NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT

ON

SECTION 871(m)

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Introduction[1]

This report comments on recently enacted Section 871(m) (originally Section 871(*l*)),[2] which imposes withholding tax on "dividend equivalents" as defined therein. The purpose of this report is to identify areas where the statutory language and/or intended scope are unclear, and to recommend that guidance be promulgated addressing these uncertainties. This report will in general not make specific recommendations as to how these issues should be addressed, but will identify possible alternative approaches depending on how Treasury and the Internal Revenue Service (the "Service") view the scope and purpose of Section 871(m).

We understand that Treasury and the Service may be in the process of writing regulations addressing aspects of Section 871(m), including identifying instruments that will or will not constitute "specified notional principal contracts" ("SNPCs") after March 18, 2012. While we hope that this report will assist Treasury and the Service in that process, we will in general not attempt to make specific recommendations as to the circumstances under which one or more instruments should or should not be considered SNPCs.

The primary recommendation of this report is that Treasury and the Service make explicit their view of the intended scope of Section 871(m). The statute and its legislative history do not do so, leaving this determination to regulations and other guidance. Many aspects of the statute require fleshing out, either explicitly (*i.e.*, because the statute delegates authority to the Treasury and the Service to make determinations) or implicitly (*i.e.*, because terms and concepts have not been defined), and it is crucial in making these decisions to

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[1] This Report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates. This report was prepared by an *ad hoc* committee of the Tax Section consisting of John Barrie, Peter Blessing, Shlomo Boehm, Angelo Ciavarella, Margo Czapiewska, Sam Dimon, Sanjeev Doss, Francisco Duque, Pamela Endreny, Larry Gelbfish, Marcy Geller, David Hariton, Jack Heinberg, Jodi Schwartz, Jiyeon Lee-Lim, Will Lu, Bill McRae, David Miller, Jessica Millett, Mitch Moetell, Erika Nijenhuis, Laura Pomeroy, Mike Schler, Bonnie Tellgmann, Kirk Wallace, Gordon Warnke and Diana Wollman. The principal drafter of this report was Michael Farber, with substantial assistance from Lauren Murphey. Helpful comments were received from Peter Blessing, Peter Connors, Sam Dimon, Marcy Geller, David Hariton, Stephen Land, David Miller, Andrew Needham, Michael Schler, David Schnabel, Bonnie Tellgmann, Kirk Wallace and Gordon Warnke.

[2] Section references are to the Internal Revenue Code (the "Code") or the regulations thereunder.

know what is viewed as the purpose and intended scope of the statute – *i.e.*, fundamentally, what should be viewed as "the potential for tax avoidance" for purposes of this regime.

I. Summary of Section 871(m)

Section 871(m) was enacted in March 2010 in response to concerns that transactions involving stock lending transactions[3] and/or equity notional principal contracts ("NPCs")[4] were being used to avoid U.S. withholding taxes. In the case of stock lendings, the statute effectively codifies the result reached in a package of regulations promulgated in 1996 (the "transparency regulations"), but overrules Notice 97-66, which interpreted the transparency regulations in such a way as to allow taxpayers to argue that chains of securities loans, or securities loans coupled with NPCs, could avoid U.S. withholding tax.

Basically, Section 871(m)(1) treats "dividend equivalents" as U.S.-source dividends for purposes of Sections 871(a), 881 and 4948(a) and subchapters 3 and 4 (generally involving withholding on payments from U.S. sources). Section

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[3] A stock lending transaction is very generally one in which an owner of stock lends it to a borrower, in exchange for the borrower's commitment to return it or identical stock, typically either on demand or at a specified time. The stock loan agreement typically puts the lender in the economic position of an owner of the stock during the term of the loan, *e.g.*, by requiring the borrower to make "substitute" payments of any amounts paid on the underlying stock during the term of the loan. Often the borrower will post collateral for the loan in an amount equal to the value of the lent stock. The borrower will in economic terms pay the lender a fee for the use of the lent stock, although this amount is often simply deducted from the return provided to the borrower on its posted collateral (known as "rebate"). The borrower may under the contract use the stock it borrows as it chooses (*but see infra* note 12), though borrowed stock is commonly used to close a "fail" sale (where a person committed to sell stock is unable to deliver that stock and must borrow stock to satisfy its delivery obligation) or a "short" sale (where the seller wishes to bet against the stock and so sells borrowed stock hoping to "cover" when the stock declines in value and return cheaper stock to its lender, locking in the difference between the "short proceeds" and the cost of "cover" as gain).

[4] Very generally, an NPC in common understanding among tax lawyers is a contract under which one party is required to make periodic payments to the other by reference to a specified index and a specified notional amount, in exchange for specified consideration or the other party's obligation to make similar payments (by reference to a different index). A typical equity NPC, in general terms, might look as follows: The "long" party might agree to pay periodically (*e.g,* monthly) a funding rate like LIBOR on an amount (*e.g.*, $1 million) equal to the then-value of a specified number of shares (*e.g.*, 10,000) of stock of a specified entity ("ABC Corp."). In exchange, the "short" party might agree to pay periodically amounts equal to dividends paid on 10,000 shares of ABC Corp. stock during the relevant period, and the parties might agree that at maturity either (a) the short party will pay to the long party the amount (if any) by which the then-value of 10,000 shares of ABC Corp. stock exceeds $1 million or (b) the long party will pay to the short party the amount (if any) by which $1 million exceeds then then-value of 10,000 shares of ABC Corp. stock. In other words, the NPC puts the long party in the economic position of someone who has borrowed $1 million at a rate of LIBOR for a period and used that money to purchase 10,000 shares of ABC Corp. stock (which it has economically agreed to sell on the maturity date, unless the contract is extended).

871(m)(2) defines a "dividend equivalent" for this purpose as (A) a "substitute dividend" pursuant to a stock lending or sale-repurchase transaction[5] or (B) a payment pursuant to an SNPC, that in either case (A) or (B) is (directly or indirectly) contingent on or determined by reference to the payment of a U.S.-source dividend, or (C) any other payment determined by the Secretary of the Treasury to be substantially similar to a payment described in Section 871(m)(2)(A) or (B).

An SNPC is defined in Section 871(m)(3) as (a) an NPC with respect to which the underlying security is (i) transferred by the "long" party to the "short" party at inception of the NPC; (ii) transferred by the short party to the long party at maturity or earlier termination of the NPC; (iii) not "readily tradable on an established securities market"; or (iv) posted as collateral by the short party;[6] (b) an NPC that is identified by Treasury as an SNPC; or (c) any NPC, to the extent dividend equivalents are paid thereunder after March 18, 2012, unless Treasury determines that the NPC is of a type that does not have the potential for tax avoidance.[7]

For these purposes, Section 871(m)(5) provides that a "payment" includes any gross amount that is used in computing any net amount transferred to or from the taxpayer. Section 871(m)(4)(C) provides that (x) an "underlying security" with respect to an NPC means the security with respect to which a U.S.-source dividend described in Section 871(m)(2)(B) has been paid (see the second preceding paragraph), and (y) for this purpose, any index or fixed basket of securities is treated as a single security.

Section 871(m)(6) permits (but does not require) Treasury to reduce the tax imposed under Sections 871(a) and/or 881 in the case of any chain of dividend

[5] A sale-repurchase transaction or "repo" is one in which one party (the "repo seller") sells (or "repos out") stock or securities to another (the "repo buyer"). Under the contract, the parties agree that the repo buyer will sell the same or substantially identical stock or securities back to the repo seller at the maturity of the contract or on demand. The repurchase price may be greater than the original sales price by an amount reflecting time value, or the contract may permit the repo buyer to retain income earned on the repo'd securities equal to an agreed amount reflecting time value. In this manner, repos act economically much like secured cash loans, which is generally how they are treated for tax purposes. *See, e.g., Nebraska Dep't of Revenue v. Loewenstein,* 513 U.S. 123 (1994); Rev. Rul. 74-27, 1974-1 C.B. 24.

[6] Senator Levin noted on the floor of the Senate on the day that President Obama signed Section 871(m) into law that, "[t]he four specified criteria define the worst of the abusive notional principal contracts that the [Senate's Permanent Subcommittee on Investigations] uncovered." Remarks of Senator Levin, 156 Cong. Rec. S 1745, 1746 (Mar. 18, 2010).

[7] Senator Levin observed in his remarks on the day that Section 871(m) was signed into law that, "it is the intent of this language that the Secretary uses this exception authority very sparingly, that only narrow types of contracts be excepted, and that such exceptions be fashioned only after conducting a thorough analysis to ensure that the contracts under consideration cannot be exploited for tax avoidance. . . . . That is intentionally a very high standard." *Id*.

equivalents, but only to the extent that either the taxpayer can establish that such tax has been paid with respect to another dividend equivalent in the chain or is not otherwise due, or Treasury determines appropriate to address the role of financial intermediaries in the chain. For this purpose, a dividend is treated as a dividend equivalent.

The legislative history[8] adds very little in the way of detail as to what is meant by various of these concepts, most notably what types of NPCs (do not) have the potential for tax avoidance and what it means for a payment to be "substantially similar" to a payment that is otherwise treated as a dividend equivalent under the statute.

The Senate's Permanent Subcommittee on Investigations (the "PSI") held hearings on the issue of abusive dividend withholding tax avoidance transactions in mid-2008, and thereafter issued a report on its findings.[9] The PSI Report identified a number of "red flags" that the PSI viewed as signaling abusive transactions, including (i) the short duration of a transaction; (ii) the payment by the short party of amounts in excess of 70% of a dividend; (iii) the short party charging fees tied to tax savings; (iv) the long party selling shares before and reacquiring them after a dividend distribution; (v) the use of third-party intermediaries to create the appearance of market sales; (vi) the coordination of stock sales and repurchases to minimize or eliminate risk of financial loss; and (vii) the short party treating the transactions as creating tax risk and setting "risk limits."

Then in March 2009, Senator Levin and Representative Doggett sponsored identical proposals that would have treated any payment that is contingent upon or referenced to the payment of a dividend on U.S. stock or substantially similar or related property under any NPC as a U.S.-source dividend.[10]

Shortly thereafter, in May 2009, the Obama administration proposed to address dividend withholding in connection with stock loans and equity swaps.[11] That proposal would have treated income from equity swaps attributable to or calculated by reference to dividends paid by domestic corporations as U.S.-source,

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[8] *See* Staff, Joint Comm. on Tax'n, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate*, at 77 (JCX-4-10, Feb. 23, 2010) [hereinafter, *JCT Report*].

[9] Staff, Senate Permanent Subcomm. on Investigations, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, at 6 (Sept. 11, 2008) [hereinafter the *PSI Report*].

[10] Stop Tax Haven Abuse Act, S. 506, Section 108 (Mar. 2, 2009); H.R. 1265, Section 108 (Mar. 3, 2009) [hereinafter collectively the *Levin/Doggett proposals*].

[11] *See* Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (2009).

with an exception for swaps with all of the following characteristics: (i) the terms do not require the long party to post more than 20% of the value of the underlying stock as collateral; (ii) the terms do not address the hedge position of the short party; (iii) the underlying stock is publicly traded and the swap's notional amount represents less than 5% of the public float and less than 20% of the 30-day average daily trading volume; (iv) the long party does not sell the stock to the short party at inception or buy it from the short party at termination (commonly referred to as "crossing in" and "crossing out," respectively); (v) the prices of the underlying stock used to measure the parties' rights and obligations are based on objectively observable prices; and (vi) the swap has a term of at least 90 days.

Whether and to what extent the PSI Report or the Levin/Doggett and Obama administration proposals should inform the discussion surrounding the scope of Section 871(m) as enacted is not entirely clear. Moreover, precisely what they would imply as to the intended scope of the statute is also not entirely clear, although as we will discuss in Part II.A, the PSI Report and the Obama administration proposal would suggest a fairly limited understanding of what is or might be "abusive" about NPCs and stock loans, whereas the Levin/Doggett proposals would suggest quite a broad interpretation. In any event, we think that it is essential for the government, taxpayers and practitioners to have a clear understanding of what the concepts "substantially similar" to a dividend equivalent and (lack of) "potential for tax avoidance" entail, because as we will discuss, they affect one's views on a significant number of issues raised by the statute.

II. Issues with Section 871(m)

There are a number of interpretive and other issues raised by Section 871(m). There follows a discussion of these issues and, where possible, our recommendations as to how to address them. In general, however, our recommendation is that guidance make explicit how Treasury and the Service intend to address these issues, one way or another.

A. Policy Basis for Section 871(m)

As has been alluded to, the policy basis for Section 871(m) is not entirely clear or self-explanatory. In particular, what is viewed as "tax avoidance" in the context of withholding on payments equivalent to dividends is not self-explanatory. The statute identifies "substitute dividend" payments under stock loans (and sale-repurchase transactions) as well as payments equivalent to dividends under SNPCs, which are NPCs that (at least until March 2012) have specified characteristics – *i.e.*, where the underlying stock has been "crossed in" or "crossed out," is not "readily tradable on an established securities market," or has been posted as collateral. To understand when a transaction has the potential for tax avoidance, or when a payment is substantially similar to a "dividend equivalent" as defined in the statute, it may be useful to understand what these circumstances have in common.

The “history” of Section 871(m), discussed briefly in Part I, is somewhat instructive in this regard. The statute is clearly the culmination of several years’ worth of legislative and administrative scrutiny of the use of stock lending and swap transactions to achieve what has been viewed as the inappropriate avoidance of dividend withholding tax. The PSI Report was focused on transactions in which the long party (and/or the short party) entered into an NPC or stock loan for the express purpose of avoiding withholding tax, in particular where the long party disposed of pre-existing stock in connection with the entry into the position (typically to the short party), held a swap position for a short period around a dividend date, and then reacquired the stock. The Levin/Doggett proposals clearly took the view that ***all*** total-return exposures to U.S. dividends should be subjected to U.S. withholding tax. The Obama administration proposal seems more in line with the PSI Report; it attempted via its “safe harbor” exception to identify aspects of NPCs that suggest that they are not being used for the purpose of avoiding dividend withholding tax via either effective crossing of the underlying stock back and forth between the parties or illiquid underlyings, in either case in the context of a short-term derivative position.

To summarize, the PSI Report suggests an emphasis on the intent to avoid withholding tax by a long party that owns underlying stock prior to entry into a transaction and enters into the contract with the intent to receive the underlying dividend amount tax-free and then to reacquire the underlying stock shortly thereafter. The Obama proposal reflects this focus to some extent, and adds a concern that unless the underlying is a liquid stock that the short party is free to do with as it chooses and that can be and is objectively priced, there may be some form of abuse involved.

As we discuss below, it is not clear that the existence of some or all of these features really does indicate tax avoidance in many cases. Certainly the Levin/Doggett proposals seem overly broad in several senses (again, discussed below). Moreover, it is not entirely clear that (or how) the enumerated features of SNPCs in the statute reflect the same concerns as those reflected in the PSI Report or the Levin/Doggett or Obama administration proposals, and it is thus unclear whether or to what extent these prior analyses should inform the question what the intended scope of the statute is or should be. Below, we consider four possible policy bases for subjecting dividend equivalents to U.S. withholding tax.

One possibility – leading to a quite narrow reading of the statute – is that the critical issue is whether the underlying stock has been or can be presumed to have been “immobilized” or isolated in the short party’s possession “for the benefit of the long party” in some sense. However, the criteria currently set forth in the statute for determining what is a “dividend equivalent” would not seem to lead to this conclusion. For example, stock borrowers generally do not hold on to the stock they borrow, but typically on-lend it or use it to cover short or fail sales.[12] And as for NPCs, the fact that stock has been "crossed in" or "crossed out" does not indicate anything about whether the short party holds that stock during the term of the NPC. Indeed, we understand that in many cases it will not do so, as a general rule; short parties typically endeavor to on-lend "hedge" stock or use it in their business (*e.g.*, "repo" it out or otherwise borrow against it) to the extent possible, as this generates income (or at least cash) and thus defrays the cost of financing the transaction.

Another possibility – which would lead to a very broad interpretation of the intended scope of the statute – would be that any instrument that provides a long party with essentially "total return" exposure to underlying domestic stock (*i.e.*, with substantially all the economic effects of owning the underlying stock, including the right to benefit from appreciation, the risk of loss as a result of depreciation, and the right to receive dividend-equivalent amounts), should be subject to the statute. In this event, for instance, it might make sense to test an instrument under rules similar to those of Sections 1259 and 1260, or to impose a "delta" threshold, in order to determine whether an instrument or combination of instruments is sufficiently "total return" that the statute should apply.[13]

However, this interpretation also does not seem supported by the statutory SNPC criteria, at least without more. For one thing, nothing in the definition of an SNPC requires that the NPC in question provide total return exposure to underlying stock (although nothing in the legislative history, the PSI hearing or Report, the Levin/Doggett proposals or the Obama administration proposal indicates that there was any concern with NPCs that do ***not*** provide total return exposure). Indeed, nothing in the statute requires that an SNPC provide ***any*** exposure to underlying stock, other than one or more payments contingent upon the payment of a dividend with respect thereto. In addition, if all total return exposures were intended to be viewed as having the potential for tax avoidance, then it is unclear to us why the statute would not simply have said so, as the Levin/Doggett proposals did; indeed, if "total return" exposure to the underlying stock were without more the policy basis for the regime, it is unclear why Congress might have thought "typical" equity NPCs[14] could ever be "of a type which does not have the potential for tax avoidance."[15]

[12] Indeed, brokers are generally prohibited from borrowing securities for other than such an exempted "purpose." *See* Regulation T under the Securities Exchange Act of 1934, 12 C.F.R. Section 220.10.

[13] "Delta" is expressed as a fraction and is essentially the amount by which a unit of position A changes value when a like-sized unit of position B changes value by $1.

[14] *See supra* note 4.

[15] Moreover, if we were to test an instrument for "total return" exposure, it would become critical to make clear ***when*** that testing should occur. For example, an ordinary listed option on an underlying stock can become "deep in the money" and begin to trade like the underlying stock. It would seem impractical to require the exchange (or issuers of over-the-counter options) to monitor (…continued)

As another alternative, a critical issue might be whether there are feasible alternative means for the short party to hedge its exposure to the instrument, other than holding the underlying stock. This might be the logic that motivated the requirement that the underlying security be readily tradable on an established securities market (and presumably the Obama administration proposal to exempt NPCs that among other things involved a relatively small percentage of the float and average daily trading volume of a publicly traded stock). For example, if this is determined to be a significant policy concern, it might be appropriate to analyze whether there is a liquid market for options or futures available that would permit the short party to hedge without owning the stock.[16] Indeed, even an active "borrow" market would suggest that the short party could expect (and be expected) to lend out or otherwise "use" any underlying stock it holds as a hedge of the NPC in its business, effectively hedging its exposure by holding a right to receive the underlying stock from a third party under a stock loan agreement. In this event, it can be expected that a third party will own the underlying stock on dividend record dates (and thus be taxed on dividends), as discussed further below.

However, if this is the primary policy issue under the statute, it would be helpful to understand why that is the case. For example, even where the underlying security is relatively illiquid or where there may be some difficulty finding alternative means of hedging the instrument, it would seem potentially relevant to the analysis, as a policy matter, whether the short party has lent the stock or used it in its business, in such a way that an unrelated third party owns it (and is presumably being taxed appropriately on its dividends). On the other hand, again, this "counterargument" seems not to have been considered significant in the case of stock loans, where the underlying security may (likely will) have been sold into the market.

A final possibility is that the statute was aimed at long parties that use NPCs to avoid withholding tax that they would otherwise have incurred, because they were owners of the underlying stock prior to entry into the NPC and/or intend to remain owners of the underlying stock following termination of the NPC. While this was clearly the principal source of concern in the PSI hearings and Report, we think the statutory language is not limited to this situation. This is because only the SNPC criteria involving "crossing" establish (or tend to establish)

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trading of those instruments to determine when they have become "too" deep in the money or when their delta has risen above a specified threshold.

[16] If so, presumably that would not include "pushing the issue down a level" by entering into a back-to-back arrangement with another entity that would itself be expected to hold the underlying stock (or at least to have no feasible alternatives to doing so).

that the long party was the owner of underlying stock prior to entry into the NPC or intends to continue to own underlying stock after termination of the NPC.[17]

The fact that nothing in the statute requires immobilization, total-return exposure, feasible alternative hedging or historic or continuing ownership by the long party (or any other particular characteristic) leaves the concepts of what is "substantially similar" to a dividend equivalent, and what has the "potential for tax avoidance," fairly untethered. We suspect (and generally think it appropriate) that some combination of immobilization of the underlying stock, total-return exposure, feasible alternative hedging and historic or continuing ownership ought to be the touchpoint(s) for determining what kinds of dividend equivalent payments should be considered "substantially similar" to those described in Section 871(m)(2)(A) and (B), and what ought to be considered (not) to have the "potential for tax avoidance." However, this general observation is not very elucidating, because the enumerated criteria in Section 871(m)(3) really do not get at what can categorically be described as "tax avoidance" (outside of certain clearly targeted circumstances) in any clear way. And as we discuss further below, it is indeed quite difficult to articulate concisely what "should" be considered tax avoidance.

For example, the statute treats an NPC as an SNPC in many cases where it is difficult to discern any material potential for tax avoidance.[18] Conversely,

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[17] In fact, we understand that sophisticated long parties may desire to cross in in circumstances where they have not owned the underlying stock (or to cross out in circumstances where they do not intend to own the underlying stock), *e.g.*, where the long party desires to establish the price at which it enters into its exposure itself, rather than letting the short party do so via the NPC pricing. For example, the long party might buy the underlying shares shortly prior to entry into the NPC, in order to establish its own "entry price," and then sell those shares to the short party on entry into the NPC. This requires (momentary) funding on the part of the long party, obviously, but many view themselves as sufficiently capable of executing transactions that they prefer this cost to allowing the short party to establish pricing. Similarly, a long party may short the underlying shares shortly prior to the unwind of the NPC in order to establish its own "exit price," and then wish to acquire the short party's hedge position in order to deliver those shares to the long party's lender.

[18] For example, stock that is crossed in or is not readily tradable may nonetheless be lent or used by the short party in its business during the term of an NPC, which as described below in this Part can be viewed as evidence of a lack of any tax avoidance. Also, an NPC is an SNPC if a transfer from the long party to the short party (or *vice versa*) occurs in connection with entry into (or out of) the NPC, even if the transfer occurs at a price unrelated to the pricing of the NPC (and even if it occurs with a different desk than the desk that executes the NPC, which may not even know that the NPC has been executed – which we understand is in fact not uncommon). It is not at all clear to us that this fact pattern constitutes – at least "simple" – tax avoidance, given that the long party is taking meaningful market exposure by selling or buying at a price unrelated to the NPC pricing. As another example, we understand that short parties often pledge entire accounts as collateral for NPCs, and that in some cases, from time to time, some portion of the assets in the account may – inadvertently – be reflected in the NPC. This too would trigger Section 871(m).

Even if perhaps not common fact patterns, the mere fact that these situations implicate Section 871(m) is a source of some uncertainty as to what should be considered the policy basis
(…continued)

consider a fact pattern in which none of the enumerated criteria of Section 871(m)(3) is met, but the short party in fact acquires the underlying stock and holds it as a hedge for the entire duration of the NPC. Assume also that the short party uses the prices at which it acquired and sold the stock as the "entry" and "unwind" prices under the NPC. Or consider an NPC in which the long party sells a number of shares equal to the number of shares underlying an NPC into which it simultaneously enters, but does not sell those shares to the short party. Assume also that the long party acquires that same number of shares upon unwind of the NPC, but not from the short party. Without a clear understanding of what the enumerated criteria of Section 871(m)(3) are (or should be) "driving at," it is difficult to analyze whether these NPCs should be considered to have the potential for tax avoidance or whether payments under non-NPC instruments with similar features should be viewed as "substantially similar" to dividend equivalents.

Consider another example: Suppose a borrower issues an otherwise typical debt instrument that (among other things) makes periodic payments equal to dividend amounts on the stock of an unrelated third party.[19] Are those payments "dividend equivalents," or substantially similar thereto? If they were made under an NPC, then they might well be dividend equivalents (perhaps under current law, if one of the conditions for being an SNPC were met, but in any event beginning in March 2012, unless Treasury issues guidance excluding the particular NPC before that time) – even if that NPC otherwise provides no exposure to the underlying stock. As an example of such an (arguably "substantially similar") NPC, consider a "dividend swap," a not-uncommon instrument in which one party simply agrees to pay dividend amounts with respect to a specified number of shares of an underlying stock for a period of time, in exchange for the other party agreeing to pay an interest or other rate.

Under Section 871(h)(4)(C)(v)(II), the amounts paid on the hypothetical debt instrument described above are explicitly entitled to the portfolio interest exemption, as long as the underlying stock is actively traded (within the meaning of Section 1092(d)) and is not stock of the issuer or a related person. We doubt that Section 871(m) was intended to change the result provided by Section 871(h)(4)(C)(v)(II), given the lack of any indication that Congress intended to do so and the fact that dividend equivalents under debt instruments are far-removed from the types of transactions that were perceived in the press and congressional hearings to be giving rise to tax avoidance. However, the fact that (at least beginning in March 2012) these payments will look a lot like payments under

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for the regime. At a minimum, these seem to indicate that the formal application of the enumerated features of an SNPC can produce results that are at least quite debatable as a policy matter.

[19] For example, instruments commonly known as "PHONES" had this feature. *See, e.g.,* Comcast Corp., Final Prospectus (Form 424B2) (Mar. 15, 1999), available at http://sec.gov/Archives/edgar/data/22301/0000893220-99-000328-index.html.

"dividend swaps," which will be SNPCs (unless Treasury and the Service act) calls into question whether the statute effectively has (or will beginning in March 2012 have) that result.

Obviously, Treasury and the Service could simply issue guidance stating, *e.g.*, that dividend swaps are not SNPCs.[20] However, we would not recommend that either, at least categorically – dividend swaps could be combined with other instruments to produce what might be considered tax avoidance. For example, a dividend swap that is in fact coupled with a "price return" NPC with respect to the same underlying stock could have an effect similar enough from the long party's perspective to what is (and perhaps "should be," depending on what one concludes constitutes tax avoidance in this context) a dividend equivalent under the statute that it should be treated as "substantially similar" thereto.[21] Of course, if the short party to the dividend swap has no knowledge of that fact (*e.g.*, because the "price return" NPC was done with an unrelated party), that would call into question whether it should have any withholding obligation. The statute doesn't provide a simple means of dealing with these issues, but we question whether it is appropriate simply to "exempt" dividend swaps from the regime in all cases.

At bottom, the question is what it is about chains of stock loans and/or equity NPCs that creates the potential for tax avoidance, and what it is that makes a payment equivalent to a dividend "substantially similar" to one already described in the statute. At one extreme, we do not believe (nor does Congress, see Section 871(h)(4)(C)(v)(II)) that it is imperative that every dividend equivalent payment made to a non-U.S. person be subject to U.S. withholding tax. Moreover, as discussed further below, the imposition of U.S. withholding tax on every dividend equivalent payment would not necessarily prevent foreign investors from avoiding the U.S. withholding tax by, for example, entering into forward or other derivative contracts that implicitly take account of the difference between current dividend yields and interest rates and that can be terminated in the unlikely event that the dividend yield changes. At the other extreme, it is at least arguable that a tax-indifferent or largely tax-indifferent entity (such as a U.S. dealer in securities, which in a very oversimplified sense is taxed on fully hedged securities positions only to the extent of the "spread" it earns) that actually holds U.S. stock should not as a matter of policy be permitted to transfer substantially

[20] It is quite clear as an economic matter that dividend swaps are commonly used for purposes other than tax avoidance. *See, e.g.*, "S&P Strangle Built," DERIVATIVES WEEK, Jan. 31, 2011 (describing among other things the use of dividend swaps as a hedge of "plain vanilla" option positions, as well as an evidently common arbitrage in the current environment between U.S. index dividends and European index dividends).

[21] Indeed, even a debt instrument could be used, with other instruments, to achieve a result that one might find inappropriate under the statute (depending on one's view of the proper scope of the statute). For example, an "optionally exchangeable" debt instrument linked to an underlying stock, providing for upside exposure plus dividend amounts, could be coupled with the sale of a put option on the underlying stock to provide a total return exposure.

all of the economic exposure to that stock to a non-U.S. person without dividend withholding tax (assuming for this purpose the continued existence of a withholding tax on portfolio dividends).

But importantly, to the extent that the "tax-indifferent party" lends the hedge stock or uses it in its business in such a way that an "unrelated" third party ends up owning it, the picture becomes markedly less clear. In that event, the result may be that more dollars are being taxed than were actually paid as dividends by the underlying stock issuer. Again, this is not necessarily an unacceptable result in the scheme of things, and we do understand and sympathize with the desire to err on the side of being conservative in this regard (particularly given how difficult it can be to know when and to what extent underlying stock dividends are being taxed appropriately), but it is hard to see the result as "tax avoidance" under these circumstances.

Put simply, we think there might in fact be "tax avoidance" in any case where a short party that is largely tax-indifferent holds underlying stock on a dividend record date while it has an obligation to a long party (under a stock loan, NPC or any other "total return" exposure) that would have been subject to withholding tax had it (the long party) held the underlying stock on the record date. The SNPC criteria in Section 871(m)(3)(A) may be factors indicating this might be a possible state of affairs on any dividend record date, but they in no way "get at" it; they are both over- and under-inclusive from the perspective of this sense of tax avoidance. They are over-inclusive because none of them establishes that the short party in fact holds the underlying stock on a dividend record date (or is largely tax-indifferent). They are under-inclusive because there are many fact patterns where the short party ***will*** hold the underlying stock over a record date that are not described in Section 871(m)(3)(A) (as described above).

On the other hand, the substitute dividend rule of Section 871(m)(2)(A) applies (to payments under stock loans and sale-repurchase transactions) without regard to the state of affairs that might be considered to constitute tax avoidance – a substitute dividend will be subject to withholding tax, even if (as is highly likely, see note 12 and accompanying text) the underlying stock is not held by the short party (the borrower) on a dividend record date.

One way to reconcile all this might be to articulate the policy objective of the statute as a desire to put the burden on long parties and short parties (*i.e.*, taxpayers and withholding agents) to establish that there was (or that there is no reason to believe there was not) "net" tax paid on the dividend on the underlying stock or some other equivalent payment (*e.g.*, in a "chain"), in any case where total return derivative exposure is provided to a long party that would have been subject to U.S. withholding tax had it owned the underlying stock directly on a record date, at least where either (a) the long party disposes of underlying stock in connection with the entry into the derivative or acquires underlying stock in connection with the termination of the derivative (and, where the issue is the short party's withholding obligation, the short party knows that) or (b) there is reason to expect the short party to hold underlying stock over dividend record dates during the term of the derivative (Section 871(m)(3)(A) might be viewed as a list, though perhaps not exhaustive, of features that suggest such a reason).

If this approach to fleshing out the potential for tax avoidance and substantially similar payments were adopted, whether the "antecedent" tax ought to be required to be a withholding tax and, if so, whether it ought to be required to be subject to "net" tax at the same rate as the long party's rate, are more subtle questions. Section 871(m)(6)'s authorization to reduce "such tax" where there is a chain of payments might suggest that the proper comparison is to the withholding tax that would have been imposed at the long party's rate. On the other hand, as a matter of first principles in considering what constitutes "avoidance," there would not seem to be tax avoidance if (it could be shown that) the stock underlying a stock loan were in fact owned by a non-tax-indifferent U.S. taxpayer (which generally would not include the short party, as for this purpose we assume that entity will typically be a broker-dealer that as described above is largely tax-indifferent) over the relevant record dates(s).[22] The obvious observation here is that whenever a dividend associated with stock that can be thought to "underlie" a derivative is "properly" taxed in one form or another, any tax imposed under Section 871(m) can be viewed as "excessive, either in whole or (if the proper comparison is viewed as the long party's gross-basis withholding tax rate, and the amount by which the "antecedent" tax liability is less than that), in part.

And in practice, the most important issue with an approach like this would be what to assume when it is not known whether any "antecedent" tax was paid, *e.g.*, where on the record date(s), the short party has sold, lent or otherwise disposed of any stock it was holding as a hedge of the derivative. To our knowledge, there is in general no reason to believe anything in particular about the ownership of that stock – that is, there is no reason to assume it is owned by a tax-indifferent entity, for example a charitable organization or a foreign government. On the other hand, there certainly is the "potential" that this is the case. But again, where it is not, the net effect of imposing withholding tax under Section 871(m) is "excessive" taxation.

In any event, once again, we think the critical task for Treasury and the Service is to determine (and to make public) the circumstances under which NPCs have the potential for tax avoidance and (we assume relatedly) the criteria for determining whether a payment is "substantially similar" to a dividend equivalent.

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[22] This would in theory require an analysis of whether the "ultimate" owner of the underlying stock was hedging its exposure, and whether if so it was entitled to a deduction for dividend-linked payments it might be making under its hedge position(s). In general, Sections 263(g) and (h) operate to prevent such deductions on a current basis, though they are typically ultimately available (often as capital losses). In any event, however, as discussed in the text, there is no particular reason to expect the "ultimate" owner of underlying stock that has been lent or disposed of by the short party to hedge that stock.

B. Terminology Issues

There follows a discussion of several terms used in Section 871(m) that are unclear and as to which we hope Treasury and the Service will provide guidance.

1. What Is a "Notional Principal Contract"?

Section 871(m), and indeed the Code, nowhere defines a "notional principal contract," and thus does not permit a clear delineation as between SNPCs and other instruments that may or may not have similar economic features but that are not (at least "currently"[23]) within the scope of the statute. There is no doubt that under the "substantially similar" provision in Section 871(m)(2)(C), Treasury and the Service could determine to treat all instruments similar to an NPC as having the potential to give rise to "dividend equivalents," so this issue may ultimately not have much effect on the application of the regime. However, the mere fact that Congress referenced an NPC may indicate something about what should be considered a dividend equivalent. And in any event, there are issues surrounding how taxpayers and withholding agents should treat non-NPCs prior to the issuance of any guidance relating to them. We will here briefly discuss what is and what is not an NPC.

The term "notional principal contract" is defined in two sets of Treasury regulations – Section 1.446-3 and Section 1.863-7. Section 1.446-3 sets forth the rules for tax accounting for notional principal contracts, and Section 1.863-7 provides rules to determine the source of notional principal contract payments. Each of these definitions is somewhat unclear in scope, containing a variety of uncertainties. Moreover, while they are similar to each other, it is by no means clear that they are the same.[24] We would imagine, given that the issue raised by

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[23] An ambiguity arises under Section 871(m)(2)(C), which applies the statute to payments that are "determined by the Secretary to be substantially similar to" dividend equivalents. The uncertainty here is whether Treasury and the Service must make the relevant determination in guidance (*e.g.*, via a regulation or Revenue Ruling) in order for the relevant payment to become subject to Section 871(m), or whether the Service can make such an assertion after the fact, *e.g.*, in connection with an audit of a taxpayer. As a matter of good administration, we strongly recommend the former approach. Assuming Treasury and the Service agree on this, then it is accurate to say that dividend-linked payments under instruments that are not NPCs (whatever that means) are not currently within the ambit of Section 871(m).

[24] Notably, the Section 1.446-3 regime is in a sense "elective," in that it applies only to instruments that provide for periodic payments to be made at least annually. *See* Treas. Reg. Section 1.446-3(e)(1). Section 1.863-7 contains no such requirement. In addition, Section 1.446-3 enumerates the scope of a "specified index," on which a notional principal contract must be written in order for that regime to apply, *see id.* Section 1.446-3(c)(2), (4), including a requirement that any index other than a fixed rate, price or amount or certain interest rates must be based on objective financial information that is not within the control of either party or unique to either party's circumstances. Section 1.863-7 again contains no such limitation.

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Section 871(m) is the source of certain payments, that the most analogous definition would be that found in Section 1.863-7. On the other hand, nothing about the definition in Section 1.863-7 makes it obviously preferable to the definition in Section 1.446-3 for purposes of Section 871(m) (or *vice versa*). Indeed, for example, the regulations under Section 512 (relating to unrelated business taxable income) define a notional principal contract by reference to the definition in *either* regulation.[25] Fundamentally, what is important is for taxpayers and practitioners to understand what is considered an NPC (and thus potentially an SNPC) and what is not (at least currently) within the ambit of the regime.

What does seem clear, as a matter of tax law, is that there are many instruments (or combinations of instruments) that are not NPCs, even if they have economics very similar to the economics of an NPC. For example, we think it clear that a "forward contract" is not an NPC.[26] A "bullet swap," as defined in proposed Treasury regulations Section 1.1234A-1(c)(2), is an instrument that in all respects resembles an NPC, except that all obligations under the instrument are settled at or close to the maturity of the instrument.[27] The proposed regulation would treat "bullet swaps" (and "forward contracts") markedly differently from NPCs as defined in Treasury regulations Section 1.446-3. Further, we assume it is clear that futures contracts (including single stock futures contracts) are not

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(continued…)

Further, Section 1.446-3(c)(3) specifies that the "notional principal amount" of an NPC is not borrowed or loaned between the parties, whereas again, Section 1.863-7 contains no such proscription. This latter item has led to a great deal of confusion and uncertainty among practitioners, in that Section 1.446-3 does not provide that an instrument isn't a notional principal contract if the notional principal amount is lent from one party to the other, but only that if an amount is lent from one party to the other, it isn't the notional principal amount. The better reading is probably that if the notional principal amount is lent from one party to another (*e.g.,* in the case of a "prepaid forward" that provides for periodic payments to be made at least annually), the instrument is not a Section 1.446-3 NPC. But nothing prevents the instrument from being a Section 1.863-7 NPC – although we are not aware of practitioners or taxpayers, at least with any confidence, treating a prepaid forward with periodic payments as an NPC for purposes of Section 1.863-7.

[25] See Treas. Reg. Section 1.512(b)-1(a)(1).

[26] *See* JCT Report, *supra* note 8, at 78 ("A dividend equivalent also includes any other payment that the Secretary determines is substantially similar to a [dividend equivalent under a stock loan, repo or SNPC]. Under this rule, for example, the Secretary may conclude that payments under certain forward contracts or other financial contracts that reference stock of U.S. corporations are dividend equivalents.").

[27] Also curious, the definition provides that a "bullet swap" is not an "excluded contract" as defined in Section 1.446-3(c)(1)(ii), which contains a list of types of instruments, including forward contracts. It is not entirely clear how one knows whether an instrument is a "bullet swap" as opposed to a "forward contract," but it is clear that both are treated differently from NPCs.

NPCs.[28] And as recognized by Congress in Section 1260(d)(1)(C), a purchased (written) call option plus a written (purchased) put option, if struck at substantially the same prices and maturing substantially contemporaneously, can act like a forward contract or NPC. This combination of instruments, too, is clearly not an NPC.

We expect that Treasury and the Service will determine that payments of dividend amounts under forward contracts, bullet swaps, futures contracts, and put/call combinations, under circumstances where the instrument(s) would be an SNPC if it/they were an NPC, should be treated as "substantially similar" to dividend equivalents. It would be helpful if this were made explicit, *a priori*, in published guidance, to avoid confusion in the market and to ensure that short parties feel authorized/empowered to withhold and report such amounts appropriately.[29]

2. What Is "Readily Tradable on an Established Securities Market"?

Section 871(m) defines an SNPC as one with respect to which the underlying security is not "readily tradable on an established securities market." However, Section 871(m) and its legislative history do not define this term. The

[28] While we understand that most typical futures contracts do not pay through ordinary dividend amounts but merely make adjustments to the "forward" price in the case of "extraordinary" dividends as defined, we understand that OneChicago has recently announced a program to trade single stock futures that will simply adjust strikes for (essentially, "notionally reinvest," as described further in Part II.B.6, below) ordinary dividend amounts.

[29] It is important to understand that even where it is overwhelmingly clear that something is substantially similar to a dividend equivalent described in Section 871(m)(2)(A) or (B), there will be reluctance on the part of financial institutions and others to so treat it unless/until guidance so provides, because erroneous reporting (and withholding) can have adverse consequences even if done with noble intent. At a minimum, it would be helpful if Treasury and the Service clarified that withholding/reporting agents will not be penalized for treating items as substantially similar to dividend equivalents in the absence of guidance.

term is used in various Code Sections,[30] and defined in two regulations.[31] Similar terms are used in various other Sections of the Code[32] and regulations.[33]

In general, we think the concept of ready or regular or active or public trading as used in the Code and regulations is generally intended to get at one of the following factual issues: the ability to determine the fair value of an

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[30] *See* Section 1(h)(11)(C)(ii); 170(b)(2)(B)(i)(I); 351(g)(2)(C)(ii)(I); 401(a)(28)(C); 401(a)(35)(G)(v); 409(*l*)(1); 453(f)(5) ("readily tradable ***in*** an established securities market") (emphasis added); 664(g)(4)(A); 1042(c)(1)(A); 2057(e)(2)(B); 6166(b)(10)(B)(iii). *See also* Section 280G(b)(5)(A)(ii)(I) ("readily trad***e***able on an established securities market") (emphasis added).

[31] *See* Treas. Reg. section 1.401(a)(35)-1(f)(5)(ii) (briefly, traded on a domestic exchange or a foreign exchange that is officially recognized/sanctioned/supervised by a governmental authority and that the SEC has deemed to have a "ready market" for purposes of SEC Rule 15c3-1; 15a.453-1(e)(4)(iii), (iv) (briefly, regularly quoted by brokers/dealers making a market, or in fact traded on a registered exchange, an exchange that's exempt under section 5 of the Securities Act due to volume limits, or an over-the-counter market as defined).

[32] *See, e.g.,* Section 67(c)(2)(B)(i)(II) ("regularly traded on an established securities market"); 168(h)(6)(F)(iii)(II) ("publicly traded on an established securities market"); 401(a)(22)(A) ("readily tradable on an established market"); 409(h)(1)(B) ("readily tradable on an established market"); 409A(a)(2)(B)(i) ("publicly traded on an established securities market"); 453(k)(2)(B) ("regularly traded on an established market"); 469(k)(2)(A) ("traded on an established securities market"); 475(c)(2)(B) ("widely held or publicly traded"); 503(e)(1)(A) ("traded on . . . a national securities exchange"); 856(d)(3) ("regularly traded on an established securities market"); 883(c)(3)(A) ("primarily and regularly traded on an established securities market in [a] foreign country"); 884(e)(4)(B)(i), (C)(ii) (same); 897(c)(3) ("regularly traded on an established securities market"); 1044(c)(1) ("traded on an established securities market"); 1273(b)(3)(A), (B)(i) ("traded on an established securities market"); 1273(b)(3)(B)(ii) ("of a kind regularly traded on an established market"); 1296(e)(1)(A) ("marketable," meaning "regularly traded on" a national securities exchange or any exchange or market the Secretary determines is adequate); 1297(e)(3) ("publicly traded," meaning essentially the same as "marketable" in Section 1296(e)(1)(A); 1400N(i)(3)(A) ("publicly traded on an established securities market"); 1445(b)(6) ("regularly traded on an established securities market"); 1471(d)(2)(C) (same); 1472(c)(1)(A) (same); 1473(3)(A), (B) (same); 2701(a)(1), (2)(A) ("market quotations are readily available . . .on an established securities market"); 3406(h)(6)(A) ("traded on an established securities market (within the meaning of section 453(f)(5))"); 4101(a)(5) ("regularly traded on an established securities market"); 4975(f)(10)(A)(ii) ("traded on . . . a national securities exchange"); 6050L(a)(2)(B) ("market quotations are readily available on an established securities market"); 6664(c)(4)(A) (same); 7704(b) ("traded on an established securities market," or "readily tradable on a secondary market (or the substantial equivalent thereof)"). For those counting, there are twelve instances of "regularly traded . . ." (though four are on "an established market" or a "national securities exchange" rather than "an established securities market"); seven instances of "traded . . ." (though two are on "a national securities exchange" rather than "an established securities market"); three instances of "publicly traded . . ."; three instances of "market quotations are readily available . . ."; two instances of "primarily and regularly traded . . ."; two instances of "readily tradable on an established market"; one instance of "widely held or publicly traded"; and a "readily tradable on a secondary market (or the substantial equivalent thereof)."

[33] *See, e.g.,* Section 1.83-7(b) ("actively traded on an established market"); 1.1092(d)-1(a), (b) ("actively traded," "established financial market").

instrument with reasonable certainty, the ability to dispose of or monetize the instrument easily and efficiently, or the ability to hedge the instrument (in this case, generally stock) easily and efficiently. We believe that it is some combination of the second and third of these – "liquidity" and "hedgeability" – at which Section 871(m)'s notion of "readily tradable on an established securities market" is (or should be) directed.

As to the concept of liquidity, Section 453(f)(5) and the regulations thereunder may provide a framework for thinking about the scope of this phrase (although those rules are themselves quite dated). As to "hedgeability," we think Section 1.1092(d)-1(a) would be a sensible analog (though a case can be made that that regime itself should arguably reach more broadly than it currently does). On the other hand, while we think not intended to achieve the same end, Section 1273(b) has received a good deal of attention recently, and is now the subject of recently proposed regulations updating and expanding the concept of "traded on an established securities market."[34] The regime of the proposed Section 1273 regulations, while using different phrasing and arguably having a different purpose from Section 871(m), might be viewed as the "state of the art" in this area, although its breadth would lead to a correspondingly narrow scope of the definition of an SNPC.

Focusing briefly on the plain meaning of the words themselves, we note that the notion of "ready tradability" is in fact broader than other similar phrasings in the Code, such as "traded," "regularly traded," actively traded," etc. To make the point explicit, something can be "tradable" even if it is not in fact traded. We obviously do not know if Congress in fact intended by the choice of this phrase to indicate a concept broader (more liberal) than that found in the many regimes cited in notes 32 and 33 (perhaps most notably including Section 1273), but as a matter of statutory interpretation, that would seem a valid inference.

In addition to determining what it should mean to be "readily tradable on an established securities market" in general, we think it will be important to provide guidance on how taxpayers and practitioners should consider the issue on particular facts. For example, even if a class of stock is "liquid" and "hedgeable," we presume it would nonetheless be relevant to an analysis of whether a particular NPC should be considered an SNPC if the notional size of the NPC represents a significant percentage of the stock's "float" or of its average daily trading volume, perhaps similar to the analysis that would have been required under the Obama administration's proposal.[35]

In any event, the critical point is that taxpayers and practitioners need guidance as to when stock or a security is "readily tradable on an established

[34] *See* Prop. Treas. Reg. Section 1.1273-2(f).

[35] These parameters may also bear on whether one could or should argue that there has been a direct or indirect "transfer," as discussed in Part II.B.3, below.

securities market." Again, the importance of this issue after March 18, 2012 is unclear, pending guidance from Treasury and the Service. The more broadly Treasury and the Service interpret the scope of the regime, the less important it will be after that date whether the underlying stock is readily tradable (for an obvious example, it will be immaterial if ***all*** NPCs and similar instruments are then within the ambit of the statute).

3. What Is a "Transfer"?

Section 871(m) defines an SNPC to include among other things an NPC as to which the "long" party "transfers" the underlying security to the "short" party in connection with the entry into the contract, or as to which the short party "transfers" the underlying security to the long party in connection with the termination of the contract. In many cases, it will be quite obvious whether these criteria have been met. However, there has been much debate in the market and with the Service regarding what constitutes (or should constitute) "crossing" for purposes of analyzing NPCs.

For example, the Service recently issued a "directive" to its agents recommending that they challenge NPCs that provide for "market on close" or "market on open" pricing, on the theory that those markets effectively permit one party to an NPC to transfer the underlying stock to the other – though ***indirectly,*** *i.e.*, "through the market." This is because in at least some markets, market-on-close and/or market-on-open prices are "guaranteed,"[36] and we understand that the volume of trading in those markets (apart from trading associated with entry into/unwind of NPCs and similar derivatives) may be quite small relative to the number of shares underlying the relevant NPC, as a result of which it might be expected, probabilistically, that at least some of the specific stock being sold by one party to the relevant NPC will end up being purchased in the market by the other. If, *e.g.*, the long party is selling underlying stock at market on close in connection with entry into an NPC, and the short party is buying underlying stock at market on close at the same time, while this obviously is not a "direct" transfer from one to the other, it is not clear whether this constitutes a "transfer" from the one to the other for purposes of Section 871(m).

The Supreme Court, in *McWilliams v. Commissioner,* 331 U.S. 694 (1947), concluded under the predecessor of Section 267 that where a husband directed his broker to sell shares for his (or his wife's) account through the exchange, and simultaneously to purchase a like number of shares for his wife's (or his) account through the exchange, with the acknowledged intent to recognize losses for tax purposes, the transactions amounted to the transfer of the stock from his (or his wife's) account to his wife's (or his) account, resulting in disallowance of the loss by virtue of (the predecessor of) Section 267(b). The Court clearly relied on, among other things, the fact that the statute (then, as now) disallowed losses on

[36] *See, e.g.,* NYSE Rule 123C; NASDAQ Rule 4754.

sales "directly or indirectly" between family members. On the other hand, the Court used very strong language in asserting that what was done was not intended to be permitted, noting that allowing transfers "through the exchange" would "leave a loophole almost as large as the one [Congress] had set out to close."[37]

Section 871(m) obviously contains no concept of "indirect" transfers. And yet, it seems clear that at least some forms of "indirect" transfer (*e.g.*, where the long party sells stock to a broker that it knows will sell that stock to the short party in connection with the inception of an NPC) should rise to the level of a "transfer" within the meaning of the statute. For reasons stated in Part II.A above, we do not believe it is necessarily the case that an NPC "avoids" U.S. withholding tax merely because of a transfer from the long party to the short party in connection with entry into the NPC or a transfer from the short party to the long party in connection with the termination of the NPC (without more). However, how broadly this term should be interpreted clearly depends on one's views of that issue. Accordingly, once again, guidance is needed as to how broadly Treasury and the Service intend to interpret this term.[38]

In particular, if it is determined that market on open pricing, or market on close pricing, or even daily reported volume weighted average or "time-weighted average" pricing, should or could amount to an indirect transfer, it is important that taxpayers and practitioners understand the scope of this criterion. For example, we think that if the long party in fact is not in the market on entry into or termination of an NPC, it should be immaterial how the contract was priced. Moreover, even if both parties are in the market (or, as is more likely to be the case in practice, if the short party does not know whether the long party is in the

[37] *McWilliams*, 331 U.S. at 701.

[38] In this regard, there are at least two other "non-traditional" senses in which the concept of transfer could be interpreted broadly. First, presumably, if the long party does not transfer the underlying stock to the short party at inception but instead transfers an amount of cash equal to the NPC's notional amount (*e.g.*, in connection with a "prepaid" or via the posting of an unusually large amount of collateral), that could be viewed as the economic equivalent of transferring the underlying stock. On the other hand, here, the "transfer" in no sense establishes that the long party was exposed to the underlying stock prior to the entry into the NPC, or therefore that it might be entering into the NPC in order to avoid withholding on dividends that might otherwise have been taxed in its hands. Nor does it establish that the short party has acquired the underlying stock to hedge its exposure to the NPC. Thus, whether this constitutes transfer again depends on one's view of the policy bases for the regime.

Similarly, automated trading or "DMA" could conceivably be considered a "transfer," at least in those cases where the long party's entry into the NPC directly causes the short party to acquire the underlying shares. This is considerably less defensible than the case of a "prepayment," because it requires a characterization in which the long party essentially borrowed money from the short party and then directed it to use that money to acquire the underlying shares.

In providing guidance on what constitutes a transfer, we recommend that Treasury and the Service provide answers to, or at least views on, these issues.

market), if the volume of shares underlying a particular NPC is small in comparison to the daily trading volume in the relevant market (*e.g.*, 20% or less of the market-on-close market volume), it would seem to be unlikely that an indirect sale of a material amount of the stock from the long to the short party (or vice versa) is in fact occurring.

All NPCs (and other derivatives) must be priced on some basis, and the parties must make determinations as to whether "transfers" are occurring in order to assess their tax/withholding obligations. If and to the extent a "transfer" can include an "indirect" transfer, it is essential that the parties (especially the short party, which uniquely, in the case of an indirect transfer, may lack, and indeed may be unable to obtain, complete information) be able to determine with clarity whether and when a transfer has occurred.

4. What Is an "Underlying Security"?

Section 871(m)(4)(C) provides that the "underlying security" is the security with respect to which a dividend was paid that triggered a dividend equivalent payment under the relevant NPC. That paragraph continues by providing that "for purposes of this paragraph, any index or fixed basket of securities shall be treated as a single security." This sentence (the "single security rule") has caused a fair amount of confusion among practitioners and taxpayers.

There is anecdotal evidence that the single security rule was intended merely to clarify that an NPC linked to a broad-based index was not for that reason an SNPC, *i.e.*, because the index itself cannot be "readily tradable on an established securities market."[39] However, as discussed below, the rule may be read to extend well beyond that.

First, many would dispute the issue that the single security rule was reportedly intended to solve. An NPC linked to an index is at any moment in time simply linked to a basket of securities. This is because an index is (obviously) not a security, indeed is not a tangible asset; it is merely an item of intellectual property. Thus, while it is clear that an index is not "readily tradable," it is equally clear that an index is not (without more) a "security," and thus that an index would not (but for the single security rule) have been an "underlying security" that could have failed to be readily tradable and thereby caused an NPC to constitute an SNPC.

Instead, each underlying component of an index will or will not be a security, will or will not pay dividends, and will or will not be "readily tradable," crossed in or out, or posted as collateral. Had the single security rule been absent from the statute, we think it unlikely that practitioners would have concluded that

[39] *See* Letter from ISDA to Sens. Max S. Baucus and Charles E. Grassley, on Tax Extenders Act of 2009, Section 541 (Dec. 21, 2009).

index NPCs were for that reason alone SNPCs. Most likely, they would instead have tested each component of the index to determine if it was subject to the regime. In particular, where an NPC is "total return," whether to treat the NPC as one or multiple NPCs for tax purposes is for the vast majority of NPCs almost an arbitrary decision, because a "total return" instrument can as easily be written as one thing or many, with no effect on the economics[40] (though this issue has potentially very material tax consequences, *e.g.,* whether modification of one component of the basket constitutes modification of the rest of the instrument). Thus, it would seem quite straightforward to require each component of an index or fixed basket to satisfy (avoid) the statute, failing which the dividend equivalents attributable to the offending component(s) would be subject to the regime.

Indeed, if there is a meaningful concern to which the single security rule could be responsive, it is that practitioners might have read the statute as not applying to index swaps ***at all***, precisely because an index is ***not*** an "underlying security." Even absent the single security rule, we would have rejected this interpretation, for the reasons discussed above; an index swap is at any time a swap on a basket of securities, the applicability of the statute to each of which can easily be assessed security-by-security. Accordingly, while perhaps not the most straightforward interpretation of the single security rule, we recommend interpreting the rule as simply making this explicit; *i.e.,* as requiring that an index be treated as a collection of single securities.

The most plausible alternative reading of the single security rule is that an index or basket must be viewed as one indivisible security. This reading will have material and, we think, unintended consequences. First, if an index or fixed basket is a single security, it is unclear how one knows whether this security has been crossed in or out or posted as collateral or is readily tradable. The JCT Report indicates, as to "readily tradable," that "it is intended that [the single security comprising the index or fixed basket] will be deemed to be regularly traded . . . if every component of such index or fixed basket is a security that is readily tradable on an established securities market." However, this would appear to be far too restrictive, if read literally. Imagine an index comprising 500 components, one of which is not readily tradable. Imagine that one component isn't a dividend-paying stock. Or imagine instead that component isn't even a ***domestic*** stock. Or alternatively, imagine all components are readily tradable, but one of them isn't a ***security*** – say, it's a commodity. The JCT report would say that each of these NPCs is an SNPC, without further analysis. There would seem to be no basis in policy for any of those results.

[40] This is true, at least, where all the relevant positions are between the same two parties and are fully "nettable" and "offsettable" against each other – as is the case under an ISDA, where the vast majority of NPCs are documented.

Moreover, if this is the correct interpretation of the single security rule with respect to what is readily tradable, we see no basis to reach a different answer regarding what has been crossed in or out or posted as collateral. On this interpretation, an index would be viewed as crossed in or out or posted as collateral only if "every component of such index is" crossed in or out or posted as collateral.[41] Again, we do not believe this is an intended or appropriate result. Thus, we view it as essential that Treasury and the Service make clear that this result is not intended (at least until March 2012, where again the need to "preserve" instruments like this will depend fundamentally on the scope of any carveout from the "catch-all" definition of an SNPC beginning at that time).

If it were determined that our recommended interpretation of the single security rule is not consistent with the language of the statute, and that legislative correction is needed, we would at a minimum recommend that Treasury and the Service provide guidance to the effect that (i) insubstantial deviations from the JCT's "all-or-nothing" approach to SNPC status under this language will be disregarded, (ii) in any event, components that do not involve U.S. dividends will be disregarded, and (iii) a dividend does not fail to be described in the relevant paragraph merely because it was paid on a component of the index rather than on the entire index, or because not all components of the index paid a dividend.

5. <u>What Is "Contingent upon, or Determined by Reference to"?</u>

Section 871(m) defines the term "dividend equivalent" as, among other things, "any payment made 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."[42] We think it may be advisable to provide guidance as to the scope of this language. The following examples illustrate potential issues with this language.

First, suppose an SNPC by its terms requires a payment whenever a particular U.S. corporation pays a dividend, the amount of which is equal to the value of an asset unrelated to the underlying stock or the relevant dividend, *i.e.*, the payment is "contingent upon" the payment of a dividend, though its amount is not in any way related thereto. If the actual dividend payment by the corporation is $2, would the entire payment under the terms of the SNPC be considered a

[41] Somewhat similarly, the single security rule raises the question how a dividend can be paid on the single security that is the index or fixed basket. Obviously, what in fact will happen is that dividends will be paid on some of the underlying components (perhaps all), at various times depending on when the relevant entities declare and pay dividends. If 80 of the 500 stocks in an index pay a dividend during the term of an NPC on the index, it is not clear whether "the underlying security" has paid a dividend. Based on the language of the legislative history, the answer would seem to be no, because each stock in the index or basket has not paid a dividend. This sort of mischief is a good example of why we think that Treasury and the Service need to clarify the scope of this phrase.

[42] Section 871(m)(2)(B).

dividend equivalent payment? We do not suggest that this is a real-world example, but have some concern that issues like this may arise, and it would seem clear that no more than the amount of the underlying dividend should be subject to the regime. On the other hand, where an instrument pays by its terms a multiple or fraction of a U.S. dividend (and otherwise meets the criteria for falling within the statutory scheme), we expect that the regime is intended to apply to the entire payment. However, whether this is an appropriate result as a policy matter may depend again on one's view of the policy basis for the regime, or one's expectation as to how such an instrument might be used by taxpayers. If "total return" exposure is determined to be an important aspect of the policy basis for the regime, for example, then in the case of an instrument providing exposure to only one share of an underlying stock but three times the share's dividends (where no other transactions are entered into with respect to the underlying stock), the "excess" over one dividend might seem as a policy matter more similar to the example of a payment by reference to the value of an unrelated asset discussed above.

We acknowledge that it may be difficult to imagine (or in any event for the Service to know) that an instrument with these features is not being used for an inappropriate purpose. Perhaps Treasury and the Service could impose a rebuttable presumption under these circumstances, giving taxpayers an opportunity to explain the feature (which will of course be easier to do if taxpayers know when and under what circumstances an instrument or combination of instruments will be viewed as having the potential for avoidance).

As another example, suppose the terms of an SNPC require the automatic termination of an SNPC upon the payment of a dividend by a particular U.S. corporation. Would the "termination payment" resulting from this dividend payment be "contingent upon . . . the payment of a dividend"? Literally, this would seem to be a legitimate concern, although we are quite confident this result was not intended. Clarification on the point would be helpful.

6. <u>What Is a "Payment"?</u>

A somewhat related issue is what is meant by a "payment" under an SNPC. Section 871(m)(5) defines a "payment" to include "any gross amount which is used in computing any net amount which is transferred to or from the taxpayer." It will often be clear when a "payment" has been made under the statute – in the paradigm case, dividend amounts (netted against LIBOR amounts payable by the long party) are paid through to the long party on a periodic (*e.g.*, monthly or quarterly) basis. However, it is not clear how the statute applies to instruments that do not pay through dividend amounts on a current basis. For example, imagine an instrument otherwise identical to a paradigm equity NPC but with the following differences: The long party will make LIBOR-based payments periodically, but will not receive dividend amounts periodically. Instead, those amounts will be "notionally reinvested" in the underlying stock (with the resulting amounts, *i.e.*, net of interim "performance" following the notional reinvestment, credited to the long party on termination of the NPC).

There are several ways to analyze this instrument. One is to determine that no dividend equivalent payments are being made, because the underlying dividend amount is not "used in computing" the amount paid to the long party (at least, not solely). This result is difficult to defend, to say the least, because it is relatively clear that the underlying dividend amount is used to determine how much "additional stock" was added to the NPC, the value of which is what ultimately gets paid (or at least credited, which because of the definition of "payment" in Section 871(m)(5), is the same thing for purposes of the statute) to the long party.

Another approach is to treat "payment" as occurring (and the attendant withholding obligation as triggered) *when the underlying dividend amount is notionally reinvested*, on the ground that it is this amount that will in the future be used to determine (after accounting for the notionally reinvested stock's performance) the payment to (or by) the long party. We are not confident that this result was intended by the drafters of the statute, but we also do not think it is precluded by the language of Section 871(m)(5). An obvious drawback to this interpretation of the statute is that it would require withholding at times when no payments are due between the parties at all, although this is clearly contemplated by the statute, *e.g.*, in a case where netting a dividend equivalent payment to the long party against other amounts then due from the long party results in no payment to the long party.

A third alternative is to attempt to "trace" the underlying dividend amount and withhold on the amount that gets credited to the long party at maturity that would not have been credited but for the underlying dividend (*i.e.*, to treat this as the amount that is "contingent upon" the underlying dividend, which in a literal sense it clearly is). This approach would be extraordinarily complicated, because it would require the short party to determine "what has become" of the stock notionally acquired with interim dividend amounts. Note also that it would result in amounts being subject to withholding that bear only a distant relation to underlying dividends – *e.g.*, a notionally reinvested $2 dividend may "become" $1 or $3, depending on how the underlying stock performs following the notional reinvestment. As discussed in Part II.B.5, it is not clear to us that this makes sense as a policy matter (at least where the "ultimate" amount is larger than the underlying dividend).

We suspect that the second approach (imposing withholding as and when interim dividend amounts are credited via notional reinvestment into the NPC) will be viewed as most administratively feasible, but again, guidance is needed on this issue.

As something of an aside, "notional reinvestment" is economically the equivalent of a strike adjustment under an option or other similar derivative. Thus, apropos of the discussion in Part II.A of the policy basis and scope of the regime, if one views all amounts contingent on or determined by reference to U.S. dividends as potentially subject to the regime (because substantially similar to a dividend equivalent on an SNPC), and if one concludes that whenever such an amount is "credited" under a derivative there has been a "payment" of that amount, then – among many other things – strike adjustments under listed options on U.S. equities will be subject to withholding under the regime.

7. When Is a Payment "Directly or Indirectly" Contingent upon or Determined by Reference to a U.S.-Source Dividend?

Section 871(m)(2) defines a "dividend equivalent" as a payment under a stock loan, repo or SNPC "that (directly or indirectly) is contingent upon, or determined by reference to, the payment of" a U.S.-source dividend. It would be helpful to understand what was meant by the parenthetical "(directly or indirectly)" in this context. One possibility is that if one receives a substitute payment with respect to a partnership distribution, and that partnership distribution consisted in whole or part of dividends received by the partnership on stock owned by it, this amount is intended to be treated as a "dividend equivalent" under the statute. While this would not be an unreasonable interpretation of the phrase, we note that in general, a partnership distribution has no causal relation to withholding on dividends received by the partnership and allocable to a non-U.S. partner.

However, if that interpretation is correct, then amounts received from a foreign corporation that are equivalent to amounts that corporation received from a domestic corporation could be considered to have been "indirectly" contingent upon the underlying U.S. dividends. This would at a minimum be difficult to monitor and/or police. And given that the foreign corporation may (or may not, under certain treaties) have been withheld on, it would seem inappropriate in general to impose a second level of withholding tax. On the other hand, it is not clear on what basis one would distinguish between amounts received from partnerships and amounts received from foreign corporations. For this reason, if for no other, it would be helpful to have a sense what Treasury and the Service view as the impact of the phrase "(directly or indirectly)."

C. Ancillary/Scope Issues

The following are a number of "ancillary" issues raised by the statute, generally relating to its scope and/or implications for other aspects of the tax law.

1. When Are "Projected" or "Assumed" Dividend Amounts "Payments"?

Many instruments linked to underlying equities assume the amounts of interim dividends that will be paid during the instrument's term. This assumption can be expressed in numerous ways, and the consequences of its not proving true can also be dealt with in various ways. For example, "price return" exposures to underlying equities in theory reflect the expected amounts of interim dividends in the pricing of the instrument – in other words, because the long party will not receive interim dividends, it will want to "pay" less for the instrument, or to be compensated for forgoing the right to receive those amounts. In the case of a typical NPC, this could be done by providing the long party with exposure to "more" of the underlying stock than the amount being used as the notional principal amount for purposes of computing LIBOR. Or, the long party could receive an "amplified" exposure to the upside of the underlying stock (1.1 times, *e.g.*) or an amount of "protection" against declines in the value of the underlying stock (*e.g.,* it will not be required to pay the first 5% of the downside performance of the underlying stock, often called a "buffer"). In theory, the "value" of this amplification or buffer will equal the "value" of the right to receive the expected stream of dividends that the long party has forgone, though the actual outcome in both cases is unknown at the time of entry into the NPC. We assume that this sort of "assumption" or "projection" as to the value of interim dividends raises no issue under the statute, because the long party's economics are unaffected by the actual payment (or not) of interim dividends or the amounts thereof. In other words, no adjustment is being made to the parties' rights and obligations to account for the interim dividends.

At the other extreme, an instrument that projects a specified quarterly dividend and then provides for one party to pay (or credit) the other the amount by which an actual dividend amount differs from its projection is in essence providing for actual dividend amounts to be credited (and/or paid) to the long party. Thus, depending on one's view of the "right" answer to the "payment" issue discussed in Part II.B.6, this instrument (if an SNPC or substantially similar thereto) should require withholding.

A third category of instruments might provide for the actual payment (or crediting) of estimated interim dividend amounts, but with no adjustments if the estimates prove wrong. On its face, this may look more like the second category than the first, but in our view it is not. This is because paying these amounts (or crediting them) is the same as replacing them with other rights, like the right to amplified upside or a buffer. These payments (credits) are not "contingent upon or determined by reference to the payment of" any actual dividend amounts that will be paid during the instrument's term. Even if the underlying stock has paid the same quarterly dividend for many years, there is no certainty it will do so again. Put differently, if projections of dividends are themselves, without more, within the ambit of the statute, then every instrument linked in any way to one or more U.S. equities involves "dividend equivalent payments;" even options and other instruments that make no adjustment for interim dividends will take into account their expected amounts in pricing and other terms. We do not believe this was intended, or that it reflects good policy.

This raises an issue regarding instruments that provide for the payment of a projected dividend (with no adjustments for the actual outcome) that has already been declared, and is thus all but certain to be paid in a known amount. It would seem reasonable to conclude (at least where there is in fact no reason to doubt that the dividend will be paid as declared) that this projected amount is nonetheless "contingent upon or determined by reference to the payment of" a U.S.-source dividend, though very clearly it is not – it is a payment contingent on the ***expectation*** that a declared dividend ***will*** be paid. One way to deal with this would simply be to require withholding in connection with interim projected dividends that have been declared at the time of entry into the NPC (perhaps with a rebuttable presumption, in cases where the payment might be in substantial doubt) but not other projected dividends. Alternatively, as a matter of administrative convenience (because NPCs are entered into in large volumes, some will inevitably but "unintentionally" be entered into in the interval between the declaration and payment of underlying dividends), it might be determined to be acceptable to disregard these items if the NPC is of sufficient duration (in form and in fact) that only a relatively small portion of interim projected dividends will have been declared by the time of entry.

On the spectrum between a provision for projected future dividends and a provision for declared dividends, there is of course the possibility that an instrument (particularly a very short-term one) might provide for payment (without adjustments) of a projected dividend that is all but certain to be declared and paid shortly after entry into the instrument. While some such instruments may be viewed as raising the potential for abuse, particularly where there is 'crossing" in and out, *e.g.*, it would be helpful if Treasury and the Service delineated the boundaries of this concern, for example by imposing a presumption that a short-term instrument where the underlier has been crossed in or out and where the underlying corporation declared a dividend in substantially the same amount as the projected payment within a specified number of days following entry into the instrument is within the scope of Section 871(m), unless the parties can show that they did not expect the interim dividend declaration.

2. Is a "Dividend Equivalent" a Dividend for Treaty Purposes?

The statute leaves unanswered the important question of the application of treaties to amounts treated as U.S.-source dividends thereunder. Thus, it is unclear whether a dividend equivalent to which Section 871(m) applies that is paid to a resident of a country with which the United States has an income tax treaty should be subject to withholding tax at the rate applicable to dividends under the relevant treaty, or instead at some other rate (most commonly, the rate applicable to "other income" thereunder). Again, the statute provides that dividend equivalents are treated as dividends "for purposes of [Section 871(a)], sections 881 and 4948(a), and chapters 3 and 4 [Sections 1441-1474]." By contrast, the "Stop Tax Haven Abuse Act," discussed in Part I above,[43] which

[43] *See supra* note 10 and accompanying text.

also contained provisions addressing substitute dividend and dividend equivalent payments, included the following language:

> COORDINATION WITH TAX TREATIES.— The meaning of the term 'dividend' in any income tax convention shall be construed to include dividend equivalents and substitute dividends in accordance with this section.[44]

Nothing in the legislative history indicates whether the exclusion of this language from Section 871(m) as enacted indicates congressional intent that dividend equivalents should not be treated as dividends under U.S. tax treaties. Nonetheless, the statutory language itself creates a number of issues, which we discuss below, and guidance is needed as to whether and/or when dividend equivalents will be treated as dividends under U.S. treaties.

Without specific treaty language in the statute (or authoritative guidance from Treasury and the Service), the question whether dividend equivalents are dividends for the purposes of the various U.S. treaties must be determined treaty by treaty. The definition of "dividends" of course varies from treaty to treaty, as does the rule for interpreting terms used in the treaty. Thus, by the terms of the various treaties, Section 871(m) dividend equivalent payments may be (or be likely to be, or be at risk of being) dividends under some treaties but not others. Basically, there are three possibilities: A treaty may define "dividends" for its purposes, or may provide rules for determining what law governs what constitutes a dividend for purposes of the treaty, or may be silent. We will discuss several representative provisions of current tax treaties in each of these categories. Depending on the interpretive issues discussed below, it seems that dividend equivalents could be considered dividends under some but not other U.S. tax treaties, absent guidance.

A number of U.S. tax treaties[45] do not define the term "dividend," but most[46] treaties include a provision establishing a procedure for interpreting undefined terms. For example, the U.S.-Israel tax treaty states that an undefined term shall "have the meaning which it has under the laws of the Contracting State whose tax is being determined."[47] Under this treaty, the term "dividend" would

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[44] *E.g.,* S. 506, Section 108(a), supra note 10.

[45] These include the treaties with Armenia, Azerbaijan, Belarus, Cyprus, Georgia, Greece, Indonesia, Israel, Korea, Kyrgyzstan, Moldova, Morocco, New Zealand, Norway, Pakistan, Poland, Romania, Tajikistan, Turkmenistan and Uzbekistan.

[46] The following treaties (all with former republics of the Soviet Union) do not contain a rule for interpreting undefined terms: Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.

[47] Convention with Respect to Taxes on Income, U.S.-Israel, art. 2(2) (Nov. 20, 1975). The Article goes on to state: "Notwithstanding the preceding sentence, if the meaning of such a term under the laws of one of the Contracting States is different from the meaning of the term
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be interpreted using U.S. tax law. However, one of the unclarities created by the statute is that it explicitly treats a dividend equivalent as a U.S.-source dividend only for the purposes of Section 871(a), sections 881 and 4948(a) and chapters 3 and 4 (Sections 1441-1474). Thus, the drafters of Section 871(m) consciously excluded all other Sections of the Code, including Sections 316 (the definition of a dividend) and 861 (the general rule for sourcing dividends, among other things). Therefore, dividend equivalents are ***not*** dividends for most purposes of U.S. tax law, but only for the purposes of a limited number of Code sections. Of course, whenever the application of the treaty is being considered in this context, the very U.S. law that is at issue – *i.e.*, the imposition of withholding tax on U.S.-source dividends – ***would*** treat dividend equivalents as dividends. However, we think it far from clear that this is what is meant by "the laws of" the United States, and in any event (absent guidance) suspect that many practitioners and taxpayers will view the issue as sufficiently open to debate to allow them to choose the position that most favors them in a particular situation.[48]

For those tax treaties that include neither an explicit dividend definition nor a provision addressing undefined terms, courts will obviously search for a definition. Under traditional treaty interpretation principles, courts will work from the text of the treaty and "give the specific words of a treaty a meaning consistent with the shared expectations of the contracting parties," by examining both the language and the context of the agreement."[49] If there is any ambiguity, courts then look at the intent of the parties and the history of the treaty and its negotiations to determine whether the plain meaning of words will effectuate this intent.[50] This process of interpretation would likely seek to uncover the plain meaning of the term "dividend," but would also look at the overall purpose of the

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under the laws of the other Contracting State, or if the meaning of such a term is not readily determinable under the laws of the Contracting State, the competent authorities of the Contracting States may, in order to prevent double taxation or to further any other purpose of this Convention, establish a common meaning of the term for the purposes of this Convention."

[48] It is important to keep in mind that under many treaties, including the Canadian and many Asian treaties, it may be preferable to treat a dividend equivalent as a dividend, because under those treaties, dividends are taxed at lower rates than "other income," or are not taxable at all. On the other hand, the "Other Income" provision of many treaties may raise a similar issue. For example, Article XXII(1) of the U.S.-Canadian treaty provides that, "[i]tems of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles . . . shall be taxable only in that State, except that if such income arises in the other Contracting State it may also be taxed in that other State." Thus, if a dividend equivalent paid by a non-U.S. short party under an NPC or a stock loan were determined not to constitute a dividend for purposes of the Canadian Treaty, it would be taxable by the United States as "Other Income" only if it were determined to "arise in" the United States – thus raising a version of the issue discussed below in the text accompanying notes 56 to 58.

[49] *Johansson v. United States*, 336 F.2d 809, 813 (5th Cir. 1964) (*citing Maximov v. United States*, 299 F.2d 565, 568 (2d Cir. 1962)).

[50] *See, e.g., Eastern Airlines Inc. v. Floyd*, 499 U.S. 530 (1991).

treaty and the expectations of the parties. Thus, when a treaty is silent on the definition of "dividends" and lacks a provision regarding undefined terms, courts would have the leeway to include Section 871(m) dividend equivalents as dividends (or not).

When treaties do provide a definition of the term "dividend," these definitions vary somewhat from treaty to treaty. A common definition can be found in the Australian treaty:

> The term "dividends" in this Article means income from shares, as well as other amounts which are subjected to the same taxation treatment as income from shares by the law of the State of which the company making the distribution is a resident for the purposes of its tax.[51]

The most common definition among U.S. tax treaties, [52] this language tracks the OECD Model Treaty[53] and explicitly references the law of the distributing company's state, which where the underlying stock is domestic will be the United States. However, as discussed above, the fact that U.S. tax law governs the meaning of the term does not answer the question whether dividend equivalents are dividends for purposes of the relevant treaty. The specific issue here is what it means for an amount to be "subjected to the same taxation treatment" as dividends. Clearly, the U.S. subjects dividend equivalents to the same taxation treatment as dividends for certain purposes, relating generally to withholding tax. It is not clear to us whether this will suffice to establish that these amounts are "dividends" within the meaning of the Australian and similar treaties. Thus, again, guidance is needed.

The Japanese treaty, while using language very similar to the Australian treaty, raises an additional issue:

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[51] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Australia, art. 10 (Aug. 6, 1982).

[52] Treaties with the following countries use this or substantially similar language: Australia, Austria, Bangladesh, Barbados, China, the Czech Republic, Egypt, Estonia, Finland, France, Germany, Hungary, India, Ireland, Italy, Jamaica, Kazakhstan, Latvia, Lithuania, Luxembourg, Mexico, The Netherlands, the Philippines, Portugal, Russia, the Slovak Republic, Spain, Sri Lanka, Sweden, Thailand, Tunisia, Turkey, Ukraine, the United Kingdom and Venezuela.

[53] "The term 'dividends' as used in this Article means income from shares, 'jouissance' shares or 'jouissance' rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident." OECD Model Tax Convention on Income and on Capital, art. 10 (July 22, 2010).

> The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income which is subjected to the same taxation treatment as income from shares by the tax laws of the Contracting State of which the payor is a resident.[54]

Because Section 871(m) targets derivative transactions, the "payor" of U.S.-source dividend equivalents thereunder need not be a resident of the United States. For example, if a Cayman entity pays a dividend equivalent subject to withholding tax under Section 871(m) to a Japanese person, and if the "payor" under the treaty is determined to be the Cayman entity, then the treaty will not apply, because the payor's jurisdiction (the Cayman Islands) does not (so far as we know) treat dividend equivalents as dividends. Thus, the issue here is how clear it is that the "payor" under the Japanese and similar treaties is intended to be the payor of the underlying dividend rather than the payor of the relevant dividend equivalent.

Treasury's explanations of the U.S.-Japan and U.S.-Australia tax treaties suggest that Treasury interprets provisions using the term "payor" in exactly the same way as provisions using the term "company making the distribution."[55]

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[54] This or similar language is used in the U.S. tax treaties with Belgium, Bulgaria, Canada, Denmark, Malta, Slovenia, South Africa, and Iceland, as well as the U.S. Model Income Tax Convention (the "U.S. Model Treaty"). The U.S. Model Treaty language was changed in 1996 from "company making the distribution" to "payer." Treasury's Technical Explanation of the 1996 version of the U.S. Model Treaty did not discuss this change, and there is no indication of any intent to change the substance of the definition of a "dividend."

[55] With regard to the Japanese Treaty, Treasury explained that:

> Paragraph 10 defines the term "dividends" broadly and is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined in accordance with paragraph 2 of Article 3 (General Definitions) under the tax laws of the Contracting State of source, as well as arrangements that might be developed in the future.

Treas. Tech. Explanation, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-Japan (Feb. 25, 2004).

With respect to the Australian Treaty, Treasury explained:

> Paragraph (6) defines the term "dividends" broadly and flexibly. The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the State of source, as well as arrangements that might be developed in the future.

Treas. Tech. Explanation of the Protocol Amending the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Australia (Mar. 5, 2003).

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Specifically, the Treasury explanations state that both definitions are "intended to cover all arrangements that yield a return on an equity investment in a corporation as determined . . . under the tax law of the State of source, as well as arrangements that might be developed in the future."[56] The idea that the terms "payor" and "company" would have the same meaning makes sense for typical dividend payments made by a U.S. corporation to a foreign payee, but the drafters and ratifiers of the treaties (and Treasury in its explanations) presumably did not contemplate Section 871(m) dividend equivalents. However, it is not clear that Treasury's explanations will govern how these provisions are interpreted by our treaty partners, or by U.S. courts.[57]

Another set of issues arises as a result of treaty language like Switzerland's:

> The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income which is subjected to the same taxation treatment as income from shares under the law of the Contracting State in which the income arises.

Where does a dividend equivalent "arise"? The answer depends on another question, namely which law governs the question. The United States might (subject to the uncertainty noted above as to whether Section 871(m) has this effect) treat dividend equivalents with respect to U.S. underlying stocks, by whoever paid, as "arising" in the United States, but the other contracting state, and the jurisdiction of the payor of the dividend equivalent, might not (likely will not) do so. Again, Treasury's explanation of the Swiss treaty provides the same interpretation of the provision as for the treaties with Japan and Australia, implying that the state "in which the income arises" is the same as the state "of which the payor is a resident," *i.e.*, the state "of which the company making the distribution is a resident."[58] And again, this does not lead to a clear answer under Section 871(m).

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The U.S. Model Treaty mirrors the language of the Japanese Treaty, see above, and Treasury's Technical Explanation of the U.S. Model Treaty is consistent with its Technical Explanations of the Japanese and Australian Treaties. *See* Treas. Tech. Explanation of the U.S. Model Income Tax Convention (Sept. 20, 1996).

[56] *See id.*

[57] Moreover, the Treasury's instruction to use "the tax law of the State of source" does not necessarily solve the problem, because the source of the payment could be the United States or the payor's residence (depending on which law one thinks governs that question).

[58] Treas. Tech. Explanation of the Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, U.S.-Switzerland (Jan. 1, 1998).

An additional and important issue relating to treaty application is that in 1997, Treasury amended existing regulations under Section 894 to provide that, "the provisions of an income tax convention dealing with interest or dividends paid to or derived by a foreign person include substitute interest or dividend payments that have the same character as interest or dividends under § 1.864-5(b)(2)(ii), 1.871-7(b)(2) or 1.881-2(b)(2)."[59] This "transparency regulation" gives substitute dividends the same character as actual dividend income for purposes of U.S. tax treaties. Some commentators questioned Treasury's authority to promulgate this regulation, which seemingly (potentially, as discussed above) conflicts with existing treaties, but Treasury and the Service expressed their belief that Section 7701(*l*) provided the authority for this regulation.[60]

Treasury regulations Section 1.894-1(c) applies only to substitute dividend payments made pursuant to securities lending and sale-repurchase transactions, not to dividend equivalents under SNPCs, and not to payments that are "substantially similar" to dividend equivalents under Section 871(m)(2)(C). It would seem clearly inappropriate after the enactment of Section 871(m) to treat substitute payments under stock loans and repos differently for treaty purposes from dividend equivalents under SNPCs and payments substantially similar to any of the above. Moreover, it is at least possible that Congress intended to change the result in Treasury regulations Section 1.894-1(c) (*e.g.,* if the intent of Section 871(m)'s failure to adopt the prior proposal to make explicit that "dividend equivalents" are "dividends" for treaty purposes was that they are ***not***). And as discussed above, if it is determined that Congress intended that ***all*** dividend equivalents should be treated as dividends under U.S. tax treaties, we are not at all confident the statute as drafted has that result. In any event, it is clear that guidance is needed reconciling Section 871(m) and Treasury regulation Section 1.894-1(c).

3. What Are the Consequences of Section 871(m) under Sections 1471 and 1472?

It is clear that a "dividend equivalent" under a stock loan, repo or SNPC (or substantial equivalent) is so treated for purposes of Sections 1471-1474 (commonly referred to as "FATCA"). Accordingly, because these instruments are "property of a type which can produce" U.S.-source dividends, payments of proceeds on terminations of any of these instruments are also subject to FATCA withholding.

However it is not clear in all cases what it means for property to be "***of a type*** which can produce U.S.-source dividends" for this purpose. Any NPC (at

[59] Treas. Reg. Section 1.894-1(c).

[60] *See* T.D. 8735 (Oct. 14, 1997).

least any linked to a U.S. equity, or that pays amounts contingent upon or determined by reference to U.S. dividends) is arguably property "of a type which can" produce U.S-source dividends. This would, for example, include an instrument that is an SNPC (*e.g.*, the underlying stock was crossed in) but as to which the underlying stock pays no dividends, or isn't domestic. However, we assume it was not intended that this be considered to be property of a type which can produce U.S.-source dividends. Moreover, it is possible to read the statute as dictating that the ***short*** party (if a non-U.S. person) could be subject to FATCA with respect to termination payments ***to it***, because the instrument can produce U.S.-source dividend payments – to its ***counterparty***.

In general, we imagine that none of this was intended, and that FATCA should apply only to instruments that provide for dividend equivalents that are subject to the statute (and only to payments of gross proceeds of the disposition of such instruments to the long party). However, because FATCA was obviously targeted to reach as many entities and instruments as possible, we are not entirely certain whether Treasury and the Service would agree with this assertion. In any case, we ask that Treasury and the Service provide guidance as to the applicability of FATCA to instruments that are or may be subject to Section 871(m).

4. What Are the Implications of Section 871(m) under Section 892?

Under Section 892, foreign governments and their affiliates are or may be exempt from federal income tax with respect to their "investments in the United States in," among other things, stock.[61] Thus, a foreign government that simply owns U.S. stock will not be subject to tax (including withholding tax) with respect to income therefrom (including dividends and gains). On the other hand, a foreign government that enters into an NPC will in general not be subject to any withholding tax with respect to the NPC because that income will not be from U.S. sources under regulations Section 1.863-7, discussed in Part II.B.1, above. However, if a foreign government receives a "dividend equivalent" under an SNPC with respect to a U.S. underlying stock, it may under Section 871(m) be treated as receiving income (a dividend) from U.S. sources that will not be from an "investment in the United States in stock," and thus might not be exempt from tax under Section 892.[62] Indeed, because Section 871(m) applies only for purposes of Sections 871, 881 and 4948 and subchapters 3 and 4, and not for purposes of other Code Sections – *e.g.,* Sections 861 and 863 – there is an argument that for purposes of Section 892 (among other Sections), dividend

[61] Section 892(a)(1)(A)(i).

[62] Note that this would not appear to be the case if the foreign government lends U.S. stock and receives substitute dividends as described in Section 871(m)(2)(A), at least where the loan is pursuant to an agreement that complies with Section 1058. *See* Treas. Reg. Section 1.892-3T(a)(2). A simple way to address the issue raised in the text would be to extend this regulation to included dividend equivalents under SNPCs.

equivalents are not even U.S.-source income, and thus that Section 892 does not exempt them from any withholding tax imposed under Section 871(m).[63] We hope and assume this result was unintended, given that foreign governments could own the underlying stock directly (and could lend it out and receive substitute payments), with no tax consequences. Given the potential importance of this issue for international governments, clarification that Section 871(m) has no impact under Section 892 is needed.

5. Issues under Notice 2010-46

There follows a discussion of several aspects of Notice 2010-46, which "officially" withdraws Notice 97-66 and sets forth a first cut at addressing issues relating to avoiding overwithholding on "cascading" dividend equivalents under Section 871(m)(6), *i.e.*, the possibility that multiple withholdings could result under Section 871(m) within a "chain" of stock loans, repos, and/or NPCs. Very briefly and generally, Notice 2010-46 notifies taxpayers that Treasury and the Service intend to issue regulations establishing a documentation-based approach to reducing withholding where it can be shown that withholding has been imposed on another payment "in a chain." The Notice also introduces a "qualified securities lender" ("QSL") regime exempting certain non-U.S. financial institutions from withholding tax on payments to them, provided the QSL agrees to impose appropriate tax on payments they make to others. Finally, the Notice provides for transition rules that withholding agents can use prior to the promulgation of these regulations. Below is a discussion of several issues raised by Notice 2010-46.

(a) Cascading NPCs, etc.

For substitute dividend payments (*i.e.*, under stock loans and repo transactions) made on or after September 14, 2010, Notice 2010-46 withdraws the previous rules under Notice 97-66, which addressed "cascading" or multiplicative dividend withholding on chains of stock loans. Notice 2010-46 provides a new framework for dealing with cascading withholding, but this framework is limited to withholding on chains of stock loans. Under Section 871(m), the Secretary has broad authority to address "any chain of dividend equivalents,"[64] whether resulting from stock loans, swaps, repos or a combination thereof. We see no basis to distinguish chains of stock loans from chains of NPCs or other

[63] This raises another oddity that should be resolved: Under Section 1461, dividends must be reported as such on Form 1042. Section 1461 is in chapter 3 and thus is within the scope of Section 871(m)(1). On the other hand, income from non-effectively connected NPCs within the meaning of Section 863-7 is foreign-source, and as discussed in the text, Section 871(m) does not by its terms change that result – even for dividend equivalents. Foreign-source income is ***not*** subject to reporting on Form 1042.

[64] Section 871(m)(6).

instruments from the perspective of endeavoring to minimize overwithholding, nor do we have any sense that Congress had any intention in this regard.

We understand that there may be a view that it was intended that chains of NPCs would result in multiple withholdings, with no relief from "over-withholding." Moreover, we understand that this result might be viewed as appropriate as compared with the result in the case of chains of stock loans, where the underlying stock is necessarily being transferred from lender to borrower through the chain of transactions. First, we see no basis for this dichotomy in the statute, which permits relief in the case of "a chain of dividend equivalents."[65] That term includes "substitute dividends" described in Section 871(m)(2)(A) and ***also*** payments linked to dividends under SNPCs, as described in Section 871(m)(2)(B). If payments under NPCs had not been intended to be included within the relief provision, it would have been quite easy to make that clear, and we would have expected that Congress would have done so.

Nor do we understand why the overwithholding issue should, as a policy matter, turn on whether or not the underlying stock has been lent. In the case of stock loans, that stock will in most cases have been sold or disposed by the "last" borrower in the chain, as discussed in note 12 and accompanying text. By contrast, as has been discussed, in many cases involving SNPCs, the underlying stock may in fact be in the hands of the last short party in the chain (as a hedge). We fail to see why the ultimate location of the underlying stock should determine whether inappropriate overwithholding has occurred, and we think the statute evidences an intent to permit mitigation in ***any*** case where it can be shown that chains of dividends and/or dividend equivalents have resulted in excessive withholding. More fundamentally, we see no policy basis for imposing withholdings in a chain that may in the aggregate exceed not only the amount of withholding tax that would have been imposed on the underlying dividend but the amount of the underlying dividend itself (***especially*** where the underlying stock is ***not*** in the chain, and thus the actual underlying dividend may be presumed to have been taxed appropriately). Accordingly, we recommend that Treasury issue guidance addressing multiplicative withholdings in situations other than chains of stock loans, and we in general think that these rules should apply equally to chains of stock loans, NPCs or any combination thereof.

(b) Actual Dividends Received by QSLs

The Notice establishes a regime for QSLs to act as withholding agents with respect to dividend equivalents they pay, in exchange for which payments to QSLs will not be subject to any withholding. However, the Notice does not exempt withholding on actual dividends paid to QSLs acting as such (*i.e.*, where the QSL makes an offsetting substitute dividend payment with respect to identical securities). For example, if a QSL holds U.S. stock that it has borrowed from

[65] *Id.*

another foreign person (or, assuming our recommendation that the Notice apply equally to NPCs, is the short party on an NPC and hedges the position by holding the underlying stock), we hope and assume that the QSL rules are intended to apply to allow the QSL to determine the amount of withholding that should be imposed on the payment to the "ultimate" recipient, just as is the case where the QSL instead onlends the stock it has borrowed. Indeed, this result is arguably mandated by the statute, which provides that for purposes of dealing with chains of dividend equivalents (to whatever extent the Secretary chooses to do so), dividends are treated as dividend equivalents.[66]

[66] *See* Section 871(m)(6).