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October 22, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on the Taxation of Dividend Equivalent

Dear Commissioner Shulman:

Enclosed are comments on the taxation of dividend equivalent. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

Enclosure

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ABA SECTION OF TAXATION
COMMENTS ON THE TAXATION OF A DIVIDEND EQUIVALENT

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Matthew A. Stevens of the U.S. Activities of Foreigners and Tax Treaties Committee of the Section of Taxation. Substantial contributions were made by Matt Blum, Julio Castro, Michael J. Miller, Dean Marsan, and Jeff Rubinger. The Comments were reviewed by Alan I. Appel, the Committee Chair. The Comments were further reviewed by Michael Hirschfield of the Section’s Committee on Government Submissions and by Joan Arnold, Council Director for the U.S. Activities of Foreigners and Tax Treaties Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: October 22, 2010

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EXECUTIVE SUMMARY

In response to the April 7, 2010, request for comments by the Internal Revenue Service (the “Service”),¹ these Comments address certain issues raised by the Hiring Incentives to Restore Employment Act of 2010 (the “HIRE Act”).²

Section 541 of the HIRE Act, which enacted section 871(l),³ treats a “dividend equivalent” as a U.S. source dividend, and thereby generally subjects such dividend equivalent, if paid to a non-U.S. person, to the U.S. tax that applies to fixed or determinable, annual or periodical gains, profits, and income earned by a non-U.S. person. Section 871(l) was subsequently redesignated as section 871(m).⁴ The new statutory regime will be implemented in two phases. The first phase applies to payments made between September 14, 2010, and March 18, 2012, while the second phase applies to payments made after March 18, 2012. These Comments address only the issues arising during the first phase.

With respect to the implementation of section 871(m) during the first phase, we recommend:

1. With respect to a notional principal contract (“NPC”), if the parties take certain actions with respect to the transfer of the underlying equities that are the subject of the contract, the contract will be a “specified” NPC and the payments thereunder be subject to section 871(m). We recommend that guidance provide that if the representations in the HIRE Act Protocol to the form of ISDA Master Agreement are made to a withholding agent by a “long party,” then the withholding agent may rely upon such representations unless the withholding agent knows the representations are false. The representations would provide comfort that the long party is not engaged in the specified activity and provide the withholding agent a basis upon which to decide to not withhold.
2. If a particular swap is a specified NPC, we recommend that guidance provide that the parties be permitted to convert it to a swap that is not a specified NPC by terminating the existing swap and initiating a new one, as long as (i) the initial price of the new swap is not determined with reference to the final price of the old swap and (ii) the representations made in the HIRE Act Protocol are given.

¹ See Announcement 2010-22, 2010-16 I.R.B. 602.

² Pub. L. No. 111-147, 124 Stat. 71.

³ References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

⁴ The subsection that is the subject of these Comments was enacted as section 871(l) in the HIRE Act. Section 871(l) was then redesignated as section 871(m) by Pub. L. 111-226, 124 Stat. 2389 § 217(b)(2) (Aug. 10, 2010), effective for taxable years beginning after December 31, 2010. For convenience, in the body of these Comments we refer to the subsection by its new designation, section 871(m).

3. If a particular swap is a specified NPC, we recommend that guidance be issued to allow taxpayers to avoid the cascading of withholding taxes in the same way as in Notice 2010-46,⁵ so that only a single level of withholding tax is imposed on a chain of payments.
4. With respect to the issues that arise when stock serves as collateral for a swap, we recommend that the Service and the Department of the Treasury (“Treasury”) provide guidance stating that if stock is used to provide collateral on an equity swap and on each day of the existence of the NPC the total dollar value of the stock provided is less than ten percent of the total dollar value of the collateral provided on such day, then no stock will be treated as having been provided as collateral on the NPC.

⁵ 2010-24 I.R.B. 75.

COMMENTS

I. Background of Section 871(m).

Beginning in the late 1980s, Treasury provided administrative guidance establishing that income first from interest rate swaps,⁶ then from most foreign currency swaps,⁷ and finally from almost all NPCs⁸ would be sourced by reference to the residence of the recipient of the income. For a foreign recipient, then, the income from a NPC would be foreign source and therefore not subject to the gross basis U.S. income or withholding tax imposed by sections 881 and 1442, respectively. While this administrative guidance did not specifically address total return swaps over equities,⁹ the final Regulations by their terms also applied to these swaps. Thus, a payment made by a U.S. broker-dealer to a foreign person on a total return swap over a U.S. equity would be treated as foreign source, and therefore not subject to U.S. gross basis tax, even if that payment were paid in respect of a dividend paid on the underlying equity. The actual dividend, however, would have been U.S. source and, if earned by a non-U.S. person, would have been subject to U.S. tax and withholding.

At approximately the same time, a different set of rules was developing in the area of stock lending transactions. A securities loan is similar to a total return swap over equity in the sense that neither one who has lent stock nor one who is long under an equity swap¹⁰ is the owner of the stock for U.S. federal income tax purpose. Under a securities loan, however, the lender frequently has a contractual right to recover possession of the stock with three business days' notice.¹¹ In 1997, Treasury promulgated Regulations providing that a substitute dividend payment made with respect to a securities loan would have the same source as the actual dividend would have had.¹² Because the other requirements under section 881 would have been satisfied (*i.e.*, the substitute dividend was clearly fixed or determinable, annual or periodical income), the Regulations subjected substitute dividend payments made with respect to U.S. stocks to U.S. withholding tax.

The regime described in the previous paragraph could have resulted in cascading withholding obligations in the case of multiple loans of the same shares between foreign

⁶ Notice 87-4, 1987-1 C.B. 416.

⁷ Prop. Reg. § 1.863-7(b), 54 Fed. Reg. 38,874 (1989).

⁸ Reg. § 1.863-7.

⁹ A total return swap over equities is a NPC in which one party is entitled to receive payments corresponding to the appreciation in a stock or a basket of stocks and to the dividends on such stock or stocks, and is required to make payments corresponding to the depreciation in such stock or stocks and to an interest rate applied to the value of the notional amount of shares.

¹⁰ By "long," we mean, with respect to any underlying security of any NPC, the party that is entitled to receive payments thereunder corresponding to an increase in the value of the security and corresponding to a payment of a dividend, and that is required to make payments corresponding to a decrease in the value of the security.

¹¹ Indeed, the long-standing Proposed Regulations under section 1058 require the lender to be able to terminate the loan upon notice of not more than five business days. Prop. Reg. § 1.1058-1(b)(3), 48 Fed. Reg. 33,912 (July 26, 1983).

¹² Reg. § 1.861-3(a)(6).

persons. In order to prevent such cascading withholding tax, Treasury and the Service promulgated Notice 97-66 (the “Notice”).¹³ The Notice essentially provided for a zero rate of withholding tax on the substitute dividend payment made to the lender of the shares if the borrower of the shares and the lender of the shares are both in foreign jurisdictions (not necessarily in the same foreign jurisdiction) with which the United States lacks an income tax treaty. This approach would have produced a result satisfactory to the government if the share of stock had remained with the borrower. In that case, because the borrower is by assumption organized under the laws of a country with which the United States does not have an income tax treaty, the actual dividend would have been subject to a 30% withholding tax in the borrower’s hands. However, the Notice did not contain any requirement that the loaned shares continue to be held by the borrower. (Such a requirement would not have made any sense, because the purpose of borrowing shares generally is to deliver them to another party to create or transfer a short position). Because there was no requirement in the Notice that any withholding tax actually be imposed on the physical dividend, some foreign entities relied on the Notice when they lent out dividend paying U.S. stocks over dividend payment dates. The lending entity would not receive the physical dividend and, under the Notice, would not be subject to withholding tax on the substitute dividend. The borrowing entity also would not receive the physical dividend and therefore also would not be subject to withholding tax.

Congress was, of course, aware of this history when it enacted section 871(m). The operative rule of section 871(m) is that, for the purposes of the U.S. gross basis income tax, “a dividend equivalent shall be treated as a dividend from sources within the United States.” The term “dividend equivalent,” in turn, is defined as meaning—

(A) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States,

(B) any payment made¹⁴ pursuant to a specified notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and

(C) any other payment determined by the Secretary to be substantially similar to a payment described in subparagraph (A) or (B).¹⁵

¹³ 1997-2 C.B. 328.

¹⁴ While most if not all swaps require a netting of amounts owed by one party against amounts owed to that party, the legislation indicates that the term “payment” includes any gross amount that is used in computing any net amount which is transferred to or from the taxpayer. I.R.C. § 871(m)(5).

¹⁵ I.R.C. § 871(m)(2) (footnote added).

In turn, a “specified” NPC means—

(A) any notional principal contract if—

(i) in connection with entering into such contract, any long party¹⁶ to the contract transfers the underlying security¹⁷ to any short party¹⁸ to the contract (a “Cross In”),

(ii) in connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract (a “Cross Out”),

(iii) the underlying security is not readily tradable on an established securities market,

(iv) in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract, or

(v) such contract is identified by the Secretary as a specified notional principal contract,

(B) in the case of payments made after the date which is 2 years after the date of the enactment of subsection (m), any notional principal contract unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance.¹⁹

In the case of any chain of dividend equivalents one or more of which is subject to tax under section 871(a) or section 881, the Secretary may reduce such tax, but only to the extent that (i) the taxpayer establishes that such tax has been paid with respect to another dividend equivalent in such chain, or is not otherwise due, or (ii) the Secretary determines is appropriate to address the role of financial intermediaries in such chain.²⁰ For purposes of this provision, a dividend will be treated as a dividend equivalent.

As noted above, these Comments focus on the rules relating to payments made between September 14, 2010, and March 18, 2012, and therefore these Comments do not address paragraph (B), quoted above.

¹⁶ The term “long party” means, with respect to any underlying security of any NPC, any party to the contract which is entitled to receive any payment pursuant to such contract which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to such underlying security. I.R.C. § 871(m)(4)(A).

¹⁷ The term “underlying security” means, with respect to any NPC, the security with respect to which the relevant dividend is paid. For purposes of this paragraph, any index or fixed basket of securities shall be treated as a single security. I.R.C. § 871(m)(4)(C).

¹⁸ The term “short party” means, with respect to any underlying security of any NPC, any party to the contract which is not a long party with respect to such underlying security. I.R.C. § 871(m)(4)(B).

¹⁹ I.R.C. § 871(m)(3) (footnotes added).

²⁰ I.R.C. § 871(m)(6).

II. Safe Harbor To Avoid Crossing In and Crossing Out.

A specified NPC includes an NPC in which there has been a Cross In or a Cross Out. In order to decide whether withholding is required, the withholding agent needs to prove a negative – that the parties have not engaged in either such transaction. In considering potential guidance, we recommend that Treasury and the Service not attempt to craft a comprehensive description of what would constitute a direct or indirect “transfer” between the short and long parties to a swap. We believe such an effort would effectively require drafting guidance that would cover the amorphous law of indirect transfers that has arisen in the tax common law. Rather, in the interest of providing guidance to the largest number of taxpayers generally, we recommend that a withholding agent (*e.g.*, the dealer) be permitted to rely on certain specific representations of its counterparty, much like a withholding agent may rely on the representations found in a Form W-8BEN with respect to the status of a taxpayer as foreign and the taxpayer’s ability to claim the benefits of a tax treaty. Because all or almost all NPCs are entered into using a form of Master Agreement of the International Swap Dealers Association (the “ISDA Master Agreement”), we recommend that the guidance approve specific language that is already contained in the current HIRE Act Protocol to the form of ISDA Master Agreement,²¹ as this would promote certainty in the marketplace, and consistency in application.²²

More specifically, we recommend that the guidance provide that if the representations and covenants contained in Paragraph 8(b) to the Attachment to the HIRE Act Protocol to the ISDA Master Agreement (the “ISDA Representations”)²³ are given by the parties, the withholding party may rely upon those representations and covenants to determine that no Cross In or Cross out has occurred, unless the withholding party has actual knowledge that such representations are untrue. In the ISDA Representations, as currently drafted, the Long Party²⁴ states that, unless it is a U.S. person or the swap is entered into in connection with the conduct of a trade or business in the United States, (i) it has not transferred and will not transfer the referenced equity to the Short Party in connection with its entering into such Transaction, and (ii) it will not acquire the reference equity from the Short Party in connection with the termination of such Transaction. Without limiting the foregoing, the Long Party further represents that (i) in the event that the opening price on such Transaction is determined by reference to “market on close” (“MOC”) or “market on open” (“MOO”) on a given day or days, it has not in connection with entering into the Transaction put in a sell order for the referenced equity at MOC or MOO on such given day or days and (ii) in the event that the closing

²¹ Available at <http://www.isda.org/isda2010hireactprot/docs/2010-HIRE-Act-Protocol-Text.pdf>.

²² While a withholding agent, together with its adviser, may formulate its own representations, the resulting lack of uniformity will create needless uncertainty in the marketplace. This uncertainty will be eliminated if a taxpayer can obtain a specific representation that has been sanctioned by the government.

²³ The Attachment, which includes the ISDA Representations, also is available at <http://www.isda.org/isda2010hireactprot/docs/2010-HIRE-Act-Protocol-Text.pdf>.

²⁴ Terms used but not defined in this paragraph have the meaning assigned to them in the HIRE Act Protocol.

price on such Transaction is or will be determined by reference to MOC or MOO on a given day or days, it will not in connection with the termination of the Transaction put in a buy order for the referenced security at MOC or MOO on such given day or days.²⁵

We believe that if in a transaction the ISDA Representations are contained in the governing documents, and the withholding agent lacks actual knowledge that such representations are untrue, any concerns that the Service or Treasury might have regarding a direct or indirect transfer should largely if not entirely be assuaged. We recognize that the mere fact that a representation is given does not ensure that it is true. We believe, however, that most counterparties want to comply with their U.S. tax obligations, and will not violate a covenant freely given. Additionally, if, unbeknownst to the withholding agent, the terms of the representation were untrue, only the withholding agent (*i.e.*, the dealer), and not the counterparty would be protected from liability for tax. This provides the Long Party an additional incentive to be certain that its representations are accurate. Thus, we recommend that Treasury and the Service provide guidance to the effect that if the ISDA Representations are provided by a Long Party to the withholding agent, the withholding agent may rely upon them unless the withholding agent knows the representations to be false.

We acknowledge that there are numerous other fact patterns that raise issues as to whether a Cross In or a Cross Out has occurred. We would be pleased to discuss these fact patterns in subsequent comments or to discuss them with Service and Treasury personnel if that would be more convenient.

III. Cleansing of Existing Positions.

Certain existing swaps would be specified NPCs because there was a Cross In at the inception of the swap and therefore would be subject to section 871(m). In such a case, the parties may wish to terminate the existing swap and enter into a new swap that meets the requirements for avoiding treatment as a specified NPC. From an economic perspective, the parties may wish to enter into the new swap at the same price at which the old swap is terminated. This raises the issue whether the new swap is simply a continuation of the old swap for purposes of determining whether the new swap is a specified NPC. On the other hand, if the old swap is terminated, and a new swap is entered into more than 30 days later (*i.e.*, the required waiting period under the wash sale rules), we would expect that, even in the absence of specific guidance, the new swap will not be considered a continuation of the old swap for purposes of determining whether the new swap is a specified NPC. In our judgment, the best approach does not require a lengthy waiting period, but does require that the investor take some economic risk. While there is no legislative history accompanying the enactment of section 871(m) and the Joint Committee Report is silent on why a Cross In was viewed as undesirable, it seems reasonable to conclude that Congress wanted offshore investors to accept at least a

²⁵ We understand that the current version of the HIRE Act Protocol may be amended in the future. If it is so amended, we respectfully request that Treasury and the Service allow a withholding agent to continue to rely on the HIRE Act Protocol so long as comparable representations are included in any future revised version of the HIRE Act Protocol.

modicum of price risk when going from physical ownership to swap, or from swap to physical ownership. If this is indeed the case, we recommend that guidance be issued that would provide that a taxpayer who accepts a similar degree of price risk in going from an old swap (with a Cross In) to a new swap should be viewed as having cleansed the taint of the Cross In on the old swap. Specifically, we recommend that guidance be issued that provides that if (i) the old swap is terminated and a new one initiated, (ii) the initial price of the new swap is not determined with reference to the final price of the old swap, and (iii) the ISDA Representations are given as in the HIRE Act Protocol discussed above, then the resulting new swap would not be viewed as a continuation of the old swap for purposes of section 871(m).

IV. Application of Rules for Avoiding Cascading Withholding Taxes.

Some swaps will constitute specified NPCs under section 871(m), and, absent further guidance, the dividend equivalent payments made thereon generally will be subject to U.S. withholding tax. For example, consider a foreign investor who borrows shares of a U.S. corporation from a foreign customer to establish a short position. Assume that the foreign investor decides to hedge its short position by purchasing shares on the market and Crossing In to a swap with a broker-dealer. The Cross In will cause the NPC to be a specified NPC and withholding will be required with respect to the dividend equivalent. However, withholding also will be required with respect to the substitute payment made with respect to the stock loan. Under the general rules governing withholding taxes, there is nothing to prevent withholding taxes from being imposed on a series of payments, each of which corresponds to a single economic event (*i.e.*, the payment of a dividend on the stock of a U.S. corporation).²⁶ In the analogous context involving chains of securities loans, the Service and Treasury recently issued Notice 2010-46,²⁷ which provides guidance that taxpayers may rely upon to prevent the cascading of withholding taxes on substitute dividends. We believe the principles of Notice 2010-46 are equally applicable to the issues presented under chains of specified NPCs. Accordingly, we recommend that guidance be issued that would extend the principles of Notice 2010-46 to chains of specified NPCs, as well chains consisting of both specified NPCs and securities loans.

V. Posting of Collateral.

Section 871(m) also provides that a NPC is a specified NPC if the underlying security is posted as collateral by any short party to the contract (*e.g.*, the Dealer) with any long party to the contract. Traditionally, practitioners have pointed to the fact that the counterparty is taking the full credit risk of the dealer under the swap as a way of distinguishing entering into a swap on the one hand from ownership of the equity on the other hand. While there is no specific indication of Congressional intent in imposing this requirement, it appears that Congress was concerned that the pledging of the stock as collateral undercuts the full credit risk shift. While we believe this concern is reasonable

²⁶ See Rev. Rul. 80-362, 1980-2 C.B. 208 (imposition of U.S. withholding tax on royalty paid by Netherlands corporation for right to use patent in the United States).

²⁷ 2010-24 I.R.B. 757.

when the counterparty is looking to the underlying equity as credit support sufficient to fully collateralize the dealer's obligations, a dealer, in the course of providing collateral to a counterparty, might provide the underlying stock to the counterparty as collateral along with a large amount of other collateral. We believe the perceived concern is less applicable when the fair market value of the underlying stock posted as collateral is small relative to the total amount of cash or other property used as collateral for the swap. For example, we believe that an NPC on ten million shares of stock that otherwise would not be a specified NPC should not become a specified NPC merely because a single share of such stock is posted as collateral to secure the dealer's obligation under the NPC. To avoid having taxpayers falling into a specified NPC when there is no apparent abuse, we recommend that the Service and Treasury provide guidance stating that if stock is used to provide collateral on an equity swap and on each day of the existence of the NPC the total dollar value of the stock provided is less than ten percent of the total dollar value of the collateral provided on such day, then no stock will be treated as having been provided as collateral on the NPC.