New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

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May 26, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section concerning the imposition of U.S. withholding tax on substitute and derivative dividend payments received by foreign persons.

Despite the similarity of certain equity derivative transactions to leveraged ownership of the underlying equity security, we conclude that there are strong arguments against broad-based imposition of U.S. withholding on derivative dividend payments. First, derivative contracts do not necessarily involve any net inbound U.S. investment by the foreign person. Second, there are generally no net current payments made under an equity derivative contract (because the "dividend-equivalent" component is less than the "interest-based" component) and it would be difficult (though not impossible) to disaggregate payments for purposes of imposing withholding tax. Third, the statutory authority for treating derivative

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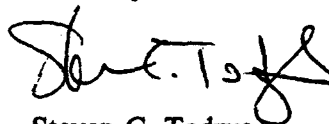
dividend payments as "dividends" is questionable. Fourth, it is not clear that an expansive application of the dividend withholding tax is necessary as a tax policy matter.

However, we have previously supported the imposition of withholding tax on substitute dividend payments with respect to an inbound loan of U.S. equities and believe that it would be appropriate to impose withholding tax on derivative dividend payments in similar circumstances. In the case of a stock loan, the foreign person has an easily identified net inbound investment in the United States. By analogy, withholding tax on derivative dividend payments could be imposed where a similar net inbound investment can be identified -- i.e., where a derivative contract replaces actual ownership of U.S. equities by a foreign person.

In making these observations, we note that a "line-drawing" exercise in this area is inherently unsatisfactory because economically-similar transactions will always fall on different sides of the line. We encourage Treasury and the Internal Revenue Service to attempt to develop a more consistent policy framework for the taxation of derivative transactions, and would be pleased to work with you towards that objective.

Sincerely,



Steven C. Todrys

Enclosure

cc:

Internal Revenue Service
The Honorable Stuart L. Brown
Michael Danilack
Charles C. Saverude
Paul S. Epstein

Department of Treasury
The Honorable Joseph H. Guttentag
Philip R. West
Patricia A. Brown
Stuart Leblang

Joint Committee on Taxation
Lindy L. Paull

NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on the Imposition of U.S. Withholding Tax on Substitute and Derivative Dividend Payments Received by Foreign Persons[1]

May 26, 1998

This report responds to both recently finalized regulations treating certain substitute dividend payments received by foreign persons in connection with loans of U.S. equities as dividends from the underlying U.S. equities for purposes of U.S. source, withholding tax and treaty characterization rules (the "Look-through Substitute Payment Regulations")[2] and a possible extension of such "look-through treatment" to periodic payments received by foreign persons pursuant to certain equity swaps where the amounts of such payments are determined by reference to the amounts of the dividends paid on U.S. equities ("derivative dividend payments"). The Internal Revenue Service has requested comments on both of these subjects.[3]

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[1] This report was prepared by an ad hoc subcommittee of the NYSBA Tax Section. David P. Hariton was the principal author. Substantial commentary and input was received from Dale S. Collinson, Samuel J. Dimon, Robert A. Jacobs, Harold R. Handler, Richard O. Loengard, David S. Miller, Charles M. Morgan, III, Robert H. Scarborough, Michael C. Schler, Robert T. Smith and Steven C. Todrys.

[2] Treas. Reg. §§ 1.861-3(a)(6), 1.864-5(b)(2)(ii), 1.871-7(b)(2), 1.881-2(b)(2), and 1.894-1(c), T.D. 8735, 1997-43 I.R.B. 4. The Regulations provide that substitute dividend payments made with respect to securities lending and sale-repurchase transactions have the same source as the dividend income from the transferred security, and for purposes of income and withholding tax imposed on U.S. source income of a nonresident alien or non-U.S. corporation not engaged in a U.S. trade or business, the substitute payment is characterized as a dividend payment on the borrowed securities.

[3] T.D. 8735, 1997-43 I.R.B. 4.

This report addresses these subjects primarily from a policy perspective to assist the Treasury Department in deciding how it should treat these payments for U.S. tax purposes. The issues raised illustrate the difficulty of drawing lines between economically-equivalent transactions involving derivatives and other financial instruments. Until a consistent framework for addressing these issues is developed, similar transactions will continue to be taxed differently.

I. Summary of Recommendations

A. Despite the similarity of certain equity derivative transactions to leveraged ownership of the underlying equity security, we believe that there are strong arguments against broad-based imposition of U.S. withholding tax on derivative dividend payments.

First, a foreign person who takes a long position in an equity swap does not necessarily have any net investment in the United States to support the imposition of U.S. withholding tax. Imposition of the tax in such a case must therefore be based on an assumption (which may not be correct) that the foreign person is deriving income from a direct or indirect investment in the United States.

Second, in most equity swaps, the foreign person will not receive any current payment under the swap, because the interest-based payment will exceed the dividend-equivalent payment. Derivative payments are often netted against each other, or deferred to maturity of the relevant derivative contract, and it may be difficult to disaggregate and tax payments based on a theory of economic equivalence. Moreover, there are a wide variety of derivative contracts which might be viewed as economically equivalent to an equity swap. As a result, it would be difficult (but not impossible) to administer and enforce such a tax.

Third, there is limited authority for imposition of such a tax. Derivative payments are clearly not dividends for U.S. tax purposes or treaty purposes -- i.e., they are not distributions of earnings by U.S. corporations. And even to the extent that there is authority to treat payments under an equity swap as U.S. source income under section 863, as noted above, there is likely to be no current net payment to the foreign person because the smaller dividend-equivalent payment will be netted against the larger interest-based payment under the swap.

Fourth, we are not persuaded that expanded application or enforcement of the U.S. withholding tax on dividend-related payments makes sense as a matter of policy. The statute does not require withholding tax on anything other than actual distributions of earnings by U.S. corporations, and an expanded application or enforcement of this tax may have limited benefits.

B. We have previously supported the imposition of withholding tax on substitute dividend payments received by a foreign person with respect to an inbound loan of U.S. equities.[4] We note that, in such a case, the foreign person does have an easily identified net inbound investment in the United States and net income derived from U.S. sources on which U.S. withholding tax may reasonably be imposed. We have questioned, however, whether there is sufficient authority to apply look-through treatment as the technical mechanism for imposition of U.S. withholding tax. Rather, we think that substitute dividend

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[4] Report on Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions, July 7, 1992 (the "1992 Report").

payments under a stock loan agreement could be treated as derived from U.S. sources under the authority of section 863, not because the payments are dividends.[5]

By analogy to the stock loan case, we have identified one case in which we think Treasury might impose U.S. withholding tax on derivative dividend payments received by a foreign person: the case in which an equity swap replaces the actual ownership of U.S. equities -- i.e., where a transaction which is economically equivalent to an inbound stock loan is documented as an equity swap plus a loan to a U.S. swap counterparty. We note, however, that such an approach would involve a somewhat complex inquiry into the factual circumstances surrounding an equity swap.

II. Introduction

Although Congress repealed the U.S. withholding tax on outbound payments of interest in 1984, the U.S. continues to impose withholding tax on dividends received by foreign portfolio investors from U.S. corporations in respect of U.S. stock. No specific statutory provision, however, imposes withholding tax on "derivative" payments received by foreign persons the amounts of which are determined, in whole or in part, by the amounts of the dividends paid on U.S. stocks ("derivative dividend payments"). This includes certain payments received by foreign persons in respect of "loans" of U.S. equities, bilateral notional principal contracts (so-called "equity swaps") and other derivative contracts (e.g., options, forwards, deferred payment equity swaps, stock-index swaps, etc).

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[5] In the 1992 Report, we suggested legislation to characterize substitute payments on inbound stock loans as dividends. We now believe that "look-through treatment" should apply, if at all, only to substitute interest payments on inbound securities loans; alternatively, substitute interest payments could be sourced by reference to the residence of the recipient under Treas. Reg. §1.863-7.

The principal argument for imposing U.S. withholding tax on derivative dividend payments is that in some cases these payments may be equivalent to, or effectively replace, dividends which would otherwise be paid by U.S. corporations to foreign persons. Derivative dividend payments may therefore serve to undermine the U.S. withholding tax on dividends paid to foreign persons, inasmuch as they may permit foreign persons to use derivative transactions to avoid the U.S. withholding tax. The arguments against imposing U.S. withholding tax on derivative dividend payments (as opposed to "substitute" dividend payments in respect of stock loans) received by foreign persons may include the following: (a) that such treatment may not be consistent with the treatment of U.S. persons holding similar derivative positions, (b) that such treatment may be difficult to enforce, (c) that there may be limited authority to provide for such treatment, (d) that enforcement of the U.S. withholding tax on dividends paid to foreign persons may have limited benefits, and the tax may therefore not be worth defending through an "expansive" interpretation of the statute, and (e) that such treatment may not serve to reduce inconsistency in the U.S. tax treatment of similar transactions -- i.e., that similar transactions will be taxed differently no matter where the line is drawn.

We believe the Treasury Department could take the view that dividend-related withholding tax need only apply to a distribution by a U.S. corporation of earnings to a foreign person. For example, we do not believe that the statute required a withholding tax on "substitute dividends" paid by a U.S. broker dealer to a foreign person pursuant to an inbound loan of U.S. equities. Likewise, we do not think the Treasury Department is required to impose U.S. withholding tax on equity swap payments on the theory, for example, that the long position in an equity swap is economically equivalent to a leveraged position in U.S.

equities, even if such equity swaps permit foreign persons to avoid U.S. withholding tax and still achieve economic results that are similar to those arising from the ownership of U.S. equities.

If, therefore, the Treasury Department decides to impose U.S. withholding tax on derivative dividend payments arising from transactions which it views as economically equivalent to the ownership by foreign persons of U.S. equities, we assume that it will do so because it has concluded that this is in fact good tax policy, rather than because it is constrained to do so by statutory mandate. We therefore think it important for the Treasury Department to begin by considering the role which the U.S. withholding tax on dividends plays in the broader context of U.S. tax policy concerning the treatment of foreign persons making portfolio investments within the United States.

To begin with, we believe that the application of "look-through treatment" to substitute or derivative payments received by foreign persons is a departure from general U.S. federal income tax principles, notwithstanding the superficial similarity which such derivative payments may bear to actual payments of dividends or interest. For example, it is generally accepted in the domestic context that the recipient of a fixed or floating-rate payment under a typical "on market" interest-rate swap should not be treated as having received an actual payment of interest for U.S. tax purposes, because (a) the recipient has not made any loan to the swap counterparty, (b) most of the amounts received will not result in net income to the recipient, because the recipient must make corresponding fixed or floating-rate payments which may equal or exceed the amounts of the payment received, and (c) even to the extent that the amounts received exceed the amounts paid, the resulting net income is generally attributable to unanticipated changes in interest rates, rather than to the time value of money,

and is therefore not properly characterized as interest income from a loan.[6] Likewise, periodic payments received pursuant to the terms of an equity swap are generally not treated as dividends for domestic tax purposes, because (a) the recipient has not made any equity investment in the payor, or in any other U.S. corporation, (b) the recipient probably has no net income in respect of the receipt, since the amounts of the "LIBOR" payments which the recipient makes to the swap counterparty generally exceed the amounts of the "dividend equivalent" payments received, and (c) even where the recipient does have net income, the income is not attributable to a distribution by a U.S. corporation of earnings derived by that corporation from an equity investment made by the recipient.

Likewise, substitute payments received pursuant to stock and securities loans are not normally treated as dividends (e.g., for purposes of the dividends received deduction) or interest (e.g., as tax-exempt interest) for domestic tax purposes.[7] The words "borrower" and "lender" are misnomers in this regard: the parties to the transaction are more properly described as "transferor" and "transferee", since the property "borrowed" is not typically retained by the transferee. The relevant stocks or securities having been sold by the "borrower" to an entirely new owner (a good faith purchaser for value), the amounts received by the "lender" from the "borrower" are in the nature of derivative payments unless and until the "borrower" purchases substantially similar stocks or securities on the open market and

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[6] See Deputy v. Dupont, 308 U.S. 488 (1940). In the cross-border context, this concept is reflected in Treas. Reg. § 1.863-7, which generally sources net income from an interest rate swap or other notional principal contract by reference to the residence of the recipient, rather than by reference to the residence of the payor.

[7] See e.g., Rev. Ruls. 60-177, 1960-1 C.B. 9, and 80-135, 1980-1 C.B. 18.

delivers them to the "lender".[8] (The resulting receipt by the "lender" of entirely new property, as opposed to a return of the same property, is statutorily exempted from tax, however, by section 1058.)

Nonetheless, there may be cases in which it is appropriate to impose U.S. withholding tax on derivative dividend payments received by foreign persons. Because the statute does not require withholding, the issue becomes one of policy, rather than of interpretation of technical statutory requirements. Relevant policy questions include the following:

To what extent do derivative dividend payments threaten to undermine the U.S. withholding tax on outbound dividend payments on U.S. portfolio stocks which would otherwise be held by foreign persons (hereafter, "outbound portfolio dividends")? To what extent are foreign persons intentionally using cross-border derivative contracts and stock loans to avoid the U.S. withholding tax? To what extent does such avoidance constitute a "tax abuse"? To what extent would imposition of U.S. withholding tax serve to prevent such

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[8] See e.g., Provost v. United States, 269 U.S. 443, 456 (1925):

> "When the transaction is thus completed, neither the lender [A] or the borrower [B] retains any interest in the stock that is the subject matter of the transaction and that has passed to and become the property of the purchaser [C]. Neither the borrower [B] nor the lender [A] has the status of a stockholder of the corporation [X] whose stock was dealt in, nor any legal relationship to it. Unlike the pledgee of stock who must have specific stock available for the pledgor on payment of his loan, the borrower of stock [B] has no interest in the stock nor the right to demand it from any other. For that reason he can be neither a pledgee, trustee nor bailee for the lender [A], and he is not one 'with whom stock has been deposited as collateral security for money loaned.' For the incidents of ownership, the lender [A] has substituted the personal obligation, wholly contractual, of the borrower [B] to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into."

abuse, i.e., to what extent would the treatment be "effective"? Under what circumstances could imposition of such a withholding tax reasonably be enforced, and under what circumstances would the enforcement be overly broad, from either a technical or policy perspective? Could any such withholding tax itself be easily avoided by foreign persons? Would imposition of such a withholding tax be inconsistent with the treatment of other economically equivalent transactions? How much revenue is at stake? What other policy concerns are at stake? Is there a coherent technical basis for imposing the tax? If not, what is the "cost" of imposing the tax given its technical divergence from general U.S. tax principles?

To what extent should the Treasury Department even be trying to defend the "substance" of the U.S. withholding tax on outbound portfolio dividends? What role does the U.S. withholding tax on outbound portfolio dividends play in the context of our tax-related dealings with other countries? More specifically, how does the Treasury Department's enforcement of the U.S. withholding tax on outbound dividends affect both the inbound flow of capital into the United States and the behavior of other countries insofar as their taxation of their own residents investing in the United States is concerned? What role does the tax play in connection with our outbound investment concerns? To what extent does enforcement of the U.S. withholding tax provide leverage, for example, for our efforts to persuade other countries to lower the source taxes they impose on our portfolio investment in their countries?

We first address the role which the U.S. withholding tax on actual dividends received by foreign persons from U.S. corporations plays in the broader context of U.S. tax policy.

We then go on to analyze cross-border equity swaps and consider some of the challenges which they and similar derivative contracts present for the imposition of U.S. withholding tax on outbound dividends. We consider the merits of application of "look-through treatment" to derivative dividend payments and the technical, practical and policy arguments for and against doing so. In general, we conclude that imposing U.S. withholding tax on such payments may be appropriate where derivative positions replace the initial actual ownership by a foreign person of U.S. equities. We also consider an alternative, and perhaps more feasible, technical basis for imposing U.S. withholding tax in such a case.

Finally, we make a similar analysis of substitute dividend payments received by foreign persons in connection with stock loans, and the technical, policy and practical merits of the Look-through Substitute Payment Regulations. In general, we conclude that there may be better arguments for imposing U.S. withholding tax on such payments than on payments made pursuant to equity swaps and other derivative contracts. We nevertheless question the technical basis on which the tax is imposed under the Look-through Substitute Payment Regulations and offer an alternative technical basis for imposing the tax.

III. U.S. Withholding Tax on Portfolio Dividends--Policy Considerations

While the U.S. withholding tax on dividends paid to foreign persons may be intended as a "surrogate" for the analogous income tax which U.S. residents would pay on portfolio dividends, it is only coincidental when the tax approximates the net income tax imposed on U.S. residents. Unlike U.S. residents, moreover, foreigners are viewed primarily as potential outside sources of both inbound capital investment and tax revenue whose inbound investments may be discouraged or encouraged by alternative taxing policies. Considered solely within the context of the U.S. tax system, and without regard to the broader

context of international tax policy, the U.S. withholding tax on portfolio dividends received by foreign persons is somewhat anomalous. There is no U.S. tax on gain from the sale by a foreign person of U.S. portfolio stock (including gain attributable to accumulated earnings), notwithstanding the fact that U.S. residents must pay tax on such gain (albeit at lower rates). Moreover, there is no U.S. withholding tax on outbound payments of portfolio interest, and the resulting discontinuity in the tax treatment of outbound income from similar forms of inbound foreign investment is difficult to enforce. The tax distinction between equity and debt is itself difficult to enforce in the modern financial environment, given their relative economic equivalence. It is even more difficult, however, to enforce a tax distinction between inbound portfolio equity investment on the one hand, and an economically equivalent combination of inbound debt investment plus equity-related derivative contracts on the other.

To the extent that the U.S. views itself as a "source" country for inbound portfolio investment, and before taking the tax system of the inbound foreign investor's country of residence into account, imposition of U.S. withholding tax on outbound portfolio dividends merely discourages inbound portfolio investment by reducing the foreign investor's after-tax yield. The investor is doubly discouraged, moreover, by the disparate corporate-level treatment of payments of dividends and interest. Thus, a foreign investor's current return from inbound equity capital is taxed once at the U.S. corporate level (at a 35% rate) and again at the investor level (at a 15% or 30% rate). By contrast, a foreign investor's current return from inbound debt capital is not taxed at either level.

The U.S. withholding tax on outbound dividends is also arbitrary, and to some extent avoidable, in the sense that no similar tax is imposed on gain from the sale of stock to the extent attributable to the retention of accumulated earnings. Moreover, even the portion

of a foreign investor's gain from the sale of U.S. portfolio stock that is in excess of any allocable share of accumulated earnings is arguably as much attributable to inbound investment in the United States as are distributions of current earnings. There is no strong theoretical basis for imposing U.S. withholding tax solely on that portion of the earnings which happens to be currently realized and distributed. And given the increased tendency for U.S. corporations to accumulate a greater portion of their earnings, the tax presumably raises comparatively less revenue than it used to.

In addition, recent legislation seems to be more directed to encouraging foreign investment in the United States than collecting revenue from foreign persons. It would appear, for example, that Congress repealed the U.S. withholding tax on outbound payments of interest to encourage inbound capital investment in U.S. corporations -- i.e., to give U.S. corporations free access to European capital markets.[9] Likewise, the 1966 Foreign Investors Tax Act created an exception for trading in stocks and securities in the United States which has been effectively extended by the recent associated repeal of the so-called "10 Commandments," which had prevented trading funds from maintaining principal offices within the United States.[10]

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[9] It did not do so because the tax had already been effectively repealed through the use of Netherlands Antilles Finance companies. Congress could presumably have prevented the latter through the enactment of legislation similar to Section 7701(l). Likewise, the Service issued Rev. Rul. 84-153, 1984-2 C.B. 383, shortly after the repeal, effectively eliminating the Netherlands Antilles vehicle. See, e.g., Blum, How the United States Should Tax Foreign Subsidiaries, 7 Va. Tax Rev. 583, 638 (1988). See also Holden, Repeal of the Withholding Tax on Portfolio Debt Paid to Foreigners: Tax and Fiscal Policies in the context of Eurobond Financing, 5 Va. Tax Rev. 375, 386-89 (1985); Franson, The Repeal of the 30 Percent Withholding Tax on Portfolio Interest Paid to Foreign Investors, 6 J. Int'l. L. Bus 930, 939 (1985).

[10] Section 864(b)(2)(A)(ii), as amended by P.L. 105-34.

In deciding how broadly to enforce the U.S. withholding tax on outbound dividends, however, the Treasury Department must also consider the tax's interaction with the taxes imposed by other countries, and thus the consequences of enforcement, or non-enforcement, of the tax, both on a unilateral basis (i.e., assuming the Treasury Department acts alone) and on a bilateral basis (i.e., assuming that the actions of the Treasury Department in this regard will ultimately be mimicked by many of our trading partners). For example, the Treasury Department must consider the fact that the foreign investor's country of residence may also impose tax, or forgo tax, on the investor's dividend income (e.g., may or may not grant the investor a credit for such withholding taxes). If, therefore, the U.S. withholding tax on outbound portfolio dividends was effectively undermined through derivative transactions, it would not be clear, in any given case, that this would serve to increase inbound foreign investment. It might serve only to shift revenue from the U.S. to a foreign country, to the extent that the relevant foreign country was otherwise willing to permit the relevant foreign investors to credit any outbound withholding tax imposed by the United States against their local foreign tax liabilities.[11/]

Likewise, the Treasury Department must consider the fact that the investor's country of residence is itself a source country which may likewise impose withholding tax on dividends received by U.S. persons from their cross-border capital investment within that country. An effective undermining of the U.S. withholding tax on outbound dividends might encourage foreign countries to impose, increase or refuse to lower their own source-country

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11/ This would not be the case, of course, if the foreign investor was tax-exempt in its country of residence.

withholding taxes on portfolio investments made by U.S. persons, on the theory that they have nothing to lose by way of U.S. retaliation.[12]

The revenue loss associated with the effective undermining of the U.S. withholding tax through the use of derivative transactions is presumably mitigated, however, by revenue gain associated with the corresponding undermining of the withholding taxes imposed by other countries, to the extent that those withholding taxes would otherwise have been creditable against U.S. federal income tax liability. If we assume, for example, that the United States and a relevant foreign country (a) have equal amounts of portfolio investment in the other, (b) impose withholding tax at the same rate on outbound portfolio dividends received by residents of the other country, (c) distribute dividends to shareholders at the same rates, (d) permit their residents an unlimited credit against residence-based income tax for the withholding tax imposed by the other, and (e) are equally vulnerable to "undermining" of their outbound withholding taxes through the use of derivative transactions, then it may be reasonable to suppose that such undermining will have no net revenue consequences for either country (what each loses as a source country from taxing the other country's residents it will gain as a residence country from increased tax on its own residents) or their residents (who

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[12] The enforcement of outbound U.S. withholding tax may be less important than the impact of the U.S. foreign tax credit, however. The principal leverage available to the United States to induce other countries to lower the withholding taxes on foreign portfolio investment is not necessarily its behavior as a parallel source country, but rather its behavior as the corresponding residence country for such investment. Insofar as the U.S. does, or does not, grant its own residents credits for the withholding taxes imposed by the relevant source country, it directly determines the extent to which the foreign withholding tax discourages U.S. portfolio capital export to that particular source country. Indeed, to the extent that the relevant foreign country is solely a source country, it may not care at all about the parallel response of the United States as a source country, but rather only about the response of the U.S. as a residence country.

presumably don't care which country they pay their taxes to). An effectively bilateral decision to impose withholding tax on derivative dividend payments may therefore serve only to introduce costly and annoying collection, compliance and policing measures and associated transaction costs. If, moreover, U.S. portfolio investment in the relevant foreign country exceeds portfolio investment by residents of that country in the United States, the bilateral imposition of withholding tax on derivative transactions may actually serve to shift revenue from the United States to the relevant foreign country.[13]

In any event, the U.S. government has traditionally been opposed to selective tax "sparing" and other measures designed to proactively affect the tax policies of other countries towards U.S. outbound and inbound investment.[14] It does not seem entirely consistent, therefore, for the Treasury Department to be pro-actively defending the U.S. withholding tax on outbound dividends solely in order to affect the behavior of other countries.

To summarize, it is not clear that expanded enforcement of the U.S. withholding tax on dividend-related payments would save a great deal of revenue, particularly after taking full account of the responsive behavior of foreign investors and foreign countries. Moreover, such enforcement may have a substantial policy cost, inasmuch as it serves to limit investment by foreign persons in U.S. equities. As discussed below, the technical basis for

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[13] For an excellent discussion of the bilateral consequences of tax policy decisions, see Kingson, "The Coherence of International Taxation," 81 Columbia Law Review 1151 (1981).

[14] See, e.g., Rosenbloom & Langbein, United States Tax Treaty Policy: An Overview, 19 Colum. J. Transnat'l L. 359, 392 (1981); Tillinghast, Tax Treaty Issues, 50 U. Miami L. Rev. 455, 475-76 (1996); Comment, Reese, United States Tax Treaty Policy Forwards Developing Countries: The China Example, 35 UCLA L. Rev. 369, 379 (1987).

treating derivative dividend payments as "dividends" is weak, and the associated practical and enforcement problems are substantial.

IV. Analysis of Equity Swaps

There are two principal arguments for imposing U.S. withholding tax on derivative dividend payments received by foreign persons pursuant to the terms of an equity swap. The first argument is that the long position in an equity swap is economically equivalent to a leveraged position in U.S. equities which would be subject to U.S. withholding tax. The second argument is that equity swaps can be used by foreign persons to effectively replace an ownership of U.S. equities which would give rise to U.S. withholding tax. Notwithstanding their similarities, we think there are significant differences between these arguments which justifies addressing them separately. Before we can address either argument, however, we first consider the basis on which the United States imposes a withholding tax on dividends actually paid by a U.S. corporation to a foreign person.

Suppose, therefore, that an individual (the "Foreigner") owns a share of U.S. stock (the "Share") which she purchased for $100, and this share is held in a custodial account with a foreign securities dealer (the "Local Foreign Dealer") operating in the country (the "Local Country") in which the Foreigner resides. The Share pays an annual dividend of $10. The Local Foreign Dealer has a related U.S. securities dealer (the "U.S. Dealer") operating in the United States.

If the Local Country has a treaty with the United States, the rate of U.S. withholding tax on dividends received by the Foreigner in respect of the Share is reduced

from 30% to 15%.[15] The Foreigner therefore keeps $8.50, and the Internal Revenue Service keeps $1.50, of any dividend paid by U.S. Co. to the Foreigner. The Foreigner will presumably credit the $1.50 U.S. withholding tax against her Local Country income tax liability, and if we assume that the rate of Local Country income tax on the Foreigner's U.S. source dividend income is 30%, then the United States and the Local Country will effectively split the $3 of tax which the Foreigner is required to pay to at least one of these two countries. In the absence of any treaty, the rate of withholding would be 30% (i.e., $3) of each dividend, and the Foreigner would presumably claim a $3 credit against Local Country income tax. Thus, the United States would effectively keep all of the tax paid by the Foreigner in respect of dividends received from U.S. sources, and the Local Country would presumably likewise keep all of the tax paid by a U.S. citizen on dividends received from sources within the Local Country.

In any case, the basis for the assertion by the United States of full or partial taxing jurisdiction over the dividends which the Foreigner receives from U.S. Co. is the fact

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[15] Until January 1, 2000, the paying agent (the "U.S. Paying Agent") who represents the issuer of the Share (the "U.S. Issuer") will withhold 15% (rather than 30%) of the payment, because the payment is made to an address in the Treaty Country (the so-called "address rule"), and will remit the withheld amount to the Internal Revenue Service. After January 1, 2000, the U.S. Paying Agent will only withhold at the lower treaty rate if it receives from the Local Foreign Dealer a new Form W-8 (replacing old Form 1001) which has been signed by the Foreigner and contains the Foreigner's statement that she lives in the Treaty Country (i.e., only if the Local Foreign Dealer "passes through" documentation establishing the Foreigner's entitlement to treaty benefits). Alternatively, the Local Foreign Dealer may choose to become a "qualified intermediary" withholding agent subject to Internal Revenue Service audit, in which case the U.S. Paying Agent will not withhold any portion of the dividends it remits to its sister withholding agent, the Local Foreign Dealer. Instead the Local Foreign Dealer will itself withhold 15% of the dividend it pays to the Foreigner and remit it to the Internal Revenue Service, based on the Form W-8 which it retains in its own files.

that the Foreigner has made an "inbound investment" of $100 in the United States which gives rise to the income in question. The Foreigner is considered to have earned $10 from sources within the United States because her $100 of capital is presumably being used by U.S. Co., a U.S. corporation, to conduct business within the United States. (Indeed, if it can be established that U.S. Co. derives all of its income from the conduct of business outside the United States, the United States will give up taxing jurisdiction. See Sections 861(a)(2)(B) and 861(c).)

If the Foreigner were actually residing in the United States, the Internal Revenue Service would have collected up to $3.96 of income tax on the $10 dividend she received. Unlike a resident, however, the United States does not grant the Foreigner any deduction for expenses, including interest expense, she incurs in order to earn the dividend income. Instead, as a matter of "rough justice," the United States imposes a lower rate of tax on her dividend income -- i.e., 30%--than it would impose on its own residents before taking expenses into account. This is presumably intended as an administrative convenience -- the U.S. does not wish to require foreign portfolio investors to file U.S. tax returns. It means, however, that if the Foreigner borrows $100 to purchase the Share, the Foreigner is subject to gross U.S. withholding tax on the dividends she receives even though she has no net current income (i.e., even though her interest expense likely exceeds the amount of any dividends she earns) and no net inbound investment in the United States.

One could argue that, in such a case, the United States should not impose any withholding tax on the Foreigner. The response to this argument is that the withholding tax, though imprecise, is imposed with a view to administrative convenience. Currently, the Foreigner may choose the structure of her transactions and avoid the tax by, for example,

entering into an equity swap, rather than buying stocks on margin. Moreover, where the Foreigner's country of residence allows a full credit for the withholding tax, the Foreigner may not care about the tax.[16]

Suppose, then, that the Foreigner does enter into such an equity swap -- i.e., the Foreigner agrees to pay the U.S. Dealer LIBOR multiplied by a notional principal amount equal to $100, and at maturity an amount equal to any excess of $100 over the value of a Share. The U.S. Dealer agrees in exchange to pay the Foreigner amounts equal to the dividends paid on a Share, and at maturity the excess, if any, of the value of a Share over $100.

Should the U.S. respond by imposing withholding tax on the derivative dividend payments which the Foreigner receives? The argument for doing so is that the Foreigner's position is economically equivalent to a leveraged position in U.S. equities on which U.S. withholding tax would be imposed.[17] But it is the tax treatment of the leveraged position in U.S. equities, not of the equity swap, which raises the basic tax policy question. The equity swap is a mere "side bet" which does not affect U.S. taxing jurisdiction over the Share itself, and the Foreigner may enter into that "side bet" with another foreign

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[16] Similarly, prior to the repeal of the U.S. withholding tax on outbound interest payments, a foreign person who borrowed "fixed" from a U.S. person and lent "floating" to a U.S. person was subject to U.S. withholding tax on the interest received from the latter, despite the absence of any net investment in the United States. The foreign person could avoid this result, however, by entering into a fixed-to-floating interest rate swap.

[17] The position would not be completely economically equivalent, however, since the Foreigner would have credit exposure to the U.S. Dealer and the U.S. Dealer would have the power to dispose of the Share.

person, in which case the absence of a connection with the U.S. would be clear. The Foreigner will not even have any income from this bet, unless she turns out to be lucky.

By contrast, the case for imposing U.S. withholding tax is more sympathetic where the Foreigner also lends the U.S. Dealer $100 which the U.S. Dealer uses to acquire a Share. In that case, the Foreigner actually has $100 of inbound investment in the United States, and it is more difficult to distinguish her economic position from the one in which she simply directs the U.S. Dealer to acquire a Share on her behalf and hold it for her in a custodial account. In such a case, it may even be possible to argue that the Foreigner owns the Share acquired by the U.S. Dealer and is subject to U.S. withholding tax under general U.S. tax principles, although this does not seem to be the rule under current law.[18]

The case for imposing U.S. withholding tax becomes progressively weaker, however, where:

(1) The U.S. Dealer does not acquire the Share with the borrowed funds. In this case, however, the Foreigner still has $100 of net investment in a derivative contract with the U.S. Dealer, and this contract still produces net derivative income which is arguably derived from U.S. sources.

(2) The Foreigner lends $100 to a U.S. person other than the U.S. Dealer. In this case, the Foreigner still has $100 of inbound investment in the United States, but in order to justify U.S. withholding tax, the Treasury Department must "integrate" the inbound loan and the equity swap. Such integrated treatment is generally not imposed upon U.S. persons holding various economic positions, and taxation by reference to integration leads to some very complicated issues.

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[18] See n. 7, supra, and ns. 19 and 21, infra.

(3) The Foreigner's $100 investment in the United States is indirect, as for example where the Foreigner lends $100 to another foreign person, and the other foreign person lends $100 to a U.S. person. The argument for integration under these circumstances seems rather tenuous. Moreover, where imposition of U.S. withholding tax turns on a tracing rule, the tax is easily avoided by hiding the cash flows.

(4) There is no inbound investment at all.

The Treasury Department may be concerned in all of these cases, however, that the Foreigner has $100 of capital invested somewhere, and given the fungibility of money, it is impossible to determine whether and to what extent that capital (traveling through various intermediaries) has found its way into the United States. The Treasury Department may therefore think it reasonable, as a practical matter, to tax the Foreigner as if she had invested $100 in the United States. This approach is, however, speculative. Moreover, the United States would be purporting to impose withholding tax under circumstances where it would have limited ability to collect the tax.

Even if an argument based on economic equivalence and presumed inbound investment seems relatively coherent in the case of a single-stock equity swap, it soon breaks down as one proceeds to consider more complex derivative financial arrangements. Suppose, for example, that equity swap payments are not made on a gross basis, but rather are netted against each other, leaving only a single net payment made each period by the Foreigner to the U.S. Dealer. Suppose that the payments are not made periodically, but rather only at maturity of the swap, leaving only a single net payment made at maturity by either the U.S. Dealer or by the Foreigner. Suppose that the right and obligation to make this net payment at maturity is not documented as an equity swap, but rather as a cash-settling forward contract.

Suppose that the right and obligation to make this net payment is documented as a put option issued by the U.S. Dealer and a call option issued by the Foreigner, where notional strike prices are adjusted to account for dividends paid on the underlying stock. Suppose that the rights and obligations described above are not with respect to a single stock, but rather with respect to a group of stocks, or an index of stocks, such as the S&P 500 Index.

Imposition of U.S. withholding tax in these cases would require the rights and obligations of foreign persons to be disaggregated, deconstructed or reconstructed in order to arrive at a deemed acquisition by foreign persons of U.S. equities. We think it would be difficult to impose withholding tax based on these types of recharacterizations.

A stronger, but more limited, case for imposing withholding tax on derivative dividend payments received by foreign persons occurs where the relevant derivative transactions have actually replaced ownership by foreign persons of U.S. equities. This argument would permit the Treasury Department to impose U.S. withholding tax on derivative dividend payments in cases where a foreign person begins by actually owning U.S. equities and then substitutes for such ownership an economically equivalent derivative position. This approach would result in withholding tax in cases similar to those covered by the Look-through Substitute Payment Regulations.

There are fundamentally two cases where the Foreigner begins by owning a Share and winds up holding a derivative position. In the first case, the Foreigner sells her Share to the U.S. Dealer, enters into an economically equivalent equity swap with the U.S. Dealer and lends the proceeds of the sale to the U.S. Dealer. The U.S. Dealer does not go on to sell the Share in the market, however. Rather, the U.S. Dealer retains the Share and earns dividends on the Share directly. In such a case, the Treasury might attempt to treat the

Foreigner as continuing to own the Share, because the Foreigner continues to possess most of the burdens and benefits of ownership of the Share.[19]

This leaves the more complex case, however, in which the U.S. Dealer effectively borrows the Foreigner's Share to cover a short sale. We understand that many cross-border derivative arrangements, and most inbound stock loans, fall into this category.[20] There are several ways in which this transaction can be documented. The essence of the transaction for purposes of this analysis, however, is the following: the Foreigner, as an accommodation, sells her Share to a U.S. person who wants to invest $100 of capital in the Share (the "Long U.S. Person") and enters into an equivalent derivative contract with a U.S. person who wants to eliminate economic exposure to the Share (the "Short U.S. Person"), using a U.S. Dealer and a Local Foreign Dealer as intermediaries. In more detail, the Foreigner lends to a Local Foreign Dealer the $100 proceeds which she receives from the sale of the Share in exchange for a $100 debt obligation of the Local Foreign Dealer promising $10 of interest per annum and $100 of principal at maturity. The Foreigner then enters into an equity swap with the Local Foreign Dealer under which the Foreigner pays the Local Foreign Dealer $10 per annum, and $100 at maturity, and the Local Foreign Dealer pays the Foreigner amounts equal to the dividends paid on a Share, plus the value of a Share at maturity (or alternatively an actual Share at maturity). The Local Foreign Dealer hedges its resulting short position by entering into an identical offsetting swap with the

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[19] See n. 7, supra. It does not appear that the Foreigner would be treated as the owner under current law, however, given that (a) the U.S. dealer has the power to dispose of the Share, (b) the U.S. dealer has the power to vote the Share, and (c) the Foreigner is exposed to the risk of the U.S. Dealer's bankruptcy.

[20] See the 1992 Report at p. 6.

U.S. Dealer, and it likewise loans the $100 it has borrowed from the Foreigner to the U.S. Dealer. The U.S. Dealer in turn hedges its resulting short position by entering into an identical offsetting swap with the Short U.S. Person and lending the $100 it has borrowed from the Local Foreign Dealer to the Short U.S. Person, who then posts the $100 as collateral for the Short U.S. Person's obligations under the swap. Thus, the Short U.S. Person's interest payments on his $100 borrowing and his receipt of interest on his $100 of collateral offset each other, leaving the Short U.S. Person making only net dividend payments. The U.S. Dealer has use of another $100 of capital, which it can invest in the United States.

As a matter of domestic law, however, it is quite clear that the Long U.S. Person, not the Foreigner, is the owner of the Share and it is, therefore, difficult to treat the Foreigner as continuing to own the Share for U.S. tax purposes.[21] On the other hand, the Foreigner now has, for U.S. tax purposes, an inbound loan of $100 into the United States (in effect, to the U.S. Dealer) and a derivative contract exposing her to the burdens and benefits of ownership of a Share. The problem, of course, is that the United States has repealed its withholding tax on outbound payments of interest on that loan. To maintain consistency with general U.S. tax principles, however, we do not think that it would be appropriate to treat the Foreigner as if she still owned the Share.

One possible alternative is to effectively "aggregate" the equity swap contract and the inbound loan for U.S. tax purposes and treat the Foreigner as receiving net payments from the U.S. Dealer (through the Local Foreign Dealer) that are equal in amount to the dividends paid on a Share (since the interest she receives on the loan and the interest

[21] Rev. Rul. 60-177, 1960-1 C.B. 9; S.M. 4281, C.B. IV-2, 187 (1925). See n. 7, supra.

equivalent payments she makes on the swap cancel each other out, leaving the Foreigner with net current receipts equal to the dividends paid on a Share). These net payments would still be "derivative" payments received from the U.S. Dealer, rather than dividends received from ownership of a Share. The derivative payments would constitute net income, however. The Treasury Department could then limit the application of Treas. Reg. §1.863-7 and treat the net payments received by the Foreigner as derived from sources within the United States. In this case, we think this treatment could be appropriate since, unlike the unanticipated net income which might be derived by a foreign person from an interest rate or equity swap lacking any net investment, the anticipated net income derived by the Foreigner from $100 of net investment in a derivative contract with a U.S. broker-dealer is income derived from sources within the United States, assuming that the broker-dealer generally deploys its capital within the United States. The derivative dividend payments would therefore constitute U.S.-source fixed and determinable annual or periodic income subject to U.S. withholding tax.

We recognize that under this approach, there would be questions of technical authority under some treaties. Where a treaty with a trading partner, such as the U.K., forbids the imposition of U.S. withholding tax on both interest and "other income" derived by treaty-eligible foreign residents from sources within the United States, the United States might have to negotiate the right to impose withholding tax on such derivative payments. We do not think the United States can avoid this problem, however, by characterizing such payments as "dividends" received by foreign persons. Most treaties define dividends to include any item of income that is characterized as a dividend for internal purposes by the laws of the country of the payor. The U.S. Model Treaty defines a dividend, for example, as "income from shares or other rights, not being debt-claims, participating in profits, as well as income

from other corporate rights that is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident." Section 316 of the Code defines a dividend as a distribution of property made by a corporation to its shareholders, and as noted above, domestic law is quite clear on the point that derivative payments made by one party to another do not constitute dividends for U.S. tax purposes.

In any event, we think this analysis is relevant only in cases where an inbound loan and derivative contract replaces what was initially the actual ownership by a foreign person of U.S. equities. We recognize, however, that identification of such transactions is likely to be difficult.

V. Analysis of Cross-border Substitute Payments

The transaction described above can be documented in a slightly different manner, even though the economic results are substantially the same. Rather than directly selling the Share to the Long U.S. Person, the Foreigner "loans" the Share to the Local Foreign Dealer, who "on loans" the Share to the U.S. Dealer, who delivers the Share to the Long U.S. Person in order to cover the Short U.S. Person's short position. As a result of these arrangements, the obligations running between the Short U.S. Person and the U.S. Dealer, between the U.S. Dealer and the Local Foreign Dealer and between the Local Foreign Dealer and the Foreigner, respectively, are economically the same as they are in the example above.

The Look-through Substitute Payment Regulations treat the Foreigner, for purposes of sourcing and imposition of U.S. withholding tax, as continuing to own the Share and receiving outbound dividend payments. For the reasons discussed, we believe that the result in this case--imposition of U.S. withholding tax on the substitute dividend payments--is reasonable as a matter of policy. We do not necessarily agree, however, that the Treasury Department has the authority to reach this result by concluding, under section 7701(l) or otherwise, that the substitute payments should be treated as dividends for U.S. tax purposes on the theory that the Foreigner continues to own the Share.[22] Rather, the substitute dividend payments received by the Foreigner should be subject to U.S. withholding tax as derivative income from sources within the United States under section 863.

One argument for imposing U.S. withholding tax on substitute dividend payments by applying "look-through treatment" is that such treatment is important, as a matter of policy, for substitute interest payments. If substitute interest payments were treated as net U.S. source derivative income subject to U.S. withholding tax, foreign persons would never be able to lend U.S. debt securities to U.S. dealers (unless they used swap and loan documentation). We think this problem could reasonably be dealt with, however, by applying "look-through treatment" only to inbound securities loans. In that case, the U.S. tax treatment

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22/ This is consistent with our view in the 1992 Report. In the 1992 Report, however, we recommended that Treasury seek statutory authority to impose "look-through treatment". On reflection, we believe it would be more appropriate to simply conclude that a substitute dividend payment on a stock loan is U.S. source income, given that it arises from an investment of capital with a U.S. person (i.e., the U.S. Dealer), and is fixed and determinable annual or periodic income, even though it is not dividend income per se. The Treasury might want to seek statutory authority, however, to override treaties with “other income” provisions which might otherwise be viewed as preventing the Treasury from imposing U.S. withholding tax on such payments.

of the foreign holder based on the "fiction" -- that the foreign person is deriving net income from a continued loan to the U.S. Treasury or other issuer of the underlying bond -- is the same as the tax treatment based on the truth -- that the foreign person is making a loan to a U.S. dealer. An alternative approach might be to simply source substitute interest payments by reference to the residence of the recipient under Treas. Reg. §1.863-7.

We in any event believe there is a stronger technical basis for imposing U.S. withholding tax on derivative dividend payments received by the Foreigner when the transaction is documented as a stock loan than when it is documented as an equity swap. In the stock loan case, the Treasury Department need not rely on an "integration" of two transactions to conclude that the Foreigner has net income attributable to inbound investment which can be treated as U.S. source periodic income. The $100 inbound loan and equity swap are already merged into a single agreement--the stock loan. Integration raises questions of authority under treaty because it requires the Treasury Department to treat foreign persons differently from U.S. persons insofar as the interpretation of financial transactions for U.S. tax purposes is concerned.

Likewise, from both a policy and a practical perspective, there may appear to be more reason for the Treasury to impose U.S. withholding tax in the case of stock loan documentation, because the effective "fusing" of the $100 inbound investment and the derivative contract assures both (a) that the Foreigner originally held an actual Share, and (b) that there is $100 of inbound investment. Once the Treasury Department extends application of U.S. withholding tax to the equivalent transaction where the Foreigner uses equity swap and loan documentation, it must begin policing the circumstances under which foreign persons enter into equity swaps in order to identify those cases in which a foreign person who has the

long position in an equity swap (a) started out by owning a Share, and (b) is also lending money to the swap counterparty.

Of course, failing to impose U.S. withholding tax on the analogous equity swap leaves an obvious practical problem: the U.S. withholding tax can still be avoided by simply documenting an equity derivative transaction as a loan plus an equity swap, rather than as a stock loan. This is a problem that exists in any "line-drawing" exercise. Extending the ambit of the U.S. withholding tax on outbound dividends by imposing it on substitute dividend payments made on inbound stock loans merely moves the line from the documentation border between equity and debt to the documentation border between stock loans and economically equivalent equity swaps. Extending it even further to cover equity swaps which replace initial long ownership of U.S. equities merely moves the line to the border between choosing, and not choosing, to actually own U.S. equities before entering into an economically equivalent equity swap. And extending it even further to cover all "economically equivalent" equity swaps merely moves the line to the border between current pay equity swaps and a broad array of economically equivalent financial instruments and transactions, including deferred payment swaps, net payment swaps, options, futures, forwards, etc. If one believes that there is not a strong policy basis for imposing U.S. withholding tax on outbound dividends to begin with, extending the tax to derivative transactions would not appear to be necessary.