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1996

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

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Recommended Citation
Avi-Yonah, Reuven S. "Virtual Taxation: Source-Based Taxation in the Age of Derivatives." *Proceedings of the Annual Conference on Taxation Held under the Auspices of the National Tax Association-Tax Institute of America* 89 (1996): 269-274. (Work published when author not on Michigan Law faculty.)

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CONCURRENT SESSION

INTERNATIONAL TAXATION

Tuesday, November 12, 1996, 8:30 a.m.
James R. Hines, *presiding*

Virtual Taxation: Source-Based Taxation in the Age of Derivatives

Reuven S. Avi-Yonah
Harvard Law School*

What are the implications of the explosive growth in the market for derivative financial instruments for international taxation? As Rosenbloom (1996) has pointed out, derivatives do not pose a particular international tax problem as long as one focuses on residence-based taxation. In that context, the issues raised by derivatives are the same as in a purely domestic context, which have been discussed extensively elsewhere (e.g., Warren, 1993). However, when the focus is on source-based taxation, and in particular source-based taxation of passive income (i.e., withholding taxes), the rise of derivatives has far-reaching implications. In 1994, then U.S. International Tax Counsel Cynthia Beerbower was quoted as saying that "opportunities for synthetic investments, as opposed to real investments, are so prevalent that withholding taxes are no longer real."[1]

The purpose of this paper is to explore the implications of this statement not just for the tax treatment of derivatives but also for the international tax regime as it relates to source-based taxation of passive investment. In particular, the paper will address the following questions. Is Ms. Beerbower's statement true? If so, what can (or should) the United States do about it?

CURRENT U.S. SOURCE-BASED TAXATION AND ITS LOOPHOLES

Ms. Beerbower was clearly exaggerating when she stated that U.S. withholding taxes are obsolete, because the U.S. does collect about $2 billion of them a year. However, the fact that only this small amount is collected when inbound investment has been increasing rapidly since the 1980s suggests that she is not far from the truth. Even before derivatives, the current withholding tax regime is filled with loopholes, which have been surveyed extensively elsewhere and therefore can just be mentioned here: (a) The exemption for capital gains (except on real estate), even when they represent the accumulated profits of the enterprise or the present value of future dividends; (b) the portfolio interest exemption, which is the biggest loophole in terms of forgone revenues; and (c) the ease of converting royalties and rents into capital gains or income from services performed abroad.[2]

I would like to thank the participants in the Harvard International Tax Program's symposium on the Taxation of New Financial Instruments, and especially Greg May, Reed Shuldiner, Lew Steinberg, and Phil West, the participants in a workshop at Harvard Law School (especially Hugh Ault, Louis Kaplow, Diane Ring, and Al Warren), Steve Gordon, Michael Schler, Linda Swartz, and my fellow panelists at the National Tax Association meeting, Rosanne Altshuler, Harry Grubert, and Jim Hines for their contributions to thinking about the topics of this paper. All errors and omissions are mine.

In general, as a result of these loopholes, the $2 billion collected in U.S. withholding taxes comes almost entirely from withholding on dividends (including dividend equivalents under the branch profit tax) and some capital gains on real estate. With the rise of derivatives, however, this form of withholding may well become obsolete. This result obtains because of the U.S. rule that payments on notional principal contracts (such as swaps, caps, floors, and collars) are generally sourced according to the residence of the recipient.[3] Thus, to take a simple "total return" equity swap, suppose foreign party (F) and domestic securities dealer (D) enter into an agreement under which F pays D annually x percent and an amount equal to any depreciation in the value of 100 shares of USCo, a U.S. issuer, while D pays F an amount equal to the dividends paid on the stock and any appreciation in its value. F gets the x percent to pay D by investing in a U.S. Treasury bond, while D hedges its exposure by acquiring USCo stock. When the swap terminates, F may choose to roll over its position indefinitely.

In this example (Example 1), F pays no U.S. withholding tax: the interest on the bond is portfolio interest, while the swap income is foreign source (as long as it is not connected to a U.S. trade or business). The other parties to the transaction benefit as well: USCo has received an additional investment in its stock (D's), while D can use the mark-to-market rule for securities dealers to ensure that the timing and character of its income, gains, and losses match (e.g., that it can deduct the dividend equivalent payments currently).[4]

From F's perspective, it has created an investment that is economically equivalent to buying the USCo stock: it has invested in the U.S. market by buying the bond, but is at risk for capital depreciation and USCo bankruptcy as if it had bought the USCo stock; and it receives the same returns (both appreciation and dividends). The only missing ingredient is the right to vote the shares, but if F controls USCo, this problem can perhaps be solved by paying no dividends on the common stock (held directly by F) and routing all dividends through a special class of preferred stock held by D.[5] Thus, there is no reason even for foreign corporations that currently hold USCo stock to be subject to withholding on future dividends paid by USCo.

A POSSIBLE SOLUTION TO THE CHALLENGE POSED BY DERIVATIVES

The preamble to the regulations governing hedging transactions issued in 1993 (when Ms. Beerbower was the U.S. International Tax Counsel) stated that "the IRS is considering whether notional principal contracts involving certain specified indices (e.g., one issuer's stock) should be excluded from the general sourcing rules of Sections 861 through 865 and whether contracts involving other specified indices (e.g., United States real property) are subject to Section 897."[6] However, nothing has been done so far to curb the transaction described above. What can be done about it?

The rule governing periodic payments under notional principal contracts should be contrasted with the rule for securities lending transactions in which, under regulations proposed in 1992 (but not yet finalized), dividend-equivalent payments paid by the borrower of the securities to the lender to compensate the lender for the dividends it would have received but for the loan are treated as dividends for purposes of determining their character and source.[7] Thus, under this look-through rule, dividend equivalent payments in cross-border securities lending transactions are treated as dividends when they are paid by the party holding the stock (the borrower) to the party that held it originally (the lender). When the borrower is U. S. and the lender is foreign, the result would be the imposition of withholding taxes (subject to reduction by treaty) on the dividend equivalents.

A similar rule could be imposed on dividend-equivalent amounts paid under notional principal contracts. Specifically, when a payment is made under a notional principal contract that is tied to the dividends paid by a U.S. issuer *and* the payor holds the shares of the issuer (i.e., the payor has hedged), the dividend equivalent should be treated as a dividend for withholding tax purposes. The same rule applies to payments tied to the appreciation in real estate.

Why restrict this look-through rule only to equity swaps in which the U.S. party has hedged? If there is no investment in USCo at all, it is hard to see how F has benefited from the U.S. economy or how withholding could serve as a meaningful backup for residence-based taxation.

An unhedged swap is pure speculation, like a bet, which can take place with no connection to the United States. Should two residents of China be taxed by the U.S. if they bet on the outcome of the Superbowl, but not on the outcome of the European Soccer championship? As a practical matter, however, all equity swaps are hedged, so that this issue is moot.

Should the United States impose a look through rule on notional principal contracts, as it has hinted it might do in the 1993 preamble and as it proposed to do in the 1992 regulations for cross-border securities loans? Several arguments can be made against such a move:

First, it may hurt its competitive position in the world market for portfolio capital if it imposes source based taxation on derivatives. This probably also explains why the securities lending regulations have yet to be finalized, and the issue is discussed further below.

Second, double taxation may result, since the prevalent international practice, which was also embodied by a 1995 IFA resolution, is that there should be no source-based taxation on payments under derivatives, including equity swaps (Rosenbloom, 1996). Double taxation results because the residence country regards the dividend equivalents as having a domestic source and will therefore refuse to credit any withholding tax imposed on them. Indeed, the double taxation issue is a problem in the embedded loan context under notional principal contracts, in which the interest may sometimes be subject to withholding (Elvin, 1995), although given the portfolio interest exemption, the issue in that case may be of limited importance.

Third, a look-through rule raises issues of scope and administrability: if it applies only to holding the actual stock of USCo, it could be avoided by holding an economically similar basket of equities. However, the problem has been dealt with in other contexts and is not insupportable; the issue is defining how much risk the taxpayer has to bear for two positions not to be considered economically equivalent.

Finally, May (1996) has argued that even if dividend equivalents are subjected to withholding the same result can be obtained from an economically equivalent transaction that would not be subject to withholding under current rules. As is well known, holding a bond and agreeing to buy equity forward (or, equivalently under the put/call parity theorem, holding a bond and a put and a call on the equity) are economically equivalent to holding the stock. Thus, even assuming that the U.S. has enacted a look-through rule like the one suggested above, F can obtain the economic benefit of an equity investment without paying withholding tax by buying a bond and a forward. Assume F wants to invest $100 in USCo at $1 per share and would be subject to a withholding tax of 30 percent on dividends if he does so directly. Instead, F invests $100 in a USCo bond and enters into a cash-settled forward contract to buy 100 shares of USCo for $100 on the maturity date of the bond, pledging the bond to secure the obligation under the forward. The price of the forward is reduced by the expected value of the dividends to be paid by USCo, so that F gets the economic benefit of those dividends.

In this example (Example 2), F would pay no U.S. tax because the interest on the bond is portfolio interest, while any gain on the forward is foreign-source income not effectively connected with a U.S. trade or business.[8] The two holdings are not integrated and can be rolled forward indefinitely if F wishes to do so, so that no withholding tax will ever be collected on the dividends paid by USCo.

If so, should the U.S. refrain from imposing the look-through rule in Example 1 because an economically equivalent result can be achieved (in Example 2) that would not be covered by the rule? There are several reasons why the U.S. should nevertheless adopt the look-through rule. First, for almost any anti-abuse rule in tax, there is another form of the transaction that avoids the rule; IRS would be constrained from adopting any loophole-closing measure if it used this form of analysis. Second, the two transactions are not precise equivalents. In Example 1, F is assured of getting the equivalent of the actual dividends paid by USCo, while in Example 2 he only gets their expected value. Third, the equivalence of Examples 1 and 2 only holds if there are no transaction costs. In the real world, entering into an equity swap may entail different costs than entering into a cash-settled forward.

In addition, it can be argued that Example 2 differs fundamentally from Example 1 from the point of view of the U.S., even if the economics are similar from F's point of view. Specifically, in Example 1, some dividends paid by USCo go untaxed (because D has income and an offsetting

deduction, while F pays no withholding tax), while in Example 2, no dividends go untaxed. Thus, the issue is whether source-based taxation on passive income should be looked at from F's perspective, in which case Example 2 illustrates that it would be necessary to tax all forms of outgoing payments to achieve consistent treatment of economically similar transactions, or from the point of view of the U.S. tax base, in which case Example 2 is not problematic.

DEVISING A CONSISTENT RULE FOR SOURCE-BASED TAXATION OF PASSIVE INCOME

To resolve this problem, it is useful to discuss the rationale for source-based taxation of passive income. Source-based taxation is usually justified in terms of the benefits afforded by the source country to the investor (Edrey, 1996). However, those benefits are much more significant for active business income than for passive investment income. Moreover, most active income is earned by multinationals, and source-based taxation can be justified in that case because multinationals do not have a meaningful tax residence (Avi-Yonah, 1996). Most passive income, on the other hand, is earned by individuals, in which case source-based taxation is harder to justify because only residence-based taxation is congruent with the ability-to-pay criterion (Green, 1993).

Thus, the international tax regime is generally based on taxing active income on a source basis, with an exemption or credit granted by the residence country, while taxing passive income on a residence basis, with reduced or no withholding imposed by the source country. The latter result is typically achieved by tax treaty. This, however, suggests a second, perhaps more compelling rationale for source-based taxation of passive income: to serve as a backstop to residence-based taxation in cases when a treaty does not ensure that the income is subject to residence-based taxation. This "backup withholding" rationale for source-based taxation is of increasing importance because of the increase in international portfolio investment (which has been growing faster than direct investment) and the proliferation of tax havens, and because developing countries in particular find it difficult to enforce residence-based taxation on the foreign-source income of their residents.

Much of the effort in constructing the international tax regime has gone into preventing double taxation through the credit and exemption systems in place. However, in a world in which some jurisdictions must have positive tax rates but tax havens exist, the efficient allocation of investment without tax-induced distortions also requires that all income be taxed once, rather than not be subject to any current taxation. Source-based taxation of passive income (as well as the various anti-deferral regimes adopted by all developed countries to combat tax havens) can be viewed as a step toward insuring that this goal is met, in those cases when there is no treaty to assure that the income is subject to residence-based taxation.

The practical implication of viewing withholding taxes primarily as a backstop to residence-based taxation is that one need not worry too much about the theoretical purity of the withholding tax regime. As Edrey (1996) points out, a consistent regime of source-based taxation based on benefits or "economic allegiance" to the source country would impose taxes on the various type of distribution (e.g., dividends, interest, and wages) by any firm operating in the source country, regardless of its nationality. This type of tracing of distributions to income derived from any given source is very difficult to achieve in practice, and collecting taxes on distributions by foreign firms to their foreign distributees is likewise difficult. If the focus is on withholding taxes as a backstop, however, the emphasis is on those types of payments that as an administrative matter can be subjected to withholding tax—the same emphasis that underlies a lot of the history of the U.S. taxation of "fixed or determinable, annual or periodic" income.[9]

The most practical rule for imposing withholding taxes that is consistent with viewing them as a backstop is to impose a tax on all outgoing payments that have not been subject to one level of tax at source (i.e., that are deductible by the payor). The implication of this rule is that interest, royalties, and capital gains (to the extent evidenced by a deductible payment from a U.S. buyer) should be subject to withholding. On the other hand, actual dividends, which are not deductible, and "dividend-equivalent amounts" under the branch profit tax should not be subject to withholding. Dividend-equivalent payments under equity swaps should be subject to taxation only if they

are not offset by dividends received by the payor, because otherwise there is no net deduction in the United States.

What would happen were the United States to adopt such a rule? The answer is unclear, and has not yet been the subject of a serious empirical inquiry. The usual reply is that such a move would lead to an unacceptable flight of portfolio investment out of the U.S. and into other countries in which there is a zero rate of withholding on interest. The example commonly given is the notorious failure of Germany's attempt to impose a withholding tax on interest in 1989, which led to a massive outflow of funds to Luxembourg and necessitated repealing the tax three months later.

However, there are several reasons to suggest that further study is required on whether the consequences to the U.S. of repealing the portfolio interest exemption would be disastrous. *First, the exemption was enacted in unusual circumstances because in 1984 the U.S. had a severe need for foreign investment as a result of its increasing budget deficit.* This need, while it still exists, is lower now that the U.S. budget deficit is shrinking.

Second, the same argument could be made for dividends, and yet the existence of a positive withholding tax on dividends (even in the treaty context) did not prevent foreign parties from investing in U.S. equities. It needs to be demonstrated why the equity market is so significantly different from the debt market.

Third, some developed countries with economies that are smaller than the U.S., and thus less attractive to foreign investors, have managed to survive and attract investment with a positive withholding tax on interest. While most European countries do not impose a withholding tax on interest paid to nonresidents, Australia, Canada, Japan, and the United Kingdom all do so, with exceptions that are much narrower than the portfolio interest exemption. One could imagine the U.S. enacting a much narrower exemption than the current one.

In the absence of empirical studies, it is unclear whether the adoption of the rule suggested above would have a significant negative impact on the U.S. economy (as opposed to much smaller economies, for which the usual conclusion is that source-based taxation is not recommended). Such studies should, however, take into consideration the possibility that adoption of a broad-based withholding rule by the U.S. would lead other countries to follow suit, as has happened when the U.S. adopted the first anti-deferral rule for controlled foreign corporations. If that were the result, any initial outflow of investment from the U.S. would be reversed in the longer run.

Even if it is concluded that the United States could not adopt a withholding tax on deductible payments on a unilateral basis, that would not necessarily mean such a rule could not be adopted. Instead, the solution would appear to be a multilateral agreement by the major economies (e.g., the members of the OECD) to impose such withholding on a coordinated basis. Since all participants would benefit from the resulting revenue, and would not be hurt as long as other participants adopt the same tax, such an agreement does not appear impossible to reach.

NOTES

1. 94 TNI 54-3.
2. See Avi-Yonah (1996) for a fuller discussion of each of these loopholes.
3. Treas. Reg. 1.863-7(b)(1).
4. May (1996), Example 5; IRC 475(a), (C)(2)(E), (D)(3); Treas. Reg. 1.1221-2.
5. This form of the transaction, however, increases the risk of IRS re-characterization by looking at D as a pure conduit to be ignored.
6. T.D. 8491, 1993-2 C.B. 215.
7. Prop. Treas. Reg. 1.861-2(a)(7); 1.861-3(a)(6); 1.861-7(b)(2); 1.881-2(b)(2); 1.894-1(I)(c) and 1.1441-2(a). For a fuller description of those rules, see Avi-Yonah and Swartz (1997).
8. I.R.C. 864(c)(4), 865(a), (e)(2).
9. See, for example, I.R.C. 871(j) (gambling winnings are FDAP whenever collecting the tax is administratively feasible).

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