REPORT #725

TAX SECTION

New York State Bar Association

Report on Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions

July 7, 1992

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Tax Report #725

TAX SECTION
New York State Bar Association

July 7, 1992

The Honorable Shirley Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Commissioner Peterson:

Please find enclosed a report on Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions.[1]

The report strongly supports the U.S. tax policy objectives reflected in the Proposed Regulations that substitute dividend and interest payments should be treated for source, character and income tax treaty purposes as dividends and interest paid by the issuer of the underlying securities.

However, the report expresses substantial doubt whether Section 7805 or any other section of the Code provides the Treasury with the requisite statutory authority to promulgate enforceable regulations characterizing substitute dividend or interest payments as actual dividends or interest.

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[1] The report was prepared by a subcommittee consisting of Dan Chung, David Gillespie, Loretta Finger, Charles Morgan, Erika Nijenhuis, Chris Scobey, Jeffrey Sion and Phillip Spector. Helpful comments were received from Cynthia Beerbower, Peter C. Canellos, John A. Corry, Michael L. Schler and Esta E. Stecher.

To eliminate this uncertainty, the report recommends that the Administration sponsor legislation to assure that the substantive objectives of the Proposed Regulations will be attained. In this connection, it states that although any legislation designed to accomplish the substantive objectives of the Proposed Regulations might be regarded as overriding the provisions of a number of U.S. income tax treaties, our foreign treaty partners should not legitimately object to the adoption of such legislation.

The report urges that if there is to be any delay in the finalization of the Proposed Regulations, guidance should be provided immediately to withholding agents as to "facts and circumstances" will be considered relevant under current law.

The report next recommends that regulations be promulgated to source securities lending fees by reference to the residence of the securities lender, in a manner similar to the residence-based sourcing rules under Regulation §1.863-7 with respect to income from notional principal contracts.

The report then states that, although it is not necessary to expand the scope of the Proposed Regulations to provide guidance with respect to sale and repurchase transactions ("Repos") that are characterized as loans for U.S. tax purposes, the transparency approach of the Proposed Regulations should be applied to all cross-border Repos that are not so characterized.

Finally, in part because the authority for doing so would be even more tenuous than in the case of securities loans, the report recommends that, subject to a limited exception, the scope of the Proposed Regulations generally should not be expanded to include the substitute dividend component of equity or equity index swaps. Further, subject to some dissent, it does not recommend the enactment of legislation that extends the sourcing rule of the Proposed Regulations to equity-based notional principal contracts.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

John A. Corry
Chair

Identical Letter Sent to:

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Tax Report #725

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions

July 7, 1992

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions

Introduction

This report[1] comments on regulations proposed on January 6, 1992 (the "Proposed Regulations") which provide rules concerning the source, character and income tax treaty treatment of certain payments made pursuant to cross-border securities lending transactions described in Section 1058(a)[2] or substantially similar transactions.[3]

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[1] This report was prepared by a subcommittee consisting of Dan Chung, David Gillespie, Loretta Finger, Charles M. Morgan III, Erika Nijenhuis, Chris Scobey, Jeffrey Sion and Philip Spector. Helpful comments were received from Cynthia Beerbower, John A. Corry, Peter C. Canellos, Michael L. Schler and Esta E. Stecher.

[2] Unless otherwise indicated, section numbers refer to sections of the Internal Revenue Code of 1986, as amended (the "Code") or to the Treasury regulations promulgated thereunder. Section 1058 provides for nonrecognition of gain or loss by a transferor of securities pursuant to an agreement that

> (i) provides for the return to the transferor of securities identical to the securities transferred;
>
> (ii) requires that payments shall be made to the transferor of amounts equivalent to all interest, dividends and other distributions which the owner of the securities is entitled to receive during the period of the securities loan; and
>
> (iii) does not reduce the risk of loss or opportunities for gain of the securities transferor in the securities transferred.

[3] We understand that the term "substantially similar transactions" is intended to apply to transactions that are similar to transactions described in Section 1058 but which fail to satisfy one of the technical requirements of Section 1058, e.g., the requirement of Proposed Regulation 1.1058-1(b)(3) that the lender have a right under the agreement to terminate the loan on five days notice.

Summary of Proposed Regulations

The Proposed Regulations provide that payments made in a cross-border context to a securities lender of an amount equivalent to an interest or dividend payment which the owner of the transferred security is entitled to receive under the terms of the transaction (a "substitute payment") will be treated as interest or dividend income received pursuant to the terms of the transferred security for purposes of the sourcing rules of Section 861(a)(1) and (2)[4] The Proposed Regulations provide similar treatment under Sections 871, 881, 1441 and 1442 with respect to the taxation of nonresident alien individuals and foreign corporations on income that is not effectively connected with a United States trade or business.[5] Finally, the Proposed Regulations state that substitute dividend and interest payments will be treated, respectively, as dividends and interest for purposes of the relevant provisions of income tax treaties between the United States and foreign countries.[6]

The Proposed Regulations do not address the status of fees that are paid in connection with securities loans. The Internal Revenue Service (the "Service") has invited comments concerning the source, character and income tax treaty treatment of such fees as well as the treatment of certain "repo" transactions and certain equity-based notional principal contracts.

The Proposed Regulations are to be effective with respect to securities transfers made more than 30 days after the date they are published in final form in the Federal Register. The source, character and income tax treaty treatment of

[4] Prop. Reg. § 1.861-2(a)(7), § 1.861-3(a)(6).

[5] Prop. Reg. § 1.861-7(b)(2), § 1.881-2(b)(2) and § 1.1441-2(a).

substitute payments made prior to their effective date "will be determined under all the facts and circumstances of a particular transaction."[7]

Summary Of Conclusions And Recommendations

1. We strongly support the U.S. tax policy objectives reflected in the Proposed Regulations that substitute dividend and interest payments should be treated for source, character and income tax treaty purposes as dividends and interest paid by the issuer of the underlying securities.

2. We believe that there is substantial doubt whether Section 7805 or any other section of the Code provides the Treasury with the requisite statutory authority to promulgate enforceable regulations characterizing substitute dividend or interest payments as actual dividends or interest. To eliminate this uncertainty, we recommend that the Administration sponsor legislation to assure that the substantive objectives of the Proposed Regulations will be attained.

3. Although any U.S. legislation designed to accomplish the substantive objectives of the Proposed Regulations might be regarded as overriding the provisions of a number of U.S. income tax treaties, we do not believe that our foreign treaty partners could legitimately object to the adoption of such legislation.

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[6] Prop. Reg. § 1.894-1(c).
[7] Preamble to the Proposed Regulations.

4. If there is to be any delay in the finalization of the Proposed Regulations, guidance should be provided immediately to withholding agents as to what "facts and circumstances" will be considered relevant under current law.

5. We recommend that regulations be promulgated to source securities lending fees by reference to the residence of the securities lender, in a manner similar to the residence-based sourcing rules under Regulation §1.8637 with respect to income from notional principal contracts.

6. Although we do not believe it is necessary to expand the scope of the Proposed Regulations to provide guidance with respect to sale and repurchase transactions ("Repos") that are characterized as loans for U.S. tax purposes, we believe that the transparency approach of the Proposed Regulations should be applied to all cross-border Repos that are not so characterized.

7. In part because the authority for doing so would be even more tenuous than in the case of securities loans, we believe that, subject to a limited exception, the scope of the Proposed Regulations generally should not be expanded to include the substitute dividend component of equity or equity index swaps. Further, subject to some dissent, we do not recommend the enactment of legislation that extends the sourcing rule of the Proposed Regulations to equity-based notional principal contracts.

Background

Securities Lending in the Marketplace

Securities lending transactions in the international marketplace generally occur through lending agents, typically a bank or other financial institution that maintains securities accounts for various customers (including pension funds, regulated investment companies, insurance companies, corporations). While security lending transactions typically are described herein for convenience as a transaction between a lender and a borrower, such lending agents are in fact frequently “market makers” for securities lending transactions, creating not only liquidity but also the structure of the securities lending marketplace.

Thus, a typical cross-border securities lending transaction involves three parties: The securities borrower (the “Borrower”), generally a securities broker or other securities dealer or trader borrowing securities in order to cover a short sale or “fail” to deliver situation; the securities lender (the “Lender”), generally an insurance company, pension fund, corporation, bank or other foreign institutional investor; and, finally, the lending agent (the “Lending Agent”) with which the Lender maintains a custodial securities account. Securities are loaned in connection with a short-sale because the short-seller is obligated to make delivery before it otherwise wishes to close the short sale. In a typical fail to deliver transaction, the short seller has either lost or been unable to take delivery of the securities. In both situations, the Borrower is contractually obligated to return substantially identical securities to the Lender, and the terms of the lending agreement do not differ by reason of the origin of the transaction.

As part of a Lending Agent’s securities lending program, the Lender and the Lending Agent would execute an agreement in which the Lender authorizes the Lending Agent to enter into agreements as agent on its behalf with specified Borrowers to lend securities held in the Lender’s custodial account with the

Lending Agent.[8] In general, securities lending agreements are structured to satisfy the requirements of Section 1058, so that the securities loan does not result in recognition of gain or loss by the Lender upon transfer of its securities.

The collateral and fee arrangements used in securities lending transactions can take a variety of forms.[9] Collateral can take one of any several forms, including (a) cash collateral, (b) securities collateral, (c) letter of credit collateral, or (d) any combination thereof. Generally, the Borrower is required to maintain the value of the collateral at a fixed spread over the value of the borrowed securities (e.g., 102 or 103 percent), both of which are valued daily on a mark-to-market basis.

The fee structure of a securities lending transaction depends on the type of collateral, if securities or a letter of credit are used as collateral, a Borrower often will pay a separate fee ("borrow fee") based on the value of the borrowed securities and on market conditions (e.g., supply and demand for the securities loaned, interest rates, etc.). In such a case, any interest or dividend income generated by securities collateral while held by the Lending Agent belongs to the Borrower and, in practice, is simply added to the amount of the collateral that must be returned to the Borrower upon termination of the securities loan.

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[8] Thus, there are actually two agreements involved: (1) the agreement by Lender authorizing the Lending Agent to enter into securities lending agreements with Borrowers as its agent and (2) the actual agreement between the Lending Agent and a specific Borrower to loan the securities in question, sometimes referred to as the "securities borrowing agreement." For convenience, this Report refers to these agreements collectively as the "securities lending agreement".

[9] In practice, the Lending Agent receives and holds the collateral securing the Borrower's obligations under the securities lending agreement on the Lender's behalf.

When, on the other hand, the Borrower posts cash collateral, the Lender's fee ("embedded fee") is represented by the income earned from investment of the cash collateral, less a negotiated percentage[10] of such income rebated to the Borrower ("rebate fee").

Present Tax Treatment Under U.S. Tax Treaties

In the preamble to the Proposed Regulations, the Service expressed concern that payments designed to replicate interest or dividend payments may be used to avoid U.S. withholding tax. The rules contained in the Proposed Regulations, however, raise significant income tax treaty issues by attempting to characterize substitute dividend and interest payments for treaty purposes. The status of substitute payments under current U.S. treaties is unclear, and may vary according to country. In general, substitute payments might qualify under one of the following three treaty categories: dividends and interest; "industrial or commercial profits" and "business income"; or "other income". Because current treaties between the U.S. and foreign countries reduce the rate of U.S. withholding tax on dividends (normally to 15%) and either reduce or eliminate the rate on interest, parties to securities lending agreements might desire dividend or interest characterization. Under general U.S. income tax principles, however, substitute dividend and interest payments do not constitute actual dividends or interest on the underlying securities.[11] In the case of interest, if none of the treaty exemptions apply, substitute interest payments, apart from

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[10] Note that the rebate to the Borrower could also be a fixed interest rate on the cash collateral during the securities loan.

[11] See discussion in Section 2. below. Moreover, although a number of tax treaties include in the definition of interest, income that is "assimilated" to interest under U.S. tax laws, it is unlikely that the "assimilation" language was intended to include income defined as interest solely for treaty purposes, as in that case any treaty partner could

the position taken in the Proposed Regulations, would not be eligible for the portfolio interest exemption of Sections 871(h) and 881(c). Thus, substitute interest payments might be subject to U.S. tax even where the interest itself would be exempt.

In part because Proposed Regulation §1.1058-1(d) provides that a substitute payment is "a fee for the temporary use of property", some substitute dividend and interest payments would likely constitute "industrial or commercial profits" or "business profits" for tax treaty purposes. Payments to a tax-treaty protected recipient falling into these categories would not be subject to U.S. tax unless they are effectively connected with a permanent establishment of the recipient.[12]

In addition, certain treaties provide that income not elsewhere dealt with will be taxable only in the foreign recipient's country of residence.[13] If these provisions apply, substitute dividend and interest payments would not be subject to U.S. tax (including withholding tax) even if no other basis for exemption were available.

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unilaterally change the taxation of a particular form of income merely by redefining it as interest for treaty purposes.

[12] Loans by individuals, trusts, estates generally will not qualify under the business parameters of these provisions. Indeed, while substitute payments received by banks and financial institutions will generally constitute industrial or commercial profits or business profits, payments on securities loans received by other businesses may not.

[13] These treaties are those with France, Germany, Hungary, Italy, Malta, Spain and the United Kingdom, See also. Article 21.1 of the 1981 Treasury Department model income tax treaty.

In the Proposed Regulations, the Service also expressed concern that securities lending transactions may be used to increase the foreign tax credit limitations of U.S. taxpayers. The Service's concern might be based on the tax avoidance potential of loans by a U.S. taxpayer of U.S. securities to a foreign borrower. Since the lender would be relying solely on the borrower's credit for repayment, substitute dividend and interest payments would probably be treated as foreign source income rather than U.S. source income under current law. If the lender were a business organization and the borrower were a resident of a country with which the United States has a tax treaty, it is likely that the payments would be exempt from foreign withholding taxes on the basis that they were non-effectively connected industrial or commercial profits or business profits. Thus, substitute payments in respect of loans of U.S. securities would be transformed into foreign source income that was not subject to foreign tax.[14]

Discussion

1. Tax Policy - We strongly support the U.S. tax policy objectives reflected in the Proposed Regulations that substitute dividend and interest payments should be treated for source, character and income tax treaty purposes as dividends and interest paid by the issuer of the underlying securities.

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[14] The Service's concern in this respect may be somewhat exaggerated, since under Treas. Reg. § 1.954- 2T(h)(1), as "income equivalent to interest" these payments would fall in the "passive" income basket of taxpayers other than financial services entities for foreign tax credit limitation purposes. Section 904 (d)(2)(A). Since it is otherwise relatively easy for U.S. taxpayers to acquire securities of foreign obligors, such as foreign governments, which produce "passive" or "financial services" income that is exempt from foreign withholding tax, foreign source treatment of income from securities loans to foreign borrowers does not generally create a tax loophole.

Admittedly, the position taken in the Proposed Regulations would have the effect, for U.S. federal income tax purposes, of causing a single dividend or interest payment to be characterized as dividend or interest income in the hands of more than a single holder. In some respects, such a result might appear to be at odds with the policy reflected in the longstanding Service ruling position concerning securities lending transactions and the eligibility for the dividends received deduction under Section 243[15] and the exclusion of certain interest from income under Section 103.[16]

Nevertheless, because the foreign holders to whom the Proposed Regulations would apply are not subject to U.S. federal income tax (other than U.S. withholding tax), are receiving payments which, except for the fees, are identical in amount to the income they would receive had they continued to hold the underlying securities, and with respect to stock are not eligible for the dividends received deduction under Section 243, there is little U.S. tax policy justification for treating them differently than if they continued to own the underlying securities.

As an investor's principal non-tax reason for lending securities is to increase the securities' yield without losing the potential economic benefits of owning them, the rules contained in the Proposed Regulations should not interfere with the non-tax reasons for engaging in securities lending. Rather, such rules, if enforceable, would prevent the inappropriate avoidance of U.S. dividend withholding tax by foreign owners of U.S. equities, would encourage the lending of U.S. debt securities, and would make the tax consequences of securities loans more predictable.

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[15] Rev. Rul. 60-177, 1960-1 C.B. 9.

Consistent with the underlying policy objectives, we have considered whether, for source purposes, particularly in connection with the calculation of the foreign tax credit limitation, the transparency approach of the Proposed Regulations should be extended to the sourcing of substitute dividend and interest payments between U.S. persons. If the Proposed Regulations are adopted in their current form, for example, a substitute dividend payment on a foreign equity will be foreign source if the equity is loaned to a foreign borrower, but U.S. source if loaned to a U.S. borrower. We generally believe that the source of a substitute payment in connection with a loaned security should not depend on the status of the borrower, but rather on the status of the issuer of the underlying security.[17] On the other hand, where the loan is of foreign securities, the effect of such a rule would be to treat what would be U.S. source income under the Proposed Regulations as foreign source income. Since the result under the Proposed Regulation does not result in any “loophole”, and since a primary purpose of the Proposed Regulations is to close loopholes, others of us question whether the suggested change is either necessary or desirable since its effect would be to provide additional foreign source income that is not subject to foreign withholding taxes. On balance, we believe the transparency principle should be applied in such a case and that the Proposed Regulations should be changed in this respect.[18]

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[16] Rev. Rul. 80-135, 1980-1 C.B. 18.

[17] Also in connection with the calculation of the foreign tax credit limitation, consideration should be given to the method of allocating a borrower’s deductions for substitute dividend and interest payments.

[18] If the transparency rule is not extended to the sourcing of substitute dividend and interest payments between U.S. persons, then its application to non-U.S. persons should be limited to payments that are not effectively connected with a U.S. trade or business. As written, the Proposed Regulations apply the transparency rule to all payments to foreign persons, without any such limitation. The result for sourcing purposes thus would be different for U.S. branches of foreign persons and

In one important respect, however, we believe that the Proposed Regulations should be clarified. Section 1.871(b)(2) and 1.881-2(b)(2) provide that, if substitute interest payments are to be treated as portfolio interest, a Form W-8 or substantially similar form must be received by the withholding agent. The Proposed Regulations do not distinguish between securities in registered form and securities in bearer form. This distinction, however, is crucial in the context of the portfolio interest exemption. Although Code Sections 871(h)(2)(B) and 881(c)(2)(B) require that such statements be made in the context of interest on registered obligations, it is clear from Sections 871(h)(2)(A) and 881(c)(2)(A) that there is no similar requirement in the case of bearer obligations.[19]

Therefore, the Proposed Regulations, read literally, apply a different rule with respect to interest substitutes on bearer obligations that are subject to securities loans from the rule that applies to such obligations when they are retained by their initial owners. We are unaware of any policy reason for such a distinction, which is inconsistent with the basic format of the portfolio interest provisions of the Code and also with the transparency standard that the Proposed Regulations generally adopt. Further, if this provision in the Proposed Regulations is finally adopted in its present form, we have reason to believe that it could significantly restrict securities lending transactions in bearer obligations of U.S. corporations, with an adverse effect on foreign securities markets. Therefore, the final regulations should specifically provide that the Form W-8 requirement applies only to substitute interest payments with respect to registered form indebtedness.

U.S. persons, even though otherwise the income sourcing treatment of each generally is the same. This is not a desirable result.

2. U.S. Statutory Support - We believe that there is substantial doubt whether Section 7805 or any other section of the Code provides the Treasury with the requisite statutory authority to promulgate enforceable regulations characterizing substitute dividend or interest payments as actual dividends or interest. The Proposed Regulations are issued under Sections 861, 871, 881, 894 and 1441. None of these sections provide the Treasury with authority similar to that granted by some other sections of the Code to "prescribe such regulations as may be necessary or appropriate to carry out the purpose of this section".[20] Instead, the Proposed Regulations cite Section 7805 as the underlying statutory authority. Under Section 7805, the Treasury is authorized to "prescribe all needful rules and regulations for the enforcement of this title ...". We do not believe, however, that Section 7805 confers on the Treasury the power to do more than implement statutory provisions.[21]

3. The legal standard for assessing the validity of an interpretative regulation promulgated under Section 7805 of the Code is reasonably clear:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the

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[19] Compare also Treas. Reg.§ 35a.9999-5 Q&A-l (bearer obligations) with Q&A-8-17 (registered obligations).

[20] See, e.g., Section 865(j).

[21] Very broad powers to promulgate regulations to source items of income not specifically covered by Sections 861 and 862 are contained in Section 863. We therefore believe the Treasury has sufficient authority to promulgate enforceable regulations establishing the source of substitute dividend and interest payments. Such an approach, however, would not have prevented the application of a number of U.S. tax treaties, which would have resulted in an exemption from U.S. withholding tax. For example, if the Proposed Regulations had merely declared that substitute dividend payments would be classified as U.S. source FDAP payments, but had not also characterized the income as dividends, that classification would not have prevented foreign persons from relying on the "business profits" or "other income" articles of several U.S. tax treaties to claim a complete exemption from U.S. tax on such payments.

plain language of the statute, its origin, and its purpose..."[22]

The Proposed Regulations categorize substitute dividend and interest payments as actual dividend and interest income respectively, for purposes of Sections 861, 871, 881, 894 and 1441. Even if it were permissible to restrict the definitions to those Sections of the Code, however, the terms dividend income and interest income cannot be redefined in a vacuum. In this regard, it is very difficult to harmonize the expanded definitions of these terms in the Proposed Regulations, "with the plain language of the statute, its origin and its purpose."[23] This is true even though imposition of dividend withholding on dividend substitutes, in particular, seems clearly in accord with other policies reflected in the statute and the U.S. tax treaties and therefore arguably supports interpreting the term "dividends" to include such payments for withholding purposes.

Under Section 316 (and the language of contemporaneously issued regulations in 1955), a substitute dividend payment, by reason of not constituting a "distribution of property made by a corporation to its shareholders..." is not within the definition of "dividend". Similarly, a substitute interest payment is not within the definition of interest.[24] Although, as described above, we strongly support the policy objectives reflected in the Proposed Regulations, we question whether Section 7805 provides sufficient authority to characterize substitute dividend or interest payments as actual dividend or interest payments.

[22] National Muffler Dealers Ass'n., Inc. v. United States, 440 U.S. 472, 477 (1979).

[23] Id.

[24] As per Deputy v. Dupont. 308 U.S. 488 (1940), interest only arises in connection with payments made as consideration for the loan of money. See also, Rev. Rul. 80-135, 1980-1 C.B. 18.

Thus, in other instances involving securities loans in which the definition of dividend and interest payments was modified for specific purposes, a legislative change was believed necessary.[25] The Service's rulings with respect to the application of the dividends received deduction and the exemption for interest on municipal obligations in securities lending transactions reflect this understanding of the definitions of dividends and interest under the Code. For example, Revenue Ruling 60-177, which holds that a substitute dividend payment is not a dividend for purposes of the dividends received deduction, is based on the definition of a dividend in Section 316(a) as a distribution of property by a corporation to its shareholders, and the premise that there can be only one real owner of a single share of stock. Similarly, Revenue Ruling 80-135, which holds that the lender of a tax-exempt bond is not entitled to treat the substitute interest payment received from the borrower as exempt income, is implicitly based on the Supreme Court's holding in Provost v. United States, 269 U.S. 443 (1926), that title passes to the buyer of a security loaned in a short sale transaction, with the result that the lender is not in receipt of interest on the loaned tax-exempt bond.

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[25] Public Law 95-345. Prior to its enactment, the Service had ruled privately that substitute dividend and interest payments did not constitute qualified dividend or interest income for regulated investment companies under Section 851(b)(2). For the same reason, substitute payments were not treated as dividends and interest exempt under Section 512(b)(1) from the unrelated business income tax imposed by Section 511 on tax exempt organizations. In order to resolve the tax status of such payments to tax exempt organizations and regulated investment companies, Congress found it necessary to amend Sections 512(b)(1) and 851(b)(2) to provide that "payments with respect to securities loans" are qualified income thereunder.

Accordingly, we believe that there is a substantial possibility that a court would determine that the transparency approach of the Proposed Regulations can be adopted only by legislation. We therefore recommend that the Administration immediately sponsor legislation to assure that the substantive objectives of the Proposed Regulations will be accomplished.

The Treasury may be of the view that the practical risk associated with finalizing the Proposed Regulations is low, largely because of a belief that the risk-averse withholding agent community will begin withholding on all substitute dividend payments, notwithstanding the questionable statutory underpinning for the proposed rules. There is no reason to believe, however, that if the Treasury decides to finalize the Proposed Regulations with respect to substitute dividend payments prior to the enactment of legislation designed to accomplish the same policy objective, litigation will not develop between foreign persons that were subjected to withholding and the U.S. Government, with the foreign persons having a significant possibility of success. For example, we would expect that after finalization of the Proposed Regulations, certain securities lenders resident in a treaty jurisdiction (e.g., the United Kingdom) that had 15% U.S. taxes withheld on their substitute dividend payments would file a suit for refund of the U.S. tax in a U.S. court. At the very least, even a favorable resolution of the Treasury’s authority to issue these regulations would be unlikely for a number of years.

We believe that any legislation which is introduced should have as its effective date the date of its introduction. We further believe that the legislation should be introduced immediately. We recognize that it is unlikely that the legislation would be enacted this year. On the other hand, because the legislation would be clearly desirable as a loophole closing measure, it should be viewed as noncontroversial and hence almost certain to be enacted at some future date. The immediate effective date therefore would have an in terrorem effect, which would lead withholding agents and others who were concerned as to the authority for the proposed regulations to follow the position expressed therein. Further, because it would almost certainly be enacted prior to the time that any taxpayer could file a suit for refund, it would effectively preclude such claims. Although we recognize that legislation of this sort is the exception rather than the rule, there is precedent for it. For example, the interest equalization tax was proposed (with immediate effect) in July, 1963 but was not enacted until more than a year later.

4. Treaty Provisions - Any U.S. legislation designed to accomplish the substantive objectives of the Proposed Regulations might be regarded as overriding the provisions of a number of U.S. income tax treaties. As we have discussed, failure to adopt provisions that accomplish the purpose of the proposed regulations would result in payments to lenders of shares of stock being exempted from tax under U.S. income tax treaties, whereas dividends and in certain cases interest would be subject to withholding tax.

This raises the question whether U.S. treaty partners would be concerned at this effort to impose withholding tax by regulations, where literally read, these treaties provide an exemption[26]. These treaty override concerns must be examined with respect to U.S. treaties that contain their own definitions of

[26] A similar concern in the case of substitute interest payments under a treaty that exempts interest from tax is unlikely to arise since the effect, i.e., exemption from tax, would be the same.

dividends and/or interest,[27] but also where the relevant treaty contains a general provision under which undefined terms have the meaning they have under the laws of the contracting state seeking to impose the tax. As previously discussed, under particular provisions of U.S. law, substitute dividend and interest payments generally do not constitute actual dividends and interest as a statutory matter, and it is therefore questionable whether a change effected by regulations should automatically apply for tax treaty purposes.

These considerations constitute another reason why the result reached under the Proposed Regulations should be confirmed by legislation. Under section 7852(d) and its legislative history[28], a treaty provision generally is ineffective as against a contrary provision in a subsequently enacted law. This, however, probably does not give the Treasury the authority unilaterally to override a treaty by regulation.

Notwithstanding this legislative background, U.S. treaty partners can still legitimately object where legislation overrules provisions in tax treaties, particularly if the provision in question has been viewed by the parties as applying to the transactions dealt with by the legislation[29]. This, however, is not the case as to the treatment of substitute payments on securities loans. There is no reason to assume that

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[27] See, e.g., United Kingdom Treaty Article 11(3), defining a dividend to "include” any item which under U.S. law is treated as a distribution out of earnings and profits and French Treaty Article 9(7), defining a dividend as a "distribution" under U.S. law.

[28] See S. Rep. 100-445, 100th Cong., 2d Sess (1988) 316-328.

[29] See the Tax Section’s Report on the Override of U.S. Tax Treaty Provisions by Amendment to the Internal Revenue Code (October 7, 1987) reproduced at 37 Tax Notes 931 (Nov. 30, 1987).

U.S. treaty partners, in negotiating treaties, ever considered their status. Further, it is likely that residents of these treaty countries view dividend and interest substitute payments as akin to dividends and interest rather than as some other form of income. Thus, since the purpose of the legislative override would be to close a clear U.S. tax loophole inadvertently supplied by a treaty, a treaty partner could not legitimately object to the legislative action.

The Proposed Regulations have been outstanding for more than four and a half months apparently without any objection to them of which we are aware being made by either foreign treaty partners or residents of foreign treaty countries. It would appear very likely that the same would be true with respect to legislation that accomplishes the same purpose. Although we believe that, as a matter of good international relations, U.S treaty partners should be advised as to any such proposed legislation (if in fact they have not already been advised with respect to the proposed regulations), this process should not in any way delay the introduction of legislation. We do not believe that our foreign treaty partners could legitimately object to such a course, any more than the United States could legitimately object if its foreign treaty partners took similar action in a reverse situation.

5. Effective Date - The Proposed Regulations contain a prospective effective date. If the Proposed Regulations are not to be finalized in the very near future, clarification should provided immediately as to the applicable rules under current law. The statement in the preamble to the Proposed Regulations that the source, character and income tax treaty treatment of substitute payments made prior to the effective date of the regulations will be determined under all the “facts and

circumstances" of a particular transaction has understandably generated a great deal of confusion. A Treasury clarification of this statement would be very helpful, if not essential. For example, is the Treasury intending to suggest that the transparency rule of the Proposed Regulations is in some way applicable under current law? Or is the Treasury intending to suggest that all cross-border securities loans are abusive, notwithstanding any non-tax economic objectives, to the extent an exemption from U.S. withholding tax is potentially involved and is one of the purposes for the loan? If so, in many cases a withholding agent will be unaware of the securities lender's motivation and hence as a matter of self protection will be required to withhold tax as though the Proposed Regulations were currently effective. The Treasury therefore should clarify what "facts and circumstances" it has in mind and with reference to which rules of law, particularly because of the relatively straightforward, albeit "favorable", U.S. tax treatment that U.S. advisors believe currently applies to many cross-border securities lending transactions.

6. Treatment of Fees - We recommend that regulations be promulgated to source securities lending fees by reference to the residence of the Lender, in a manner similar to the residence-based sourcing rules under Regulation § 1.863-7 with respect to income from notional principal contracts.

Numerous analyses of securities lending fees have failed to produce a consistent, non-manipulable, and theoretically sound basis for determining the tax treatment of such fees. Additional uncertainty is introduced when taxpayers and their advisors attempt to analyze the potential application of withholding taxes, tax treaties, and (in some cases) the portfolio interest exemption to such fees.

We believe these uncertainties exact an unnecessarily high cost, especially when compared to the relative simplicity of the transactions involved, and place undue burdens on the U.S. securities lending marketplace. Even a brief review of some of the ways in which securities lending fees have been analyzed reveals that any attempt to pigeonhole each type of fee for character, source, and tax treaty applicability would create anomalous tax results for economically similar or identical transactions — which, of course, would create not only additional complexity but also the opportunity for manipulation by well-advised taxpayers. As a step in the direction of greater certainty, therefore, we recommend that securities lending fees be sourced by reference to the residence of the Lender. This result- oriented approach would simplify the tax treatment of securities lending transactions and promote the liquidity of the U.S. securities lending marketplace. The residence- based sourcing rules under Regulation § 1.863-7 with respect to income from notional principal contracts represent such a result-oriented approach.

(a) Current Practice with Respect to Securities Lending Fees

One reason for reaching this conclusion is that legal authorities on the tax treatment of securities lending fees (whether borrow fees or embedded fees) in cross-border transactions are scarce.[30] Hence, residence based sourcing does not conflict with any existing rule. In actual practice, uncertainty regarding the treatment of security lending fees has

[30] See Rev. Proc. 91-6, 1991-2 I.R.B. 29 (Service ordinarily will not rule on source, character or income tax treaty treatment of any payments in securities lending transactions). Cf. Code § 512(a)(5)(A)(iii), (iv); Reg. § 1.512(b)-1(a) (treating fee income as investment income and, thereby, excluding such income from treatment as "unrelated business taxable income" for exempt organizations).

required cautious U.S. Lenders and Lending Agents to treat fees as neither dividends nor interest but as some (unspecified) type of “fixed or determinable, annual or periodical income” subject to 30% U.S. withholding tax, unless an exception from withholding applies.[31] As with substitute payments, many foreign Lenders claim exemption from, or reduction of, the U.S. withholding tax on such fees based on the “business profits,” the “industrial and commercial profits” or the “other income” provisions of U.S. income tax treaties with jurisdictions in which the Lenders are resident.[32]

Thus, for example, in P.L.R. 8822061 (March 7, 1988), the Service held that either borrow fees or embedded fees earned by a foreign insurance company lending its securities were “industrial or commercial profits” and, therefore, were exempt from withholding under the applicable tax treaty, assuming that the foreign taxpayer had no permanent establishment in the United States to which such income would be attributable. P.L.R. 8822061 focuses on the fees earned by the foreign Lender and Lending Agent, but does not discuss the tax treatment of the rebate fee to the U.S. Borrower posting cash collateral. Nor does the ruling address situations where the securities lender is not engaged in a financial services business.

The present tax treatment of rebate fees is somewhat clearer than the treatment of borrow and embedded fees. Rebate fees generally are viewed as interest for tax purposes, since they compensate the Borrower for the Lender’s use of the Borrower’s cash collateral during the securities loan period and,

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[31] Code §§ 1441, 1442.

[32] Of course, if the foreign lender is a resident of a non-treaty jurisdiction, no withholding exemption or reduced rate is available.

therefore, fall within the traditional definition of interest.[33] Moreover, this treatment comports with the taxation of Repos in circumstances where the additional amount received by the purchaser upon repurchase of the loaned securities by the Seller is treated as interest for tax purposes.[34]

Interest is sourced to the United States if it is paid on “bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations.”[35] While not entirely free from doubt, most cautious U.S. Lenders treat the securities lending agreements between the Lender, Borrower and Lending Agent as “interest-bearing obligations” and, therefore, treat rebate fees as U.S. source interest income to a foreign Borrower. Although a 30 percent U.S. withholding tax could apply to such interest, exemption is likely under either an applicable tax treaty or the portfolio interest rules. In addition to determining whether tax treaty benefits are available (i.e., whether the rebate fee continues to be treated as “interest” for purposes of the relevant tax treaty (which may have a specific definition)) or whether the portfolio interest provisions apply, a variety of other tax issues must be examined. For example, a rebate fee must still be analyzed to determine (i) whether it is effectively connected with a U.S. trade or business of a foreign Borrower; (ii) whether the securities lending transaction can be structured to qualify for the short term original issue discount exception from withholding; and (iii) whether the securities loan qualifies under the portfolio interest exemption in Code §§ 871(h) and 881(c), which in turn depends on classifying the loan agreements as either registered form obligations or bearer form and their accompanying rules.

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[33] Deputy v. Dupont. 308 U.S. 408 (1940) (compensation for the use or forbearance of money).

[34] See the discussion of Repos in Section 6 below.

[35] Code § 861(a)(1).

(b) Sourcing of Fee Income

We believe that the uncertainty regarding the tax treatment of security lending fees could be substantially reduced through the adoption of an appropriate sourcing rule. Although a variety of possibilities exists, we support adoption of a rule that sources fees by reference to the residence of the Lender. Rather than repeat the analysis presented by other commentators regarding the theoretical or legal bases for the alternative approaches, the following discussion focuses on the practical issues and effects that adoption of alternative sourcing rules would create.

(i) Location of Loaned Securities - “Location based” sourcing relies on a determination of the physical location of the loaned securities, and derives from the source rules for rental income. A simple application of such a rule would, for example, source lending fees to the U.S. if a foreign Lender loans its securities to a U.S. borrower who holds the loaned securities in a U.S. custodial account or otherwise within the United States. However, this superficially simple rule is fraught with administrative and practical difficulties.

In practice, Borrowers generally retransfer (e.g., to cover a short sale or prevent a fail), reloan, or even sell borrowed securities, all without specific knowledge of the Lenders. Aside from the practical difficulty of tracking a Borrower’s subsequent use of loaned securities, a location-based source rule provides ample opportunity for taxpayer manipulation. For example, a foreign Lender of U.S. securities could simply require that the Borrower use a non-U.S. custodial account to hold the securities (either its own or, if subsequently reloaned or transferred by the Borrower, of a foreign lending agent or foreign transferee). A location-based source rule could also reduce the competitiveness of U.S. Lending Agents in the international securities lending marketplace and decrease the liquidity of the U.S.-based securities lending market to the extent foreign Lenders attempted to control Borrowers' use of loaned securities to achieve favorable source determinations.

(ii) Location of Lending Activity - sourcing based on the location of the securities lending transaction presumably would be derived from the source rules for loans and other financial transactions.[36] It is not entirely clear how such a sourcing rule would be applied to securities lending transactions. Such uncertainty might arise, conceptually, from the "two loan" aspect that could be considered present in securities lending transactions: the cash collateral loan (from the Borrower's point of view)[37] and the actual securities loan by the Lender. In any event, a lending location source rule would require an examination of the economic substance of the securities lending transaction to determine the source of fees and, accordingly, administrative enforcement and taxpayer compliance costs could be high. Such a rule could also raise the same treaty based exemption issues as the securities loans themselves.

Moreover, a source rule based on lending location would appear to be subject to manipulation by taxpayers almost to the same extent as the location-of-securities rule discussed above.

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[36] See, e.g., Bank of America v. United States. 680 F.2d 142 (Ct. Cl. 1982) (source of commissions earned from confirmations of, or other transaction with respect to, letters of credit issued by foreign banks depends on economic substance of transaction).

[37] As discussed below, certain Repos are viewed in this manner, that is, as cash loans secured by securities, yet may be nearly indistinguishable economically from cash-collateralized securities loans.

In particular, if non-U.S. sourcing of lending fees was desired, foreign Lenders would simply shift such transactions to foreign Lending Agents, to document and execute them in foreign jurisdictions.

(iii) Location of Security Issuer - This would be similar to the rule that the Proposed Regulations use for substitute dividend and interest payments. The difficulty with such a rule is that the lending fees, unlike dividend and interest substitutes, could not easily be classified as dividends and interest with a withholding tax status that is the same as those substitute payments. Instead, their tax treatment would be subject to the same questions that presently exist with respect to those payments, i.e., whether they constitute exempt industrial or commercial profits or business profits or, alternatively, whether they are exempt under the "other income" provisions of certain treaties.

(iv) Residence of Borrower or Lender - Sourcing fees according to the residence of either the Borrower or the Lender would provide a simple, administrable, largely non manipulable source rule. The difference between the two source rules would be their disparate effects on the international securities lending marketplace.

In particular, if fees are sourced according to the Borrower's residence, unless an industrial or commercial profits or business profits treaty exemption is available, foreign Lenders could be subject to U.S. withholding tax on their lending fee income from transactions with U.S. Borrowers. Foreign Lenders could avoid such U.S. withholding taxes, however, to the extent they were able to effect securities lending transactions only with foreign Borrowers. Thus, U.S. Borrowers (e.g., U.S.

securities brokers and other trader/dealers) would be disadvantaged in the international securities lending market to the extent foreign Lenders could execute transactions with foreign Borrowers without imposition of U.S. withholding tax.

On the other hand, while effectively exempting foreign Lenders from U.S. withholding tax on their lending fees, sourcing such fees by reference to the Lender’s residence would preserve the liquidity of the securities lending marketplace and enhance the competitiveness of U.S. Borrowers (and Lending Agents). Further, with respect to U.S. Lenders, a Lender-based source rule would tend to eliminate any foreign source income manipulation that might otherwise exist, while a Borrower-based source rule would tend to increase such foreign source income (to the extent of the Lender’s fee income).

We recognize that anomalous results would to some extent exist under either rule (as with the above sourcing rules) to the extent that, in a single securities lending transaction, some payments will be subject to withholding while other payments will not. In a cross-border securities loan between a foreign Lender and a U.S. Borrower, for example, if a Borrower’s residence source rule is adopted, under the approach of the Proposed Regulations substitute interest payments generally would not be subject to U.S. withholding tax (by virtue of the portfolio interest exemption), while fees could be (as U.S. source income to the foreign Borrower). On the other hand, under a Lender’s residence source rule, such a securities loan with respect to debt obligations would be entirely free of U.S. withholding tax; however, an equity securities loan between the same parties would result in U.S. withholding tax on substitute dividend payments but no withholding on the Lender’s fees (as foreign source income to the foreign Lender).

None of the source rules discussed herein for securities lending transactions represents a model of tax consistency. Nevertheless, we support adoption of a Lender-based source rule, in part because it is simple, administrable and largely non-manipulable, and in part because it is consistent with the source rules that have been developed for notional principal contracts under section 863.[38] We believe that in connection with the continued growth of the cross-border business in swaps, financial derivatives and other notional principal contracts, it is desirable to develop tax rules that promote consistency of treatment whenever possible.

7. Sale and Repurchase Transactions "Repos" - Although we do not believe it is necessary to expand the scope of the Proposed Regulations to provide guidance with respect to sale and repurchase transactions ("Repos") that are characterized as loans for U.S. tax purposes, we do believe that the transparency approach of the Proposed Regulations should be applied to all cross-border Repos that are not so characterized.

In a Repo agreement, one party (the "seller") sells securities (typically debt securities) to another party (the "purchaser") for a cash purchase price[39] and, concurrently, agrees to reacquire identical or substantially identical securities from the purchaser at a price equal to the original cash purchase price plus an agreed upon interest rate ("repo margin"), at some time in the future (the "repurchase date")[40].

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[38] Reg. § 1.863-7.

[39] The original purchase price of the securities normally approximates their fair market value at such date.

[40] Repo transactions can be for overnight, for a longer specified period ("term Repo"), for the maturity of the underlying security, or with an open settlement date ("open repo").

Most Repos permit the purchaser to deal freely with the underlying securities, specifying only that substantially identical securities must be returned on the repurchase date. Moreover, as in a securities lending transaction, if interest payments are made on the underlying securities during the life of the Repo, the purchaser generally must also pay equivalent, “substitute” payments to the seller.

For U.S. tax purposes, Repos are widely referred to as loans.[41] In fact, however, there are at least two types of Repos, those that are readily characterized as secured loans for U.S. tax purposes, and those that are economically extremely similar to cash collateralized securities lending transactions. In practice, it is often difficult to draw a distinction between the two types of Repos, although any effort to do so would focus, in part, on the purchaser’s power of disposition over the securities and on whether the purchased securities were disposed of during the term of the Repo.

In general, the revenue rulings published by the Service in connection with Repos are largely restricted to transactions in which it seems reasonably clear that the purchasers did not possess unrestricted powers to dispose of the “purchased” securities, and in fact did not dispose of such securities during the terms of the Repos. We do not believe guidance is necessary with respect to the U.S. tax treatment of such Repos in a cross-border setting. The foreign sellers of securities in such Repo transactions would be respected as the owners of such securities for U.S. tax purposes, and would be taxable or not on the income derived from such securities, under well established U.S. tax principles.

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[41] Revenue Ruling 79-108, 1979-1 C.B. 75; Revenue Ruling 77-59, 1977-1 C.B. 59; Revenue Ruling 74-27; 1974-1 C.B. 24.

Another type of Repo, which we understand to be much more common, involves circumstances in which purchasers regularly dispose of the purchased securities (e.g., in connection with short sale or fail to deliver transactions). Such Repos are economically extremely similar to cash collateralized securities lending transactions. He believe the substitute payments due by the purchasers to the sellers in such Repos should be characterized in the same manner as the substitute payments in cross-border securities lending transactions, as from a tax policy perspective, it is not possible to distinguish between them on any reasonable basis.

The purchaser's repo margin, to the extent received from a foreign seller, is treated as foreign source interest income (as interest paid by a foreign obligor). This treatment would be the same as the tax treatment of rebate fees to a U.S. Borrower in a securities lending transaction, if a residence-of-the-lender source rule is adopted. To the extent the foreign seller in a Repo earns an embedded fee while it holds the purchaser's cash loan proceeds, such fee income is similar economically to the embedded fee earned by a Lender in a securities lending transaction. Achieving tax symmetry between Repos and securities lending transactions with respect to such fees will minimize the opportunity for taxpayer manipulation.

This is another reason supporting our recommendation that Treasury adopt a "residence of the Lender" source rule for fees in securities lending transactions (as described above).

8. National Principal Contracts - We believe that the scope of the Proposed Regulations generally should not be expanded to include the substitute dividend component of equity or equity index swaps.

While the terms of equity-based notional principal contracts are evolving rapidly, a basic equity swap can be described as follows: one party to the contract would pay on a periodic basis (i) any increase in value of a notional investment in an individual equity, multiple equities or an equity index (the “Notional Principal Amount”) and (ii) amounts equivalent to dividends paid during the period in question on the equities that constitute the Notional Principal Amount; the counterparty to the contract would pay on the same periodic basis (i) any decrease in value of the Notional Principal Amount and (ii) amounts equivalent to a market rate of interest on the Notional Principal Amount. A common variation would determine substitute dividend payments by reference to expected or historical dividend payments rather than actual dividends; many other variations exist.[42]

Under current law, payments made with respect to notional principal contracts are sourced by reference to the residence of the recipient.[43] Accordingly, U.S. withholding tax is not imposed on payments made by U.S. persons to non- U.S. persons under such contracts. As previously discussed, the residence-based rule is simple to understand and readily administrable.

The Treasury should not address this issue by regulation. Substantive issues aside, there is even less statutory authority for the Treasury to treat dividend equivalent payments as dividends than there is in the case of securities

[42] The Preamble refers to "an equity index swap structured to replicate the cash flows that would arise from an installment purchase of one or more securities" as a transaction that generated payments analogous to substitute dividend payments under a securities loan. While such a swap could include payments analogous to substitute dividend payments, the choice of this structure as an example is puzzling, as the structure is neither analogous to the payment flows on a securities lending transaction nor, to the best of our knowledge, a common form of equity-based swap.

[43] Reg. S 1.863-7; Reg. § 1.988-4.

loans. In the latter case, actual securities are transferred and later returned, whereas swap transactions usually involve no transfer or other ownership of securities by the recipient of dividend equivalent payments.

As in the case of income from securities loans, we believe that the Treasury does have authority to treat equity swap payments by U.S. persons to non-U.S. persons as having a U.S. source. As a matter of analysis, however, it is difficult to find a non-result oriented basis for treating equity swap payments any differently from interest rate swap payments. In both cases, payments are being made by a U.S. person to a foreign counterparty, which is relying on the U.S. person's credit. Although swap payments based upon dividends paid on specified securities may be more closely related to specific asset returns than payments on interest swaps, this need not always be the case, e.g., the payment of interest determined with reference to U.S. government obligations. Further, the adoption of a rule that treats equity swap payments determined with reference to dividends on U.S. securities as U.S. source income raises the same questions that presently exist under treaties in the context of securities loans, i.e., are the payments exempt as business profits or as "other income".

Therefore, we believe that any change in current law with respect to withholding tax and related treatment of equity swaps should be addressed, if at all, by legislation, and that the Treasury should take appropriate action with respect to securities lending transactions as soon as possible and not delay such action in an attempt to address issues raised by other derivative financial products such as equity swaps. There is, however, one specific context in which an equity swap is closely equivalent to a securities loan and as to which it might be appropriate to apply the principals of the proposed regulations. If an investor that holds equities (i) economically disposes of those equities and acquires debt securities (for example, U.S. Treasury obligations), (ii) enters into a swap under which the amounts paid are measured by the equities and debt securities in question, and (iii) at the termination of the swap economically disposes of the debt securities and reacquires the equities, the transaction as a whole is, in our view, sufficiently similar as an economic matter to a securities lending transaction to warrant the application of a transparency rule to the payments made under the swap.

Such transactions could be dealt with under an anti-abuse rule in the Proposed Regulations, however, without venturing on the broader issue of sourcing equity swaps generally.[44]

Turning to the question of any legislation that might be considered, perhaps the most difficult issue raised by the prospect of changing the residence-based sourcing rule for notional principal contracts in order to impose U.S. withholding tax on substitute dividend components of such contracts is the scope of such a change. Where along the continuum (with a swap

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[44] We would limit the anti-abuse rule to the situation where all parts of the transaction are carried out with the same counterparty. First, the transaction described is unlikely, in our view, to take place if the swap and the other steps are carried out with different counterparties because of the significant transaction costs that could result from the other steps, e.g., the bid-ask spread on the sale and repurchase of the equities. Second, any rule that broadly applied the Proposed Regulations’ sourcing rule to any transaction in which an investor disposed of equities in connection with entering into a swap whose payments are measured in part by similar equities would impose burdensome administrative requirements on a U.S. swap counterparty to determine whether withholding should be imposed in connection with a particular transaction. This concern is not present if all steps in the transaction are carried out with the same counterparty. In addition, a broader rule is likely to be impossible for the U.S. swap counterparty or the Service to administer.

based on a single equity at one end, and a swap based on a publicly traded equity index at the other) is the line (if any) to be drawn that separates residence-sourced contracts from contracts sourced under a different rule?[45]

Put somewhat differently, the treatment of equity derivatives raises the fundamental and far-reaching questions of the extent to which certain now-established principles, for example, (i) that notional principal contracts are taxed under a regime separate from that applicable to the stock, debt instruments, options, forward contracts and combinations thereof that those contracts may resemble as an economic matter and (ii) that except for the special rules applicable to contracts taxed under Section 988, notional principal contracts are taxed in a uniform and consistent manner, should be reconsidered in toto. These issues will not easily be resolved.

Another difficult question relating to the dividend component of equity-based notional principal contracts is whether the current lack of taxation of similar amounts under contracts that can be used to replicate (albeit imperfectly) the economics of notional principal contracts continues to be justified. Currently, there are payments of dividend-based amounts under derivative products that are equally, if not more, analogous to the dividend component of equity swap payments, and that are not sourced as substitute payments. Most obviously, a foreign person can enter into exchange-traded options or futures contracts that are priced in a manner that takes into account dividends, without being subject to U.S. withholding tax on the substitute dividend component. Over-the-counter options are similarly priced and are

[45] The rationale for imposing U.S. dividend withholding tax on notional principal contract payments would be least compelling in the case of notional principal contracts based on equity index swaps, as highly liquid exchange-traded alternatives exist upon which U.S. dividend withholding tax is not imposed.

also not subject to U.S. withholding tax with respect to any dividend component.

Finally, there can be significant economic differences between securities loans and notional principal contracts. The principal decision of a securities lender usually will have been to invest in the security; the investor’s ability to increase its yield by entering into the securities loan does not change that decision, and therefore should not alter the taxation of the payments it receives. The same is not necessarily true in the case, for example, of the investor that enters into an equity or equity index swap. Unlike an investor that enters into a securities lending transaction, a party to an equity or equity index swap need not own the equities by reference to which swap payments are determined, and the investor will not become an owner of the underlying equities by reason of the transaction. Indeed, a principal reason for foreign persons to enter into equity- based swaps may be to avoid the transaction costs of purchasing actual equities. The sourcing rule of the Proposed Regulations presumably is based upon the principle that foreign owners of U.S. equities should not be able to avoid U.S. dividend withholding tax through a temporary lending arrangement under which the owner retains all of the economic detriments and benefits of ownership of the actual U.S. equity securities including the right to the return of the securities on 5 days’ notice[46]. Rendering the securities lending transaction “transparent” is therefore appropriate based on the economic substance of the lender’s investment, i.e., its determination to actually own the equity securities. This principle, however, implies that an equity swap party conversely does not stand in the same economic position as an actual owner of the securities.

[46] See Prop. Reg § 1.1058-1 (b)(3).

Another significant economic difference between securities loans and many equity-based notional principal contracts stems from the fluid nature of the latter. As mentioned earlier, substitute dividend components of swaps may be measured by expected or historical dividends rather than actual dividends. Additional variations on this theme may easily be imagined: payments measured by dividends, but with a cap and floor, or payments based on historical dividends but fixed in amount throughout the term of the swap. These variations change the economic effect of the transaction. At some point, the change may be substantial enough that terming the payment a "substitute dividend" will no longer be an accurate description of the payment's function. This flexibility is derived from the lack of any necessary direct linkage between an actual equity or equity index and the terms of a swap, unlike a transaction in which an actual equity is loaned.

Notwithstanding these distinctions, several of us believe that, in the absence of legislation, certain equity-based contracts, not including the "classic" type of contract described above, could be structured in a manner that would place the recipient of the dividend equivalent payment in an economic position almost identical to that of an actual owner of the stock. Those persons believe that, as to payments under such contracts, (1) the source rules of the Proposed Regulations should be applied, and (2) legislation should be adopted characterizing such payments as dividends under the principles of the Proposed Regulations. Those persons are concerned about situations such as one where foreign person F enters into a contract with domestic broker D under which F initially pays D $100 (which happens to be the current trading price of a share of XYZ stock), D agrees to pay F an amount measured by all dividends payable on a share of XYZ stock, F has the option at any time to terminate the contract (at which time D will pay F the then-current trading price of a share of XYZ stock, whether it be more or less than $100), and D may (although is under no obligation to) hedge its obligation to F by buying a share of XYZ stock. Those persons believe dividend withholding should apply in cases such as this because otherwise non-U.S. persons desiring to hold a portfolio of U.S. equity securities could easily achieve the economic equivalence of ownership (including “purchases” and “sales” of individual stocks whenever desired) without becoming subject to U.S. withholding tax on dividends.[47]

For the reasons previously stated, however, a majority of us do not recommend the enactment of legislation that extends the sourcing rule of the Proposed Regulations to equity-based notional principal contracts.

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[47] Those persons also believe that if the proposed rule is limited to contracts that create rights that are economically equivalent (or almost so) to stock ownership, (1) many of the foregoing arguments against withholding do not apply; (2) the rule of residence-based sourcing for notional principal contracts should not preclude withholding on dividend equivalent payments under such contracts, since there is a much stronger U.S. tax policy in favor of dividend withholding as compared to interest withholding (given the portfolio interest exemption and numerous treaty exemptions from interest withholding); (3) line-drawing between covered and noncovered contracts would not be unduly difficult, and, in any event, the need to draw distinctions should not prevent the application of withholding tax to the cases to which it clearly should apply; and (4) if withholding tax is to be applied in the case of dividend equivalent payments in securities lending