New York State Bar Association Tax Section

Report on Dividends Provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003

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This report comments on issues relevant to guidance to be provided by the Treasury Department and the Internal Revenue Service (the "Service") under section 1(h)(11) and related provisions of the Internal Revenue Code of 1986, as amended (the "Code").[1] The report also notes some areas in which changes to the law may be warranted.

Section 1(h)(11) was enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act"), and provides that certain dividends earned by individual taxpayers are taxed at long-term capital gain rates.[2] Section 1(h)(11)'s benefits apply to virtually all dividends paid by domestic corporations, subject to various limitations applicable at the level of the taxpayer. Section 1(h)(11) also applies to dividends paid by "qualified foreign corporations," a newly minted term that raises many of the more difficult questions addressed by this report.

I. Summary of Section 1(h)(11)

Section 1(h)(11) provides for a 15 percent maximum tax rate on "qualified dividend income" of individuals and other taxpayers subject to tax under section 1. Included in this category are dividends paid by most domestic corporations and by qualified foreign corporations.

For this purpose, dividends do not include dividends from tax-exempt organizations and dividends from mutual savings banks and/or employers for which a deduction is available to the payor. Amounts treated as ordinary income on the disposition of preferred stock under section 306 are treated as dividends for purposes of section 1(h)(11). Mutual funds and real estate investment trusts ("REITs") are permitted to designate the portion of the ordinary income dividends they pay that is attributable to qualified dividend income, which portion generally will then be treated as such in the hands of their shareholders. In the case of a REIT, an amount broadly comparable to the REIT's undistributed earnings and profits for the preceding taxable year also is treated as qualified dividend income received by the REIT.

Qualified foreign corporations include those that are incorporated in possessions of the United States and, subject to certain limitations, those that are eligible for the benefits of a comprehensive income tax treaty with the United States. If a foreign corporation's stock is

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[1] The principal draftsperson of this report was Erika W. Nijenhuis. Helpful comments were received from Andrew N. Berg, Kimberly S. Blanchard, Dickson G. Brown, Peter C. Canellos, Michael Farber, David P. Hariton, Charles M. Morgan III, Andrew W. Needham, Deborah L. Paul, Yaron Z. Reich, Richard L. Reinhold, Andrew P. Solomon, Michael L. Schler, Jodi J. Schwartz, Lewis R. Steinberg, Andrew R. Walker, David E. Watts and Diana L. Wollman.

All citations to sections are to the Code or to the Treasury regulations promulgated thereunder, except where otherwise indicated.

[2] Pub. Law No. 108-27, 108th Cong. 1st Sess., section 302.

readily tradable on an established securities market in the United States, the foreign corporation is treated as a qualified foreign corporation with respect to dividends on that stock. Notwithstanding the foregoing, qualified foreign corporations do not include corporations that meet the definition of foreign personal holding company (as defined in section 552), a foreign investment company (as defined in section 1246(b)), or a passive foreign investment company (as defined in section 1297) in either the taxable year in which the dividend was paid or the preceding taxable year.

The Act imposes certain restrictions on taxpayers' ability to benefit from the reduced rate. As applied to dividends from domestic corporations, the restrictions are similar to those applicable to the dividends-received deduction available to corporate taxpayers, although in some cases quite different in their actual operation.

First, the stock with respect to which the dividend is paid must have been held by the taxpayer for more than 60 days during the 120-day period beginning 60 days before the stock's ex-dividend date. For purposes of meeting this requirement, the holding period is reduced for periods where the holder's risk of loss is diminished.[3] Second, a taxpayer may not benefit from the reduced rate in respect of a dividend to the extent the taxpayer elects to treat the dividend as "investment income" for purposes of the investment interest expense rules -- that is, to the extent that the dividend income may be offset by an interest expense deduction.[4] Third, if a taxpayer receives qualified dividend income from an extraordinary dividend, as defined by section 1059(c), any loss on the sale of the stock is treated as long-term capital loss to the extent of that dividend income. Finally, rules similar to those currently found in section 904(b)(2)(B) will limit the ability of taxpayers benefiting from the reduced rate on dividends to claim foreign tax credits in respect of foreign-source dividend income. These rules will operate to prevent taxpayers from using foreign tax credits to reduce their overall tax burden in respect of dividend income to a level below 15 percent.

The legislative history of section 1(h)(11) contemplates that guidance will be issued with respect to information reporting (on Form 1099) on dividends as well as on "substitute" or "in-lieu" dividends received with respect to shares of stock that have been borrowed from a taxpayer. For the 2003 taxable year, taxpayers are to be permitted to rely on the Form 1099s they receive to determine whether to report amounts that they receive should be treated as a dividend eligible for the reduced rate or a substitute dividend that is not eligible for that rate.

Section 1(h)(11) applies for taxable years beginning after December 31, 2002, and "sunsets" for taxable years beginning after December 31, 2008. For calendar year taxpayers, therefore, section 1(h)(11) applies for the entire 2003 taxable year (that is, retroactively) and for the 2004-2008 taxable years.

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[3] These rules generally are the same as those applicable to corporate taxpayers with respect to the dividends-received deduction, except that a different holding period requirement applies.

[4] This rule is similar in concept, although different in operation, to the rules of section 246A for corporate taxpayers.

II. Summary of Recommendations

In forming our recommendations, we have been mindful of a number of practical considerations. The first is that the primary group of taxpayers that are likely to be affected by section 1(h)(11) are individuals. Some of the issues that we discuss are not new, in the sense that they or related issues have been relevant to corporate taxpayers with respect to the dividends-received deduction of section 243. As a group, however, individual taxpayers can be expected to be relatively less sophisticated about U.S. federal income tax issues and have relatively more difficulty in obtaining information and advice about those issues than those corporate taxpayers. In some cases, therefore, we suggest clarifications to the law or to guidance issued by the Service in order to assist those taxpayers and their tax advisors, with the aim of promoting effective administration of the law.

Another consideration is that a second group of taxpayers that will be affected by section 1(h)(11) are investment vehicles, such as mutual funds, that are not themselves taxable but are owned by individual investors who are, directly or indirectly, taxable on the income of those investment vehicles. These investors can be expected to engage in more complex transactions with respect to dividend-paying stock that they own, and to have access to a wider group of stocks that pay dividends that may be eligible for the benefits of section 1(h)(11), than most individual taxpayers. In some cases, therefore, we suggest guidance on transactions or issues not likely to be of direct relevance to most individual taxpayers.

- The Service should issue a notice or other explanatory guidance explaining the holding period rules of section 246, as well as other shareholder-level restrictions on treating dividends as qualified dividend income.

- Clarification should be provided as to whether the Act's provisions relating to extraordinary dividends apply to non-corporate holders other than individuals.

- The Service should provide guidance with respect to stock held in a margin account with a broker that is "rehypothecated" by the broker, clarifying that such rehypothecation does not affect the taxpayer's holding period for the stock and more generally explaining why substitute dividends are not eligible for the 15 percent rate. New information reporting rules should not have retroactive effect.

- The term "readily tradable on an established securities market in the United States" should be defined to include stock of a class that is traded on a national securities exchange or on NASDAQ or a similar system. Such stock should include (a) shares purchased and sold through alternative trading systems, (b) ordinary shares as to which there are ADRs traded on such exchanges or NASDAQ, and (c) restricted stock held by, for example, officers, directors and employees.

- A rule or presumption based on a list of objective factors should be available to permit taxpayers to treat foreign corporations that do not have stock traded on an established U.S. securities market as stock of corporations eligible for the benefits of a U.S. income tax treaty. Consideration may also be given to a certification program, but such

certification should not be the only basis on which such corporations are treated as treaty-eligible.

- A similar rule or presumption and/or certification should be available to determine whether a foreign corporation is a foreign investment company, foreign personal holding company or passive foreign investment company.

- The Service should provide guidance in the form of a notice or other readily accessible guidance on the application of section 904(b) to dividends from qualified foreign corporations.

III. General Issues

A. Holding Period.

Section 1(h)(11)(B)(iii) provides, by cross-reference to section 246(c), that the term "qualified dividend income" does not include any dividend on any share of common stock that has been held by the taxpayer for 60 days or less during the 120-day period beginning on the date that is 60 days before the date on which such share becomes ex-dividend with respect to such dividend. In the case of preferred stock, the applicable periods are the same as under section 246(c)(2). A taxpayer's holding period is reduced for any period during which the taxpayer engages in certain hedging transactions described in section 246(c)(4). In the case of mutual funds, the holding period requirement must be satisfied at the level of the mutual fund with respect to shares held by the mutual fund, and also must be satisfied at the level of the mutual fund shareholder with respect to the shareholder's investment in the mutual fund shares. Similar rules apply with respect to REITs.

These holding period requirements will be new to individual shareholders, and may not be well understood by the general public or tax advisors to individual taxpayers. Some of the complications of these rules include: (a) the holding period requirement must be tested for each dividend, as compared to the "once satisfied, always good" holding period rule for long-term capital gain treatment; (b) the 61-day period can be satisfied by a combination of days both prior to and after the ex-dividend date; and (c) the concept of "ex-dividend date" may not be familiar to many individual taxpayers.[5] In the case of mutual funds, additional complications arise from the operation of these rules at both the mutual fund and shareholder level, especially in the case of shareholders who have elected to reinvest dividends automatically.[6]

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[5] The ex-dividend date is the first date on which a share on which a dividend has been declared is sold without an entitlement to the dividend. An example provided by the New York Stock exchange is as follows: a dividend may be declared as payable to stockholders of record on a given Friday. Since three business days are allowed for delivery of stock in a regular transaction on the New York Stock Exchange, the Exchange would declare the stock "ex-dividend" as of the opening of the market on the preceding Wednesday. That means anyone who bought it on or after that Wednesday would not be entitled to that dividend. See "Ex-Dividend" in the glossary at http://www.nyse.com.

[6] *Cf.* Rev. Rul. 91-68, 1991-2 C.B. 43, stating that similar dual-level holding period rules apply for purposes of a corporate investor's entitlement to the dividends-received deduction for ordinary dividends received from a mutual fund.

Information reporting received by individuals will identify only whether a dividend can constitute qualified dividend income, and not whether the individual in fact is permitted to treat the dividend as such. There is therefore ample scope for confusion and inadvertent noncompliance with the holding period rules. We recommend that the Service issue a notice or other explanatory guidance, with examples, that explains the holding period and other (e.g., investment income) restrictions on treating dividends as qualified dividend income, and that such guidance be referred to in the instructions to Form 1099-DIV.

As a policy matter, we do not understand why individuals are subject to a 61 day holding period for common stock, while corporations are subject to a 46 day holding period. The law is clear in this regard, however.

We suggest that further consideration be given to the potential for arbitrage between tax-favored and high-taxed categories of dividend and gain income. In particular, we note that capital gains of individuals, unlike those of corporations, may be taxed either at full ordinary income rates (in the case of short-term capital gain) or at the same rate as a qualified dividend (in the case of long-term capital gain). It is possible that rules drafted to shut down corporate arbitrage transactions between fully taxable gains and tax-favored dividends may not be adequate as applied to individuals, although we have not identified any such transactions.

It is also possible that the now common interest of both corporate and individual shareholders in tax favored dividend income may give rise to transactions that would not have taken place under prior law. Similarly, the special extraordinary dividends rule that applies to individuals may not be adequate. For example, assume that an individual that has $100 of short-term capital gain buys stock, and a few months later receives an extraordinary dividend of $60 and then sells the stock at a $60 loss. Treating the loss as long-term capital loss does not prevent the taxpayer from effectively converting $60 of the $100 short-term capital gain into tax-favored qualified dividend income. If the stock has risen in value, so that the taxpayer sells it at a gain, the long-term capital loss rule again has no effect.

While not directly within the scope of this report, we note that there are a number of interpretative issues relating to the application of section 246(c) to hedging transactions as to which it would be useful to have guidance at some point, particularly in view of the less sophisticated nature of the taxpayers to which section 246(c) will now be relevant. Those issues include the interaction between the section 246(c) stacking rule and the section 1092 identification rule,[7] the question of whether covered calls that do not constitute qualified covered

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For an example of the complications that could arise as a result of the dual-level holding period requirement, assume that an individual that has owns mutual fund shares sells some of his or her stock shortly after an ordinary income dividend is credited to that taxpayer and reinvested. If the taxpayer elects the average basis rule of Treasury regulation section 1.1012-1(e) in order to calculate gain or loss on the stock sale, the taxpayer in theory could be treated as selling a fraction of each mutual fund share owned, including the shares purchased with the reinvested dividend. Such treatment presumably would cause the dividend to be partially ineligible for the 15 percent rate. We suggest that a rule of convenience be adopted to avoid this result, at least in the case of small shareholders that have owned their mutual fund shares for more than 60 days prior to the ex-dividend date.

[7] For example, if a taxpayer owns 250 shares, enters into a hedge of 100 shares and pledges 100 of its shares to secure that hedge and identifies those shares as part of a section 1092 straddle transaction, Treasury regulation section 1.246-5(c)(5)'s stacking rule could result in the tolling of the taxpayer's holding period for shares other than

calls always toll a taxpayer's holding period, and how to identify an ex-dividend date and apply the holding period rules in transactions that are treated as dividends for U.S. federal income tax purposes but do not involve the actual payment of a dividend, such as a redemption of stock described in section 302(b).

B. Extraordinary Dividends.

Section 1(h)(11)(D)(ii) provides that if an individual receives qualified dividend income with respect to one or more dividends that are extraordinary dividends, within the meaning of section 1059(c), any loss on the sale of the share on which the dividends were paid is treated as long-term capital loss. Section 1 applies to taxpayers other than individuals, such as certain estates and trusts. It is not clear whether section 1(h)(11)(D)(ii)'s rules are intended to apply to such taxpayers. Clarification of this point, or a technical correction if application to such taxpayers is intended, would be welcome.

C. Stock Loans.

1. Margin Accounts. It is common for a customer of a brokerage firm to hold its securities through a "margin" account. The use of a margin account permits the broker to extend credit to the customer. One common example of such a transaction is a purchase of stock by a customer "on margin" – that is, by putting up only a portion of the purchase price and borrowing the remainder from the broker. Other examples include a short sale by the customer or customer transactions in certain option or other derivative financial instruments. Margin accounts thus provide flexibility to customers. Brokerage accounts may be given a variety of names for marketing purposes, and customers are not necessarily aware of whether a particular account qualifies as a margin account for legal purposes.[8]

A standard margin account agreement gives the broker the right to "rehypothecate" (or "hypothecate") the securities held in the account, to the extent permitted by law. When a broker rehypothecates stock owned by a customer, the broker (a) temporarily transfers part or all of the rights, title and interest in the stock to a third party, (b) credits to the customer's account an amount equal to any dividends on the stock during the period of the rehypothecation (a "substitute" or "in-lieu" dividend), and (c) returns identical stock to the customer's account. One common reason for a broker to rehypothecate stock is to pledge it to a bank or other lender as collateral for a loan to the broker. The broker may also use the rehypothecated stock for one of a number of purposes that result in the sale or other complete transfer of the stock to a third party, such as obtaining stock to carry out a short sale for another customer or lending the stock to a third party. For non-tax purposes, the customer is in effect treated as the continuing owner of the stock.[9] For tax purposes, a rehypothecation is very similar to a stock loan of the kind described

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those pledged, while section 1092 in theory could eliminate the taxpayer's holding period for the pledged shares. Some coordination between these rules would be useful.

[8] The broker is required to provide a "margin disclosure document" to a customer that is opening a margin account and to make additional disclosure before extending credit to the customer.

[9] *See* 17 C.F.R. § 240.15c3-3(*l*) (nothing in Rule 15c3-3 affects a customer's absolute right to receive, in the course of normal business operations following demand made on the broker, physical delivery of the customer's fully paid securities or of its margin securities upon full payment by the customer to the broker of its margin "indebtedness"). Rehypothecation by brokers is subject to limitations of various kinds intended to protect customers. *See* 17 C.F.R. §§ 240.8c-1, 240.15c2-1, 240.15c3-3a. *See also* 15 U.S.C. §§ 78fff-2(b) (in liquidation of

in section 1058 and published guidance over many years, except that the broker is not required to post collateral to the customer.

Regulations governing the operations of brokers limit the value of the securities a broker may rehypothecate to 140 percent of a customer's margin debit balance.[10] The law places no restrictions, however, on the particular stocks the broker chooses to rehypothecate. As a result, the customer has no legal right to control which of its stocks are rehypothecated.[11] Because a customer for non-tax purposes is in effect treated as the continuing owner of rehypothecated stock, the periodic statements sent to retail customers by their brokers ordinarily do not identify whether any shares of the customer's stock have been rehypothecated. The process, thus far, has been effectively invisible to retail customers.

2. Holding Period of Stock Loaned or Rehypothecated. One issue rehypothecation raises is whether it has any effect on the taxpayer's holding period for the rehypothecated securities. Rehypothecation of the kind where the broker merely pledges a customer's stock to a lender should not affect the customer's tax ownership of the stock or its holding period in the stock. If the broker sells the stock or lends the stock to a party who sells it, however, the consequences to the customer may be less obvious.

We think that it is clear that Congress intended that the loan of stock, under a stock loan agreement of the kind prescribed by section 1058(b), has no effect on the taxpayer's holding period.[12] As a matter of practice, it has generally been assumed that rehypothecation similarly has no effect on a taxpayer's holding period for its stock. In view of the fact that rehypothecation has been virtually invisible to retail brokerage customers, however, it is likely that their tax advisors have not previously considered the issue. Since the authorities addressing the holding period issue with respect to stock loans may not be readily accessible to individual

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broker-dealer in financial distress, trustee must discharge "net equity" claims of customers), 78*lll*(11) ("net equity" means the sum that would have been owed to customer if all securities positions of customer were liquidated, minus customer indebtedness to broker).

[10] Technically, this is accomplished by requiring a broker to have on hand "excess margin securities" of its customers, which term in turn is defined as margin securities having a market value in excess of 140 percent of the total debit balances in the customer's margin account. 17 C.F.R. §§ 240.15c3-3(a)(5), -3(b)(1).

[11] Institutional customers sometimes negotiate with a broker to limit or prohibit the rehypothecation of their securities. An individual customer ordinarily would not have similar negotiating power and could prevent its stock from being rehypothecated only by moving the stock to a "cash" account.

[12] *See* S. REP. NO. 762, 95th Cong. 2d Sess. 1-2 ("[Section 1058] provides that the lending of securities to a broker and the return of identical securities does not constitute a taxable sale or exchange of the securities and thus does not interrupt the lender's holding period or affect the lender's basis."), 4 (citing favorably a private ruling issued to the New York Stock Exchange on April 19, 1948 which held that a securities lending transaction did not cause any interruption in the customer's holding period), and 8 ("the lender has a substituted basis and a tacked holding period in the securities which are returned") (1978). The Service has issued proposed regulations consistent with this intent. Proposed Treasury regulation section 1.1223-2 (holding period of stock loaned pursuant to an agreement that meets the requirements of section 1058 includes both the period during which the lender held the stock and the period of the stock loan); *see also* section 1223(1) (holding period for property received in exchange includes holding period of property exchanged if property received has same basis as property exchanged); section 1058(a) (characterizing stock loan as exchange of stock for loan agreement, and exchange of loan agreement for stock); section 1058(c) (property acquired by taxpayer in section 1058(a) transaction has same basis as property transferred by that taxpayer); Field Service Advice 1992-0617-1 (June 17, 1992) (applying section 1223 in order to determine compliance with the holding period requirements of section 246(c)).

taxpayers and their tax advisors, we suggest that guidance be issued confirming that rehypothecation has no effect on a taxpayer's holding period for the rehypothecated stock.

3. Information Reporting. Section 6042 provides the general rules for information reporting with respect to dividends. Section 6042(b)(1) generally provides that the term "dividend" means any distribution by a corporation that is a section 316 dividend, and any payment made by a stockbroker to any person as a substitute for a dividend.

Section 6045(d), by contrast, provides that if any broker transfers securities of a customer for use in a short sale or similar transaction and receives on behalf of the customer a payment in lieu of a dividend during the period of the transaction, the broker is required to provide the customer a written statement identifying the payment as an in-lieu payment rather than as a dividend. Treasury regulation section 1.6045-2(a)(3) states that, except as otherwise provided, a broker that receives a substitute dividend on behalf of a customer that is an individual need not furnish a statement to the customer, subject to certain limited exceptions.

Treasury regulation section 1.6045-2(h) reconciles sections 6042(b)(1) and 6045(d) by providing that where both require reporting, section 6045(d) controls; and that where section 6045 does not require reporting, section 6042 controls. Under current law, therefore, brokers must separately report substitute dividends paid to corporate customers, and generally must report substitute dividends paid to individual customers as dividends, on Form 1099-DIV.

This regime of reporting rules was sensible prior to the passage of the Act. Individuals were taxed at ordinary income rates on both actual dividends and substitute payments. Thus, there was no reason to distinguish between these two categories on the statements provided by brokers. Corporations, on the other hand, were eligible for the dividends-received deduction with respect to actual dividends, but were taxed at regular corporate rates on substitute payments.[13] Section 6045(d) was enacted to ensure that corporations did not erroneously report substitute dividends as actual dividends.

With the passage of the Act, individual investors also face different tax burdens with respect to actual dividends and substitute payments. As a result, individuals, like corporations, will need to know what portion of their returns are actual dividends and what portion of their returns are substitute payments.

The Conference Report to the Act states that the conferees expect that the Treasury Department will issue guidance as rapidly as possible on information reporting with respect to payments in lieu of dividends made to individuals.[14] A revised Form 1099-DIV has already been released, requiring brokers to report separately total ordinary dividends and that portion of those dividends that constitute qualified dividends. Form 1099-MISC already contains a box for reporting substitute dividends. No new regulations or other guidance has yet been released instructing brokers or taxpayers how to use these forms.

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[13] Under long-standing rules, substitute dividends generally are not treated as dividends. *See, e.g.,* Rev. Rul. 60-177, 1961-1 C.B. 9; proposed Treasury regulation section 1.1058-1(d).

[14] H.R. CONF. REP. NO. 126, 108th Cong. 1st Sess. 43 (2003).

The Conference Report also states that the conferees expect that individual taxpayers who receive substitute dividends may treat the payments as dividend income to the extent that the payments are reported as such on Form 1099-DIV for calendar year 2003, unless they know or have reason to know that the payments are in fact substitute payments. Finally, the Conference Report states that in the case of brokers or dealers who engage in securities lending transactions, short sales or other similar transactions on behalf of their customers in the normal course of their trade or business, the conferees intend that the Service will waive penalties where the brokers or dealers attempt in good faith to comply with section 6042 and 6045 information reporting requirements but are unable to reasonably comply because of the period necessary to conform their information reporting systems to the retroactive rate reductions on qualified dividends provided by section 1(h)(11).[15]

While we do not have the expertise to comment on many of the details of brokerage information reporting considerations, we have the following comments.

First, in view of the fact that the distinction between actual dividends and substitute dividends will now be relevant to relatively unsophisticated individual investors who may not be aware that their stock is being rehypothecated, we think it would be helpful if the Service made available to the general public an explanation of the circumstances that give rise to substitute dividends and the different treatment accorded to actual dividends and substitute dividends. An explanation of these matters in Publication 550 ("Investment Income and Expenses") or an explanatory note on the Internal Revenue Service website may help individual investors understand the changes taking place in their Forms 1099-DIV. The instructions to Form 1099-DIV should refer taxpayers to this explanation.

Second, we think that the general principle that new rules of law should not be retroactive, which we endorse, should apply to any new information reporting rules. Accordingly, notwithstanding the fact that section 1(h)(11) is effective retroactive to January 1, 2003, we do not believe that new information reporting rules should have a similar retroactive effective date. In this regard, we note the pragmatic considerations that the Act was passed in the middle of the year, that no regulations or other guidance have been issued as of the end of August 2003, and that, as we understand it, brokers' experience with prior changes to the law (for example, the withholding tax rules under section 1441) has been that making changes to broker computer systems can take a substantial amount of money, time and effort.[16] We also think that the legislative history contemplates that individual taxpayers are likely to receive Forms 1099-DIV for the 2003 taxable year that treat at least some substitute dividends as dividends. The legislative history thus recognizes that it may be difficult for brokers to retroactively reclassify amounts credited to customers' accounts. While the degree of difficulty

[15] *Id.* at 42-43.

[16] We understand that one important issue as to which there is limited official guidance is how to determine which customers' stock has been rehypothecated. That is, if a broker is permitted to rehypothecate 500 shares of ABC stock owned by 5 customers, and the broker rehypothecates only 200 shares, what rules should apply to determine which customers' shares are treated as rehypothecated? Possible alternatives could include (i) pro rata to every customer, (ii) random allocation via a lottery system, and (iii) allocation first to customers indifferent to rehypothecation. Some guidance on these questions is provided by Treasury regulation section 1.6045-2(f) and Private Letter Ruling 8546032, but additional guidance is needed.

may vary from broker to broker, there are obvious advantages to clear and uniform rules in this area.

Finally, we understand that the Conference Report's reference to "brokers and dealers" in the statement dealing with the waiver of penalties was intended to refer to "brokers" as that term is defined by Treasury regulation section 1.6045-1(a)(1), which includes a broader class of entities than those regulated as brokers or dealers. We suggest that guidance confirm that point.

IV. Issues Relevant to Dividends from Foreign Corporations

As described in Part I, above, a dividend from a foreign corporation will be treated as a qualified dividend income if the issuer is a "qualified foreign corporation" ("QFC") A foreign corporation is a QFC if the corporation is eligible for the benefits of a comprehensive U.S. income tax treaty, subject to certain limitations. In addition, a dividend will be treated as qualified dividend income if it is paid on stock that is "readily tradable on an established securities market in the United States." In either case, the dividend will not be qualified dividend income if the corporation is a foreign personal holding company ("FPHC"), foreign investment company ("FIC") or passive foreign investment company ("PFIC"). Each of these provisions raises issues that may affect significantly the breadth of section 1(h)(11) as applied to foreign dividends, and is discussed below. Information reporting and section 904(b) issues are also addressed.

A. "Readily Tradable on an Established Securities Market in the United States".

Hundreds of foreign companies have listed stock on U.S. stock exchanges, frequently in the form of American Depositary Receipts ("ADRs").[17] Because it is easy to determine whether stock is listed on a U.S. exchange, the "readily tradable" test could prove to be the primary basis for determining whether a foreign dividend is treated as qualified dividend income.

There are, however, a number of interpretive questions with respect to this rule that would benefit from guidance. They include: (a) whether it is sufficient for a stock or ADR to be listed on a U.S. stock exchange, or whether some minimum level of trading is required, (b) whether ordinary shares of the kind that underlie an ADR that is traded on a U.S. market also are treated as readily tradable on that market, (c) whether dividends on shares of stock of a class that is listed, directly or through an ADR, on a U.S. exchange constitute qualified foreign dividends even if the particular shares – for example, restricted stock held by employees – are not so listed, and (d) whether dividends on shares of stock of a class not listed on a U.S. stock exchange can constitute qualified foreign dividends. These questions turn on the meaning of the terms "established securities market" and "readily tradable."

Before discussing those terms, we observe that it is difficult in this case to resolve uncertainties by reference to the policies of section 1(h)(11), because the legislative history of that section does not discuss the reasons for treating foreign dividends as qualified dividend income. As the bill was reported out by the House Ways & Means Committee, qualified

[17] ADRs are receipts issued by custodians holding shares of stock issued by non-U.S. issuers. Holders of such receipts are treated for some purposes as direct owners of the underlying shares. Rev. Rul. 65-218, 1965-2 C.B. 566; Rev. Rul. 72-271, 1972-1 C.B. 369; *see also* Preamble to T.D. 8759, 1998-1 C.B. 770, 771.

dividends were limited to dividends on stock of domestic corporations.[18] The "reasons for change" provided by the Committee report refers to the need to stimulate economic growth by lowering the cost of capital to encourage new investments by corporations. As the bill was reported out of the Senate Finance Committee, qualified dividends included both dividends on stock of domestic corporations and dividends on stock of a foreign corporation that is "regularly tradable on an established securities market" (not limited to a market in the United States), other than FICs, PFICs or FPHCs.[19] The description of the "reasons for change" did not change.

In conference, the bill was amended to limit the "established securities market" provision to markets in the United States, and to add the treaty provision. We understand that the treaty provision was added after the "established securities market" provision was narrowed, in order to expand the scope of the qualified foreign dividend rule to include *bona fide* operating companies resident in treaty jurisdictions that did not have stock traded on an established U.S. securities market.

From this history one can reasonably infer that Congress believed that the bill would encourage foreign corporations resident in treaty jurisdictions or with stock traded on an established U.S. securities market to invest in the United States, for example by expanding their U.S. operations. Since there is no requirement that a foreign corporation have U.S. operations in order for its dividends to constitute qualified foreign dividends, however, the policies underlying section 1(h)(11) provide little insight as to whether the foreign dividend rules should be read narrowly or broadly.

1. Established Securities Market. The term "established securities market" is found in various provisions of the Code and regulations. It is defined in a smaller number of cases.[20] These definitions generally share certain characteristics: (i) they include national securities exchanges registered under the Securities Exchange Act of 1934, such as the New York Stock Exchange, the American Stock Exchange, and the Philadelphia Stock Exchange, and (ii) they include an "interdealer quotation system," defined generally as any system of general circulation to brokers or dealers that regularly disseminates firm buy or sell quotations for stocks and securities by identified brokers or dealers, such as NASDAQ or the OTC Bulletin Board.[21]

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[18] H.R. REP. NO. 94, *Jobs and Growth Reconciliation Tax Act of 2003,* 108th Cong. 1st Sess. 8 (text of bill), 28 (explanation) (May 8, 2003). The House Ways & Means Committee originally considered a very different proposal made by the Bush Administration, which would have applied to certain dividends of domestic corporations and of foreign corporations to the extent paid out of income subject to U.S. net income tax.

[19] S. PRT. NO. 26, *Jobs and Growth Reconciliation Tax Act of 2003: Technical Explanation of Provisions Approved by the Committee on May 8, 2003*, 108th Cong. 1st Sess. 14 (May 2003). The Senate Finance Committee also considered a proposal to exclude from gross income of individuals a specified amount of dividends from domestic corporations.

[20] *See* Section 453(f)(2) and Treasury regulation section 15a.453-1(e)(4)(iv); section 884(e)(4)(B)(i), section 884(e)(4)(C)(ii), and Treasury regulation section 1.884-5(d)(2); section 897(c)(3) and Treasury regulation section 1.897-1(m); section 1273(b)(3) and Treasury regulation section 1.1273-2(f); section 7704(b)(1) and Treasury regulation section 1.7704-1(b); *see also* section 883(c)(3)(A) and proposed Treasury regulation section 1.883-2(b); Treasury regulation section 1.861-2(b)(6)(iv)(b) (defining "foreign established securities market").

Other similar but not identical terms include "qualified exchange or other market," defined in Treasury regulation sections 1.367(e)-1(d)(4) and § 1.1296(e)-(1)(c), and "established financial market," defined in Treasury regulation section 1.1092(d)-1(b)(1) and cross-referenced in Treasury regulation section 1.475(b)-1(b)(3)(i).

[21] The OTC Bulletin Board is a regulated quotation service that displays real-time quotes, last-sale prices, and volume information for over-the-counter equity securities. For information on the OTC Bulletin Board, see

In some cases, they include national securities exchanges exempt from registration because of the limited volume of trades or local and regional exchanges. The definitions explicitly or implicitly exclude quotation sheets prepared by a broker or dealer in the regular course of business that include only quotations of such broker or dealer.

In one existing definition, the term "established [securities] market" includes securities as to which price quotations are readily available from dealers, brokers or traders – that is, securities as to which there is a market-maker – subject to a number of safe harbors that limit its scope.[22] This definition is one that applies to debt instruments only, for purposes of determining their fair market value.

These definitions thus raise the question of what forms of trading foreign stock, other than on a registered national securities exchange, should be treated as trading on an established securities market in the United States. It would be useful for guidance to clarify whether foreign stocks traded through interdealer quotation systems, or through U.S. market-makers (for example, preferred stock issued under Rule 144A, or instruments with the legal form of debt that are classified as equity for U.S. federal income tax purposes) are treated as readily tradable on an established U.S. securities market.[23] That issue may be affected by the scope of the term "readily tradable."

2. Readily Tradable. The term "readily tradable" is also found in, and defined in, various provisions of the Code and regulations. Establishing its core meaning is more difficult, however, than for the term "established securities market."

The phrase "readily tradable on an established securities market" appears in a very limited number of cases, and is defined only under section 453.[24] The definition of "readily tradable" under section 453 provides that "an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market."[25]

In other cases, the phrasing is different – for example, a definition may refer to securities "*traded* on an established securities market" or "*readily tradable* on a secondary

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http://www.otcbb.com/aboutOTCBB/overview.stm#abouthistory. According to this website, market-makers in any SEC-registered ADRs not listed on an exchange or NASDAQ must provide quotations for those ADRs on the Bulletin Board.

22 Treasury regulation section 1.1273-2(f).

23 In the case of instruments with the legal form of debt that are classified as equity for U.S. federal income tax purposes, taxpayers also will have to consider whether the terms of the instrument reduce the holder's risk of loss in a manner that brings the instrument within the rules of section 246(c). *See* Treasury regulation section 1.246-5(c)(4); Rev. Rul. 94-28, 1994-1 C.B. 86.

24 *See* Section 453(f)(5) and Treasury regulation section 15a.453-1(e)(4)(iii); section 401(a)(28)(C); section 409(*l*)(1); section 664(g)(4)(A); section 1042(c)(1)(A); section 3406(h)(6) and Treasury regulation section 1.3406(h)-1(d) (defining "readily tradable instrument"); section 6166(b)(7)(B) (defining "non-readily tradable stock"); *see also* section 280G(b)(5)(A) ("readily tradable on an established securities market or otherwise"); section 351(g)(2)(C)(ii)(I) (same); section 2057(e)(2)(B) ("readily tradable on an established securities market or secondary market"); section 6166(b)(10)(B)(iii) (same).

25 Treasury regulation section 15a.453-1(e)(4)(iii).

market," as in section 7704(b).[26] In this context, it seems sensible to construe "established securities market" narrowly, allowing "secondary market" and similar phrases to pick up alternative markets. However, when the language is "readily tradable on an established securities market," the breadth to be accorded "readily tradable" is less clear. Moreover, there are similar but not identical terms – "traded," "regularly traded," "primarily traded," "actively traded," and "publicly traded" – which frequently are used in connection with the term "established securities market" and that are defined in ways that are not always clearly distinguishable from the concept of "readily tradable."[27] One way to formulate the uncertainty is to ask whether the governing phrase in determining what markets are acceptable for purposes of section 1(h)(11)(C)(ii) is "established securities market," or whether it is "readily tradable."

Very generally speaking, the term "readily tradable" seems to be used in a manner that broadens the scope of acceptable trading and/or markets to include market-making and other non-system-based trading markets. The statutory provisions in which the term is found often are those where the relevant policy issue is whether a stock or debt security is sufficiently liquid that taxpayers can manipulate the recognition of gain or loss, or whether the security can be readily or accurately valued. Liquidity and valuation issues do not seem to be relevant to section 1(h)(11). Moreover, while section 1(h)(11)'s intended scope is not clear, we think that it is unlikely that Congress intended dividends paid on foreign stock that is quoted by U.S. market-makers but is not traded on a U.S. national securities exchange or through an interdealer

[26] Such formulations include "readily tradable on an established market," in sections 401(a)(22)(A) and 409(h)(1)(B); "readily tradable on a secondary market (or the substantial equivalent thereof)," in sections 469(k)(2)(B) and 7704(b)(2) and defined in Treasury regulation section 1.7704-1(c); and "stock of a corporation for which market quotations are readily available on an established securities market," in sections 170(e)(5)(B)(i), 2701(a)(1) and (a)(2), 6050L(d) and 6664(c)(3).

[27] For Code provisions using the term "traded on an established securities market," see section 453(k)(2)(A), section 860I(d)(1)(A), and section 1273(b)(3). The term is part of the definition of "publicly traded" in section 469(k)(2)(A), section 1044(c)(1), and section 7704(b)(1). It is also part of the definition of "readily tradable" in section 3406(h)(6)(A).

The term "regularly traded" is defined in Treasury regulation sections 1.884-5(d)(4), 1.897-9T(d)(1) and (2), and 1.1296(e)-1(b). The term "regularly traded on an established securities market" is found in section 67(c)(2)(B)(i)(II), section 856(d)(3)(B), section 897(c)(3), section 897(i)(3), and section 1445 (b)(6); the term "regularly traded on an established market" is used in section 453(k)(2)(B) and section 1273(b)(3)(B)(ii); the term "primarily and regularly traded on an established securities market" appears in section 883(c)(3)(A) and section 884(e)(4)(B)(i); and the term "regularly traded on a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934 or any exchange or other market which the Secretary determines has rules adequate to carry out the purposes of this subsection" is used in the context of defining "marketable stock" in section 1296(e)(1) and in the context of defining "publicly traded" in section 1297(f)(3).

The term "primarily traded" is defined in Treasury regulation section 1.884-5(d)(3).

The term "actively traded" appears in section 731(c)(2)(A), section 871(h)(4)(C)(v)(I), section 1092(d)(1), section 1258(c)(2), and section 1259(e)(2). Treasury regulation section 1.1092(d)-1 defines the term, and that definition is referred to in section 871(h)(4)(C)(v)(I) and in Treasury regulation sections 1.338-6(b)(2)(ii), 1.475(b)-1(b)(3)(i), 1.704-3, 1.731-2(c)(2), 1.1258-1, 1.1275-5, 1.1441-6, and 1.6050P-1. "Actively traded on an established market" appears in Treasury regulation section 1.83-7(b).

Finally, the term "publicly traded" appears many times in the Code and regulations. The term is mentioned in section 475(c)(2)(B), section 1044(c)(1), section 1274(c)(3)(D), section 1297(f)(1)(A), section 1446(f)(1), and section 6050L(d). Section 469(k)(2), section 1297(f)(3), and section 7704(b) provide definitions of the term, as do Treasury regulation sections 1.170A-13(c)(7)(xi), 1.7704-1(a)(1) and 54.4975-7(b)(1)(iv); *see also* Treasury regulation sections 1.46-8(b)(6), and 1.1223-3(c)(2)(i). "Publicly traded on an established securities market" is used in section 168(h)(6)(F)(iii)(II).

quotation system to be treated as qualified dividend income unless the treaty provision applies. That conclusion is not certain, however, in view of the potential breadth of the term "readily tradable."

On balance, we believe that an appropriate definition of the term "readily tradable on an established securities market in the United States" is one that treats foreign stock as so tradable if it is traded on a registered national securities exchange or on NASDAQ or a similar system. We think that it is important that the term be defined in a manner that requires *bona fide* active trading in a corporation's stock, so that the shareholders of a closely-held foreign corporation that does not qualify under the treaty provision (for example, a Barbados corporation) cannot elect into the 15 percent rate by causing thin trading in a small amount of the corporation's stock. In the case of NASDAQ, we note that stock cannot qualify for trading through NASDAQ unless there are a minimum number of market-makers in the stock.[28] Moreover, NASDAQ is treated as a recognized stock exchange under a number of treaty limitation of benefits provisions. Trading on NASDAQ or a system with similar safeguards therefore should suffice.

Once that standard is satisfied, we think the term "readily tradable" is intended to mean that the level of actual trading of a particular stock on an established U.S. securities market is not relevant, by contrast to terms like "regularly traded" or "primarily traded." We also think that, consistent with existing law under other Code provisions, once stock is *traded* on an established U.S. securities market, that all stock of that class should be treated as readily *tradable* on that market.[29] That issue is of some importance to the following cases.

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[28] According to NASDAQ's rules, NASDAQ is an electronic securities market comprised of competing market makers whose trading is supported by a communications network linking them to quotation dissemination, trade reporting, and order execution systems. Companies must satisfy a number of criteria before their stock can be eligible for trading through NASDAQ. If a company wishes to list its securities on the NASDAQ National Market, these requirements include a minimum amount of stockholders' equity, a minimum amount of market value of listed securities or assets and revenue or net income, a minimum number of and fair market value for publicly held shares, a minimum bid price, a minimum number of shareholders, and compliance with corporate governance standards. Similar but less stringent standards apply for listing on the NASDAQ SmallCap Market. In each case, for initial inclusion of a class of stock, there must be three registered and active market makers for the stock, and for continued inclusion, there must be two registered and active market makers. In the case of ADRs, these standards generally are applied at the level of the underlying stock if the ADR itself does not qualify. See http://www.nasdaq.com, Inside NASDAQ/Listing with NASDAQ/Listing Requirements and Fees; NASDAQ's Marketplace Rules.

[29] Existing law generally treats a security as "readily tradable," "regularly traded" and so forth if the security is of a class that is in fact traded in the required manner. *See*, *e.g.,* Treasury regulation section 15a.453-1(e)(4)(ii) (an obligation is treated as readily tradable in an established securities market if it is part of an issue which is readily tradable in an established securities market); Treasury regulation section 31.3406(h)-1(d) ("readily tradable instrument" means any instrument that is part of an issue any portion of which is traded on an established securities market).

The Service has considered a comparable issue in the past, under section 1273(b)(3)(A) and (B). In our 1991 *Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges*, we observed that even where bond issues are exchange-listed, it appears that only a very small portion of the trading volume and number of trades in such bonds take place over the exchange, and estimated that exchange trading volume for exchange-listed bonds was less than 5 percent of total trading in such bonds. Treasury regulation section 1.1273-2(f)(2) nevertheless treats any bond listed on a national securities exchange or interdealer quotation system as traded on an established market.

(a) Alternative Trading Systems/Electronic Communication Networks. In recent years a number of electronic trading systems have come into being through which stock can be traded, such as Instinet, Island, Archipelago, Brut, and Bloomberg Tradebook (B-Trade).[30] These systems are generically referred to as alternative trading systems or electronic communication networks ("ECNs"). Some ECNs, like Archipelago, are regulated as national securities exchanges, so that stock traded on such ECNs should be treated as readily tradable on an established U.S. securities market. Other ECNs, like Instinet, are regulated as broker-dealers. An ECN of that kind is not treated as an exchange and also may not qualify as an interdealer quotation system of the kind referred to above, which generally requires firm bid or offer quotations from identified counterparties, because trading on an ECN is anonymous. In that regard, buying and selling securities through such an ECN is similar to buying and selling through other broker-dealers.

We understand that stocks currently sold through ECNs are listed on a national securities exchange or NASDAQ, or in some cases on the OTC Bulletin Board. To the extent that shares purchased on an ECN can immediately be sold on an exchange or NASDAQ or similar system, and therefore in fact can be readily traded on those markets, we think that shares purchased on an ECN should be treated as stock that is readily tradable on an established U.S. securities market.

(b) ADRs. As described above, ADRs are receipts issued by U.S. custodians for shares of foreign stock of an identified class held by the custodian. ADRs trade through the same variety of arrangements as do shares of stock, meaning that some are registered offerings listed on a national securities exchange, some are registered offerings that trade through over-the-counter/interdealer quotation systems, and some are issued in private placements and are subject to securities law restrictions on subsequent purchases and sales.

Revenue Rulings issued by the Service have concluded that the holder of an ADR is treated for foreign tax credit and treaty purposes as if the taxpayer held the underlying shares directly, and that an ADR is an interest in stock for purposes of the former interest equalization tax.[31] These Rulings and later private letter rulings suggest that the holder of an ADR simply holds a ticket to the underlying stock, and is treated for U.S. federal income tax purposes as holding the underlying stock. An important consideration underlying this treatment is that the holder of an ADR can acquire the underlying stock at any time. As a result, in practice shares can be moved in and out of ADR programs virtually at will and at minimal cost, and we understand that this is done on a daily basis. That is, it happens routinely that an investor will purchase stock on a foreign exchange and on a same-day basis exchange those shares for the corresponding ADR, or purchase an ADR and on a same-day basis exchange the ADR for the underlying shares, which then may be sold on a foreign exchange.

ADRs raise two issues. Section 1(h)(11)(C)(ii) provides that "[a] foreign corporation not otherwise treated as a qualified foreign corporation under [the treaty provision] shall be so treated with respect to any dividend paid by such corporation if *the stock* with respect to which such dividend is paid is *readily tradable* on an established securities market in the United States"

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23 For discussion of ECNs, see http://www.sec.gov/news/studies/ecnafter.hcm.

31 Rev. Rul. 65-218, 1965-2 C.B. 566; Rev. Rul. 72-271, 1972-1 C.B. 369.

(emphasis added). The first question, therefore, is whether dividends paid on ADRs that are traded on an exchange or other established U.S. securities market qualify as dividends paid on *stock* that are traded on that market. If that question is answered affirmatively, the second question is whether all shares of the class of stock underlying such an ADR then are treated as *readily tradable* on that market.

The Conference Report to the Act addresses the first question in a footnote, which states that a share will be treated as readily tradable on an established U.S. securities market "if an American Depository Receipt (ADR) backed by such share is so traded."[32] This position is consistent with the historic treatment of ADRs for U.S. federal income tax purposes, described above, as mere tickets to the underlying stock.

The Conference Report does not address the second question. To state that question more precisely, it is whether shares of the same class underlying an ADR traded on an established U.S. securities market that are *not* held by the depositary for the ADR program also will be treated as readily tradable on that market. For example, if a U.K. corporation's ordinary shares are traded on the London Stock Exchange and, through ADRs, on a U.S. securities exchange, would shares of that class purchased on the London Stock Exchange be treated as shares readily tradable on an established U.S. securities market? Alternatively, if a U.S. taxpayer purchases an ADR on a U.S. securities exchange, and then exchanges the ADR for the underlying ordinary share, would that share still be treated as readily tradable on an established U.S. securities market?

This issue is relevant for several classes of investors. While individual taxpayers generally may be unlikely to purchase foreign shares not listed on a U.S. securities exchange directly, mutual funds and other collective investment vehicles may well do so. In addition, we understand that foreign corporations with U.S. employees (directly or through U.S. subsidiaries) generally will provide stock-based compensation to those employees based on ADRs if they have an ADR program, and otherwise will provide stock-based compensation based on their ordinary shares. The issue thus is relevant to such employees. As discussed below, we think that there are compelling reasons to permit U.S. employees of foreign companies to get the benefits of section 1(h)(11).

Technical and policy arguments can be made in favor of and against treating underlying shares of the kind described above as readily tradable on an established U.S. securities market. In favor of a narrow reading is the fact that the Conference Report states that a share will be so treated if an ADR "backed by *such* share" is traded on an established U.S. market, that section 1(h)(11)(C)(ii) clearly requires that shares be traded on a U.S. and not a foreign market, that ADRs are not the same as the underlying shares even if so treated for tax purposes, and that the treaty provision is intended to deal with all shares traded outside the United States or not traded.

We favor a broader view. As a technical matter, once the stock underlying an ADR is treated as traded on an established U.S. securities market, then other stock of the same class is in fact "readily tradable" on that market. The active market practice of moving back and forth

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[32] H.R. CONF. REP. NO. 126, 108th Cong. 1st Sess. 42, n.41 (2003).

between ADRs and the underlying stock confirms that technical point.[33] For this purpose, we see no meaningful difference between stock of a foreign corporation that is directly listed on both a U.S. and a foreign exchange, where it is clear that all such stock is readily tradable in the United States, and stock of a foreign corporation that is listed on a U.S. exchange through an ADR and directly on a foreign exchange.

We think this approach also is the right one from an administrative and a tax policy matter. ADRs for decades have been treated as equivalent for U.S. federal income tax purposes to the underlying stock. It is difficult to square such treatment with a rule that would treat dividends on the underlying stock differently depending on whether they were paid through an ADR program. The tax treatment of a dividend should not depend on whether the shareholder holds an ordinary share through an ADR program, or has acquired the ordinary share by exchanging it for an ADR, or holds an ordinary share identical in all regards to a share exchanged for an ADR. A case-by-case inquiry of this kind into how a taxpayer acquired a particular share of stock – that is, on or off a market on which the stock can be traded – is not consistent with the manner in which the terms "readily tradable" or "established securities market" have been applied in the past. Moreover, such a rule would be virtually impossible to police. Finally, a rule that accords different treatment to ADRs and underlying shares will encourage tax-motivated trading by sophisticated investors into and out of ADR programs around ex-dividend dates, which would serve no purpose we can discern.

(c) Restricted Stock. The issues raised by restricted stock are somewhat different from those discussed above. Restricted stock may belong to a class of stock that is readily tradable on an established U.S. securities market, but the actual stock the investor holds is not characterized by that level of liquidity. The restrictions may be imposed either under the U.S. securities laws, for example with respect to stock held by officers and directors of a company or that has been privately placed with investors, or under a contractual arrangement with the issuer, where the stock has been issued pursuant to an employee compensation scheme.[34]

As a technical matter, treating such stock as "readily tradable on an established U.S. securities market" is more difficult than the cases discussed above. If securities law restrictions apply, the holder generally is limited in the timing and amount of stock that can be sold. If the stock is subject to employment-related restrictions, there may be a limited class of persons who are permitted to purchase the stock (such as family trusts), or there may be no legal restriction on selling the stock but no market for it because the stock is subject to forfeiture if the holder ceases to be employed by the issuer or its affiliates.

As a policy matter, however, we think a strong case can be made for treating such stock as readily tradable on an established U.S. securities market, at least where U.S. individuals who are officers, directors and employees are concerned. The Act as a whole and section 1(h)(11) in particular are intended to promote investment, and therefore employment, in the United States. It is hard to see how treating foreign parent stock held by U.S. employees of a U.S. subsidiary of

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[33] *Cf.* Treasury regulation section 15A.453-1(e)(5) (treating convertible debt as in a form designed to be readily tradable if it is convertible into stock that is readily tradable, subject to certain conditions).

[34] *See* 17 C.F.R. § 230.144 ("Rule 144"); section 83.

a foreign corporation less favorably than foreign parent stock purchased by other U.S. taxpayers would be consistent with that goal. Again, we think that the technical issues can be resolved if all stock of a class that is traded on an established U.S. securities market is treated as readily tradable.

B. "Eligible for the Benefits of a Comprehensive Income Tax Treaty."

Section 1(h)(11)(C)(i)(II) provides that a foreign corporation is a qualified foreign corporation if such corporation "is eligible for the benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information provision." This definition sets out three requirements: (i) the income tax treaty must be comprehensive and satisfactory to the Treasury Department, (ii) the income tax treaty must include an exchange of information program, and (iii) the corporation must be eligible for the benefits of the treaty. The legislative history adds what appears to be a gloss on the third requirement, to the effect that a foreign corporation will be treated as eligible for the benefits of a treaty if substantially all of the corporation's income in the taxable year in which the dividend is paid" qualifies for the benefits of the treaty.

1. Tax Treaty Requirements. We anticipate that the Service will issue guidance listing which treaties are considered comprehensive and satisfactory, and that include an exchange of information program. The Conference Report states that until such guidance is issued, all comprehensive treaties with exchange of information programs will be treated as satisfactory, other than the current U.S.-Barbados income tax treaty. That treaty is described as not satisfactory because it may operate to provide benefits that are intended for the purposes of mitigating or eliminating double taxation to corporations that are not at risk of double taxation.[35] While the Treasury Department and Congress have expressed concerns from time to time about the potential for other treaties, including those with countries that are not considered tax havens, to be used to avoid both U.S. and foreign taxation of certain kinds of income under certain circumstances, we believe that Congress intended that most U.S. income tax treaties would be considered comprehensive and satisfactory.

2. Corporation-Level Requirements. Before discussing these requirements, some general considerations should be mentioned. The question of whether a foreign corporation is eligible for the benefits of a treaty and whether it meets the "substantially all" test is a question that can be answered with certainty only by the corporation itself. These requirements are different in kind, therefore, from the identification of a satisfactory treaty, or the determination of whether stock is traded on an established U.S. securities market, both of which can be determined objectively if the meaning of critical terms is clear.

This point is of concern because, as we understand it, the treaty provision was intended to be of greatest significance precisely where a foreign corporation does not have stock traded on an established U.S. securities market. If the corporation has issued stock to U.S. investors, it will ordinarily provide disclosure to those investors, which can be expected to address the potential application of section 1(h)(11). If the corporation has issued stock that trades only outside the

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35 H.R. CONF. REP. NO. 126, 108th Cong. 1st Sess. 42 (2003).

United States, however, it is unlikely that there will be any definitive means by which a U.S. taxpayer can ascertain whether the corporate requirements are met. While it is not very likely that individual taxpayers will be direct investors in such stock, mutual funds and other collective investment vehicles owned by U.S. individuals may well invest in such stock. If the treaty provision is to be effective, therefore, investors must have some external indicators on which they can rely in the absence of information provided by the corporation.

One further consideration is that many foreign corporations may have had no reason, prior to the enactment of section 1(h)(11), to consider whether they are eligible for the benefits of a U.S income tax treaty. If the corporation has no business activities in the United States, directly or through subsidiaries, and derives no portfolio investment income other than interest, eligibility for a U.S. income tax treaty is not likely to have affected the corporation's tax position. Moreover, determining whether a foreign corporation satisfies a limitation of benefits provision of the kind found in treaties negotiated in the last decade or so can be quite burdensome. As a result, some foreign corporations may be reluctant to divert their management time and incur the costs necessary to make that determination unless the corporation is doing business in the United States. Even if a foreign corporation were to undertake that effort, there is no obvious means under current law for it to communicate its conclusion to U.S. investors if it does not have securities traded in the United States. Since the treaty provision is not limited to companies with U.S. business operations, implementing Congress's intent seems to us again to require some ability for investors to rely upon external indicators.

We understand "eligible for the benefits of a comprehensive income tax treaty" to mean that a corporation must be a resident, as that term is defined in the relevant treaty, of the treaty jurisdiction, and that if the treaty contains a limitation of benefits ("LOB") provision, the corporation ordinarily also must be a "qualified person" under that provision

The Conference Report states that a foreign corporation will be treated as eligible for the benefits of a treaty if "substantially all of [the corporation's] income in the taxable year in which the dividend is paid" qualifies for the benefits of the treaty.[36] The legislative history does not make clear what this requirement is intended to add. Whatever meaning is attributed to this sentence, care should be taken that it not be inconsistent with the standard set forth in the statute, which is that the corporation need only be "eligible for the benefits of" a comprehensive income tax treaty. One plausible reading is that the statement was meant to address a corporation that (a) is a resident of a treaty country (b) is not a qualified person under the treaty's LOB provision but (c) qualifies for treaty benefits with respect to certain categories of its income, such as active trade or business income where the corporation has substantial business activities in the treaty country. Under this reading, the statement in the legislative history would have the effect of saying that such a corporation is "eligible for the benefits of" the treaty only if substantially all of the corporation's income is income of this kind.

Turning to the question of external indicators, there should be some combination of objective factors that can give the government a reasonably high degree of comfort that a foreign corporation is a bona fide operating company and treaty resident of the kind that Congress intended be treated as a qualified foreign corporation. Relevant factors could include: the length

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[36] *Id*.

of time the corporation has been in existence, the nature of its business, the number of its employees, its size, the composition of its assets as shown on its balance sheet, whether it is known within its industry, and whether its common stock is traded on a home country stock exchange. We urge that rules or possibly a presumption be written permitting taxpayers to rely on such external indicators to determine whether a corporation is eligible for the benefits of a treaty, in the absence of knowledge or a reason to know to the contrary.

Another possible approach to dealing with this issue would be to establish a program similar to that applicable for original issue discount. The issuer of a publicly offered debt instrument with OID is required to file Form 8281 specifying the amount of OID on the bond on an annual basis.[37] That information is then reported by the Service in Publication 1212. A similar program could be established to permit a foreign corporation to provide a form to the Service that states whether or not dividends on specified classes of shares constitute qualified dividend income, which information would be updated when it changes and would be published by the Service. A program of this kind could be useful for issuers that choose to make the effort to determine their treaty status. We note that safeguards would have to be put in place so that the Service would feel comfortable that the representations made by these foreign corporations were truthful. Also, in order for the system to be workable, taxpayers would have to be able to rely to some extent on the representations made by these foreign corporations. We suggest in this regard that taxpayers be permitted to rely on such certification to avoid penalties, to the same extent they may rely on information provided in Form 1099s.[38] Reliance on certification of this kind alone may have the effect of narrowing the practical application of the treaty provision substantially, however, in view of the considerations described above.

C. FPHC, FIC and PFIC Rules.

Section 1(h)(11)(c)(iii) provides that, notwithstanding the definition of qualified foreign corporation otherwise applicable, the term does not include a FPHC, FIC or PFIC. For this purpose, a PFIC appears to be a non-qualified foreign corporation regardless of whether a shareholder elects to treat the PFIC as a "qualified electing fund" under section 1293 or to mark the PFIC stock to market under section 1295. Issues relevant to a foreign corporation that is a controlled foreign corporation and, absent section 1297(e), a PFIC, are discussed in Section IV.F, below.

From a tax administration perspective, this requirement is similar in some ways to the treaty provision. That is, it is likely that it will be difficult in some cases for an investor to determine with certainty whether or not a foreign corporation falls within the FPHC, FIC or PFIC categories, in view of the fact that it is not always easy for a foreign corporation to make that determination itself since U.S. tax principles must be applied to non-U.S. income and assets.

There is a risk that FPHC/FIC/PFIC rule either will be ignored in practice, because individual investors do not take it into account, or will swallow up the general rule, because investors or their surrogates (like brokers providing information reporting) will be forced to

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[37] Treasury regulation section 1.1275-3(c).

[38] *See* Treasury regulation section 1.6664-4(b)(1) (reliance on erroneous information reporting on a Form 1099 indicates reasonable cause and good faith for penalty waiver purposes, provided the taxpayer did not know or have reason to know that the information was incorrect).

assume that a foreign corporation could be a FPHC/FIC/PFIC unless the foreign corporation provides disclosure addressing the question. We note that it is not uncommon for U.S. tax disclosure to state that a foreign corporation does not believe that it is a PFIC, and we suggest that investors be permitted to rely on such a statement, provided that the investor does not know or have reason to know that it is incorrect. With respect to foreign corporations that do not provide U.S. tax disclosure, we suggest that the same test based on external indicators or certification described above with respect to the treaty provision be used as a surrogate for making the FPHC/FIC/PFIC determination.

D. Information Reporting.

As described earlier, the revised Form 1099-DIV already released by the Service requires brokers to indicate whether dividends paid to individual taxpayers are qualified dividends. As a practical matter, therefore, the burden of dealing with the uncertainties described above will fall primarily on brokers. While brokers have more resources and more sophistication than most individual taxpayers, their ability to reach a reliable conclusion with respect to a foreign corporation's eligibility for treaty benefits or its status as a non-FPHC/FIC/PFIC is not materially greater. All of the comments made above about the need for an objective test in cases where a foreign corporation's stock does not trade on an established U.S. securities market and does not provide U.S. tax disclosure thus continue to apply.

E. Section 904(b).

As is the case with the section 246 holding period rules discussed earlier, these rules will be new to individual taxpayers, and in many cases to tax advisors in view of the fact that it is not common to have foreign source capital gains under current law's sourcing rules. Foreign corporations that issue stock to U.S. investors can be expected to provide tax disclosure addressing the issue, but that disclosure will not necessarily be accessible to a taxpayer at the time that it prepares its tax disclosure. We recommend that any notice or other explanatory guidance issued by the Service explaining the rules now applicable to qualified dividend income include a brief explanation of how the section 904(b) rules will apply.

F. CFC/PFIC Issues.

The application of section 1(h)(11) to a U.S. taxpayer that is a United States shareholder of a controlled foreign corporation ("CFC") raises a number of technical and policy issues. First, we note that while section 1297(e) provides, for purposes of sections 1291-1298, that a foreign corporation is not treated as a PFIC during the period during which a shareholder is a United States shareholder, as defined in section 951(b), and the corporation is a CFC, section 1297(e) does not say that the foreign corporation is not a PFIC for purposes of other provisions of the Code. We assume that Congress did not intend dividends received by a shareholder of a CFC that is also, as to other taxpayers, treated as a PFIC to be ineligible for the 15 percent rate, but clarification on this point would be useful.

More generally, we observe that the rules for determining when an inclusion of income relating to income earned by a foreign corporation is treated as a dividend are complex. An inclusion of income under section 951(a)(1)(A) ("subpart F income") or under section

951(a)(1)(B) (a "section 956 inclusion") is not treated as an actual dividend, although it is subject to rules very similar to those applicable to a deemed dividend. Since the subpart F rules treat foreign personal holding company income or other foreign base company income as included in a United States shareholder's income before taking into account the payment of any dividends to the shareholder, and then treat any subsequent dividend as paid out of previously taxed income, amounts representing actual dividends from foreign corporations will not be eligible for section 1(h)(11). Finally, section 1248 inclusions, representing non-subpart F earnings and profits, are treated as dividends.

Very broadly speaking, we think that these rules make sense in their current form, since the effect is that "passive" income earned abroad is not eligible for the benefits of section 1(h)(11). The rules may be overbroad, however, to the extent that the foreign corporation's earnings and profits derive from dividends paid by qualified foreign corporations. And the effect of these rules is that section 1(h)(11)'s benefits are denied for income of a kind that would not cause a foreign corporation to be a PFIC, such as foreign base company services income. We think consideration of whether these results are appropriate, or whether legislative changes should be made, is warranted. We also invite consideration of whether the double inclusion of income required by section 962(d), where a United States individual shareholder has elected to be subject to corporate tax rates on subpart F inclusions and subsequently receives a distribution from the CFC, should be treated as a dividend.