

REPORT #789

TAX SECTION

New York State Bar Association

Business Plan: Substitute Payments
in Securities Lending Transactions

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April 27, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Business Plan: Substitute Payments
in Securities Lending Transactions

Dear Secretary Samuels and Commissioner
Richardson:

I am writing on behalf of the Tax Section to urge that definitive action be taken with respect to the treatment, for sourcing, withholding tax and tax treaty purposes, of substitute payments made pursuant to securities lending transactions. Proposed regulations on this subject (the "Proposed Regulations"), which were released on January 6, 1992, provided that such payments would be treated as interest or dividend income received pursuant to the terms of the transferred securities. The Proposed Regulations were not to be effective until their publication as final regulations, but to date this has not occurred and there is no reference to their finalization in the recently released list of 1994 Guidance Priorities (generally referred to as the "business plan").

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In a report on these Proposed Regulations submitted on July 7, 1992 (the "Report"), the Tax Section supported the tax policy objectives reflected therein but expressed substantial doubt whether the Treasury has the requisite statutory authority to promulgate enforceable regulations characterizing substitute dividend or interest payments as actual dividends or interest, given other outstanding authorities holding in other contexts that they are not dividends or interest. We therefore recommended that the Administration sponsor legislation to assure that the substantive objective of the Proposed Regulations would be obtained.

The preamble to the Proposed Regulations states that until they are finalized, the source, character and income tax treaty treatment of such payments "will be determined under all the facts and circumstances of a particular transaction." There is no explanation of what "facts and circumstances" are to be considered in this respect. The Report urged that if there was to be any delay in the finalization of the Proposed Regulations, guidance should immediately be provided to withholding agents as to what "facts and circumstances" would be considered to be relevant. To date, however, no guidance has been provided.

We believe that it is very much in the best interest of the Treasury and the Service that prompt action be taken on this subject. The preamble to the Proposed Regulations appropriately expressed concern that payments designed to replicate interest or dividend payments may be used, apart from the position taken in the Proposed Regulations, to avoid U.S. withholding tax.^{1/} Thus, under the "other income" provision of certain U.S. tax treaties, substitute payments for a dividend would not be subject to U.S. withholding taxes even though dividends themselves would be subject to a 15%

^{1/} The Service also expressed concern that securities lending transactions might be used to increase the foreign tax credit limitations of U.S. taxpayers.

withholding tax.^{2/} We are uncertain as to whether withholding agents today are willing to rely on this tax treaty exemption in light of the statement in the preamble to the Proposed Regulations. We believe some withholding agents may be relying on the exemption, but even where withholding occurs today we believe the present uncertain state of the law will likely lead to suits for withholding tax refunds by securities lenders resident in such treaty jurisdictions as the United Kingdom. Moreover, because of the uncertain validity of the position taken in the Proposed Regulations in the absence of legislation, as indicated in the Report, such refund suits might occur even if the Proposed Regulations are finalized without further legislation.

Moreover, prompt action in this matter is in the interests of taxpayers. It is not in the interests of potential withholding agents and participants in stock lending transactions for different persons (including competing withholding agents) to be taking different tax positions. In addition, adoption of the Proposed Regulations in final form would eliminate withholding on substitute payments for portfolio interest made by a U.S. borrower of debt securities, which payments otherwise would be subject to withholding taxes unless exempted by "other income" provisions of tax treaties. Just as we believe that substitute dividend payments should be subject to the same withholding taxes as dividends, we believe substitute payments for portfolio interest should be exempt from withholding taxes.

We therefore suggest that the Proposed Regulations be finalized with an immediate effective date. At the same time, the Treasury should announce that it will sponsor legislation confirming the result reached in the regulations with an effective date that is identical with

^{2/} See e.g., U.K. Treaty, Article 22. The continuing adoption of treaties with the "other income" language exacerbates the problem. See, e.g. Article 22 of the 1993 treaty with the Czech Republic.

the effective date of the regulations. The combination of these two actions would provide withholding agents with clear guidance, have an in terrorem effect on any efforts to utilize U.S. tax treaties to avoid U.S. withholding tax on substitute payments, and per. it payment of substitute payments for portfolio interest without withholding tax.

We would be glad to discuss this matter with you or members of your staff.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Cynthia G. Beerbower