The Past, Present, and Future of Equity Swaps

Yoram Keinan*

The taxation rules for total return equity swaps in particular have been subject to growing criticism since the 1990s. Many non-residents synthetically invest in U.S. equity using equity swaps, and as Congress, Treasury, the IRS, and commentators have argued, such synthetic investments—as opposed to direct long investments—have been mainly tax-motivated. The primary tax benefit for non-residents generally was the result of the preferential source rules for notional principal contracts (NPCs) under U.S. tax law, pursuant to which the source of payments under an NPC is the residency of the recipient. Congress urged its members, and called on Treasury and the IRS, to take immediate action to shut down what it titled "Dividend Tax Abuse," in a report issued by the Senate Permanent Subcommittee on Investigations in 2008 (the "Dividend Abuse Report"). The IRS responded by issuing detailed guidelines to IRS field agents auditing U.S. financial institutions and their U.S. branches dealing with equity swaps (the "Swap Audit Guidelines"). On March 18, 2010, Congress added a new section to the tax code (currently Section 871(m)) that generally provides for withholding on substitute payments made to non-residents on what it titled "specified notional principal contracts"(the scope of which will be significantly expanded in 2012). This article traces the evolution, and outlines the contents, of the Dividend Abuse Report, the Swap Audit Guidelines, and Section 871(m), and analyses and criticizes these authorities.

Introduction

Total return equity swaps have been around for several decades, but their tax-advantageous aspects only became apparent when the source rules for

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* Yoram Keinan is a shareholder with the New York office of Greenberg Traurig LLP, and teaches courses on taxation of financial products at the University of Michigan Law School and Georgetown University Law Center. He is also a member of the *Journal*'s Board of Advisors and Contributors. The author would like to thank Mark Leeds, a shareholder at Greenberg Traurig in New York, for his invaluable input. The views expressed in the text are solely those of the author and should not be attributed to Greenberg Traurig. Mr. Keinan's email is keinany@gtlaw.com and his phone number is (212) 801-6826.

notional principal contracts (NPCs) were introduced. In a typical total return equity swap (a TRS or an "equity swap"),[1] a foreign investor enters into an agreement with a U.S counterparty (typically an investment bank), pursuant to which amounts due to each party are based on the returns generated by a notional investment in a specified dollar amount of the stock underlying the swap (which, in the case of the perceived tax-motivated transactions, would be stock of a U.S. company). The foreign investor agrees to pay the bank (1) periodic amounts calculated by reference to a market interest rate (such as the London Interbank Offered Rate (LIBOR)) on the notional amount of the underlying stock, and (2) typically, at the end of the swap, any depreciation in the value of the underlying stock. In return, the bank agrees to pay the foreign investor (1) any dividends paid on the stock during the swap's period (the "dividend equivalent amounts"), and (2) any appreciation in the value of the underlying stock. Amounts owed by each party under the equity swap typically are netted so that only one party makes an actual payment.

For over 20 years, applicable Treasury regulations have provided that income from a notional principal contract, such as an equity swap, is foreign-source income in the hands of a non-U.S. person who did not enter into the equity swap in connection with the conduct of a United States trade or business.[2] In addition, swap income paid to such a non-U.S. person has not been subject to withholding[3] or information reporting.[4] Because actual dividends on stock of a U.S. company paid to non-U.S. persons not in connection with a U.S. trade or business have been subject to withholding tax,[5] reporting,[6] and U.S. tax at up to a 30 percent rate[7] without reduction for any deductions, non-U.S. persons wishing to invest in U.S. stocks have had a strong incentive to obtain exposure to U.S. equities through swaps rather than acquire the stocks directly.

The disparity in taxation for transactions that provide economically equivalent exposure to the same asset (i.e., the U.S. stock) prompted sellers of equity swaps (typically the large investment banks) to actively market these transactions to non-U.S. persons. Nevertheless, a growing concern about this

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[1] As used herein, an "equity swap" and a total return swap (a "TRS") are each a notional principal contract (an "NPC") within the meaning of Treas. Reg. § 1.446-1(c)(1).

[2] Treas. Reg. § 1.863-7(b)(1).

[3] Treas. Reg. § 1.1441-4(a)(3)(i).

[4] Treas. Reg. § 1.1461-1(c)(2)(ii)(F).

[5] Treas. Reg. § 1.1441-1(b)(1).

[6] Treas. Reg. § 1.1461-1(c)(2)(i)(A).

[7] IRC § 871(a)(1)(A) (non-U.S. individuals); IRC § 881(a)(1) (non-U.S. corporations). The rate of applicable tax and withholding can be reduced if the payee is eligible to claim advantage of an income tax treaty to which the United States is a party and provides the payor with certification of such fact on a Form W-8BEN. IRC § 894(a)(1); Treas. Reg. § 1.1441-6.

practice (especially regarding lost tax revenues) prompted Congress, Treasury, and the IRS to take action. This article explores the recent developments in the taxation of total return equity swaps and the possible outcome of such developments.

Criticism of Equity Swaps and IRS Approach to Them

In September 2008, the Senate Permanent Subcommittee on Investigations issued a scathing report on the marketing of equity swaps under the title "Dividend Tax Abuse."[8] The Dividend Tax Abuse Report (the Report) signaled a congressional rethinking as to whether the tax advantage for dividend equivalent payments on security lending transactions, sale repurchase transactions, and equity swaps should enjoy a tax benefit over the physical holding of stocks.[9] The Report also directly criticized Treasury and the IRS for not taking action to shut down the tax abuse associated with the transactions described in the Report and called for immediate action.

The criticism of the IRS's inaction was harsh; the IRS had showed concern over the years that financial institutions were overly zealous in their marketing of equity swaps as tax-advantageous alternatives to the holding of physical stocks. The IRS has always taken the view that the substance of a transaction documented as an equity swap may not comport with its form.[10] In these cases, the IRS has asserted, sometimes successfully, that the disputed transaction should not be taxed in accordance with the rules for NPCs.[11] However, there was no clear guidance for what circumstances should merit such a re-characterization, and the IRS's field agents had applied inconsistent approaches to this analysis.

It was just a matter of time until the IRS took action. On March 18, 2009, the Large and Mid-Scale Business (LMSB) division of the IRS announced that reporting and withholding on U.S. Source FDAP[12] was what the IRS refers to as a "Tier I Issue."[13] Tier I Issues are those that "pose the highest

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[8] Staff Report, United States Senate Permanent Subcommittee on Investigations, "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on Stock Dividends" (Sept. 11, 2008).

[9] See S. 506, § 108, 111th Cong., 1st Sess. 34 (2009), part of the "Stop Tax Haven Abuse Act." This proposal was not enacted. See also Statement of Senator Carl Levin on Introducing the Stop Tax Haven Abuse Act (Mar. 2, 2009); H.R. 3933, § 501 (the "Foreign Account Tax Compliance Act of 2009"). This proposal also was not enacted.

[10] See, e.g., Schering Plough Corp. v. U.S., 651 F. Supp.2d 219 (D.N.J. 2009) (recharacterization of an interest rate swap as a loan for purposes of IRC § 956).

[11] Id.

[12] "FDAP" is an acronym for fixed, determinable annual or periodic income. This phrase is derived from the list of types of income, such as dividends, that are potentially subject to 30 percent withholding in the hands of a non-U.S. person when recognized other than in connection with the conduct of a trade or business in the United States.

[13] LMSB Division of the IRS, "Issue Tiering Fact Sheet" (Mar. 18, 2009).

compliance risk across multiple LMSB Industries and generally include large numbers of taxpayers, significant dollar risk, substantial compliance risk, or are high visibility."[14] In a separate document, the IRS stated more specifically that the compliance initiative represented by designating U.S. Source FDAP as a Tier I Issue included the "potential use of total return swaps to minimize withholding tax."[15]

On January 14, 2010, LMSB finalized and issued the "Industry Directive on Total Return Swaps ('TRSs') Used to Avoid Dividend Withholding Tax" (the "Swap Audit Guidelines").[16] In addition to providing guidance to IRS field agents auditing U.S. financial institutions and U.S. branches of foreign financial institutions, the Swap Audit Guidelines contain six Information Document Requests (IDRs) for agents to use to solicit information from financial institutions that have equity swap operations.

Shortly thereafter, President Obama signed into law H.R. 2847, The Hiring Incentives to Restore Employment Act (the HIRE Act).[17] HIRE Act Section 541 added a new provision to the Internal Revenue Code, denominated as Code Section 871(l) (which later became 871(m)). Pursuant to prior law, taxpayers took the view that the substitute dividend payments made under a total return swap are not subject to U.S. withholding tax because such equity swaps should be treated like any other notional principal contracts and, therefore, the source of the periodic payments thereon is the residency of the recipient. The new provision treats the dividend-based amount under the equity swap as a gross payment—even though the actual payment under the equity swap, like any other NPC, is a net amount. Thus, as explained in more detail below, the U.S. swap counterparty may be obligated to withhold and remit tax on the gross amount of a dividend equivalent payment even though, as a result of netting, the U.S. counterparty would not be required to make an actual payment to the foreign investor. As a result, this provision effectively distinguishes between the source of payments on total return equity swaps (which will follow the source rules for dividends) and all other notional principal contracts, which are still subject to the source rule under Treasury Regulation Section 1.863-7(b).

My view on this issue is that the old rules made perfect sense. If a total return equity swap provides greater after-tax receipts than a physical holding of the stock then, of course, sellers of such swaps will tout this benefit in

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[14] Id.

[15] EMISC Tier I 1441, "U.S. Withholding Agents—§ 1441: Reporting and Withholding on U.S. Source FDAP Income" (undated).

[16] LMSB Control No. LMSB-4-1209-044 Impacted IRM 4.51.5 (Jan. 14, 2010). The Swap Audit Guidelines refers to itself as the industry director directive or "IDD."

[17] P.L. 111-147, 124 Stat. 106.

selling their product. If Congress, Treasury, and the IRS had not wanted to assist the development of financial products in the United States, they would not have provided this beneficial source rule for notional principal contracts back in 1989, a benefit that was praised as enhancing the liquidity in the U.S. derivative markets.

Overview of Rules Pertaining to Notional Principal Contracts

Taxpayers and their advisors generally have taken the view that total return swaps are treated for tax purposes as any other NPCs (and therefore should be subject to the same source rules) on the grounds that a typical total return swap satisfies the definition of a notional principal contract under Treasury Regulation Section 1.446-3(c). A notional principal contract is defined in the regulations as

> [a] financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[18]

A specified index for this purpose includes an index that is based on objective financial information.[19] Objective financial information is information that is not within the control of the parties to the transaction and is not unique to the circumstances of one of the parties or a related person.[20] Section 1256 contracts, debt instruments, options, and forward contracts do not constitute notional principal contracts.[21] Thus, there has been little doubt that total return equity swaps are NPCs.

The NPC regulations contain definitions for the three types of cash flows that can be made in connection with notional principal contracts:

- *Periodic Payments:* Periodic payments are defined as (1) payments made or received pursuant to an NPC; (2) payable at intervals of one year or less over the contract's term; (3) based on a specified index and on either a single notional principal amount or a notional principal amount that varies over the contract's term.[22]

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[18] Treas. Reg. § 1.446-3(c)(1)(i).

[19] Treas. Reg. § 1.446-3(c)(2)(iii).

[20] Treas. Reg. § 1.446-3(c)(4)(ii).

[21] Treas. Reg. § 1.446-3(c)(1)(ii).

[22] Treas. Reg. § 1.446-3(e)(1).

- *Non-Periodic Payments:* A non-periodic payment is "a payment made or received with respect to a notional principal contract that is not a periodic payment . . . or a termination payment." Examples include (1) premium for a cap or floor (even if paid in installments); (2) payment for an off-market swap; (3) prepayment of part or all of one leg of a swap;' and (4) premium for an option to enter into a swap.[23]
- *Termination Payments:* A termination payment is defined as any "payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract." Examples include (1) an extinguishment payment between the original parties to the contract; (2) an assignment payment made between one party to the contract and a third party; and (3) gain or loss realized on the exchange of one NPC for another.[24]

Issues Affecting Total Return Equity Swaps With Foreign Counterparties

Very frequently, a purchaser of a long position in an equity swap is foreign. As noted earlier, TRSs have been used by foreign investors to synthetically invest in U.S. stock without being subject to the withholding tax that is normally imposed on dividends paid by U.S. companies. However, if the payment to a foreign counterparty under the equity swap were subject to withholding tax, the effect would be simply to eliminate foreign counterparties from the U.S. swap market—clearly an unwarranted result, in the author's view, because participation of such foreign buyers in the U.S. derivative market is essential. Another consideration relevant to foreign counterparties is whether entering into the equity swap with U.S. counterparties could be construed as the conduct of a U.S. trade or business by such a foreign taxpayer. This too could have the practical effect of barring non-U.S. counterparties from the NPC market in the United States.

Pursuant to Code Sections 1441 and 1442, U.S. withholding tax will apply to a payment if the payment (1) constitutes a fixed or determinable annual or periodical amount (FDAP); (2) has a United States source; and (3) is not effectively connected to a U.S. trade or business.[25] If all three requirements are satisfied, a withholding tax of 30 percent applies, unless the rate is reduced by an applicable income tax treaty. Congress and Treasury can

[23] Treas. Reg. § 1.446-3(f)(1).

[24] Treas. Reg. § 1.446-3(h).

[25] Treas. Reg. § 1.1441-2(a).

exempt non-residents from withholding tax either by exempting a certain type of income from the FDAP definition[26] or by setting forth that a certain type of income is not U.S. source income.[27] Further, Congress may provide that certain activities will not give rise to a trade or business in the United States even if the income is FDAP and its source is in the United States.

Exceptions From FDAP Income. The definition of FDAP income is very broad and includes various types of income.[28] The income need not even be annual or periodical, so a single payment could also constitute FDAP.[29] Nevertheless, certain specific exceptions exist, one of which is for gains from the sale of property, including option premiums.[30]

There is no specific exception from FDAP income for payments under an NPC. Nevertheless, pursuant to Treasury Regulation Section 1.863-7(b), if the foreign counterparty is not engaged in a U.S. trade or business, a payor of periodic payments under an NPC is not required to withhold on its payments to the foreign counterparty because the payment will be treated as having a foreign source.[31] The source of the payments under a notional principal contract is the *residence of the recipient* of the income and not the residence of the payor.[32]

Source Issues. The source rules pertaining to NPCs were first established by the IRS in 1987.[33] Although not stated formally by the IRS, it appears that the reason behind the special rule was to permit cross-border NPCs without the impediment of a withholding tax.[34] There is no apparent reason why this policy should not still be valid. As stated above, the opposite policy would

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[26] See, e.g., Treas. Reg. § 1.1441-2(b)(2)(i) (exempting from the FDAP income definition gains derived from the sale or property, including market discount and option premiums). See also IRC § 871(h) (portfolio interest exemption) and IRC § 871(i)(2)(A) and (B), pursuant to which there is no withholding tax on U.S. source interest paid by U.S. banks and on dividends paid by U.S. corporations with significant foreign business activities.

[27] For example, pursuant to IRC § 861(a)(1)(A) and (B), interest paid by a U.S. taxpayer with significant foreign business activities to a foreign person is foreign rather than U.S. source income, contrary to the general source rules pertaining to interest.

[28] Treas. Reg. § 1.1441-2(b)(1)(i).

[29] Treas. Reg. § 1.1441-2(b)(1)(ii).

[30] Treas. Reg. § 1.1441-2(b)(2)(i).

[31] The definition of a notional principal contract under Treas. Reg. § 1.863-7(a) is the same as that under Treas. Reg. § 1.446-3(c). See also Treas. Reg. § 1.1441-4(a)(3), pursuant to which payments with respect to an NPC described in Treas. Reg. § 1.863-7(a) are not subject to U.S. withholding tax.

[32] Treas. Reg. § 1.863-7(a).

[33] See Rev. Rul. 87-5, 1987-1 CB 180.

[34] See, e.g., David Rosenbloom, "Source-Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions," 50 U. Miami L. Rev. 597 (1996).

not result in the collection of any tax revenues; it would simply eliminate foreign persons as potential counterparties for TRSs.

Another potential policy argument for the above source rules is that, in contrast to payments on stock or debt, where the recipient has invested capital in an income-producing asset in the United States, a swap is merely a contractual arrangement that gives rise to cash flows on a notional amount. There is rarely a significant upfront investment in a swap. Furthermore, interest and dividends can flow only to the investor, but cash flows on NPCs can flow in either direction. While it is clearly understood why the United States (as well as most other countries) reserve the taxing priority on income from capital invested in the United States, there is no such policy reason for a priority claim for taxation of cash flows on contractual rights and obligations out of the United States.

Nevertheless, almost since the introduction of the favorable source rules for notional principal contracts, Congress, Treasury, the IRS, and commentators have raised the concern that with respect to equity swaps, such source rules could be used to replicate payments subject to U.S. withholding, such as dividends from a U.S. corporation, and convert such payments into exempt swap payments.[35]

Is the Foreign Counterparty Engaged in Trade or Business in the United States? If a foreign person conducts business activities in the United States, it will generally be subject to net U.S. income tax on its income effectively connected with that trade or business.

The Code provides safe harbor exceptions, however, for business activities that consist of:

- Trading in securities and commodities through an independent agent in the United States (if the taxpayer does not maintain a U.S. office through which the transactions are effected); and
- Trading in securities and commodities for the taxpayer's own account (if the taxpayer is not a dealer).[36]

Similar to the motivation behind the source rule for NPCs and the enactment of the "portfolio interest exemption" in 1984, the purpose of these safe harbors was to encourage foreign persons to invest in U.S. capital markets without subjecting them to U.S. income tax. The safe harbors are generally aimed

[35] See Preamble to the final Treas. Reg. § 1.446-3 regulations (the "NPC Regulations"), TD 8491, 58 Fed. Reg. 53125 (1993); see also Jeffrey M. Colon, "Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads," 1999 U. Ill. L. Rev. 775 (1999).

[36] IRC § 864(b)(2)(A), (B), and (C).

at passive investments, since they are not available to dealers unless they employ independent agents, and even then only if they do not have a U.S. office through which the transactions are effected. The volume of trading does not matter, as long as there is no fixed place of business in the U.S.[37]

While these safe harbors were originally enacted prior to the explosion in the use of derivatives, Treasury and the IRS have endeavored to modernize the rules by issuing proposed regulations that would extend the safe harbors to trading in a wide variety of derivatives, including interest rate, currency, equity, and commodity NPCs.[38] These proposed regulations have yet to be finalized; however, practitioners have been relying on the proposed regulations for the view that the safe harbors apply to derivatives, including equity swaps.

The Dividend Abuse Report

The Report was drafted and published as a result of several years of investigations and public hearings concerning the potential U.S. tax abuse with respect to the use of total return swaps. The Report begins with the following language:

> The purpose of this Report is not to condemn the use of complex financial transactions that utilize stock swaps, stock loans, or other forms of structured finance, which can be used for legitimate business purposes such as facilitating capital flows, reducing capital needs, and spreading risk. Instead, this Report attempts to identify abusive financial transactions that have no business purpose other than tax avoidance and to recommend measures to stop the misuse of structured finance to undermine the U.S. tax code.

Spotlight on Lost Tax Revenues. The products examined by the Subcommittee and discussed in the Report were primarily associated with total return equity swaps, repo transactions, and stock lending transactions. The Report's targets were generally the institutions offering to sell the transaction, such as investment banks and hedge funds. In general, the Subcommittee reviewed transactions entered into by more than 10 financial institutions and hedge funds. For example, the Report provides details on Morgan Stanley's equity swaps and share loan transactions from 2000 to 2007, and reports that during these years, the amount of taxes that would have been paid by the non-U.S. residents if they had invested directly in U.S. stock instead of via Morgan Stanley's equity swaps and share loans would be $300 million. Another bank, Lehman Brothers, in only one year (2004), had been reported to have "saved"

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[37] Treas. Reg. §§ 1.864-2(c)(i) and (d)(i).

[38] Prop. Treas. Reg. § 1.864(b)-1.

non-resident clients approximately $115 million utilizing equity swaps and share loans instead of direct investment in U.S. stock. UBS had reported that from 2004 to 2007, its clients "saved" $62 million using equity swaps and share loans instead of direct investments. Finally, Maverick Capital, using several offshore hedge funds, disclosed that its clients "saved" taxes totaling almost $95 million from 2000 to 2007 by investing in synthetic positions in U.S. equity instead of direct investment.

Identified Elements of Abusive Transactions. The following is an example of a transaction that the Report considered as abusive:

> [A] few days before a stock is scheduled to issue a dividend, an offshore hedge fund sells its stock to a U.S. financial institution and simultaneously enters into a swap agreement with the financial institution, temporarily replacing its stock holdings with a swap agreement tied to the economic performance of the same stock. After the dividend is issued, the offshore hedge fund receives from the financial institution a "dividend equivalent" payment under the swap agreement equal to the full dividend amount less a fee. The fee, charged by the financial institution, is usually tied to the tax savings, and generally equals 3% to 8% of the dividend amount. The end result is that the offshore hedge fund receives 92% to 97% of the dividend amount instead of the 70% that it would have received if the 30% in taxes had been withheld. A few days after the dividend date, the offshore hedge fund terminates the swap agreement and repurchases the stock, leaving the offshore hedge fund with the same status it had before the transaction was undertaken. . . . This type of transaction is intended to enable the offshore client to maintain the same economic benefits (including the receipt of dividend payments) and market risks as owning the real stock, while dodging payment of tax on the dividend equivalent payments. That the offshore client enters into the swap agreement for only a short period of time around the dividend period, and owns shares of the underlying stock both before and after the swap, demonstrates that this type of transaction has no purpose other than to avoid the dividend tax.

The Report summarized the elements that an "abusive" transaction would typically have:

- The transaction would take place over a short period of time, during which U.S. stockholders would receive a dividend;

- The financial institution and client would agree on an explicit dividend rate above the 70 percent rate normally available after application of the 30 percent withholding tax;
- The swap or stock loan pricing and fees would be related to the amount of tax savings (i.e., taxes that were not withheld);
- Physical shares would be sold before and then reacquired after a dividend distribution;
- The financial institution and client would agree on the sale or repurchase of U.S. stock through third parties;
- The financial institution and client would coordinate their stock sales and repurchase transactions to minimize or eliminate the risk of financial loss for both;
- In stock loan transactions, the financial institution and client would insert an offshore shell corporation; and
- The financial institution would treat nonpayment of dividend taxes as a "tax risk" and set a "risk limit" on the aggregate amount of tax withholding avoidance that could be incurred by the institution.

Criticism of Treasury and IRS. The Report also directly criticized Treasury and the IRS for failing to take effective action to stop abusive transactions. Specifically, the Report pointed out that Treasury and the IRS have failed to publish final regulations to address abusive stock loans, clarify existing regulations related to equity swaps, or take enforcement actions against participating financial institutions or their clients.

This criticism appears harsh. It is very rare that Congress criticizes Treasury and the IRS in such a direct way on an issue that has been on their radar screen for a while. It came as no surprise that the IRS took immediate action in the form of the Audit Guidelines, as discussed below.

Recommended Action. The Report made four recommendations to put an end to what it classified as "abusive" transactions, as summarized below:

1. *End Offshore Dividend Tax Abuse:* Congress should end offshore dividend tax abuse by enacting legislation to make it clear that non-U.S. persons cannot avoid U.S. dividend taxes by using an equity swap or stock loan to disguise dividend payments. Such legislation would end the abuse by eliminating the different tax rules for U.S. stock dividends, dividend equivalent payments, and substitute dividend payments, and would make all such transactions equally taxable as dividends. (As set forth above, this became reality a couple of years later, with the enactment of Section 871(m).)

2. *Take Enforcement Action:* The IRS should complete its review of dividend-related transactions and take civil enforcement action against taxpayers and U.S. financial institutions that knowingly participated in abusive transactions aimed at dodging U.S. taxes on stock dividends. (The Swap Audit Guidelines issued shortly thereafter came as a partial response to this recommendation.)
3. *Strengthen Regulation on Equity Swaps:* The IRS should issue a new regulation to make dividend equivalent payments under equity swap transactions taxable to the same extent as U.S. stock dividends. (This actually came as primary legislation—see discussion below on Section 871(m)—but regulations have yet to be issued.)
4. *Strengthen Stock Loan Regulation:* The IRS should immediately meet its 1997 commitment to issue a new regulation on the tax treatment of substitute dividend payments between foreign parties to make clear that inserting an offshore entity into a stock loan transaction does not eliminate U.S. tax withholding obligations. (This topic is not covered herein in detail, as this article focuses on equity swaps.)

The Audit Guidelines

Significant New Compliance Burden. Prior to the promulgation of the Swap Audit Guidelines, IRS financial institution tax auditors looked to Section 4.10.21.8.7.6 of the Internal Revenue Manual (IRM)[39] to determine whether a financial institution had complied with its reporting and withholding obligations under swaps. This guidance was scant. Specifically, auditors were told (1) to determine if the non-U.S. payee held the swap in connection with the conduct of a U.S. trade or business, in which case Form 1042-S reporting would be required from the financial institution and (2) to look for "[i]ncome on [NPCs] that are regarded as embedded interest or recharacterized as certain other payments under U.S. tax principles [that] might be subject to NRA withholding and reporting."

Because of the criticism specified in the Report on the IRS's response to equity swaps, it was very clear that the IRS intended to take immediate action, and on January 14, 2010, LMSB issued the Swap Audit Guidelines.[40] The new guidance is substantially more detailed than the previous IRM guidance. As a result, IRS audits of financial institutions undertaken in accordance with the Swap Audit Guidelines are likely to impose a significant compliance burden on affected taxpayers.

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[39] Last revision, July 29, 2008.

[40] LMSB Control No. LMSB-4-1209-044 Impacted IRM 4.51.5 (Jan. 14, 2010).

The purpose of the Swap Audit Guidelines is to assist IRS agents in "uncovering and developing cases related to TRS transactions that may have been executed in order to avoid tax with respect to U.S. source dividend income" paid to non-U.S. persons. Since the Swap Audit Guidelines are directed at IRS auditors examining financial institutions, it seems fairly clear that the IRS intends to assert deficiencies against the financial institutions, and not directly against the non-U.S. persons. If the equity swaps constituted disguised agency relations, most likely akin to a broker-client relationship, the IRS has the right to pursue payment of the tax from the financial institutions inasmuch as these institutions would have then been withholding agents who failed to withhold.[41] The institutions could also be held liable for failure to properly report the amounts withheld, but these penalties (at $50 per return in the absence of intentional disregard) are modest in comparison to the potential liability for the tax itself.[42]

The Swap Audit Guidelines then present four different transaction structures, discussed below, involving equity swaps. An IRS agent who uncovers one of these fact patterns is encouraged to "develop facts supporting a legal conclusion that the Foreign Person retained ownership of the reference securities." Auditors are also advised to look for elements of the facts described in each of the fact patterns.

Cross-In and Cross-Out Transactions. In a typical cross-in/cross-out transaction, the non-U.S. person sells its U.S. stock position to a U.S. financial institution (the cross-in) and enters into an equity swap with the same financial institution. The sale and initiation of the equity swap occur prior to a dividend record date.[43] Following the dividend record date, the equity swap is terminated and the non-U.S. person repurchases the stock from the financial institution (the cross-out). The Swap Audit Guidelines state that "relatively few" transactions have been executed in this manner. Many tax professionals would have concerns that the substance of such a transaction would be taxed as a disguised agency relationship.

Although the Swap Audit Guidelines are not entirely clear, it appears that the IRS is also concerned about equity swaps that do not entail actual cross-ins and cross-outs but in which ostensible market transactions contain mechanisms that result in cross-ins and cross-outs. For example, suppose the non-U.S. person executes a market sale of the stock at the inception of the swap. At the same time, the financial institution is in the market purchasing stock to hold

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[41] IRC § 1461.

[42] IRC § 6721(a).

[43] The Model IDR for Withholding Strategy 1 asks financial institutions to identify transactions in which they acquired stock five business days prior to a dividend record date if the financial institution entered into an equity swap within such time frame.

as a hedge of its obligations under the swap. Notwithstanding the simultaneity of the purchase and sale, if volume in the stock is robust in comparison to the number of shares that are referenced in the swap, it would be coincidence, at best, if the non-U.S. person sold the stock to the financial institution (or vice versa at swap termination).

Pricing Mechanisms. The Swap Audit Guidelines state that swap pricing mechanisms that assist the parties in avoiding price risk between the holding of the stock and the swap can be viewed as evidence that "the parties are likely to be in the market together upon a cross." These pricing mechanisms include referencing a single interdealer broker price, market on close (MOC), market on open (MOO), and volume weighted average price (VWAP). This mandate is clearly a case of "no good deed goes unpunished." The IRS rationale is that each of the pricing mechanisms, if available for the stock purchase or sale, would enable the parties to have certainty as to their purchase and/or sale prices of the stock. Indeed, the IDR for these transactions asks for the identity of transactions in which the swap reference price "and the prices at which the U.S. equity security was sold or purchased in the cross-in or cross-out are the same prices or are based on the same prices, such as MOC or VWAP." Thus, according to the IRS, if the equity swap references these prices, there would not be any slippage in moving between the stock and the swap.

The IDR to be provided to financial institutions seeking to find cross-in/cross-out transactions asks whether pricing mechanisms that eliminated price risk were in place with respect to the equity swap.

Other Factors Indicating an Agency Relationship. In addition to pricing, the IDR included in the Swap Audit Guidelines asks about other factors that could indicate an agency relationship. Specifically:

- Was there a written or oral agreement for the financial institution to return stock to the non-U.S. person at the swap termination?
- Did the non-U.S. person have the right to direct voting of any stock held by the financial institution as a hedge of the swap?
- If the financial institution did vote any shares of stock held as a hedge of the swap, were such votes independent of the counterparty's instructions?
- Was there a written or oral agreement by the financial institution to hedge the swap in a particular way?

Again, interestingly, the Swap Audit Guidelines ask whether there was a written or oral agreement for the counterparty to bear the cost of any hedging by the financial institution under the swap. The answer here should always be, "Only if the trader was doing his or her job correctly." This question misinterprets the role of financial institutions in the swaps markets. Financial institutions do not generally enter the swaps markets for the purpose of taking any risk other than counterparty risk. The institutions have a unique ability to execute and hedge risks. If the costs of hedging increase, this is a cost that is usually borne by the client, not the institution. Accordingly, if a financial institution is acting as a dealer, it will price hedging into the swap, and retain the ability to either terminate the swap if hedging costs increase or to pass along such costs to its clients.

Cross-In/Interdealer Broker Out. In this variant, the non-U.S. person crosses in the stock that is the subject of the equity swap to the financial institution and repurchases identical stock from an unaffiliated interdealer broker (IDB) at the termination of the swap. The Swap Audit Guidelines direct auditors to develop facts showing the existence of a written or oral arrangement "with respect to the Foreign Person's repurchase of the U.S. Equity Securities." Specifically, this will occur when the financial institution sells to the IDB and the IDB then sells to the non-U.S. person at the same price except for a commission payable to the IDB. If IRS agents find the existence of these arrangements, agents are directed to determine if this represents a "pattern of dealing."

To develop these facts, the IDR for this type of transaction directs agents to find out whether:

- The financial institution received a very small fee;
- The U.S. financial institution paid a fee (or received a fee) from the IDB; and
- There were any side agreements, again written or oral, with respect to the IDB returning stock to the non-U.S. person.

The most important acknowledgement by the IRS in its discussion of cross-in/IDB out equity swaps is the direction that if an agent does not find an arrangement in which the IDB was acting as the proverbial "fig leaf" over the cross-out, "the examination should be concluded." In other words, this statement is an acknowledgement by the IRS that a one-way cross, without more, should not be viewed as a disguised agency relationship.

Cross-In/Foreign Affiliate Out. In this variation, the non-U.S. person enters into a swap with the non-U.S. affiliate of a U.S. financial institution (e.g., the London affiliate or branch of a U.S. bank). The non-U.S. affiliate of the U.S. bank will then enter into a back-to-back swap with the U.S. operation. The U.S. financial institution will hedge its position by acquiring the stock referenced in the swap. The Swap Audit Guidelines posit that the non-U.S. person and the U.S. financial institution cross-in and cross-out.

The Swap Audit Guidelines, citing Treasury Regulation Section 1.1441-7(a)(1), note that non-U.S. persons, as well as U.S. persons, can be treated as withholding agents. Implicit in the IRS's description of this transaction variant is an assumption that financial institutions have executed equity swap transactions from outside the United States with intent to circumvent the rules that would apply to U.S. taxpayers and are ignoring the reach of the regulation.

Many financial institutions have their London affiliates or branches act as the counterparty for all equity derivative transactions in order to have a central booking location for client-facing transactions, and to obtain beneficial capital and balance sheet usage. The transactions are then backed-to-back to the United States for efficient hedge execution and to ensure that U.S.-based business is properly taxed in the U.S. Given the Swap Audit Guidelines, however, a number of U.S.-based financial institutions may be facing unwarranted U.S. tax scrutiny of their London operations.

Fully Synthetic Transactions. In a fully synthetic equity swap transaction, the non-U.S. person does not own the stock referenced in the equity swap prior to the initiation of the swap and does not purchase the stock at the termination of the equity swap. The Swap Audit Guidelines state that these transactions comport with existing law and should not be pursued by auditing agents. Notwithstanding the force with which this conclusion is stated, auditing agents are advised to pursue whether the fully synthetic equity swap transaction passes through other indices of ownership to the non-U.S. counterparty (so that the swap might be re-characterized as a custodial arrangement). Among the questions to be asked are:

- Is the amount of stock referenced in the equity swap so large that the financial institution would be economically compelled to hold the stock as a hedge of its position under the swap?[44]
- Did the financial institution acquire the referenced stock as a hedge?[45]
- Did the equity swap itself, or a formal or unwritten arrangement between the non-U.S. person and the financial institution, pass voting rights on any stock held as a hedge of the financial institution's swap position to the non-U.S. person?

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[44] The IDR to determine whether this was the case asks for disclosure of equity swaps in which the amount of stock referenced in the equity swap was greater than 20 percent of the average daily trading volume (determined on the basis of the month preceding the month in which the swap was initiated) of 5 percent of the public float of the stock.

[45] See the comments in text above regarding the role of financial institutions in the over-the-counter equity markets. In virtually all cases, the financial institution will have hedged itself, many times by acquiring the referenced stock.

In addition, the IDR to be issued to financial institutions asks whether the non-U.S. person was required to post collateral equal to 50 percent of the initial value of the shares referenced in the equity swap.[46]

The Swap Audit Guidelines implicitly recognize that an equity swap over privately held stock and securities fits within the definition of an NPC and can be taxed as such.[47] Although the Swap Audit Guidelines instruct IRS auditors to "examine any transaction where the foreign person entered into a TRS that references an equity security issued by a privately-held U.S. corporation," the agents are directed only to pursue transactions described above referencing "private" securities. Specifically, the Swap Audit Guidelines advise that equity swaps over private securities should be challenged where the non-U.S. person maintains control with respect to the private securities. Conversely, if the non-U.S. person does not maintain control over the referenced securities, the transaction should be respected as a notional principal contract.

A number of financial institutions have been offering so-called "synthetic prime brokerage" platforms. In a synthetic prime brokerage transaction, the financial institution allows the non-U.S. person to access its trading operations through a computer and enter into a position that it desires to have economic exposure with respect to. The agreement in place between the financial institution and the non-U.S. person specifically states that each position posted on the system by the non-U.S. person will be treated as a swap transaction. The Swap Audit Guidelines note that synthetic prime brokerage transactions do not pose any price risk to the financial institution. The Swap Audit Guidelines tell IRS agents to consider whether the absence of involvement by the financial institution causes the non-U.S. person to be treated as the owner of the hedge. In fact, the Swap Audit Guidelines tell auditing agents to consider subpoenaing prime brokerage account statements for non-U.S. persons who have used this technique.

Summary. The Swap Audit Guidelines evidence a sophisticated approach to when swaps should be taxed as custodial arrangements. Although the IRS does have additional work to do, it clearly has learned a lot about the over-the-counter securities business through the audits that it has conducted and from industry personnel who have joined the IRS in recent years. The Swap Audit Guidelines, however, are likely to substantially increase the duration and complexity of financial product audits.

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[46] Swap Audit Guidelines, Attachment 6.

[47] See also Mark Leeds, "Giant Steps: Total Return Swaps Over Onshore Hedge Funds," 115 Tax Notes 649 (May 14, 2007).

New Code Section 871(m)

As noted earlier, the Report called for both congressional and regulatory actions, which came shortly thereafter. The new Code provision (now Section 871(m)) had been proposed for several years, but only became law last year, as part of the HIRE Act; following the Report, and in light of the new legislative environment under the Obama Administration, its time finally arrived.

Dividend Equivalent Payments Defined. Section 871(m)(1) treats a "dividend equivalent payment" under a "specified notional principal contract" (definitions to follow) as a dividend from U.S. sources for certain purposes, including, in particular, U.S. withholding tax rules applicable to foreign persons. As noted, under prior law, taxpayers took the view that the substitute dividend payments made under a total return swap were not subject to U.S. withholding tax because the source of such payments is the residency of the recipient. The new provision treats the dividend-based amount under the swap as a payment even though the actual payment under the swap is a net amount.

A dividend equivalent payment for this purpose is defined in Section 871(m)(2) as any substitute dividend made pursuant to one of the following three types of transactions:

1. A securities lending transaction;
2. A sale-repurchase (repo) transaction; or
3. 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."

A dividend equivalent payment also includes any other payment that the Secretary determines is substantially similar to a payment described in the immediately preceding list. Under this rule, for example, the Secretary may conclude that payments under certain futures contracts, forwards, options, or other financial contracts that reference stock of U.S. corporations are dividend equivalent payments. Treasury and the IRS have yet to issue guidance regarding the legislation in general or on this particular issue.

Specified Notional Principal Contract Defined. For payments made during the first two years from the effective date, a "specified notional principal contract" that is subject to the new Code section is defined in Section 871(m)(3)(A) as any notional principal contract that has *any one* of the following five characteristics:

1. In connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract;

2. In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;
3. The underlying security is not readily tradable on an established securities market;
4. In connection with entering into the contract, any short party to the contract posts the underlying security as collateral with any long party to the contract; or
5. The Secretary identifies the contract as a specified notional principal contract.

In other words, for the first two years (unless the Secretary says otherwise), a "naked" or fully synthetic position, where the non-U.S. person does not own the stock referenced in the equity swap prior to the initiation of the swap, does not purchase the stock at the termination of the equity swap, and does not post the underlying security as collateral, and where the underlying security is traded on an established market, is *not* subject to the new provision.

For these purposes, a "long party" is defined in Section 871(m)(4)(A) as the party to the contract that is entitled to receive a payment under the contract, where such payment is contingent upon, or determined by reference to, a payment of a U.S.-source dividend on the underlying stock. This would typically be the foreign investor. In addition, a "short party" is defined in Section 871(m)(4)(B) as the party to the contract that is not a long party with respect to the underlying stock. This, of course, would normally be the U.S. counterparty.

The term "underlying security" with respect to a specified notional principal contract is defined in Section 871(m)(4)(C) as the security with respect to which the dividend equivalent payment is made. For these purposes, Section § 871(m)(4)(C) makes it clear that any index or fixed basket of securities would be treated as a single security.

As set forth in Section 871(m)(3)(B), for payments made more than two years after the effective date, a specified notional principal contract would also include any NPC unless the Secretary determines that the contract is of a type that does not have the potential for tax avoidance. Thus, at that point, almost any total return swap, including a fully synthetic position, would be subject to the rule.

Source and Tax Treatment of Payments Made. As set forth above, in a typical equity swap, the gross amounts owed by each party will be computed by the parties, but then will be netted to a single amount going to the party whose right to receive payment exceeds the obligation to pay. Section 871(m)(5), however, provides that the dividend equivalent payments that will be treated as U.S.-source dividends will be the gross amounts that are used in computing any net amounts transferred to or from the taxpayer. Thus, the provision treats any dividend-based amount under the equity swap as a payment of dividend for withholding tax purposes even though any actual payment under the swap is a net amount determined in part by other amounts (for example, the interest amount and the amount of any appreciation or depreciation in value of the referenced stock). Accordingly, the domestic party to the total return swap (i.e., the bank) may be obligated to withhold and remit tax on the gross amount of a dividend equivalent payment even if, as a result of a netting of payments due under the swap, the bank would not be required to make an actual payment to the foreign investor.

Section 871(m) also applies to substitute payments made under a securities lending transaction and a sale-repurchase (repo) transaction. A substitute dividend payment made to the transferor of stock in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as actual dividends paid on the transferred stock.[48] Accordingly, because dividends paid with respect to the stock of a U.S. company are generally U.S. source, if a foreign person lends stock of a U.S. company to another person (or sells the stock to the other person and later repurchases the stock in a transaction treated as a loan for U.S. federal income tax purposes) and receives substitute dividend payments from that other person, the substitute dividend payments are U.S. source and are generally subject to U.S. withholding tax.

In 1997, the Treasury and IRS issued Notice 97-66 to address concerns that the source rule just described (and the accompanying character rule) could cause the total U.S. withholding tax imposed in a series of securities lending or sale-repurchase transactions to be excessive.[49] In that Notice, Treasury and the IRS also stated that they intended to propose new regulations to provide detailed guidance on how substitute dividend payments made by one foreign person to another foreign person would be treated. To date, no such regulations have been proposed.

Section § 871(m)(6) provides that if there is a chain of dividend equivalents (e.g., in transactions similar to those described in Notice 97-66), and one or more of the dividend equivalent payments will be subject to tax under Section § 881, the Secretary may reduce that tax, but only to the extent that the taxpayer either establishes that the tax has been paid on another dividend equivalent in the chain, or that such tax is not otherwise due, or as the

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[48] Treas. Reg. § 1.861-3(a)(6) (defining a substitute dividend payment as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction).

[49] Notice 97-66, 1997-2 CB 328.

Secretary determines is appropriate to address the role of financial intermediaries in such chain.

Conclusion

The much anticipated enactment of Section 871(m) came at a time of uncertainty. While many practitioners and commentaries had anticipated that Congress would take action, nobody looked forward to this new provision. The source rules for payments on notional principal contracts, which are still in force for all NPCs that are not specified notional principal contracts, make sense from both policy and practical perspectives. The government clearly wanted to encourage foreign persons to participate in the U.S. derivatives markets without being subject to U.S. tax. This policy remains valid, but the exclusion of equity swaps from this rule makes no sense. And this change in law will not be a significant revenue raiser. In my view, very few foreign investors are likely to continue the same practice knowing they will be subject to withholding tax, and probably very few will simply purchase the underlying securities (as opposed to a synthetic position). The chilling effect of the legislation will simply be that significantly fewer foreign persons will enter into equity swaps with U.S. counterparties, clearly an unwarranted result.