends stems from direct (over 10 percent) holders, who care about voting the stock and therefore will not enter into a TRES.[16]

15, 1998, p. 1465, *Doc 98-19132*, or *98 TNT 114-71*; David P. Hariton, ''Equity Derivatives, Inbound Capital and Outbound Withholding Tax,'' 60 *Tax Lawyer* 313 (2007).

[12]Preamble to prop. reg. section 1.861-3(a)(6), 57 *Fed. Reg.* 860 (Jan. 9, 1992).

[13]Preamble to reg. section 1.446-3, 1998-1 C.B. 1322 (June 29, 1998).

[14]NYSBA, ''Report on the Imposition of U.S. Withholding Tax on Substitute and Derivative Dividend Payments Received by Foreign Persons,'' *Tax Notes*, June 29, 1998, p. 1749, *Doc 98-17347, 98 TNT 107-21* (the NYSBA report). The NYSBA report made two arguments: first, that an investor in a TRES is not the same as an investor in the underlying stock or as an investor in a securities lending transaction because it may never hold the underlying stock; and second, that if Treasury attacked single stock TRES, the same result can be achieved using baskets. Those arguments are addressed below.

[15]An important question is whether these investors are truly foreign or whether they are U.S. persons investing through tax havens and avoiding their tax liability on dividends. Joe Guttentag and I have estimated that the United States loses $50 billion each year because of tax haven abuses by U.S. resident taxpayers. *See* Joseph Guttentag and Reuven Avi-Yonah, ''Closing the International Tax Gap,'' in Max B. Sawicky (ed.), *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration*, 99 (2005).

[16]Note, however, that it may be possible for a foreign parent to create two classes of stock in its subsidiary, one carrying the vote and the other the dividend, and engage in a TRES regarding the dividend paying stock while retaining the voting stock.

3. Securities loans. In 1992, a year after issuing the new rule for sourcing DEs, Treasury and the IRS issued proposed regulations governing securities lending transactions.[17] Those regulations take a different approach to taxing dividend substitutes (DS) made under a securities lending transaction. The regulations were finalized in 1997.[18]

In a typical cross-border securities loan, a foreign holder of U.S. stock enters into an agreement with a U.S. borrower. Under the agreement, the U.S. borrower borrows the stock for a certain period of time, and returns it thereafter. The U.S. borrower is treated as the holder of the stock for the period of the loan, and therefore is entitled to receive any dividends on it during that period.

Because the foreign lender forgoes the right to receive dividends for the term of the loan, the U.S. borrower agrees to make a DS payment any time the underlying stock pays a dividend. Thus, the U.S. borrower receives the dividend, and immediately turns around and makes a DS payment to the foreign lender. Because the DS payment is deductible, the U.S. borrower has no net income.

What are the tax consequences for the foreign borrower? Under the regulations, a ''substitute dividend payment shall be sourced in the same manner as the distributions with respect to the transferred security.''[19] Thus, a DS is treated as a dividend for all U.S. tax purposes (including for tax treaty purposes), and therefore it is subject to U.S. withholding tax when made from a U.S. borrower to a foreign lender.

The contrast between the DS rule (for securities loans) from 1992 and the DE rule (for TRESs) from 1991 is impressive because economically both transactions are identical: In both, as well as in a direct investment in the underlying stock, the foreign investor receives the full amount of the dividend.[20] Why, then, is the DS treated as a dividend for withholding tax purposes, while the DE is not?

In its 1998 report on the issue, the NYSBA Tax Section argued that the DS rule should not be applied to DEs because in a TRES the foreign holder may never have held the underlying stock, while in a DS and a direct investment the foreign holder held the stock.[21] That may or may not be true (in many TRES transactions the foreign investor holds the stock before and after the TRES, which is entered into to cover the ex-dividend date). But even if true, it is unclear why it is relevant. Economically, the foreign investor in a TRES is in exactly

[17]57 *Fed. Reg*. 860 (Jan. 9, 1992).

[18]T.D. 8735 (Oct. 6, 1997), *Doc 97-27930, 97 TNT 194-8*.

[19]Reg. section 1.861-3(a)(6).

[20]Minus any fee levied on the DS or DE, which represents a payment to the U.S. financial institution for ''enhancing the dividend yield,'' that is, enabling the investor to avoid the withholding tax.

[21]NYSBA report, *supra* note 14. NYSBA also argues that any change to the DE rule involving single stocks can be avoided by using baskets. Because of this issue, I would recommend a rule relying on the well-established ''substantially similar or related property'' standard of section 246(c). *See* recommendations below.

the same position as a foreign investor in the underlying stock or as a foreign lender in a securities loan: All three are entitled to the dividend, and all three have the upside and downside risk of holding the stock.[22]

I believe that Treasury and the IRS had second thoughts about the 1991 DE rule by the time they issued the DS rule a year later, as indicated by the concerns expressed in the preamble to the DS rule. That explains why they took a different approach in the DS rule. However, no action was taken to curb abusive exploitation of the DE rule in the period from 1992 to the present.

4. Combining equity swaps with securities loans. Treasury and the IRS finalized the DS rule in October 1997. Taxpayers immediately expressed concerns that the DS rule could result in a "cascading" withholding tax on multiple securities lending transactions.

The cascading issue arises because the DS rule applies to any securities loan involving stock of a U.S. corporation, including a securities loan between foreign persons. Suppose that foreign person 1 lends stock in a U.S. corporation to foreign person 2. Under the DS rule, if the U.S. issuer pays a dividend to foreign person 2 (the holder for the period of the loan), and if foreign person 2 then makes a DS payment to foreign person 1, both payments (the actual dividend and the DS) would be subject to withholding, resulting in a cascading tax of more than 30 percent.

How likely is this scenario? Generally unlikely because the obvious solution is to make the securities loan to a U.S. person, not to another foreign person, thereby avoiding the cascading by avoiding the withholding tax on the actual dividend. However, taxpayers argued that in some cases, regulatory limits prevented foreign lenders from engaging in securities loans with borrowers outside their own country.[23]

Because of those concerns, Treasury and the IRS issued Notice 97-66 in November 1997 (that is, a month after the DS rule became effective). Under Notice 97-66, the U.S. withholding tax on a DS foreign to foreign payment "will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S.-source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payer of the substitute payment."[24]

What this means is that if foreign persons 1 and 2 are in the same country or in two countries subject to the same dividend withholding tax rate (for example, 30 percent and 30 percent or 15 percent and 15 percent), *and if a U.S. withholding tax was imposed on an actual dividend to foreign person 2*, then a DS payment from foreign person 2 to foreign person 1 would not be subject to U.S. withholding tax because a direct payment from the U.S. to either foreign person would be subject to the same withholding tax rate.[25]

The clear intent of the notice, as stated in both the text and in the examples, is to condition this rule on an actual U.S. withholding tax being paid on an actual dividend or a DS somewhere in the chain. If no U.S. withholding tax is ever paid, no cascading issue arises.

However, because the notice (issued in haste a month after the DS rule was finalized) did not explicitly include that condition, taxpayers soon found a way to avoid the DS rule by combining it with the DE rule.[26] In such transactions, instead of foreign person 2 holding the actual stock of the U.S. corporation (and thereby subjecting itself to withholding tax), foreign person 2 would enter into a TRES regarding the stock. Foreign person 2 would then receive the DE free of withholding tax under the DE rule, and would make the DS payment to foreign person 1 free of withholding tax under Notice 97-66.

I believe this treatment of the transaction is wrong under the terms of Notice 97-66. Because the rationale for the notice hinges on an actual withholding tax being due somewhere in the chain, it is inappropriate to interpret it as exempting the DS payment from withholding tax when there is no withholding tax due anywhere. Even if the taxpayer does not know whether a withholding tax is due (for example, because foreign person 2 sells the borrowed stock into the market and does not know who the buyer is), I would argue that the notice does not apply because foreign person 2 has the burden of proof to show that a withholding tax applies somewhere before it can exempt its DS payment to foreign person 1 from withholding under the notice.

B. Reasons for Change

In my opinion, there is no good policy reason to treat actual dividends, DEs, and DSs differently for withholding tax purposes. Treating them differently causes distortions and increases transaction costs that are wasted on devising transactions like the ones set out above.

C. Proposals

I would recommend that Congress, Treasury, and the IRS take the following actions to prevent the widespread avoidance of the dividend withholding tax:

The DE rule (reg. section 1.863-7(b)) should be revised. For DEs on single stock TRESs, the rule should be the same as the DS rule (reg. section 1.861-3(a)(6)), that is, the DE should be treated as an actual dividend for all U.S. tax purposes. Moreover, DEs on a basket of stock should

[22]In some TRES and securities loan transactions, the foreign holder gets less than the full amount of the dividend; the difference is simply a fee paid to the U.S. financial institution that arranges the transaction. For TRES transactions, this fee may also incorporate a splitting of the risk that the IRS would seek to impose with a withholding tax on the TRES.

[23]I have seen no evidence that this is a serious concern.

[24]Notice 97-66, 1997-2 C.B. 328, *Doc 97-30949, 97 TNT 219-8*.

[25]Ironically, this means that a DS payment from one tax haven person to another is subject to better treatment than a payment from a non-tax-haven person to a tax haven person (because the 15 percent to 30 percent payment would be subject to tax at 15 percent, while the 30 percent to 30 percent payment is exempt).

[26]Treasury and the IRS may have realized this by the time they expressed concern on abusing the DE rule in the preamble to the section 446 regulations (June 1998).

likewise be treated as equivalent to a dividend if the basket represents ''substantially similar or related property'' (as defined under section 246(c) and the regulations thereunder) to a single stock.

Notice 97-66 should be amended to explicitly condition its application on the taxpayer showing that a U.S. withholding tax was levied on a dividend or a DS payment in the same chain of transactions to which the notice is being applied.

D. Conclusion

Congress has determined that foreign taxpayers who invest in U.S. portfolio equities should be subject to a 30 percent or 15 percent withholding tax. Many commentators have argued that this result is inappropriate when interest and royalties are usually not subject to withholding tax. However, the distinction between royalties, interest, and dividends can be defended.[27] Moreover, even if a ''dividend portfolio exemption'' is appropriate as a policy matter, as long as Congress does not enact one, and as long as the Senate does not ratify treaties with a zero rate for portfolio dividends, it is up to Treasury and the IRS to defend the U.S. revenue base by preventing taxpayers from abusing the DE and DS rules in the ways explained above. If they do not, Congress should enact legislation along the lines specified above.

[27]*See* note 5 *supra*.