

# **ABCs OF CROSS-BORDER DERIVATIVES<sup>©</sup>**

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## ABCs OF CROSS-BORDER DERIVATIVES\*

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### I. INTRODUCTION

This outline examines the U.S. tax consequences produced by derivative instruments in international financing transactions and highlights the inconsistent U.S. tax treatment that results from the use of different derivative financial instruments with the same economic results in cross-border financing transactions. The final section of the outline, which analyzes the tax provisions contained in the 1992 ISDA master multi-currency cross-border agreement, provides a practical illustration of these tax consequences.

As discussed below, the disparate results in the taxation of cross-border derivatives are in large part attributable to the historical development of separate U.S. tax rules governing each specific derivative instrument.<sup>1</sup> A specific example of this inconsistent treatment is illustrated by the comparison below of the tax consequences of notional principal contracts and substitute payments under securities loans, two derivative instruments that produce the same economic result but very different U.S. tax results. As the outline illustrates, the current patchwork of U.S. withholding tax rules is ill-equipped to address the issues raised by the use of derivative products, and U.S. income tax treaties negotiated to date have also failed to provide sensible results when treaty partners engage in cross-border derivative transactions.

Treasury is, and has for some time been, well aware of the shortcomings in the application of existing U.S. tax rules and treaties to derivative transactions. In 1994, then Treasury

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\* My thanks to Richard Andrade for contributing Section VI, and to my partner Gary T. Silverstein and our colleague Charles Kaufman for their efforts in graciously updating this outline.

This outline is an evolution of *U.S. International Tax Treatment of Financial Derivatives*, NYU Conference on Tax Issues in Corporate and International Transactions, Vol. II (April, 1996); 14 International Tax Notes 787 (Mar. 3, 1997) and 74 Tax Notes 1703 (Mar. 31, 1997), co-authored by Reuven Avi-Yonah and Linda Z. Swartz.

<sup>1</sup> See generally *Joint Committee on Taxation, Present Law and Analysis Relating to the Tax Treatment of Derivatives*, (JCX-21-08, Mar. 4, 2008).

International Tax Counsel Cynthia Beerbower was quoted as saying that “opportunities for synthetic investments, as opposed to real investments, are so prevalent that withholding taxes are no longer real.”<sup>2</sup> To date, Treasury has failed to propose a single, workable set of tax rules to govern the use of derivative products between either domestic parties or domestic and foreign parties, and until that goal is achieved (if ever), well-advised taxpayers will continue to choose the specific form of derivative transaction that produces the desired economic result with the most favorable U.S. tax consequences.

## **II. COMPARISON OF SOURCE AND WITHHOLDING RULES FOR CROSS-BORDER DERIVATIVE INSTRUMENTS**

This section compares the tax treatment of different cross-border derivative instruments. A short definition is provided for each instrument, followed by the rules regarding the timing, character and source of income and/or gain recognition, together with applicable withholding rules. As illustrated below, there are three principal tax regimes for sourcing income and gain from derivative instruments.

- First, payments on notional principal contracts (“NPCs”) that do not have an embedded loan component (“non-amortizing swaps”) are sourced in accordance with the residence of the recipient under specific regulations,<sup>3</sup> except for certain payments that are deemed to be interest on NPCs with embedded loans (“self-amortizing swaps”), which are sourced according to general rules for interest payments.
- Second, “substitute payments” on securities loans are sourced in the same manner as actual dividends or interest payment on the borrowed securities, while

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<sup>2</sup> Kathleen Matthews, “U.S. Branch IFA Meeting Highlights Cross-Border Corporate Reshufflings, Tax Treaties, APAs,” 94 TNI 54-3 (1994).

<sup>3</sup> Regulations under section 863 govern notional principal contracts generally, and section 988 regulations govern such contracts involving foreign currency. The sourcing rules of the two sets of regulations are generally consistent.

borrow and rebate fees on securities loans are attributed according to general source rules.

- Third, payments on options, forward contracts and regulated futures contracts, which generally produce only gain or loss, are sourced in accordance with the residence of the recipient under general source rules. This result is obtained notwithstanding the application of the mark-to-market rules of sections 1256 and 475 of the Internal Revenue Code of 1986, as amended (the “Code”). Each of these specific regulatory sourcing regimes suffers from different limitations, as discussed below.

#### **A. Notional Principal Contracts**

1. Definition NPCs include swaps, caps, floors and collars whereby a party agrees to make periodic payments reflecting the value of a specified variable index applied to a “notional” agreed-upon principal amount, and the counterparty agrees to either make periodic payments based on a different index or pay a fixed premium for the contract (a “cap” or a “floor”).<sup>4</sup> The notional principal amount may vary over the term of the NPC as long as the variances are set in advance or are based on certain objective or financial information.<sup>5</sup> Caps are contracts whereby a seller makes periodic payments equal to the product of a notional principal amount and any excess of a specified index over the agreed level (the cap rate). The buyer pays a single premium or makes a series of fixed periodic payments for the contract. Floors are contracts whereby a seller makes periodic payments equal to the product of a notional principal amount and any amount by which a specified index falls below a specific level (the floor rate). The buyer pays a single premium or makes a series of fixed periodic payments for the contract. Combinations of caps and floors, whereby a party purchases a cap and sells a floor, or

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<sup>4</sup> Treas. Reg. § 1.446-3(c)(1); *see* discussion regarding timing in text below.

<sup>5</sup> *See* Treas. Reg. § 1.446-3(c)(3).

purchases a floor and sells a cap, are known as collars.<sup>6</sup> An option to enter into an NPC is not considered an NPC.<sup>7</sup>

2. Timing of Income Income and deductions attributable to an NPC must be recognized using accounting methods that “reflect the economic substance of such contracts.”<sup>8</sup> Three types of income are typically received in connection with NPCs: periodic payments, non-periodic payments and termination payments. Each type of income is accrued somewhat differently:
- *Periodic Payments* Periodic payments are payments made or received pursuant to an NPC that are payable at intervals of one year or less during the entire term of the contract, are based on a specified index, and are based on a notional principal amount.<sup>9</sup> Periodic payments (payable at least annually) accrue ratably over the period to which they relate.<sup>10</sup>
  - *Non-Periodic Payments* Non-periodic payments (including up-front premiums, prepayments of one leg of a swap, and premiums for exercised options to enter into a swap, but not termination payments) are recognized over the term of the contract in accordance with their economic

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<sup>6</sup> The IRS has also concluded that an instrument issued by a corporation referencing the price of another corporation’s stock (held by the issuer) is equity rather than debt, and is part of a straddle that may be analyzed as a cash-settled collar. *See* F.S.A. 2001-50-012 (Sept. 11, 2001). The issuer may be viewed as maintaining a long position in the other corporation’s stock by owning the stock and a short position by issuing the instrument. Alternatively, the instrument may be viewed as a prepaid forward contract.

<sup>7</sup> Treas. Reg. §§ 1.446-3(c)(1)(ii), (g)(3). Note, however, that such an option may qualify as a hedge under certain circumstances.

<sup>8</sup> *See* Treas. Reg. § 1.446-3(b).

<sup>9</sup> *See* Treas. Reg. § 1.446-3(e)(1).

<sup>10</sup> *See* Treas. Reg. § 1.446-3(e)(2).

substance.<sup>11</sup> In this regard, non-periodic swap payments generally would be allocated based on values of a series of cash-settled forwards written on a specified index at the notional principal amount. Similarly, non-periodic payments on a cap or a floor generally would be allocated in accordance with a series of cash-settled options.<sup>12</sup> Non-periodic payments, other than up-front payments, may be amortized by treating the contract as if it provided for a single up-front payment (equal to the present value of the non-periodic payments) and a loan between the parties.<sup>13</sup> The deemed single up-front payment is then amortized under the level payment method described in Treasury Regulation section 1.446-3(f)(2)(iii)(A). The time value component of the loan is not treated as interest, but is instead recognized as a periodic payment together with the amortized amount of the deemed up-front payment.<sup>14</sup>

- Swaps with “significant” up-front non-periodic payments are bifurcated into an on-market, level payment swap and a separate loan.<sup>15</sup> The parties must separately account for the loan and the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap, and is instead recognized as interest for all purposes.<sup>16</sup> Deemed payments on the loan are calculated by assuming the loan is an installment

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<sup>11</sup> See Treas. Reg. § 1.446-3(f).

<sup>12</sup> See Treas. Reg. § 1.446-3(f)(2).

<sup>13</sup> See Treas. Reg. § 1.446-3(f)(2)(iii)(B).

<sup>14</sup> See Treas. Reg. § 1.446-3(f)(2)(iii)(B).

<sup>15</sup> See Treas. Reg. § 1.446-3(g)(4). It is not clear at what level an up-front payment is treated as significant (9% is not; 40% is, under the examples in the section 446 regulations).

<sup>16</sup> See Treas. Reg. § 1.446-3(g)(4). See also Rev. Rul. 2002-30, 2002-21 I.R.B. 971.

obligation with level payments and a constant yield to maturity.<sup>17</sup>

- *Termination Payments* Termination payments (payments on extinguishment or assignment) accrue in the year that the contract is extinguished, assigned, or exchanged. If such event is a deemed sale or exchange of the contract, the non-assigning party also recognizes gain or loss, and may amortize any amount recognized over the remaining term of the contract.<sup>18</sup>
- Recognition of income (and deductions) under the general rules outlined above may be affected if the NPC is (i) a foreign currency contract under section 988, (ii) a hedge or part of a straddle,<sup>19</sup> (iii) held by a taxpayer required (or

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<sup>17</sup> See Treas. Reg. §§ 1.446-3(g)(4), (6), *Ex.* 3.

<sup>18</sup> See Treas. Reg. § 1.446-3(h).

<sup>19</sup> Losses on positions in personal property that are part of a straddle (other than straddles comprised entirely of contracts marked to market under section 1256, identified straddles, hedges that are not marked to market, or straddles consisting of a qualified covered call on stock and ownership of the optioned stock under circumstances that will result in capital gain or loss) may be recognized only to the extent such losses exceed any unrecognized gain on offsetting positions under the rules of section 1092. A position includes an interest in actively traded personal property but generally excludes stock (*e.g.*, futures, forwards and options), and an offsetting position is a position that substantially diminishes the risk of loss on other positions. Unrecognized gain is the amount of gain recognized on a hypothetical sale of the offsetting positions at fair market value at year end.

Losses suspended under the straddle rules can be deducted in subsequent years to the extent the taxpayer's unrecognized gain decreases below the suspended losses, to prevent a taxpayer from recognizing loss before gain once risk has been laid off. In addition, unless a taxpayer has held a position for at least the long-term capital gain holding period, the holding period for any position that is part of a straddle begins on the date the taxpayer no longer holds an offsetting position with respect to such position. See F.S.A. 2001-50-012 (Sept. 11, 2001).

electing) to mark the NPC to market under section 475, or (iv) an equity swap with respect to a corporation's own stock governed by section 1032.

- Treasury regulations proposed in 2004 address the timing and character of income, gain, loss and deductions in respect of NPCs with contingent non-periodic payments (the "Proposed Contingent Non-Periodic Regulations").<sup>20</sup> If adopted, these regulations will likely require most market participants to change their current methods of accounting. The Proposed Contingent Non-Periodic Regulations would apply only to transactions entered into on or after 30 days after the date final regulations are published in the Federal Register.<sup>21</sup>
- Prior to the issuance of these regulations, the IRS had solicited comments and had proposed the following approaches: (i) non-contingent swap method, (ii) full allocation method, (iii) modified full allocation method, and (iv) mark-to-market method.<sup>22</sup>

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Under section 263(g), interest and other carrying charges, if any, allocable to positions that are components of a straddle (a cash and carry) must be capitalized to the extent they exceed certain income earned on the property (*e.g.*, OID, market discount or taxable portion of dividends), unless the straddle is a business hedge. As a result, business deductions that would generally shelter ordinary income are only available to either reduce capital gain or increase capital loss on a disposition of the position.

<sup>20</sup> 69 Fed. Reg. 8886 (Feb. 26, 2004).

<sup>21</sup> The IRS has publicly confirmed that it is still working on NPC guidance, although no fixed timetable has been set. See "IRS Still Working on Notional Principal Contract Guidance," 118 *Tax Notes* 1194 (Mar. 17, 2008).

<sup>22</sup> Notice 2001-44, 2001-30 I.R.B. 77. Under the non-contingent swap method described in the Notice, the contingent non-periodic payment would be converted into a non-contingent periodic amount payment taken into account over the life of the NPC on a constant yield basis. Under the full allocation method, no payments required under the NPC (*e.g.*, periodic, non-periodic, contingent, and non-contingent

At that time, the International Swaps and Derivatives Association (“ISDA”) advocated (and continues to advocate) the commonly used “wait and see” approach in lieu of the four methods proposed by the IRS, and advised that only the full allocation method could be justified on policy grounds.<sup>23</sup>

- Most significantly, the preamble to the Proposed Contingent Non-Periodic Regulations declares the “wait and see approach” to be “inconsistent” with existing authorities.<sup>24</sup> Moreover, the preamble effectively requires any taxpayer that is a party to a contingent payment NPC on or after March 27, 2004 and has not yet adopted a method of accounting to accrue the contingent payment under a “reasonable amortization method.”<sup>25</sup>

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payments) would have been included or deducted until the tax year in which all contingencies are resolved. The modified full allocation method would have required each party to an NPC to net any non-contingent payments it makes in a taxable year against payments it receives in that year, and would have permitted a deduction only if the amounts received exceeded the amounts paid. The mark to market method would have required NPCs to be marked to market, and gain or loss would be recognized, either annually or when the contract was terminated, assigned, or otherwise disposed of.

<sup>23</sup> *ISDA Comments on Notice 2001-44, Concerning Treatment of Notional Principal Contracts*, Derivatives Report at 23 (Feb. 2002); *ISDA, Comments on Proposed Regulations Relating to Notional Principal Contracts with Contingent Nonperiodic Payments* (Oct. 13, 2004), available at [http://www.isda.org/c\\_and\\_a/tax.html](http://www.isda.org/c_and_a/tax.html).

<sup>24</sup> 69 Fed. Reg. 8886 (Feb. 26, 2004), preamble.

<sup>25</sup> If a taxpayer has adopted a method of accounting to accrue the contingent payment of these NPCs, the preamble to these regulations states that the IRS will not require a change in accounting method earlier than the first year ending on 30 days or more after the regulations are finalized. In general, a taxpayer adopts a proper method of accounting by filing a return reflecting that method and cannot change such method without IRS consent. Treas. Reg. § 1.446-1(e)(1). However, if the method is impermissible, the taxpayer is considered to have adopted a method of accounting only

- If adopted, the Proposed Contingent Non-Periodic Regulations would require two alternative methods of accrual for contingent non-periodic payments:
  - the non-contingent swap method will apply to most payments. This method (which is a more complicated version of the method described in Notice 2001-44) generally requires the potential recipient of a contingent payment to accrue, and the potential payer to deduct, the projected amount of a contingent payment (and, generally, interest) over the term of the NPC and to readjust the projection (and the accrual) in each subsequent year,<sup>26</sup> and
  - the mark-to-market method, which is only available if (i) the contract is actively traded (as specially defined), (ii) the taxpayer marks the contract to market for financial accounting purposes (subject to certain additional requirements that are not specified in the Proposed Contingent Non-Periodic Regulations), (iii) one of the parties to the contract is a dealer and agrees to provide the taxpayer with valuation information, or (iv) the taxpayer is either an “open” regulated investment company (*i.e.*, one that offers its shares) or a closed regulated investment company that redeems its shares at net asset value.<sup>27</sup>
- Revenue Ruling 2002-30 requires that non-periodic payments comprised of contingent and non-contingent components be separated and each component be treated separately for purposes of applying the NPC rules in Treasury Regulation section 1.446-3 in order to properly

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after the taxpayer has filed two returns reflecting the method. Treas. Reg. § 1.446-1(e)(2)(i); Temp. Treas. Reg. § 1.446-1T(e)(2)(ii). Query whether the wait-and-see method is an impermissible method.

<sup>26</sup> Prop. Treas. Reg. § 1.446-3(g)(6).

<sup>27</sup> Prop. Treas. Reg. § 1.446-3(i)(2).

reflect the economic substance of the NPC.<sup>28</sup> The non-periodic or fixed payment associated with the transaction must be recognized over the term of the NPC in a manner consistent with Treasury Regulation sections 1.446-3(f)(2)(ii) or (iii), and 1.446-3(g)(4).<sup>29</sup> However, it is not entirely clear how this rule functions when an NPC's non-periodic payments are not described with reference to contingent and non-contingent components, but rather, as a single contingent payment referencing the value of a stock index that produces the same result in substance.<sup>30</sup>

- Notice 2002-35, released at the same time as Revenue Ruling 2002-30, provides that an NPC constitutes a “listed transaction” that is subject to the tax shelter rules if one party is required to make periodic payments to another at regular intervals of one year or less based on a fixed or floating rate index, and in return, the other party is required to make a single payment at the end of the term of the NPC that consisted of a non-contingent component and a contingent component.<sup>31</sup> Consistent with Revenue Ruling 2002-30, the non-contingent portions of such payments must be recognized over the term of the NPC in a manner that reflects the economic substance of the transaction, whether or not the payments are based on a fixed or floating interest rate.

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<sup>28</sup> Rev. Rul. 2002-30, 2002-21 I.R.B. 971.

<sup>29</sup> Presumably, the treatment of the contingent non-periodic component would be governed by the Proposed Contingent Non-Periodic Regulations, if adopted.

<sup>30</sup> For an excellent discussion regarding the issues surrounding Revenue Ruling 2002-30, see D. Hariton, “Confusion About Swaps and Rev. Rul. 2002-30,” 95 *Tax Notes* 1211 (May 20, 2002).

<sup>31</sup> Notice 2002-35, 2001-21 I.R.B. 992. The Notice fails to give an example of a non-contingent payment based on a floating rate. For further insight into the IRS' analysis of the transactions described in Notice 2002-35, see ISP Coordinated Issue Paper, All Industries-Notional Principal Contracts (Jan. 6, 2005), *Daily Tax Rep. (BNA)* No. 8, at G-4 (Jan. 12, 2005).

- Subsequently, the IRS issued Notice 2006-16, limiting the scope of Notice 2002-35.<sup>32</sup> Specifically, Notice 2006-16 provides that an NPC with contingent non-periodic payments is not a listed transaction if (i) the taxpayer uses a method of accounting for the NPC that takes the contingent non-periodic payments into account over the term of the NPC under a reasonable amortization method or (ii) the taxpayer properly accounts for the NPC under section 475 and Treasury Regulations under sections 446 and 988.
3. Character of Income Termination payments produce capital gain or loss where the contract is held as a capital asset.<sup>33</sup> Periodic and non-periodic payments on interest rate NPCs should produce ordinary income, because payments are made in exchange for money rather than property. By contrast, although such payments on contracts involving commodities, equities, or other personal property may produce ordinary income or loss,<sup>34</sup>

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<sup>32</sup> Notice 2006-16, 2006-9 I.R.B. 538. This Notice responds to the IRS' concern that Notice 2002-35 has caused large numbers of taxpayers to file disclosure statements on IRS Form 8886 for common transactions, such as total return swaps, that are entered into for *bona fide* non-tax purposes.

<sup>33</sup> *See, e.g.*, Harold R. Handler, "NYSBA Report on Proposed Changes to Corporate Own-Stock Regs.," 1999 TNT 119-22 (June 15, 1999). The Taxpayer Relief Act of 1997 expanded former section 1234A, which had provided for capital gain or loss treatment with respect to any gain or loss attributable to the cancellation, lapse, expiration, or other termination of rights or obligations with respect to actively traded personal property, to include rights and obligations with respect to all property which is (or on acquisition would be) a capital asset in the hands of the taxpayer. *See* S. Rep. No. 105-33, at 135-36 (1997). Moreover, the Proposed Contingent Non-Periodic Regulations specifically apply section 1234A treatment to termination payments. *See* Prop. Treas. Reg. § 1.1234A-1.

<sup>34</sup> Prop. Treas. Reg. § 1.162-30 states that payments on NPCs, other than interest on the loan component of a significant non-periodic payment and termination payments, are deductible as ordinary and necessary business expenses. *See also* Priv. Ltr. Rul. 98-24-026 (Mar. 12, 1998) (payment or receipt of periodic and non-periodic

capital gain or loss arguably may result where payments relate to rights with respect to a capital asset.<sup>35</sup>

However, if a taxpayer holds a long position under a contract with respect to certain pass-thru “financial assets” under the constructive ownership rules,<sup>36</sup> the amount the taxpayer could recognize as long-term capital gain upon a termination of the contract is limited to the amount of such gain the taxpayer would have recognized if it had held the financial asset directly during the term of the contract. Any additional gain would be treated as ordinary income, accrued over the term of the contract at a constant rate. Such recharacterized gain would be taxed at the highest marginal rate applicable to each taxable year and an interest charge would be imposed based on the inclusion of such recharacterized gain in the taxpayer’s income at a constant rate over the term of the contract. However, the constructive ownership rules do not apply if the contract is marked to market.

- If adopted, the Proposed Contingent Non-Periodic Regulations would change the predominant view that non-periodic “value” payments under an equity swap (*i.e.*, the appreciation or depreciation payments under an equity swap) give rise to capital gain or loss. Instead, if finalized in their proposed form, these regulations would treat all net periodic and non-periodic payments under the NPC as giving

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payments, including upfront payments, constituted ordinary income or expense); Priv. Ltr. Rul. 97-30-007 (Apr. 10, 1997) (periodic payments made and received on commodity swap constituted ordinary income and expense).

<sup>35</sup> By contrast, the Proposed Contingent Non-Periodic Regulations would treat all such payments as ordinary without distinction as to the assets to which such payments relate. *See* Prop. Treas. Reg. § 1.162-30.

<sup>36</sup> *See* section 1260, adopted as part of the Tax Relief Extension Act of 1999, which is generally effective for constructive ownership transactions entered into after December 17, 1999.

rise to ordinary income or loss.<sup>37</sup> However, terminations of swaps prior to their scheduled maturity will continue to give rise to capital gain or loss, as under current law.<sup>38</sup> Accordingly, holders could generally elect ordinary or capital treatment simply by terminating the NPC or holding it to maturity.

4. Source of Income Payments under NPCs (other than contracts with accelerated or uneven payments, such as swaps with an embedded loan component) are sourced according to the residence of the recipient.<sup>39</sup> Thus, most payments under an NPC received by a foreign holder are foreign source income not subject to U.S. withholding tax, except, under certain circumstances when the foreign holder is engaged in a U.S. trade or business.<sup>40</sup> This sourcing rule applies to NPCs with respect to debt, commodities, and likely, stock,<sup>41</sup> which permits foreign holders of dividend-paying stocks who are subject to U.S. withholding on such dividends to swap their stock for the right to receive payments measured by dividends paid on such stock without incurring a U.S. withholding tax. For portfolio investors in countries without U.S. tax treaties, avoiding the 30% withholding tax on dividends is a powerful incentive to forego the voting rights associated with a direct investment in stock.

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<sup>37</sup> See Prop. Treas. Reg. § 1.162-30(a).

<sup>38</sup> See Prop. Treas. Reg. § 1.446-3(g)(6)(i).

<sup>39</sup> See Treas. Reg. §§ 1.863-7(b)(1), 1.988-4(a).

<sup>40</sup> T.D. 8491, 1993-2 C.B. 215, preamble.

<sup>41</sup> The current section 446 regulations do not explicitly refer to equity swaps, but the language of the regulation, and the examples in Treasury Regulation section 1.446-3(c)(1)(ii) suggest that equity swaps are governed by the regulation, unless, of course, such a swap would be recharacterized under the general anti-abuse rule of the regulation or held to constitute a straddle or a hedge. By contrast, the Proposed Contingent Non-Periodic Regulations specifically refer to equity swaps. See Prop. Treas. Reg. § 1.446-3(g)(7), Exs. 6-9; Rev. Rul. 2002-30, 2002-1 C.B. 971.

- More complicated rules apply where a foreign party to an NPC is engaged in a U.S. trade or business and has entered into the contract in connection with that business. In that case, income from the NPC may be treated as U.S. source income to the foreign party “under principles similar to those set forth in Treasury Regulation section 1.864-4(c).”<sup>42</sup> Under those principles, periodic payments would constitute U.S. source income if the U.S. activities of the foreign party were a “material” (although not necessarily principal) factor in realizing the income. The booking office for the NPC is not controlling for this purpose.<sup>43</sup> This test puts a U.S. payer under an NPC in the difficult position of needing to determine whether the foreign party conducted “material” activities in connection with the NPC in order to determine the proper result under the U.S. withholding tax rules.
- The residence-based source rules contained in Treasury Regulation section 1.863-7 do not apply to foreign currency NPCs that are otherwise subject to section 988.<sup>44</sup> However, because commodity and equity indexed swaps do not constitute section 988 contracts for this purpose, those contracts are governed by the section 863 residence-based source rules.<sup>45</sup>
- Imposing withholding tax on substitute dividend payments made under an equity swap between a foreign party and a domestic party would preclude the avoidance of U.S. withholding tax which would apply if the foreign person held the underlying equity directly. Nonetheless, imposing withholding tax on all substitute payments made pursuant to equity swaps would

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<sup>42</sup> Treas. Reg. § 1.863-7(b)(3).

<sup>43</sup> Treas. Reg. § 1.864-4(c).

<sup>44</sup> Treas. Reg. § 1.863-7(a)(1).

<sup>45</sup> See Treas. Reg. § 1.988-1(a)(2)(iii)(A) and (B).

be overly broad because, depending on market movements, the foreign party may never earn any income over the life of the swap.<sup>46</sup>

- Despite the general sourcing rule for NPCs, certain payments may be subject to the general source and withholding rules.<sup>47</sup> For example, if an NPC with significant non-periodic payments was deemed bifurcated into an on-market, level swap and a loan, any deemed interest payments with respect to such loan would be sourced according to the residence of the payer. Payments by a U.S. person to a foreign holder that are attributable to deemed interest on an embedded loan would therefore presumably be subject to withholding tax.<sup>48</sup> This withholding tax might be reduced or avoided under a tax treaty, and such payments may also be exempt from withholding tax as portfolio interest.
- Accordingly, foreign banks engaging in credit derivative transactions through offices in countries that do not have zero interest rate treaties with the U.S. may be subject to withholding tax if payments under contracts are characterized as “interest” on an embedded loan that does not qualify as

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<sup>46</sup> See generally David Hariton, “Equity Derivatives, Inbound Capital and Outbound Withholding Tax,” *Tax Lawyer* Vol. 60, No. 2 (Winter 2007); David Hariton, “Taxing Equity Swaps: Don’t Throw Out the Baby with the Bath Water,” 2008 TNT 185-25 (Sept. 22, 2008).

<sup>47</sup> The application of the withholding rules to these facts is somewhat unclear, because to date the IRS has successfully avoided the question of whether some or all payments under NPCs constitute fixed or determinable annual or periodic income that is subject to withholding tax under sections 1441 and 1442. See Notice 87-4, 1987-1 C.B. 416.

<sup>48</sup> See I.R.C. §§ 871(a)(1)(A), (C), 881(a)(1), (3), 1441(a), (c), 1442(a).

portfolio interest because it is received by a bank on an “extension of credit”.<sup>49</sup>

- The Treasury Department has also expressed concern with the application of the residence-based source rules to equity swaps and swaps that mimic the performance of the U.S. real estate market, as evidenced by the following statement in the preamble to the section 446 regulations: “In light of the broad definition of specified index, the IRS is considering whether NPCs involving certain specified indices (*e.g.*, one issuer’s stock) should be excluded from the general sourcing rules of sections 861 through 865 and whether contracts involving other specified indices (*e.g.*, United States real property) are subject to section 897.”<sup>50</sup> The scope of the Treasury’s concern can be highlighted by comparing the small amount of foregone U.S. withholding tax from recipient residence sourcing for payments that mimic interest payments on debt (which would qualify in large part for the portfolio interest withholding exemption) with the much higher cost of applying the same sourcing rule to payments that mimic dividend payments on stock, or gain on real estate, would otherwise be subject to U.S. withholding tax or U.S. net income tax, respectively.
- As one commentator has observed, an option on an LLC holding real property would not minimize taxes because of the broad definition of “U.S. real property interest” in Treasury Regulation section 1.897-1(d)(2)(ii)(B). In addition, the FIRPTA definition of a “U.S. real property interest” in Treasury Regulation section 1.897-1(d)(2)(i) may also be broad

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<sup>49</sup> I.R.C. § 881(c)(3)(A). Banks headquartered in such jurisdictions typically book loans through branches in zero interest withholding countries.

<sup>50</sup> T.D. 8491, 1993-2 C.B. 215, preamble.

enough to capture a swap based on a U.S. real property index<sup>51</sup>.

- It is difficult to conceive of a principled distinction whereby Treasury could seek to characterize payments under single-instrument equity swaps as U.S. source dividends under a look-through rule, while permitting payments with respect to futures contracts tied to stocks (and indices of stock) to escape withholding tax. Nevertheless, the risk remains that Treasury will seek to exclude equity swaps from the residence-based source rules.
- The same tension between physical and virtual ownership arises with respect to swaps that mimic the performance of REITs and indices that track the value of U.S. real estate. Since foreign holders of U.S. real property are taxed on gain attributable to such property, it is not surprising that Treasury is thought to be considering whether to treat real estate based swaps as tantamount to the ownership of physical real estate for purposes of section 897.<sup>52</sup> In 2008, the IRS issued a Revenue Ruling clarifying that an interest in an NPC, the return on which is calculated by reference to certain indices that reference data from a broad range of U.S. real property, is not a U.S. real property interest under section 897 of the Code.<sup>53</sup>
- The IRS has emphasized its desire to issue more (and more timely) financial product guidance to

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<sup>51</sup> Lee Sheppard, “Derivatives Used to Beat Tax on Effectively Connected Income,” 113 *Tax Notes* 621 (Nov. 13, 2006).

<sup>52</sup> For a discussion of this issue, see J. Rubinger, “Can a Total Return Equity Swap Avoid FIRPTA?” 4 *Taxation of Financial Products*, 23 No. 2 (Spring 2003); Lee Sheppard, “Derivatives Used to Beat Tax on Effectively Connected Income,” 113 *Tax Notes* 621 (Nov. 13, 2006).

<sup>53</sup> Rev. Rul. 2008-31, 2008-26 I.R.B. 1180.

practitioners.<sup>54</sup> At the same time, the IRS warned taxpayers to expect increased enforcement in this area.<sup>55</sup> Congress has also emphasized the need for greater enforcement in this area.<sup>56</sup>

- On March 2, 2009, Senator Carl Levin introduced legislation (the “Levin Bill”) to impose a 30% dividend withholding tax on substitute dividend payments made under an NPC that are contingent upon or references dividend payments on U.S. equity securities.<sup>57</sup> The Levin Bill would impose withholding on substitute dividends even if the substitute dividends under the swap are netted against other payments so that no net payment is actually made.
- President Obama’s budget proposal for fiscal year 2010, released on May 11, 2009, (the “Obama Budget Proposal”) also contains a provision that would impose a 30% withholding tax on substitute dividend payments made on equity swaps or other NPCs that reference U.S.

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<sup>54</sup> See S. Young & Lee Sheppard, “Financial Products Official Wants faster Private Letter Ruling Process,” 2007 TNT 198-12 (Oct. 12, 2007); F. Stokeld, “Guidance on Notional Principal Contracts, Withholding Tax Under Consideration, Official Says,” 2007 TNT 200-4 (Oct. 16, 2007), J. Coder, “Treasury, IRS Officials Clarify Financial Guidance Comments,” 2007 TNT 205-2 (Oct. 23, 2007).

<sup>55</sup> See J. Coder, “IRS to Focus on New Financial Products, says Korb,” 2007 TNT 106-2 (June 1, 2007). As the Wall Street Journal has reported, the IRS issued information document requests to Citigroup and Lehman Brothers Holdings regarding their equity swaps with foreign counterparties. See J. Coder, “IRS Scrutinizing Wall Street’s Use of Derivatives,” 2007 TNT 140-4 (July 20, 2007). See H. Rothman, “Shulman Says Service Will Challenge Swap Securities Lending Transaction,” Daily Tax Rep. (BNA) No. 177 at GG-1 (Sept 12, 2008).

<sup>56</sup> See U.S. Senate Permanent Subcommittee On Investigations, “Divided Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividend,” 2008 TNT 178-27 (Sept. 12, 2008).

<sup>57</sup> S.506, 111<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2009).

equity securities.<sup>58</sup> The Obama Budget Proposal is narrower than the Levin Bill and would allow foreign taxpayers to avoid withholding on substitute dividends if the following six conditions are met:

- (i) the terms of the equity swap do not require the foreign person to post more than 20% of the value of the underlying stock as collateral, (ii) the terms of the equity swap do not include any provision addressing the hedge position of the counterparty to the transaction, (iii) the underlying stock is publicly traded and the notional amount of the swap represents less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume, (iv) the foreign person does not sell the stock to the counterparty at the inception of the contract (i.e., “cross-in”) or buy the stock from the counterparty at the termination of the contract (i.e., “cross-out”), (v) the prices of the equity that are used to measure the parties’ entitlements or obligations are based on objectively observable prices and (iv) the swap has a term of at least 90 days.

If either the Levin Bill or the Obama Budget Proposal becomes law, the ability of foreigners to avoid U.S. withholding tax through the use of equity swaps that are NPCs may be significantly reduced or even eliminated.

## **B. Cross-Border Securities Loans**

1. Definition Payments a lender is entitled to receive under the terms of a typical securities loan that are equal to any dividends or interest paid by an issuer on the borrowed securities are typically termed

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<sup>58</sup> Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals (May 11, 2009) (the “Greenbook”), *available at* <<http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>>.

“substitute payments.”<sup>59</sup> In addition to making substitute payments, a securities borrower generally pays a fee to the lender, which is sometimes termed a “borrow fee.” The securities lender also pays to the borrower a “rebate fee” equal to the earnings on the borrower’s collateral that secures the return of the borrowed securities. Borrow and rebate fees are typically netted in the case of cash collateral to produce a single payment.

2. Timing and Character of Income Revenue rulings treat substitute payments with respect to securities lending transactions as fees paid for the use of the securities that constitute ordinary income to the security lender.<sup>60</sup> In this regard, substitute payments to a lender in lieu of dividends paid on borrowed securities do not qualify for the dividends received deduction under section 243(a), regardless of the use of the borrowed securities, *i.e.*, to cover a short sale or a failed sale, because the lender is not considered the owner of the securities on the record date.<sup>61</sup> Further, substitute payments in lieu of dividends do not qualify for the lower 15% tax rate on “qualified dividends.”<sup>62</sup> Similarly, a securities

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<sup>59</sup> For another discussion on the U.S. federal income tax issues applicable to securities lending transactions, *see* M. Feder, “Securities Lending Transactions: Tax Considerations in Domestic and Cross-Border Transactions,” 3 *Taxation of Financial Products*, 11 No. 1 (Winter 2002).

<sup>60</sup> *See, e.g.*, Rev. Rul. 80-135, 1980-1 C.B. 18. However, at least with respect to a regulated investment company (a “RIC”) satisfying the diversification test of section 851(b)(3), a RIC may treat its position in a repurchase (repo) transaction as a government security as though the investment itself were a government security. *See* Rev. Proc. 2004-28, 2004-21 I.R.B. 984 (May 6, 2004).

<sup>61</sup> *See* T.D. 8735, 1997-2 C.B. 73, preamble; Rev. Rul. 60-177, 1960-1 C.B. 9; Priv. Ltr. Rul. 88-28-003 (Apr. 6, 1988), revoking Priv. Ltr. Rul. 85-38-001 (June 6, 1985).

<sup>62</sup> *See* H.R. Conf. Rep. No. 108-94, 108th Cong., 1st Sess., at 31 (2003). Thus, U.S. lenders may regard securities lending transactions as less favorable than direct investment in corporations that pay “qualified dividends,” while foreign lenders would be indifferent. To assist taxpayers in distinguishing between substitute payments in lieu of dividends and actual dividends, the IRS revised

lender is not entitled to treat substitute payments received for tax-exempt interest as the receipt of such interest in order to exclude the payments from income under section 103(a)(1).<sup>63</sup> However, the general rule that substitute payments do not constitute dividends or interest is subject to two important exceptions. First, substitute payments do retain their character as dividends or interest for purposes of determining character and source of the payments for U.S. withholding tax purposes under applicable Treasury regulations, as discussed below.<sup>64</sup> Second, substitute payments are essentially characterized as dividends or interest, as the case may be, in the hands of RICs and tax-exempt lenders.<sup>65</sup>

- As discussed in more detail below in the section of this outline dealing with forward contracts,<sup>66</sup> the IRS takes the position that a stock loan coupled with a forward purchase contract between the same parties covering the same shares will result in a current sale of those shares.<sup>67</sup>

### 3. Source of Income Before the promulgation of the Substitute Payment Regulations, substantial uncertainty existed regarding the source of

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the Treasury regulations pertaining to the reporting of substitute payments, obligating brokers to report substitute payments in lieu of dividends to the IRS and to their individual customers. These statements are made on Form 1099-MISC and not on Form 1099-DIV. T.D. 9103, 2004-3 I.R.B. 306; *see also* IRS Notice 2003-67, 2003-40 I.R.B. 1 (Sept. 16, 2003).

<sup>63</sup> *See* T.D. 8735, 1997-2 C.B. 73, preamble; Rev. Rul. 80-135, 1980-1 C.B. 18 (lender of municipal bond not entitled to exclude short interest from income).

<sup>64</sup> *See* Treas. Reg. §§ 1.861-2(a)(7), 1.861-3(a)(6), 1.864-5(b)(2)(ii), 1.871-7(b)(2), 1.881-2(b)(2), 1.894-1(c), 1.1441-2(a) (collectively, the “Substitute Payment Regulations”).

<sup>65</sup> *See* I.R.C. §§ 512(b)(1), 851(b)(2).

<sup>66</sup> *See* Section II.D.

<sup>67</sup> T.A.M. 2006-04-033 (Jan. 27, 2006); A.M. 2007-004 (Jan. 24, 2007); Coordinated Issue Paper LMSB-04-1207-077 (Feb. 6, 2008).

substitute payments, borrow fees paid to lenders and rebate fees paid to borrowers in connection with cross-border securities loans. The income sourcing rules, which generally source income by the location where the income-producing asset was used, were difficult to apply in the context of securities loans, since the location of securities may not be known and is also subject to change. As a result, taxpayers relied on several theoretical bases for sourcing payments from securities lending transactions prior to the issuance of the Substitute Payment Regulations.<sup>68</sup> The regulations have eliminated taxpayers' ability to rely on these theories for substitute payments, other than fees or interest paid to transferees, made after November 13, 1997. However, such theories have continuing applicability to the fees and interest components of securities loans and sale-repurchase transactions that are not addressed by the Substitute Payment Regulations.

- Some lenders sourced substitute payments based on the physical location of the securities, relying on the rental income source rules.<sup>69</sup> However, even when the physical location of securities could be fixed, it was not clear under a physical location rule whether substitute payments should have been sourced where a securities borrower used the securities or where it did business. Moreover, where a borrower subsequently transferred the borrowed securities to a third party, a physical location source rule may have caused the payments to be sourced in a location (where the borrower did business) that bore no relationship to the actual location of the securities (where a third party, or subsequent purchaser, held the securities).

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<sup>68</sup> As might be expected, the chosen method of sourcing generally depended on an individual taxpayer's facts and circumstances.

<sup>69</sup> I.R.C. §§ 861(a)(4), 862(a)(4); *see also* Treas. Reg. § 1.856-4(b)(1); *Loan Coal and Timber Association v. Helvering*, 122 F.2d 848, 850 (3d Cir. 1941) (rent is compensation for the right to use property, where payments are fixed and certain in amount and are payable periodically without regard to the use of the property).

- Substitute payments were also sourced according to the location where the securities lending transaction occurred, consistent with the source rules for loans and other financial transactions.<sup>70</sup> Another sourcing alternative was the location of the security issuer, based on the dividend and interest source rules. Finally, payments were sourced on the basis of the residence of either the borrower<sup>71</sup> or the lender.<sup>72</sup> Commentators consistently suggested sourcing fees according to the lender's residence, which would be consistent with the sourcing rules applied to payments under NPCs.<sup>73</sup>
- Prior to the issuance of the Substitute Payment Regulations, U.S. holders typically treated substitute payments on borrowed securities as foreign source income rather than U.S. source income on the theory that the borrower's return of the securities depended solely on the borrower's creditworthiness. As a result, where a U.S. lender was engaged in business and the borrower was a qualified resident of a treaty country, payments to the U.S. lender would be exempt from foreign withholding as business profits. Thus, substitute payments would be treated as foreign source income that was not

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<sup>70</sup> See, e.g., *Bank of America v. U.S.*, 680 F.2d 142 (Ct. Cl. 1982) (source of commissions earned from transactions with respect to letters of credit issued by foreign banks depends on economic substance of transaction); *Helvering v. Stein*, 115 F.2d 468 (4th Cir. 1940); *Zander & Cia v. Commissioner*, 42 B.T.A. (1940).

<sup>71</sup> See I.R.C. § 988(a)(3)(B) for a definition of residence for this purpose.

<sup>72</sup> See Treas. Reg. § 1.863-7.

<sup>73</sup> Treas. Reg. § 1.863-7; see New York State Bar Association Tax Section, Report on Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions, 92 TNT 151-38 (July 24, 1992) (the "1992 NYSBA Report"); ABA Section of Taxation, Committee on Financial Transactions, Report on the Proposed Cross-Border Securities Lending Regulations, 92 TNT 87-38 (Apr. 23, 1992) (the "1992 ABA Report").

subject to foreign tax, but would nevertheless increase the U.S. lender's foreign source income and thus the lender's allowable foreign tax credit.<sup>74</sup> U.S. holders of securities in excess foreign tax credit positions that could increase their allowable credits by loaning securities to foreign borrowers would certainly have advocated this result.

4. Effect of Substitute Payment Regulations In response to the uncertainty that had contributed to the disparate tax treatment of payments pursuant to securities loans, Treasury issued the Substitute Payment Regulations in 1997 to address the character, source and tax treaty treatment of substitute dividend and interest payments between U.S. and foreign parties in securities loan transactions and "substantially similar transactions," including substitute payments made in sale-repurchase (repo) transactions.<sup>75</sup> However, these regulations are not comprehensive, and thus uncertainty persists with respect to certain payments

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<sup>74</sup> U.S. taxpayers could also have acquired other securities, such as securities issued by foreign governments, that would similarly have produced passive foreign source income (for taxpayers other than financial services entities) that was exempt from foreign tax. However, since such investments typically entailed greater risk than securities loans, many U.S. taxpayers preferred to increase their allowable foreign tax credits through securities loans to foreign borrowers.

<sup>75</sup> Treas. Reg. §§ 1.861-2(a)(7) (substitute interest payments made or received in cross-border securities lending transactions treated as interest income for source purposes); 1.861-3(a)(6) (substitute dividend payments made or received in cross-border securities lending transactions treated as dividend income for source purposes); 1.871-7(b)(2) (substitute interest and dividend payments treated as interest or dividend payments, respectively, for withholding tax purposes); 1.881-2(b)(2) (same); 1.894-1(i)(c) (same for treaty purposes) and 1.1441-2(a) (same for withholding tax purposes). Although the Substitute Payment Regulations do not define "substantially similar transactions," the intent appears to be to apply the regulations to transactions that are economically similar to the transactions described in section 1058, but fail to satisfy the technical requirements of that section.

and transactions that are not within the scope of the regulations.<sup>76</sup>

- Generally, section 162 allows both corporate and individual taxpayers to deduct currently any ordinary and necessary expenses incurred in carrying on any trade or business, and section 212 permits an individual to deduct all expenses that arise in connection with the production of income even if the activities that give rise to the expense do not constitute a trade or business. Therefore, an individual taxpayer making a substitute dividend payment may be able to deduct the amount of any substitute payments in connection with a securities loan as an investment expense (subject to the usual limitations on miscellaneous itemized deductions).<sup>77</sup> However, because no statutory deduction exists for a corporation's non-trade or business investment expenses, it is not clear whether a corporation not engaged in the business of dealing or trading in securities may deduct a substitute dividend or interest payments on its securities loans.<sup>78</sup> Corporations that are traders or dealers in stock or securities should be able to deduct substitute dividend or interest payments, subject to other

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<sup>76</sup> See, e.g., T.A.M. 2002 07 003 (Oct. 23, 2001) (repo transactions in a dealer's "matched book" generated interest income and expense rather than net fee income).

<sup>77</sup> See generally I.R.C. § 263(h). Cf. Rev. Rul. 72-521, 1972-2 C.B. 178 (acknowledging general deductibility rule for individual taxpayers but not for corporate taxpayers).

<sup>78</sup> See Gen. Couns. Mem. 37,513 (Apr. 25, 1978) (stating that all profit-making activities of a corporation are conducted as part of a corporation's trade or business); but see *Maine Line Distributors, Inc. v. Commissioner*, 37 T.C. 1090 (1962); *1955 Production Exposition, Inc. v. Commissioner*, 41 T.C. 85 (1963) (stating that corporate taxpayers that are not dealers or traders in securities cannot deduct substitute payments); Gen. Couns. Mem. 38,694 (Apr. 15, 1981) (suggesting that corporate taxpayers that are not dealers or traders in securities should not be able to deduct substitute payments under section 162).

restrictions on a corporation's ability to deduct such expenses.<sup>79</sup>

- The Substitute Payment Regulations treat substitute payments pursuant to a cross-border securities lending transaction as interest or dividend income on a look-through basis, depending on the type of underlying security, solely for purposes of determining the character and source of the payments.<sup>80</sup> In the typical case where foreign holders lend debt securities to a U.S. borrower, the look-through rule would permit substitute payments of interest to qualify as portfolio interest that is exempt from U.S. withholding tax, assuming proper documentation is timely provided to the withholding agent.<sup>81</sup> Whether the look-through rule will prevent foreign holders from characterizing the payments as other than dividend income, *i.e.*, as business profits, under the terms of a tax treaty with the United States, will depend on the terms of a specific treaty, as discussed below.

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<sup>79</sup> See, e.g., I.R.C. § 163(j).

<sup>80</sup> Treas. Reg. §§ 1.861-2(a)(7), 1.861-3(a)(6), 1.871-7(b)(2), 1.881-2(b)(2), 1.894-1(c), 1.1441-2(a). As discussed above, such substitute payments do not qualify as dividends or interest for purposes of qualifying for the dividends received deduction or excluding tax-exempt interest from income. See T.D. 8735, 1997-2 C.B. 73, preamble.

<sup>81</sup> The adoption of this look-through rule insures that a foreign holder that has lent securities it owns to a U.S. borrower will continue to obtain the same U.S. withholding tax results attendant to direct ownership of the borrowed securities. For example, if a foreign owner of U.S. equity securities loans its securities to a U.S. borrower in a section 1058 (or substantially similar) transaction, the substitute dividend payments the U.S. borrower makes to the foreign lender would be treated as U.S. source dividend income. As such, the lender's payments generally would be subject to the 30% U.S. withholding tax, but many qualified residents of countries with U.S. tax treaties would pay a reduced amount of U.S. withholding tax, under the terms of those treaties.

- The Substitute Payment Regulations also treat substitute payments as dividends or interest for purposes of the relevant provisions of income tax treaties between the U.S. and foreign countries wherever a treaty refers to U.S. tax law definitions of dividends or interest.<sup>82</sup> However, the regulations may nonetheless mandate look-through treatment only with respect to foreign securities lenders that are resident in certain treaty countries, because many treaties do not contain clear references to U.S. tax law definitions.
- For example, the Trinidad/Tobago treaty with the United States defines dividends for U.S. tax purposes as “any item which under the law of the United States is treated as a distribution out of earnings and profits.”<sup>83</sup> The former U.S.-U.K. treaty also contained the same language. Because substitute dividend payments are not distributions out of earnings and profits, such payments may not be covered by the dividend article of the Trinidad/Tobago treaty, notwithstanding the intent of the Substitute Payment Regulations to effect dividend treatment. As a result, substitute payments to lenders in Trinidad/Tobago may be exempt from U.S. withholding tax under the treaty if the payments constitute “business profits” or “other income” to the lender.
- The 2006 Model Treaty omits the zero rate of withholding on parent-subsidiary dividends and dividends paid to pension funds, as well as the zero rate of branch profits tax.<sup>84</sup> The New York State Bar Association’s comments to the Model Treaty question the wisdom of a 15% rate on dividends paid to investment companies that

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<sup>82</sup> See Treas. Reg. § 1.894-1(c).

<sup>83</sup> See, e.g., U.S.-Trinidad/Tobago Treaty, Article 12(3).

<sup>84</sup> United States Model Income Tax Convention, Nov. 15, 2006, available at <http://www.ustreas.gov/offices/tax-policy/library/model006.pdf>.

primarily invest in REITs since that lower rate is not available to REITs themselves.<sup>85</sup>

- To the extent a substitute payment may be viewed as a fee for the temporary use of property, query whether substitute dividend payments may be viewed as rental income, which qualifies under many treaties as “industrial or commercial profits,” “business income,” or “other income.” This characterization would enable certain taxpayers to avoid U.S. withholding tax on the payments under various tax treaties, because payments that constitute business income or other income generally are not subject to U.S. withholding tax if made to a treaty-protected taxpayer whose activities constitute a trade or business, as long as the payments are not connected with a U.S. permanent establishment of the taxpayer.<sup>86</sup>
- Under this theory, borrow fees paid in connection with securities loans also may be exempt from withholding under tax treaties that impose tax on income not specifically addressed in the treaty only in the recipient taxpayer’s country of residence.<sup>87</sup> In one ruling the IRS concluded that borrow fees received in connection with a taxpayer’s trade or business may constitute “industrial and commercial

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<sup>85</sup> Patrick Gallagher, “NYSBA Members Submit Report, Recommendations on New Model Income Tax Treaty,” 2007 TNT 72-15 (April 13, 2007).

<sup>86</sup> Under this analysis, however, lenders resident in countries that do not have tax treaties with the United States, and lenders who are not engaged in the business of investing in (and lending) securities may be subject to U.S. withholding tax.

<sup>87</sup> *See, e.g.*, U.S. Income Tax Treaties with France, Germany, Hungary, Italy, Malta, Spain and the United Kingdom; *see also* 1981 Treasury Department Model Income Tax Treaty, Article 21.1; Priv. Ltr. Rul. 88-22-061 (Mar. 7, 1988) (fees paid to lender are “industrial or commercial profits” and so are exempt from U.S. withholding tax under the relevant treaty where lender had no U.S. permanent establishment, but actively conducted an insurance business).

profits” for income tax treaty purposes.<sup>88</sup> Notably, however, the IRS no longer rules on this issue,<sup>89</sup> and in the absence of a treaty-based withholding exemption and because of the uncertainty regarding the treatment of borrow fees, the IRS may argue that borrow fees are “fixed or determinable, annual or periodical income” that is otherwise subject to a 30% withholding tax.<sup>90</sup> However, there is no clear authority for this position since the Substitute Payment Regulations do not address borrow fees. Consequently, because no formal guidance has set forth the manner in which borrow fees are sourced or characterized, borrowers remain free to treat borrow fees as foreign source income that is not subject to U.S. withholding tax to the extent permitted under the general source rules, as discussed below.

- Notably, the proposed Substitute Payment Regulations did not apply to substitute dividend and interest payments between U.S. borrowers and U.S. lenders of foreign securities.<sup>91</sup> As a result, the same substitute payment on a security of a foreign issuer may have been foreign source income if the security borrower was foreign and U.S. source income in the case of a U.S. borrower.<sup>92</sup> Substitute payments would also have been differently sourced for U.S. branches of foreign persons and for U.S. persons. This would have been an unusual and undesirable result that would not have been consistent with the intent of the branch profits tax, because the

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<sup>88</sup> Priv. Ltr. Rul. 88-22-061 (Mar. 7, 1988).

<sup>89</sup> See Rev. Proc. 2009-7, 2009-1 I.R.B. 226 (Jan. 5, 2009) (IRS ordinarily will not rule on source, character or income tax treaty treatment of any payments in securities lending transactions).

<sup>90</sup> See I.R.C. §§ 1441, 1442.

<sup>91</sup> See 1992 NYSBA Report.

<sup>92</sup> This result would make loans of foreign securities less attractive to U.S. lenders in an excess foreign tax credit position that are seeking to generate additional foreign source income.

proposed Substitute Payment Regulations applied to all payments to foreign persons, including foreign persons engaged in a U.S. trade or business. The Substitute Payment Regulations remedy this inconsistent treatment by (i) applying the sourcing rule to all substitute payments, regardless of whether the recipient of the income is U.S. or foreign, and (ii) limiting the “look-through” approach to substitute payments made to foreign persons not engaged in a U.S. trade or business.<sup>93</sup>

- Because the Substitute Payment Regulations do not address the tax treatment of borrow fees and interest paid to lenders or rebate fees paid to borrowers in connection with securities loans and repurchase transactions,<sup>94</sup> such fees may be sourced differently than substitute payments from the same securities loan or repurchase transaction, since lenders can be expected to continue to source their fees under the varying theories discussed above in the absence of specific guidance.
- The IRS has historically viewed rebate fees paid by U.S. lenders to foreign borrowers from earnings on collateral as U.S. source interest income.<sup>95</sup> Even under a U.S. source characterization of rebate fees, however, a determination must then be made as to whether the rebate fee is effectively connected with a foreign borrower’s U.S. trade or business, and whether the rebate fee qualifies for a U.S. withholding tax exemption as either portfolio interest (if the underlying debt security is in either registered or bearer form) or short-term original issue discount.

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<sup>93</sup> See T.D. 8735, 1997-2 C.B. 73, preamble.

<sup>94</sup> The IRS has invited comments concerning the proper tax treatment of such fees and of certain repo transactions and equity-based NPCs. See T.D. 8735, 1997-2 C.B. 73, preamble.

<sup>95</sup> See *Deputy v. Du Pont*, 308 U.S. 488 (1939).

- A 2002 Technical Advice Memorandum states that repurchase transactions and reverse repurchase transactions give rise to interest expense and interest income respectively (rather than fees or fee income), that must be sourced separately under the rules applicable to each, and may not simply be netted in “matched book” repurchase transactions in which the operator simply earns a spread.<sup>96</sup>
- The Substitute Payment Regulations do not address the foreign tax credit treatment of substitute payments, since the look-through rules do not apply for purposes of sections 901 and 903 and the Substitute Payment Regulations do not affect the determination of the payer of a foreign tax for purposes of the foreign tax credit rules.<sup>97</sup> More specifically, they do not discuss whether a U.S. lender of stock in a foreign corporation may claim the deemed-paid credit for foreign taxes that generally is permitted on the receipt of dividends from a 10% or more owned foreign corporation.
- The Substitute Payment Regulations also do not address the potential for the payment of multiple withholding taxes in connection with back-to-back securities loans and sale-repurchase

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<sup>96</sup> See T.A.M. 2002-07-003 (Oct. 23, 2001) (noting that Temporary Treasury Regulation section 1.861-10T(c)(1) does not permit integration for matched book repurchase transactions); see also Rev. Rul. 79-195, 1979-1 C.B. 177; Rev. Rul. 79-108, 1979-1 C.B. 209; Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 74-27, 1974-1 C.B. 24; *Nebraska Dept. of Rev. v. Lowenstein*, 513 U.S. 123 (1994). For an interesting discussion of repurchase transactions, see R. Rudnick and K. Garry, “The Ultimate, Definitive Federal Income Tax Treatment of Real Repo Transactions,” 5 *Taxation of Financial Products*, 47 No. 4, (2005). In that article, the authors argue by analogy to securities lending transactions and section 1058 that the ability of the purchaser/lender in a repurchase transaction to sell or hypothecate the repoed securities should not prevent the transaction from being treated as a secured financing rather than a sale.

<sup>97</sup> T.D. 8735, 1997-2 C.B. 73, preamble.

transactions. Notice 97-66 was subsequently issued to address this issue by limiting total withholding tax liability on such transactions. Under the Notice withholding tax on foreign-to-foreign payments that form the second leg of such transactions generally equals the product of (i) the payment, and (ii) the excess of (x) the U.S. withholding tax rate for such a U.S. source payment by a U.S. person to the substitute payment recipient, over (y) the U.S. withholding tax rate for such a U.S. source payment made by a U.S. person to the payer of the substitute payment. However, the resulting withholding tax may be reduced or eliminated to the extent that total withholding payments on all legs of the transaction would otherwise exceed the U.S. withholding tax that would have been imposed on U.S. source payments by a U.S. person directly to the payer of the substitute payment.<sup>98</sup>

- The Obama Budget Proposal would revoke Notice 97-66 and replace it with new guidance that would impose dividend withholding tax on securities loans that otherwise improperly avoid withholding tax on dividends while minimizing over-withholding.<sup>99</sup> It is unclear what this guidance will provide.
- The enforceability of certain provisions of the Substitute Payment Regulations is uncertain. There is little dispute that authority exists under sections 863(a) and 865(j)(2) permitting the Substitute Payment Regulations to determine the source of substitute payments under securities loans. It is less clear, however, that

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<sup>98</sup> See Notice 97-66, 1997-2 C.B. 328. It is not clear whether Notice 97-66 covers both substitute dividend and interest payments. See generally M. Feder, "Securities Lending Transaction: Tax Considerations in Domestic and Cross Border Transactions," 3 *Taxation of Financial Products*, 11 No. 1 (Winter 2002).

<sup>99</sup> Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (May 11, 2009) (the "Greenbook"), available at <<http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>>.

such authority permits inconsistent determinations of the character of securities loan substitute payments for foreign and domestic tax purposes in the absence of legislation.<sup>100</sup> It is interesting to note in this regard that statutory authorization exists in each other case where substitute dividend and interest payments on securities loans are characterized on a look-through basis.<sup>101</sup> It is also not clear whether and to what extent the Substitute Payment Regulations will operate to characterize substitute payments as dividends under the terms of tax treaties with the United States, as discussed above.<sup>102</sup>

- If A loans equity to B, and B makes substitute dividend payments to A for the life of the loan, then A would be the tax owner of the underlying equity and would be taxed on receipt of these substitute dividend payments accordingly. But if B sells the equity to C, the substitute dividend payments B continues to pay to A ought not to be subject to withholding tax. In that case, the Service ought to impose the withholding tax only on C. Correct treatment of situations in which B (i) owns the underlying equity (x) for less than the full life of the swap or (y) potentially to hedge a second swap it enters into, or (ii) sells the underlying equity to an affiliate with which B shares a parent, remain unclear.<sup>103</sup>
- The treatment adopted by the Substitute Payment Regulations is inconsistent with the treatment of dividends and interest employed in

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<sup>100</sup> See generally 1992 NYSBA Report.

<sup>101</sup> I.R.C. §§ 512(b)(1), 851(b)(2).

<sup>102</sup> See David Hariton, "Withholding on Cross-Border Stock Loans and Other Equity Derivatives," 72 *Taxes* 1050 (Dec. 1994) and David Hariton, "Equity Derivatives, Inbound Capital and Outbound Withholding Tax," *Tax Lawyer*, Vol. 60, No. 2 (Winter 2007) for a thorough discussion of this issue.

<sup>103</sup> David Hariton, "Equity Derivatives, Inbound Capital and Outbound Withholding Tax," *Tax Forum* No. 594 (Nov. 6, 2006).

other cross-border financial transactions, most notably those involving NPCs. For example, dividend equivalent payments made in connection with equity index swaps are not treated as dividend payments for purposes of determining the character and source of the payments.<sup>104</sup> Because the IRS offers no rationale for the look-through rule, it is difficult to reconcile this contradictory treatment on any principled basis. If the IRS seeks to extend look-through treatment to substitute payments on equity swaps, the same issue of whether such treatment requires a legislative change will obviously be revisited.<sup>105</sup>

### C. Option Contracts

1. Definition An option purchaser pays a premium to the writer/grantor of the option for the right (but not obligation) to sell/put or purchase/call specified property at a specified time and strike price. European-style options have a single exercise date, while American-style options can be exercised at any time during their term. Options generally may be physically or cash settled, except that options on indices or with respect to interest rates must be cash settled. Options may be standardized and traded on exchanges, or they may be privately negotiated and held or placed. Traded options may be settled by entering into an offsetting position on the same exchange. In addition to being used for directional

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<sup>104</sup> See Treas. Reg. §§ 1.863-7, 1.988-4. However, as discussed above, both the Levin Bill and the Obama Budget Proposal may treat dividend equivalent payments made in connection with equity swaps as dividend payments.

<sup>105</sup> See Preamble to the Proposed Substitute Payment Regulations 57 Fed. Reg. 860-01 (Jan. 9, 1992). (“The Service is considering whether the proposed regulations should apply to dividend equivalent payments made in connection with certain NPCs, such as an equity index swap structured to replicate the cash flows that would arise from an installment purchase of one or more equity securities.”). See also Lee Sheppard, “Getting Around the Substitute Payment Withholding Rules,” 2007 TNT 186-5 (Sept. 24, 2007).

bets, options may also constitute straddles and/or hedges.

2. Timing of Income Recognition The purchase and sale of an option generally is not a taxable event to either party to the transaction (unless the option is so deep-in-the-money when written or purchased that it is virtually certain to be exercised).<sup>106</sup> The writing and purchase of an option is generally treated as an open transaction until a further event establishes gain or loss.<sup>107</sup> It is important to note, however, that this open transaction treatment may be overridden by specific rules governing certain options. For example, sections 1256 and 475 each require that certain traded options and options held by dealers (or electing traders), respectively, be marked-to-market each year.<sup>108</sup>
  - An option purchaser (holder) recognizes gain or loss on a sale, lapse, or termination of the option equal to the amount realized (if any), less the option premium and any related costs.<sup>109</sup> If an option is exercised, the purchaser of the option must take the premium into account as an adjustment to the basis of the property being purchased or sold.<sup>110</sup> For example, the purchaser (holder) of a call option generally recognizes no gain or loss on exercise of the option; instead, the purchaser adds the option

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<sup>106</sup> See Rev. Rul. 85-87, 1985-1 C.B. 269; Rev. Rul. 82-150, 1982-2 C.B. 110.

<sup>107</sup> See Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 78-181, 1978-1 C.B. 261; Rev. Rul. 58-234, 1958-1 C.B. 279.

<sup>108</sup> See I.R.C. § 1256(a), (b), (g)(3)-(6); I.R.C. § 475(a), (c)(2)(E).

<sup>109</sup> I.R.C. § 1234(a); see Rev. Rul. 78-182, 1978-1 C.B. 265. Note, however, corporations generally do not recognize gain or loss with respect to any exercise, sale, assignment, termination, or lapse of an option to buy or sell its stock (including treasury stock) under section 1032, unless the consideration it delivers consists of appreciated property (other than cash). Query, however, whether nonqualified preferred stock would be treated as stock for purposes of section 1032.

<sup>110</sup> See Rev. Rul. 88-31, 1988-1 C.B. 302.

premium (and any related costs) to its basis in the property acquired on exercise unless an option is subject to either the section 988 rules or the mark-to-market rules under section 1234(c)(1). Similarly, the purchaser of a put option adds the option premium to the basis of any property that is delivered on the exercise of the put option.<sup>111</sup> As discussed below, an option holder's current recognition of losses on options that are hedges or straddles also may be deferred under certain circumstances.

- The writer (grantor) of an option recognizes gain or loss on exercise by the holder (*i.e.*, delivery), sale, assignment, termination, or lapse of the option. A call option writer's gain or loss on an exercise is measured by the difference between the grantor's basis in the optioned property and the sum of the option strike price plus the option premium.<sup>112</sup> Gain or loss on sale or assignment of the option itself equals the amount of the premium less any payment to the transferee of the grantor's obligations, or, on termination, less any payment by grantor to terminate. The premium is the amount of the grantor's gain on a lapse of the option.<sup>113</sup>
3. Character of Income An option purchaser's income, gain or loss with respect to an option is treated as derived from a sale of the optioned property.<sup>114</sup> Whether such gain or loss is long-term or short-term capital gain or loss depends on the option purchaser's holding period.<sup>115</sup>
- An option grantor (writer) generally recognizes short-term capital gain or loss with respect to an

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<sup>111</sup> See Rev. Rul. 71-521, 1971-2 C.B. 313.

<sup>112</sup> See I.R.C. § 1234(b); F.S.A. 2000-11-006 (Mar. 17, 2000); Priv. Ltr. Rul. 86-44-002 (July 17, 1986); Rev. Rul. 78-182, 1978-1 C.B. 265.

<sup>113</sup> See Rev. Rul. 82-150, 1982-2 C.B. 110.

<sup>114</sup> I.R.C. § 1234(a).

<sup>115</sup> See Treas. Reg. § 1.1234-1(a).

option on stocks, securities or commodities, unless (i) the option is inventory of the grantor, (ii) the 60/40 futures contract rule of section 1256 applies because the option is marked-to-market, (iii) the option produces foreign currency gain or loss, (iv) the option is a hedge and section 1221(a)(7) or Treasury Regulation section 1.1221-2 applies, or (v) the option is part of a conversion transaction under section 1258.<sup>116</sup> Gain or loss with respect to options on other property that would be a capital asset in the hands of the grantor will be subject to the ordinary holding period rules.<sup>117</sup> Treasury Regulations provide that regardless of their character, option premiums do not constitute FDAP income.<sup>118</sup>

- If a taxpayer is the holder of a call option and the grantor of a put option with respect to certain pass-thru “financial assets,” and the options have substantially equal strike prices and substantially contemporaneous maturity dates, the constructive ownership rules<sup>119</sup> would limit the amount the taxpayer could recognize as long-term capital gain on a disposition to the amount of such gain the taxpayer would have recognized if it had held the financial asset directly during the term of the option. Any additional gain would be treated as ordinary income, accrued over the term of the option at a constant rate. Such recharacterized gain would be taxed at the highest marginal rate applicable to each taxable year and an interest charge would be imposed based on the proper inclusion of the recharacterized gain in the taxpayer’s income over the term

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<sup>116</sup> See I.R.C. § 1234(b); Treas. Reg. § 1.1234-3, -4.

<sup>117</sup> I.R.C. § 1234A.

<sup>118</sup> Treas. Reg. § 1.1441-2(b)(2)(i).

<sup>119</sup> I.R.C. § 1260.

of the option at a constant rate.<sup>120</sup> However, these rules would not apply if both options are marked-to-market.<sup>121</sup>

4. Source of Income Gain on the disposition, settlement or lapse of an option contract is generally sourced according to the residence of the contract holder receiving the gain. Thus, capital gain recognized by a foreign holder would be foreign source gain that would not be subject to U.S. tax, unless the gain is effectively connected with a foreign holder's U.S. trade or business.<sup>122</sup>

#### **D. Forward Contracts**

1. Definition A forward contract is a privately negotiated agreement to purchase and sell property on a fixed, future date for a specified price. Parties generally exchange property, although a forward contract may permit cash settlement. Typically, the parties to a forward contract do not exchange any payments when the contract is executed; however, so-called "prepaid" forward contracts require the buyer of the forward to prepay its obligations under the contract. Because forward contracts are not regulated, they entail counterparty credit risk not present in exchange traded futures contracts.
2. Timing of Income Recognition Forward contracts that are not part of a hedge or a straddle are not marked to market unless held or entered into by a dealer (or electing trader) subject to section 475. Gain or loss generally is not recognized until the contract is settled or sold unless the forward contract represents a "constructive sale" under

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<sup>120</sup> See I.R.C. § 1260(b).

<sup>121</sup> See I.R.C. § 1260(d)(2).

<sup>122</sup> Section 865(j)(2) authorizes the Treasury department to promulgate regulations governing the source of gain from dispositions of forward contracts, futures, options and other financial products. No regulations have been promulgated to date.

section 1259.<sup>123</sup> At that point, the deliverer, but not the recipient, recognizes gain or loss. However, the recipient of property pursuant to a forward contract generally is not taxed upon physical settlement of the contract. Rather, the recipient's basis in the forward contract becomes its basis in the property and the recipient is not taxed until disposition of the property. Forward contracts involving foreign currency will trigger gain or loss to the recipient measured by a deemed sale on the settlement date.<sup>124</sup>

- Forward sales by corporations of their stock should be included within the scope of section 1032, which generally provides for nonrecognition of gain or loss on the receipt of money or property in exchange for a corporation's stock or with respect to options to buy or sell its stock.<sup>125</sup> However, under the Obama Budget Proposal, a portion of the forward payment received by a corporation on a

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<sup>123</sup> One type of transaction targeted by section 1259 is a short sale of securities by a holder of such securities (a "short against the box"). A holder can go short against the box by selling short other shares of the same stock in the cash market or by presently contracting to sell its securities on a future date through a forward, futures or options contract. Under prior law, a taxable disposition of the shares sold short did not occur until securities were delivered to close the short sale. By contrast, section 1259 treats a taxable disposition as occurring when the holder enters into the contract to sell the securities. However, an investor directing a broker to close out a short sale by purchasing stock does not realize a loss until the short sale is closed by delivery of the stock. *See* Rev. Rul. 2002-44, 2002-28 I.R.B. 1. Further, an investor that borrows securities from a second broker to satisfy its initial obligation under a short sale of a first broker is not deemed to close the short sale until the investor delivers securities to the second broker. *See* Rev. Rul. 2004-15, 2004-8 I.R.B. 515.

<sup>124</sup> I.R.C. § 988(c)(5); Treas. Reg. § 1.988-2(d)(2)-(4).

<sup>125</sup> *See, e.g.*, Harold Handler, "NYSBA Report on Proposed Changes to Corporate Own-Stock Regs.," 1999 TNT 119-22 (June 15, 1999). In 2000, section 1032 was amended to include a "securities futures contract" (within the meaning of section 3(a)(55)(A) of the 1934 Act) to buy or sell a corporation's stock. I.R.C. § 1032(a).

forward contract to sell its own stock would be treated as an interest payment.<sup>126</sup>

3. Variable Prepaid Forward Contracts Variable prepaid forward contracts, designed to allow shareholders to monetize a significant portion of their appreciated publicly traded stock while deferring tax liability, have been a widely employed planning technique although the availability of the intended tax treatment was historically unclear. However, in 2003 the IRS issued a significant Revenue Ruling confirming that a shareholder who pledges shares under a variable prepaid forward contract has neither currently sold such shares under section 1001, nor constructively sold shares under section 1259, as long as (i) the shareholder retains an unrestricted legal right to substitute cash or other property for the pledged shares, and (ii) the shareholder is not economically compelled to deliver the pledged shares.<sup>127</sup> Thus, the parties typically treat the arrangement as a financing secured by, and payable in, the pledged shares.
  - This monetization technique may have lost some of its attractiveness after the enactment of the American Jobs Creation Act of 2004, which denies an interest deduction to a corporation for interest payable in equity (including equity of unrelated third parties) owned by the corporation. Instead, interest paid in such pledged shares must be capitalized.<sup>128</sup>

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<sup>126</sup> Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (May 11, 2009) (the "Greenbook"), available at <<http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>>.

<sup>127</sup> See Rev. Rul. 2003-7, 2003-5 I.R.B. 363. For an excellent discussion of Revenue Ruling 2003-7, see R. Lipton, "New IRS Ruling Sanctions Some Variable Prepaid Forward Contracts," 6 *J. Tax'n of Passthrough Entities* 29 No. 3 (May-June 2003). For an example of the IRS' application of this revenue ruling, see T.A.M. 2003-41-005 (Oct. 10, 2003).

<sup>128</sup> Pub. L. No. 108-357, 108th Cong., 2d Sess., § 845(a). Prior to this legislation, section 163(l) denied a deduction to a corporation for

- The ability of a taxpayer to rely on this Revenue Ruling may be in question when the forward contract is coupled with a securities lending arrangement. In a 2006 Technical Advice Memorandum, the IRS held that a forward contract coupled with a pledge of shares was a taxable disposition because the taxpayer concurrently loaned the shares to the counterparty and the counterparty sold the shares. The cumulative effect, the IRS held, was a taxable disposition of the shares by the taxpayer.<sup>129</sup> The IRS restated its position and expanded its analysis slightly in generic legal advice memorandum AM 2007-004.<sup>130</sup> Relying on substance-over-form authorities, the AM distinguished Revenue Ruling 2003-7 and instead focused on the “economic realities” of the transaction, concluding that the offsetting contracts resulted in a current sale of stock by the taxpayer to the nominal borrower in exchange for cash and “a variable right to receive stock in the future” equal to the difference between the fair market value of the

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interest on any of its debt that was payable in equity of the corporation or a related party (within the meaning of section 267(b) or 707(b)), but not if such interest was payable in third-party equity owned by the corporation (or any related party).

<sup>129</sup> T.A.M. 2006-04-033 (Jan. 27, 2006). For additional analysis of this Technical Advice Memorandum, see J. Rubinger, “Taxation of Variable Prepaid Forward Contracts Uncertain (Once Again) in Light of Recent TAM,” 104 *J. Tax’n* 296 No. 5 (May 2006); Lee A. Sheppard, “Should Share Lending Affect a Prepaid Forward Contract?” 110 *Tax Notes* 12 (Jan. 9, 2006); Kenneth Gideon “Skadden Arps Seeks Guidance on Tax Treatment of Variable Prepaid Forward Contracts,” 2006 TNT 217-30 (Nov. 2, 2006) (Gideon argues that TAM 2006-04-033 “misreads section 1058 and its history and is erroneous”, because ownership does not pass until delivery of the forward purchased property occurs, and is inconsistent with Revenue Ruling 72-478, which holds that a taxpayer that has a forward obligation as the result of a short sale, and enters into a securities lending agreement with his broker to lend a sufficient number of shares to close the short position, does not close the short sale). See also Lee Sheppard, “Your Government at Work On Financial Products,” 2007 TNT 89-3 (May 7, 2007).

<sup>130</sup> AM 2007-004 (Jan. 24, 2007).

stock on that date and the cash received. The AM also found that the offsetting agreements fell outside the protection of section 1058 because they reduced the taxpayer's risk with respect to the transaction.<sup>131</sup> The IRS again restated its position in Coordinated Issue Paper LMSB-04-1207-077. The Issue Paper reiterated that a variable prepaid forward contract that includes a share lending arrangement results in a current taxable sale of the underlying shares.<sup>132</sup>

- Congress has been investigating a type of prepaid forward contract known as an exchange traded note (“ETN”), which is essentially a publicly-traded prepaid forward contract sold to both retail and institutional investors.<sup>133</sup> The Congressional hearings were prompted in part by Revenue Ruling 2008-1, which held that an ETN linked to a single foreign currency was a “nonfunctional currency debt instrument” under section 988 rather than a forward contract,<sup>134</sup> and the introduction of legislation that would require investors to accrue interest on ETNs at the applicable federal

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<sup>131</sup> See Lee Sheppard, “Your Government at Work On Financial Products,” 2007 TNT 89-3 (May 7, 2007).

<sup>132</sup> Coordinated Issue Paper LMSB-04-1207-077 (Feb. 6, 2008).

<sup>133</sup> See J. Coder, “Ways and Means Hearing on Derivative Tax Treatment Gets Mixed Reactions,” 2008 TNT 45-1 (Mar. 6, 2008) (including citations to the hearing materials and testimony). Due to their being offered to retail investors, ETNs have been called “derivatives for the masses.” See Lee Sheppard, “Are Exchange-Traded Notes Too Good to be True?” 2007 TNT 243-7 (Dec. 17, 2007) (quoting remarks made by Alex Gelinas of Sidley Austin LLP during a panel discussion at the Practising Law Institute’s 2007 Corporate Tax Strategies seminar). For a thorough discussion of these and related products published prior to the ruling, see M. Farber, “Equity, Debt, NOT—The Tax Treatment of Non-Debt Open Transactions,” *Tax Lawyer* Vol. 60, No. 3 (Spring 2007).

<sup>134</sup> Rev. Rul. 2008-1, 2008-2 I.R.B. 248 (Jan. 14, 2008). The Revenue Ruling was accompanied by Notice 2008-2, which requested comments on the issues surrounding prepaid forward contracts, including whether ETNs (or any mandated income accruals thereon) should be subject to tax under the withholding rules. See Notice 2008-2, 2008-2 I.R.B. 252 (Jan. 14, 2008).

rate.<sup>135</sup> Pending further guidance or legislation, the status of ETNs linked to other assets remains unclear.

4. Character of Income Taxpayers holding forward contracts as capital assets will recognize capital gain or loss on the disposition of a forward contract, except in the following four cases where a holder generally recognizes ordinary income or loss: (i) the contract is a business hedge governed by section 1221(a)(7), (ii) the contract is part of a conversion transaction or under section 1258, (iii) the contract is a foreign currency forward subject to both the rules of section 1256 and section 988 (in which case, the character of gain may be elective), or (iv) the contract is part of a constructive ownership transaction under section 1260.<sup>136</sup>
5. Source of Income Gain on the disposition of forward contracts is generally sourced according to the residence of the contract holder receiving the gain.<sup>137</sup> Thus, capital gain recognized by a foreign holder would be foreign source gain that would not be subject to U.S. tax, unless the gain is effectively connected with a foreign holder's U.S. trade or business.<sup>138</sup>

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<sup>135</sup> H.R. 4912 (introduced Dec. 19, 2007). For a discussion of the bill, see Lee Sheppard, "Are Exchange-Traded Notes Too Good to be True? Part 2," 118 *Tax Notes* 1172 (Mar. 17, 2008).

<sup>136</sup> In addition, it is possible that dividend equivalent amounts paid under a forward contract are treated as ordinary income, rather than capital gain.

<sup>137</sup> See I.R.C. § 865.

<sup>138</sup> This result may be affected by the promulgation of regulations under section 865(j)(2) governing the source of gain from dispositions of forward contracts, futures, options and other financial products. Also, it is possible that dividend equivalent amounts paid under a forward contract may be sourced in the same manner as the underlying dividend, rather than according to the residence of the contract holder.

## E. Regulated Futures Contracts

1. Definition A regulated futures contract is an exchange-traded agreement to purchase or sell a specifically described property (e.g., commodities, stock index, currency, spread in interest rate) on a specific future date for a specified price. Options on futures contracts are subject to the same rules as the underlying contracts.<sup>139</sup> Futures contracts are usually settled in cash and have standardized contract terms. Because futures contracts are regulated by exchanges, counterparty credit risk is eliminated.
  
2. Timing of Income Regulated futures contracts are generally marked-to-market based on a hypothetical sale at fair market value on the last business day of each year.<sup>140</sup> Each holder takes any resulting gain or loss into account, after adjusting the current year gain or loss for gain or loss previously accounted for.<sup>141</sup> The termination of a futures contract by offsetting the contract, taking or making delivery on the contract, or transferring the contract (including transactions with a flow-through entity) is a taxable disposition of the contract.<sup>142</sup> Where a straddle includes two or more futures contracts, for example, taking delivery on any single contract terminates the other contracts on that date.<sup>143</sup>

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<sup>139</sup> I.R.C. § 1256(b), (g)(6); Rev. Rul 94-63, 1994-2 C.B. 188; Rev. Rul. 87-67, 87-2 C.B. 212; Rev. Rul. 86-7, 86-1 C.B. 295.

<sup>140</sup> I.R.C. § 1256(a)(1). Section 1256 trumps sections 1092 and 263(g) if all positions of a straddle are section 1256 contracts. I.R.C. § 1256(a)(4). Mark-to-market treatment is elective for “mixed” straddles in which some, but not all, positions must be marked-to-market. I.R.C. § 1256(d). Business hedges are exempt from the section 1256 mark-to-market rules if the contract is identified on the purchase date as a hedge, and gain or loss on the contract is ordinary. I.R.C. § 1256(e).

<sup>141</sup> I.R.C. § 1256(a)(2).

<sup>142</sup> I.R.C. § 1256(c).

<sup>143</sup> I.R.C. § 1256(c)(2).

3. Character of Income Taxpayers holding futures contracts as capital assets generally recognize capital gain or loss each year (absent an exception to the general mark-to-market rule stated above), and they also generally recognize capital gain or loss on a disposition of the contract. Without regard to the holding period of a contract, 60% of capital gain or loss attributable to a futures contract is considered long-term and 40% is considered short-term,<sup>144</sup> subject currently to the following three exceptions: (i) taxpayers may elect to treat gain or loss attributable to currency exchange rates on regulated futures contracts and nonequity options that would otherwise be subject to section 1256 as foreign currency gain or loss under section 988,<sup>145</sup> (ii) if the contract is a business hedge governed by section 1221(a)(7), gain or loss may be ordinary,<sup>146</sup> and (iii) if the contract is part of a constructive ownership transaction under section 1260, part of any capital gain will be recharacterized as ordinary income.<sup>147</sup> However, under the Obama Budget

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<sup>144</sup> I.R.C. § 1256(a)(3).

<sup>145</sup> I.R.C. § 988(a)(1)(D)(ii). If certain procedural requirements are satisfied, a taxpayer can elect to treat exchange gain or loss with respect to a foreign currency futures, forward or option contract that is a capital asset in the hands of the taxpayer and not part of a straddle as (i) 60/40 long-term/short term capital gain or loss if the contract is subject to section 1256, or (ii) all capital gain or loss if it is not. See I.R.C. § 988(a)(1)(B), Treas. Reg. § 1.988-3(b).

<sup>146</sup> I.R.C. § 1256(e).

<sup>147</sup> A taxpayer holds two or more opposing positions with respect to the same or similar property in conversion transactions, and substantially all of its return is generated by the time value of the investment, *i.e.*, the return resembles interest on a loan. Conversion transactions may include simultaneously created long and short positions and straddles (including stock straddles). In general, the combination of the positions in a conversion transaction eliminates equity risk to the holder (a/k/a lender). Section 1258 recharacterizes a portion of the capital gain on such a transaction as ordinary income. The “imputed interest amount” equals the product of 120% of the applicable AFR and the fair market value of the property. As a result, a taxpayer may recognize ordinary income and capital loss on the sale of property included in a conversion transaction.

Proposal, the 60/40 rule would be replaced with a rule taxing 100% of the gain as ordinary income.<sup>148</sup>

- “Securities and future contracts” described in section 1234B(c) are not section 1256 contracts and therefore are not subject to the mark-to-market requirements and 60/40 rule of section 1256. Instead, gain or loss on such contracts is treated as gain or loss from the sale or exchange of property with the same character that the underlying property would have in the taxpayer’s hands.<sup>149</sup>
- Notice 2007-71 corrects prior IRS guidance concerning the treatment of over-the-counter (“OTC”) foreign currency options as section 1256 contracts.<sup>150</sup> Since 1984, when “foreign currency contracts” became subject to section 1256, the IRS had consistently taken the position that Congress did not intend to treat OTC currency options as foreign currency contracts, based on statements in the 1984 legislative history and the fact that such products did not exist at that time, even though the language of the statute was broad enough to allow a contrary interpretation.<sup>151</sup> In apparent disregard for its own long-held position, however, a sentence in the “facts” section of Notice 2003-81 appeared to conclude as a legal matter that an OTC option on an underlying currency that trades in the interbank market is a foreign currency contract as defined in Section 1256.<sup>152</sup> Notice 2007-71 “clarifies” that this sentence in the prior notice was only the position taken by the taxpayer, and not a legal determination. The Notice

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<sup>148</sup> Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals (May 11, 2009) (the “Greenbook”), *available at* <<http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>>.

<sup>149</sup> *See* I.R.C. § 1234B(a).

<sup>150</sup> *See* Notice 2007-71, 2007 I.R.B. 35 (Aug. 10, 2007), *modifying and supplementing* Notice 2003-81, 2003-2 C.B. 1223.

<sup>151</sup> *See, e.g.*, F.S.A. 2000-25-020 (Mar. 17, 2000).

<sup>152</sup> Notice 2003-81, 2003-2 C.B. 1223. *See also* M. Feder and L.G. “Chip” Harter, “Notice 2003-81: Are OTC Currency Options Section 1256 Contracts?” 2003 TNT 246-33.

declares that the IRS and Treasury “do not believe that [OTC] foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts” are Section 1256 contracts, and warns that the government intends to challenge any such characterization by taxpayers going forward.

4. Source of Income Gain (as opposed to dividend income) attributable to a regulated futures contract is generally sourced according to the residence of the contract holder receiving the gain.<sup>153</sup> Thus, capital gain recognized by a foreign holder would be foreign source gain that would not be subject to U.S. tax, unless the gain is effectively connected with a foreign holder’s U.S. trade or business.<sup>154</sup>
  - One common variation of a regulated futures contract is the exchange-for-physical, or “EFP,” transaction. In an EFP transaction the buyer of a financial instrument transfers to the seller a corresponding amount of long futures contracts, or receives from the seller a corresponding amount of short futures, at a mutually agreed upon price difference. For example, Party A buys XYZ stock from, and simultaneously sells a corresponding amount of long futures contracts in XYZ stock to, Party B, closing out both parties’ opposite hedges in futures.
  - Absent any authority on point, taxpayers may assert that an EFP represents (i) a sale by Party B to Party A of a long cash position in XYZ stock, and (ii) the separate acquisition of a long position pursuant to a physically-settled forward contract with respect to XYZ stock. Even though the two agreements are entered into simultaneously between the same parties, they represent, both in form and substance, two

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<sup>153</sup> See I.R.C. § 865.

<sup>154</sup> Section 865(j)(2) authorizes Treasury to promulgate regulations governing the source of gain from dispositions of forward contracts, futures, options and other financial products. No regulations have been promulgated to date.

separate components of the transaction. If so respected, Party B's capital gain on its sale of the XYZ stock and capital gain (as opposed to dividend income) with respect to the futures contract should be foreign source.

## F. Credit Default Swaps

- Another common derivative used in the marketplace is the credit default swap ("CDS"). A CDS is a financial contract in which one party (the protection buyer) buys from a counterparty (the protection seller) protection against certain defined credit events with respect to a reference asset. Typically, the protection buyer either pays a single lump sum or periodic regular payments until the earlier of the maturity of the CDS, or the occurrence of a credit event. Following the occurrence of a credit event, the protection seller typically pays either the protection buyer an amount reflecting all or part the reference asset's loss in value from the date the CDS was established, or purchases from the protection buyer at a pre-determined price an obligation (the "deliverable obligation") that is expected to approximate the post-credit-event value of the reference asset.
- The proper treatment of CDS transactions under current law is unclear, and the IRS acknowledged this uncertainty in Notice 2004-52 and requested further information and submissions.<sup>155</sup> Commentators have long argued that CDS transactions should be treated either as put options (*i.e.*, following a credit event, the protection buyer "puts" the reference obligation to the credit protection seller) or as NPCs (*i.e.*, the protection buyer receives one or more payments upon a credit event in exchange for a series of periodic payments).<sup>156</sup>

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<sup>155</sup> Notice 2004-52, 2004-32 I.R.B. 168.

<sup>156</sup> See D. Miller, "Credit Derivatives: Financial Instrument or Insurance? And Why It Matters," 3 *Taxation of Financial Products*, 31, No. 1 (Winter 2002); B. Kayle, "Will the Real Lender Please Stand Up: The Federal Income Tax Treatment of Credit Derivative Transactions," 50 *Tax Law* 568 (1997); D. Nirenberg and S. Kopp,

- Nevertheless, practitioners are concerned by the possibility that CDS transactions could be recharacterized as guarantees, or possibly, as insurance contracts.<sup>157</sup> Under such characterizations, “premium” payments by a U.S. protection buyer to a foreign protection seller, and “guarantee” payments by a U.S. protection seller to a foreign protection buyer may be subject to 30% FDAP withholding (unless a relevant income tax treaty applies). Moreover, characterization of CDS transactions as insurance could subject foreign protection sellers to the special tax rules for insurance companies, including a 4% excise tax under section 4371 on insurance premiums paid to foreign insurers. In response to the Notice, the New York State Bar Association has recommended that the IRS issue a “safe harbor” that would treat CDS meeting certain criteria either as an option or as an NPC and not as an insurance policy, guarantee, letter of credit or similar contract.<sup>158</sup>
- IRS officials have publicly confirmed that the IRS is still working on NPC guidance and is considering CDS separately from NPCs.<sup>159</sup>

### III. TAX TREATIES AND DERIVATIVES

As a fundamental matter, until the domestic law of treaty countries regarding the taxation of derivative transactions is standardized, it is at best optimistic, and probably

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“Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps and Credit-Linked Notes,” 87 *Journal of Taxation* 82 (Aug. 1997); L. Sheppard, “Tax Questions Raised by Credit Derivatives,” 2009 TNT 15-11 (Jan. 26, 2009).

<sup>157</sup> This concern was heightened when the New York State Insurance Department issued Circular Letter 19, stating that New York State intends to regulate CDSs as insurance. New York State Insurance Department, Circular Letter No. 19 (Sept. 22, 2008).

<sup>158</sup> See NYSBA Report on Credit Default Swaps, 2005 TNT 176-21 (Sept. 13, 2005).

<sup>159</sup> See “IRS Still Working on Notional Principal Contract Guidance,” 118 *Tax Notes* 1194 (Mar. 17, 2008).

unrealistic, to expect consistent taxation of derivative transactions under income tax treaties.

- Treasury has repeatedly expressed its commitment to updating and expanding the U.S. treaty network; it is critical that these upcoming treaty negotiations address the treatment of cross-border derivative transactions. If, as Treasury has hinted, the current favorable sourcing rules for NPCs are amended to more closely track the Substitute Payment Regulations for securities lending transactions, treaty interpretation will once again become the most important means of reducing or eliminating withholding tax in connection with swaps.<sup>160</sup>
- The U.S. goal in treaty negotiations is clearly the express adoption of the U.S. tax treatment of derivative transactions. This will, of course, be a difficult goal to achieve in the absence of consistent worldwide treatment of derivative financial products. To the extent this goal is not achieved, a treaty partner may apply an inconsistent characterization to transactions causing withholding on payments to U.S. holders in situations where the U.S. would not withhold on like payments to foreign holders. For example, in the absence of international agreement on the correct treatment of cross-border equity or credit swaps, a payer's country of residence may deconstruct a swap, and treat periodic swap payments as dividend payments on stock, or interest payments on a loan, respectively.<sup>161</sup> This result would fall far short of the desired consistent treatment by all treaty partners, although the disparate domestic law treatment of these transactions by treaty makes such an outcome unlikely at present. As a result, double taxation of derivative income is possible. For

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<sup>160</sup> Part of the reason few countries have included income tax treaty provisions specifically addressing the taxation of derivative transactions is undoubtedly the unsettled state of the domestic law of many countries on the issue. See "Host Country Taxation of Interest Rate Swaps," 13 *Tax Management International Forum*, No. 2 (June, 1992) for a more detailed discussion of this issue.

<sup>161</sup> For an example of inconsistent treatment of repos in the case of Canada, see Lee Sheppard, "Blame Canada Part 3: Cross-Border Repos," 118 *Tax Notes* 782 (Feb. 18, 2008).

example, while the U.S. may treat substitute payments as U.S. source and apply withholding taxes, treaty partners may treat those payments as domestic source income and refuse to grant a foreign tax credit for the U.S. tax. The same outcome is likely for U.S. withholding taxes on payments under interest swaps that are treated as interest and potentially subject to withholding.

- The 2006 U.S. Model Treaty (the “2006 Model Treaty”) does not contain any provisions specifically addressing cross-border derivatives.<sup>162</sup> Similarly, the Technical Explanation to the 2006 Model Treaty does not discuss income from derivative instruments except to note that income from most types of derivatives is covered by the “other income” article, unless the income either arises in the conduct of a trade or business or hedges the risks of a trade or business, in which case the income would fall under the business profits article.<sup>163</sup> A sentence was added to the Technical Explanation to the 2006 Model Treaty stating without further clarification that the “other income” article applies to “securities lending fees derived by an institutional lender”.<sup>164</sup> The New York State Bar Association questions whether fees received by a foreign repo seller that would ordinarily be subject to the interest article were intended to be covered and the

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<sup>162</sup> See United States Model Income Tax Convention of November 15, 2006, available at <<http://www.treasury.gov/offices/tax-policy/library/model006.pdf>>.

<sup>163</sup> See United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, available at <<http://www.treasury.gov/offices/tax-policy/library/TEMod006.pdf>>.

<sup>164</sup> The pamphlet prepared by the Joint Committee on Taxation comparing and contrasting provisions of the 1996 and 2006 versions of the U.S. Model Treaty states that the other income article is “substantially identical” to the 1996 Model. See *Joint Committee on Taxation, Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

rationale for limiting the provision only to fees received by institutional investors.<sup>165</sup>

#### IV. USING DERIVATIVES TO AVOID WITHHOLDING TAXES

- The foregoing materials suggest the following conclusions regarding the sourcing of payments under derivative contracts:
  - Payments under NPCs (primarily equity and interest swaps) are sourced according to the residence of the recipient, and therefore are not subject to U.S. withholding if the recipient is a foreign party, except for any payments that are treated as interest on an embedded loan and therefore are exempt from withholding only if they qualify as portfolio interest.
  - Substitute payments under securities loans are treated as dividends or interest in accordance with the look-through rule of the Substitute Payment Regulations.
  - Payments under option contracts, forward contracts, and regulated futures contracts are generally sourced according to the residence of the holder, and therefore are not subject to U.S. withholding if the holder is foreign.
- This summary suggests that swaps, options, forward and future contracts can all be used to avoid U.S. withholding taxes on inbound investments. Specifically, if a foreign investor currently acquires stock or debt of a U.S. issuer, the dividend or interest payments may be subject to withholding (unless the portfolio interest exception or a treaty based exception applies). However, if the same investor enters into an agreement with a U.S. counterparty to receive payments that mimic the dividend or interest payments on the securities of a U.S. issuer held by the counterparty, in

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<sup>165</sup> See “NYSBA Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006,” 2007 TNT 72-15 (Apr. 13, 2007).

exchange for a fixed up front payment or a series of payments, these payments would not be subject to U.S. withholding taxes under the current rules.<sup>166</sup> That result applies even if the foreign investor concurrently holds a controlling interest in the U.S. issuer (and therefore is not eligible for the portfolio interest exemption), as long as no dividends are actually paid on the controlling stock interest (*e.g.*, because all profits are channeled to preferred stock held by the U.S. counterparty to the swap).<sup>167</sup> However, as discussed above, under the Levin Bill<sup>168</sup> or the Obama Budget Proposal<sup>169</sup> substitute dividend payments on swaps or other NPC's may be subject to a U.S. withholding tax.

- The need to use caution in employing derivative transactions involving either hybrid entities or financial products to avoid U.S. withholding taxes on inbound investments cannot be overstated, in light of Treasury's stepped up attacks on perceived abusive cross-border transactions.<sup>170</sup> Notably, Treasury issued a series of notices designed to prevent multinational taxpayers' use of hybrid entities to reduce their foreign tax liabilities without creating subpart F income.<sup>171</sup>

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<sup>166</sup> As noted above, it is uncertain whether dividend equivalent amounts paid under a forward contract are subject to U.S. withholding tax.

<sup>167</sup> Although section 1260 does not affect a taxpayer's ability to employ a constructive ownership transaction in order to avoid withholding taxes that would otherwise be obtained if such taxpayer made a direct investment in an underlying security, a taxpayer cannot avoid withholding tax, for example, under the Substitute Payment Regulations, by employing a constructive ownership transaction that constitutes a securities lending or sale-repurchase transaction.

<sup>168</sup> S.506, 111<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2009).

<sup>169</sup> Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (May 11, 2009) (the "Greenbook"), *available at* <<http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>>.

<sup>170</sup> For a discussion on the development of cross-border hybrid instruments, *see* G. Lemein and J. McDonald, "Cross-Border Hybrid Instruments," 79 *Taxes* 5 No. 11 (2001).

<sup>171</sup> *See* Notice 98-11, 1998-6 I.R.B. 18.

- One such transaction involves multinational taxpayers “checking-the-box” with respect to second-tier “controlled foreign corporations” (“CFCs”) to treat such entities as “tax nothings” for U.S. tax purposes and as separate corporations for non-U.S. tax purposes, and a first-tier CFC holding company then lending money to a second-tier CFC. By employing this structure, the second-tier CFCs are able to deduct the interest paid on the loans from the first-tier CFC and thereby reduce their non-U.S. foreign tax liabilities. A first-tier CFC’s receipt of such interest payments does not create subpart F income for U.S. federal income tax purposes because the second-tier CFC is treated as a “tax nothing” (rather than as a separate corporation) and so the first-tier CFC is treated as paying itself. Notably, the Obama Budget Proposal would effectively eliminate the use of this transaction by treating any foreign entity with a single owner that is organized in a country other than the country of organization of its single owner as a corporation for federal tax purposes.<sup>172</sup>
- Notice 98-11 and the proposed and temporary Treasury regulations it announces sought to prevent taxpayers from using these hybrid entity structures to avoid the creation of Subpart F income.<sup>173</sup> In response to pointed questions from Congress as to Treasury’s authority (or lack thereof) to promulgate such anti-hybrid entity rules, Treasury issued Notice 98-35, pursuant to which Treasury withdrew Notice 98-11 and vowed to finalize identical proposed regulations on or after January 1, 2000.<sup>174</sup> When finalized, such proposed regulations will be effective for all payments made under hybrid entity arrangements on or after June 19, 1998. Thus, hybrid entity arrangements set up prior to June 19, 1998 will be permanently grandfathered from such

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<sup>172</sup> Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals (May 11, 2009) (the “Greenbook”), *available at* <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>.

<sup>173</sup> *See* Notice 98-11, 1998-6 I.R.B. 18.

<sup>174</sup> *See* Notice 98-35, 1998-27 I.R.B. 35.

regulations. Hybrid entity arrangements set up on or after June 19, 1998, but before the issuance of final regulations will have transition relief for a 5 year period after finalization.<sup>175</sup>

- As part of its Industry Issue Focus approach, the Large and Mid-Size Business (LMSB) Division of the IRS has designated international hybrid instrument transactions as a Tier I priority issue.<sup>176</sup> The IRS describes international hybrid instrument transactions as “cross-border financing arrangements in which the taxpayer takes different positions in its treatment of the transaction as debt or equity for U.S. and foreign tax purposes,” and further subcategorizes these arrangements into (i) “Debt in U.S. Transactions,” where the taxpayer seeks to treat the arrangement as debt in the U.S. but equity in the foreign jurisdiction, and (ii) “Equity in U.S. Transactions,” where the treatment is reversed.<sup>177</sup> For example, in generic legal advice memorandum AM 2006-001, the IRS accepted the taxpayer’s position that a promissory note and a forward purchase contract involving only the taxpayer and its related foreign entities should be treated as a single instrument that is not debt for U.S. tax purposes.<sup>178</sup> The directive instructs field agents to

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<sup>175</sup> See Notice 98-35, 1998-27 I.R.B. 35.

<sup>176</sup> See Industry Director Directive #1 on International Hybrid Instrument Transactions, LMSB Control No. 04-0407-035 (June 15, 2007). According to the Industry Issue Focus (IIF) Fact Sheet published by the IRS, Tier I issues “are of high strategic importance to LMSB and have significant impact on one or more industries.” The IRS has an IIF resource page with a list of Tier I and Tier II issues and recent compliance activities posted on its website at <<http://www.irs.gov/businesses/article/0,,id=167377,00.html>> (last visited: Mar. 24, 2008). The original “top ten” priority issues were summarized by Commissioner of Internal Revenue Mark Everson in his testimony before the Senate Finance Committee in 2006. See IR-2006-94 (Jun. 13, 2006).

<sup>177</sup> Industry Director Directive #1 on International Hybrid Instrument Transactions, LMSB Control No. 04-0407-035 (June 15, 2007).

<sup>178</sup> See AM 2006-001 (Sept. 7, 2006). The IRS concluded that the separability of the two contracts was not determinative given that the taxpayer controlled the other parties to the arrangement, and the

conduct a careful examination of the facts of each case and challenge transactions that do not fall within the scope of AM 2006-001.

- Similarly, the IRS and Treasury have recently stepped up their efforts to attack so-called “foreign tax credit generator” transactions; proposed regulations issued in March 2007 would prospectively deny a credit for foreign taxes paid or accrued pursuant to a “structured passive investment arrangement” (SPIA) that meets six objective conditions.<sup>179</sup> Commentators have criticized the objective factor approach as being simultaneously over- and under-inclusive and believe that the government could have challenged the transactions targeted by the proposed regulations as lacking

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offsetting obligations of the parties under the agreements either cancelled out or were disregarded, prohibiting a finding of debt

<sup>179</sup> 72 Fed. Reg. 15081 (Mar. 30, 2007). The six conditions are: (1) the arrangement involves a special purpose vehicle (“SPV”), substantially all of the income and assets of which are passive and generates income which is subject to a foreign tax; (2) a U.S. party is eligible for a foreign tax credit with respect to the SPV’s income; (3) the foreign taxes paid under the arrangement are substantially greater than they would be had the U.S. party invested directly in the SPV’s assets; (4) the arrangement involves a foreign counterparty unrelated to the U.S. party that is treated as owning (directly or indirectly) at least 10% of the SPV’s equity or at least 20% of the value of the SPV’s assets; (5) the foreign counterparty derives a foreign tax benefit as a result of participating in the arrangement; and (6) the arrangement is treated inconsistently for purposes of U.S. and foreign tax law in a manner that materially affects the amount of income or foreign taxes of the U.S. party. The proposed regulations received only a lukewarm reception; the NYSBA comment on the proposed regulations expressed support for the general approach of the proposed regulations, but recommended substantial refinement of the six conditions for SPIA treatment and noted that a bright line objective factor test could be overly narrow or broad, depending on the circumstances. See “NYSBA Report on Proposed Section 901 Regulations Relating to Compulsory Payments of Foreign Taxes,” 2007 TNT 208-14 (October 26, 2007). For a comprehensive discussion of foreign tax credit arbitrage transactions and the policy issues they present that pre-dates the proposed regulations, see Y. Reich, *International Arbitrage Transactions Involving Creditable Taxes*, 85 *Taxes* No. 3 (Mar. 2007).

economic substance.<sup>180</sup> Diana Wollman also observed that the proposed regulations appear to be inconsistent with prior IRS guidance dealing with similar transactions.<sup>181</sup> In March 2008, the LMSB instructed field agents to review and challenge claims for credits resulting from foreign tax credit generator transactions, and provided a sample information document request for use by the field in examinations.<sup>182</sup>

## V. TOWARD CONSISTENT TAXATION OF DERIVATIVES

Goals The promulgation of a single, consistent set of rules to tax derivative transactions is a daunting task that must be approached on two levels. First, such a system must be crafted to reach fair and consistent results with regard to the use of derivative products among U.S. parties. Even assuming this goal could be achieved, the resulting rules must also be designed to produce the same consistent results with respect to cross-border derivative transactions. As the NPC and securities loan regulations demonstrate, this is no easy task. It is all too easy for a seemingly simple rule to produce different results for U.S. and foreign parties. Second, it is at least as important that any resulting U.S. tax rules be as consistent as possible with the rules adopted by other countries to tax derivative transactions.

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<sup>180</sup> See Lee Sheppard, “Banks’ Foreign Tax Credit Arbitrage, Part 2,” 2007 TNT 75-5 (Apr. 9, 2007); K. Dolan, “Foreign Tax Credit Generator Regs: The Purple People Eater Returns,” 2007 TNT 118-33 (Jun. 18, 2007). IRS officials have publicly stated that foreign tax credit generators would be vulnerable to an economic substance challenge even in the absence of regulations. See Lee Sheppard, “Government Officials Defend Regulations,” 2007 TNT 147-3 (Aug. 6, 2007) (reporting the comments of Steven Musher, IRS Associate Chief Counsel (International) at a NYSBA Tax Section meeting).

<sup>181</sup> See “Practitioner Examines IRS Position on Foreign Tax Credits,” 2007 TNT 171-8 (Sept. 4, 2007); see also Lee Sheppard, “Banks’ Foreign Tax Credit Arbitrage, Part 3,” 2007 TNT 171-7 (Sept. 3, 2007).

<sup>182</sup> See Tier I Issue Foreign Tax Credit Generator Directive, LMSB Control No: LMSB-04-0208-003 (Mar. 11, 2008); see also “IRS Alerts LMSB Field Specialists to Abusive Foreign Tax Credit Generator Transactions,” 2008 TNT 55-10 (Mar. 20, 2008).

This is a particular concern with respect to our treaty partners, since taxpayers in the U.S. and in contracting states will doubtless employ inconsistencies in such rules to continue to avoid tax on cross-border derivative transactions.

1995 IFA Resolutions The International Fiscal Association (“IFA”) addressed the issue of the taxation of derivative transactions at its 1995 meeting and adopted a resolution designed to promote sensible, consistent worldwide taxation of those transactions (the “Resolution”).<sup>183</sup> The Resolution includes the following specific recommendations in this regard. First, countries should recognize the fundamental importance of derivative transactions in both domestic and global capital markets, and fiscal authorities should remove tax impediments to the use of derivative instruments.<sup>184</sup> National tax regimes for derivative instruments should be created (or clarified) on the following basis: the tax regime should be fair, simple and practical; the use of derivative instruments should have definite and predictable results; different classes of taxpayers and different instruments that are economically similar should be similarly treated; and the above-described principles must apply consistently over time as derivative instruments change. The Resolution also includes the following rules to govern application of the recommendations:

- First, tax policy should be guided by the principle of consistent treatment for similar transactions. Taxpayers should be permitted to integrate derivative transactions on a prospective, but not retrospective basis.
- Second, timing should reflect economic income. The choice between taxing derivative instruments under an economic accrual or mark-to-market system should depend on which system gives the most economically

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<sup>183</sup> International Fiscal Association, 49th Congress, Final Resolution of Tax Aspects of Derivative Financial Instruments Approved by 49th IFA Congress in Cannes, 95 TNI 189-17 (Sept. 29, 1995).

<sup>184</sup> The recommendation also notes that fiscal authorities should recognize that taxation has a significant effect on the efficiency and economic results of derivative transactions.

correct measure of income together with the most consistent treatment.

- Third, countries should not impose source basis taxation on income received from derivative instruments by nonresidents unless the income is attributable to a branch or permanent establishment. More generally, it is appropriate not to impose withholding tax on derivative payments at source, and the practice “should be universally adopted.” Profits, gains and losses with respect to derivative instruments should be exempt from tax at source by local law or treaty, because they represent business profits (not taxable in the absence of a permanent establishment), capital gains, or “other income” (exempt under such article of an applicable tax treaty).
- Fourth, the residence principle should be reinforced through the appropriate use of anti-deferral regimes and should be clarified and harmonized in the case of global trading, split hedging, and interbranch transactions, which are currently taken into account in some, but not all, countries.
- The adoption of the IFA resolutions by the U.S. would require it to abandon withholding for substitute securities loan payments and possibly deemed interest payments on loans embedded under an NPC. While this outcome would alleviate the threat of double taxation, it would make it even easier to avoid U.S. withholding taxes on regular equity and debt investments through the use of derivatives.
- Perhaps the most realistic policy for the U.S. to pursue, consistent with its general withholding regime, would be to impose withholding tax on all forms of payments on derivatives (*i.e.*, options, forward contracts, regulated forward contracts, periodic and non-periodic payments on NPCs, and substitute payments and fees under securities loans), but only when the investment by a foreign party is coupled with a significant equity holding in the U.S. issuer (generally, 10% or more under the interest withholding regime). Otherwise, payments under derivatives would be sourced to the recipient and exempt from withholding. This regime would at least ensure that the most obvious forms of using derivatives to avoid withholding taxes on

stock and debt investment are countered, while not affecting the market for portfolio investment into the United States.<sup>185</sup>

## **VI. WITHHOLDING TAX ISSUES, REPRESENTATIONS AND FORMS IN THE ISDA MASTER AGREEMENT**

This section of the outline analyzes the tax provisions contained in the 1992 (Multicurrency–Cross Border) Master Agreement (“Master Agreement”) of the International Swaps and Derivatives Association (“ISDA”), which is commonly used to document many of the cross-border derivatives discussed in this outline.<sup>186</sup>

- Although a withholding tax is usually a tax imposed on a payee, Sections 2(d)(i)(2) and (4) of the Master Agreement places the economic burden of a withholding tax in the first instance on the payer; the payer is required to remit any withholding tax to the relevant taxing jurisdiction and to “gross-up” the payee by paying additional amounts so that the payee receives an amount net of withholding tax equal to what the payee would have received if no withholding tax were imposed. This general rule is subject to three important exceptions:

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<sup>185</sup> Other proposals for reform include the repeal of the portfolio interest exception in its entirety, *see* “Law Professor Testifies on Derivatives Taxation,” 2088 TNT 45-56 (Mar. 6, 2008) (testimony of Reuven S. Avi-Yonah), the imposition of a mark-to-market regime for all derivatives, *see* “Columbia Law School Professor Suggests Derivatives be Subject to Mark-to-Market Regime,” 2008 TNT 45-55 (Mar. 6, 2008), the shift to a territorial tax system, *see* “Support for Territorial Tax Regime Growing, Panelists Say,” 2008 TNT 36-6 (Feb. 21, 2008) and the repeal of the withholding tax altogether, *see* David Hariton, “Equity Derivatives, Inbound Capital and Outbound Withholding Tax,” *Tax Lawyer*, Vol. 60, No. 2 (Winter 2007); *see also* Lee Sheppard, “Cricket and Cross-Border Taxation at the Crossroads,” 49 *TNI* 995 (Mar. 24, 2008).

<sup>186</sup> Although ISDA revised the Master Agreement in 2002, this article will continue to refer to the 1992 version since this version continues to be widely used by market participants. There were no substantive changes in 2002 to the sections of the Master Agreement discussed herein.

- First, the payer is entitled to request and rely on tax representations and tax forms of the payee that would reduce or eliminate a U.S. federal withholding tax obligation. The illustrative payee tax representations set forth below are designed for different categories of foreign counterparties to ensure generally that they provide the proper tax form in a timely manner to a U.S. counterparty for transactions typically undertaken under the Master Agreement.
- It is important for a payer under the Master Agreement to request and receive the proper tax representations and tax forms from its counterparty for two reasons. First, if the payer fails to request and receive the proper tax form and is therefore required to withhold (or backup withhold) tax, the payer would bear the economic burden of the tax and would be required to gross-up its counterparty. Second, because a payer is a withholding agent under U.S. federal tax principles (and potentially under relevant foreign tax principles), it has an independent duty to withhold the proper amount due (and is subject to liability for the tax, interest, and possibly penalties for failure to withhold tax).
- Second, the payer does not bear the economic burden of a withholding tax if the tax arises as a result of the payee's connection with the taxing jurisdiction. Those taxes would not be "Indemnifiable Taxes" under the Master Agreement.
- Finally, although a payer has the economic burden of a withholding tax, the payer may terminate the Master Agreement if a withholding tax is imposed or increased as a result of a change in tax law or an action taken by a taxing authority after a Master Agreement is entered into, and the payer cannot avoid the withholding tax by transferring the Master Agreement to another office or affiliate. Under the Master Agreement, a change in tax law that gives rise to a withholding tax obligation does not relieve

the payer of the obligation to gross-up payments under the Master Agreement. However, on account of Sections 5(b)(ii) and 6(b)(iv) of the Master Agreement, a change in tax law would generally permit the payer—the “Affected Party” in ISDA parlance—to terminate the Master Agreement. Similarly, under the Master Agreement, if a withholding tax obligation arises on account of a party consolidating or amalgamating with, or merging with or into, or transferring all or substantially all of its assets to another entity, under Sections 5(b)(iii) and 6(b)(iv) of the Master Agreement, the party burdened with the withholding tax—the “Burdened Party” in ISDA parlance—generally has the right to terminate the Master Agreement.

- The following section sets forth sample tax representations and requests for tax forms to be requested by a U.S. counterparty entering into a transaction under a Master Agreement with a non-U.S. counterparty.
- Payer Tax Representation The following sample language is common for Section 3(e) of the Master Agreement:

For the purpose of Section 3(e) of this Agreement, Party A and Party B make the following representation:

It is not required by any applicable law, as modified by the practice of any relevant governmental revenue authority, of any Relevant Jurisdiction to make any deduction or withholding for or on account of any Tax from any payment (other than interest under Section 2(e), 6(d)(ii), or 6(e) of this Agreement) to be made by it to the other party under this Agreement. In making this representation, it may rely on (i) the accuracy of any representations made by the other party pursuant to Section 3(f) of this Agreement, (ii) the satisfaction of the agreement contained in Section 4(a)(i) or 4(a)(iii) of this Agreement, and the accuracy and effectiveness of any document provided by the

other party pursuant to Section 4(a)(i) or 4(a)(iii) of this Agreement, and (iii) the satisfaction of the agreement of the other party contained in Section 4(d) of this Agreement, provided that it shall not be a breach of this representation where reliance is placed on clause (ii) and the other party does not deliver a form or document under Section 4(a)(iii) by reason of material prejudice to its legal or commercial position.

- The payer tax representation generally serves the due diligence function of confirming the parties' understanding that no withholding taxes apply to the transaction under the Master Agreement. (As described above, even if a withholding tax obligation arises subsequent to the execution of the Master Agreement, depending on why the withholding obligation arises, the relevant party may be either (i) not required to gross-up its counterparty (*e.g.*, because the payee provided an incorrect representation or tax form) or (ii) entitled to terminate the transaction (*e.g.*, because a change in tax law has taken place)). However, the payer tax representation does not apply to payments of default interest under Section 2(e) or payments of interest upon early termination under Section 6(d)(ii) or 6(e).
- The payer tax representation is not significant in terms of the withholding tax gross-up provision. On account of Section 5(a)(iv) of the Master Agreement, breach of the Payer Tax Representation does not result in an event of default under the Master Agreement.
- Payee Tax Representations and Tax Forms Set forth below are various model Payee Tax Representations under Section 3(f) of the Master Agreement and request for U.S. tax forms to be considered in the circumstances described below. For purposes of the following illustrations, Party A is a U.S. corporate counterparty and Party B is a non-U.S. counterparty.
- Situation: Foreign Counterparty Acting Exclusively Through U.S. Branches, Offices, or Agencies

For the purpose of Section 3(f) of this Agreement, Party B makes the following representation:

Each payment received or to be received by it in connection with this Agreement will be effectively connected with its conduct of a trade or business in the United States

Part 3. Agreement to Deliver Documents. For the purpose of Section 4(a)(i) and (ii) of this Agreement, each party agrees to deliver the following documents as applicable:

(a) Tax forms, documents or certificates to be delivered are:

<i>Form/ Document/Certificate</i>	<i>Date by Which to be Delivered</i>
<i>A correct, complete and executed U.S. Internal Revenue Service Form W-8ECI (or any successor thereto) in duplicate, including appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.</i>	<i>(i) Before the first Payment Date under this Agreement, (ii) before December 31 of each third succeeding calendar year, (iii) promptly upon reasonable demand by Party A, and (iv) promptly upon learning that any such Form previously provided by Party B has become obsolete or incorrect.</i>

- Situation: Treaty Resident Foreign Counterparty That Will Act Exclusively Through Offices or Agents Outside the United States

For the purpose of Section 3(f) of this Agreement, Party B makes the following representations:

(i) It is fully eligible for the benefits of the “Business Profits” or “Industrial and Commercial

Profits” provision, as the case may be, the “interest” provision, or the “Other Income” provision (if any) of the Specified Treaty with respect to any payment described in such provisions and received or to be received by it in connection with this Agreement, and no such payment is attributable to a trade or business carried on by it through a permanent establishment in the United States.

- “Specified Treaty” means the income tax treaty between the United States and the country or countries in which Party B is resident for treaty purposes.

(ii) Party B is a “non-U.S. branch of a foreign person” for purposes of sections 1.1441-4(a)(3)(ii) and 1.6041-4(a)(4) of the United States Treasury Regulations.

- This representation avoids the requirement to treat NPC payments as effectively connected with a U.S. trade or business even if the foreign counterparty has not provided (or has not timely provided) a withholding certificate representing that the payments under the Master Agreement are not effectively connected with the conduct of a U.S. trade or business, thereby eliminating the U.S. payer’s requirement to report such payments on IRS Form 1042-S.

(iii) Party B is not (i) a bank that has entered into this Agreement in the ordinary course of its trade or business of making loans, as described in section 881(c)(3)(A) of the Internal Revenue Code of 1986, as amended (the “Code”), (ii) a 10-percent shareholder of Party A within the meaning of Code section 871(h)(3)(B), or (iii) a controlled foreign corporation related to Party A as described in Code section 881(c)(3)(C).

- The parties to the Master Agreement should know whether these relationships exist *ab initio*. This portfolio interest exemption-related payee tax representation is not necessary if the

Specified Treaty provides for a zero rate of withholding tax on interest payments.

Part 3. Agreement to Deliver Documents. For the purpose of Section 4(a)(i) and (ii) of this Agreement, each party agrees to deliver the following documents as applicable:

(a) Tax forms, documents or certificates to be delivered by Party B are:

<b><i>Form/ Document/Certificate</i></b>	<b><i>Date by Which to be Delivered</i></b>
<i>A correct, complete and executed U.S. Internal Revenue Service Form W-8BEN (including a claim of treaty benefits under Part II and with Part III marked), or any successor thereto, including appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.</i>	<i>(i) Before the first Payment Date under this Agreement, (ii) before December 31 of each third succeeding calendar year, (iii) promptly upon reasonable demand by Party A, and (iv) promptly upon learning that any such Form previously provided by Party B has become obsolete or incorrect.</i>

- Situation: Treaty Resident Foreign Counterparty That May Act Through Branches, Offices, or Agencies Located Within or Without the United States

For the purpose of Section 3(f) of this Agreement, Party B makes the following representations:

(i) (A) Party B will identify by prior written notice or in the relevant Confirmation each Transaction as to which Party B is acting through an Office or agent located in the United States (including only the States thereof and the District of Columbia).

(B) With respect to such Transactions, each payment received or to be received by Party B in connection with this Agreement will be effectively connected with its conduct of a trade or business in the United States.

(ii) With respect to Transactions that Party B has not identified pursuant to clause (b)(i)(A) of Part 2 hereof:

(A) It is fully eligible for the benefits of the “Business Profits” or “Industrial and Commercial Profits” provision (as the case may be), the “Interest” provision, or the “Other Income” provision (if any) of the Specified Treaty with respect to any payment described in such provisions and received or to be received by it in connection with this Agreement, and no such payment is attributable to a trade or business carried on by it through a permanent establishment in the United States. If such representation applies, then:

- “Specified Treaty” means the income tax treaty between the United States and insert the country or countries in which Party B is resident for Treaty purposes.

(B) It is a “non-U.S. branch of a foreign person” for purposes of sections 1.1441-4(a)(3)(ii) and 1.6041-4(a)(4) of the United States Treasury Regulations.

- This representation avoids the requirement to treat NPC payments as effectively connected with a U.S. trade or business even if the foreign counterparty has not provided (or has not timely provided) a withholding certificate representing that the payments under the Master Agreement are not effectively connected with the conduct of a U.S. trade or business, thereby eliminating the U.S. payer’s requirement to report such payments on IRS Form 1042-S.

(C) Party B is not (i) a bank that has entered into this Agreement in the ordinary course

of its trade or business of making loans, as described in section 881(c)(3)(A) of the Internal Revenue Code of 1986, as amended (the “Code”), (ii) a 10-percent shareholder of Party A within the meaning of Code section 871(h)(3)(B), or (iii) a controlled foreign corporation with respect to Party A within the meaning of Code section 881(c)(3)(C).

- The parties to the Master Agreement should know whether these relationships exist *ab initio*. This portfolio interest exemption-related payee tax representation is not necessary if the Specified Treaty provides for a zero rate of withholding tax on interest payments.

Part 3. Agreement to Deliver Documents. For the purpose of Section 4(a)(i) and (ii) of this Agreement, each party agrees to deliver the following documents as applicable:

(a) Tax forms, documents or certificates to be delivered by Party B are:

<b><i>Form/ Document/Certificate</i></b>	<b><i>Date by Which to be Delivered</i></b>
<i>With respect to Transactions <u>not</u> identified pursuant to clause (b)(i)(A) of Part 2, a correct, complete and executed U.S. Internal Revenue Service Form W-8BEN (including a claim of treaty benefits under Part II and with Part III marked), or any successor thereto, including appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax</i>	<i>(i) Before the first Payment Date under this Agreement, (ii) before December 31 of each third succeeding calendar year, (iii) promptly upon reasonable demand by Party A, and (iv) promptly upon learning that any such Form previously provided by Party B has become obsolete or incorrect.</i>

<i>Form/ Document/Certificate</i>	<i>Date by Which to be Delivered</i>
<i>on payments under this Agreement.</i>	
<i>With respect to Transactions identified pursuant to clause (b)(i)(A) of Part 2, a correct, complete and executed U.S. Internal Revenue Service Form W-8ECI (or any successor thereto) in duplicate, including appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.</i>	<i>(i) Before the first Payment Date under this Agreement, (ii) before December 31 of each third succeeding calendar year, (iii) promptly upon reasonable demand by Party A, and (iv) promptly upon learning that any such Form previously provided by Party B has become obsolete or incorrect.</i>

- Situation: Non-Treaty Resident Foreign Counterparty That Will Act Exclusively Through Branches, Offices and Agencies Outside the United States

For the purpose of Section 3(f), Party B makes the following representations:

(i) Party B is a “non-U.S. branch of a foreign person” for purposes of sections 1.1441-4(a)(3)(ii) and 1.6041-4(a)(4) of the United States Treasury Regulations.

- This representation avoids the requirement to treat NPC payments as effectively connected with a U.S. trade or business even if the foreign counterparty has not provided (or has not timely provided) a withholding certificate representing that the payments under the Master Agreement are not effectively connected with the conduct of a U.S. trade or business, thereby eliminating

the U.S. payer's requirement to report such payments on IRS Form 1042-S.

(ii) Party B is not (i) a bank that has entered into this Agreement in the ordinary course of its trade or business of making loans, as described in section 881(c)(3)(A) of the Internal Revenue Code of 1986, as amended (the "Code"), (ii) a 10-percent shareholder of Party A within the meaning of Code section 871(h)(3)(B), or (iii) a controlled foreign corporation related to Party A within the meaning of Code section 881(c)(3)(C).

- The parties to the Master Agreement should know whether these relationships exist *ab initio*.

Part 3. Agreement to Deliver Documents. For the purpose of section 4(a)(i) and (ii) of this Agreement, each party agrees to deliver the following documents as applicable:

(a) Tax forms, documents or certificates to be delivered by Party B are:

<b><i>Form/ Document/Certificate</i></b>	<b><i>Date by Which to be Delivered</i></b>
<i>A correct, complete and executed U.S. Internal Revenue Service Form W-8BEN (with Part III marked) or W-8IMY, or any successor thereto, and appropriate attachments, that eliminates U.S. federal withholding and backup withholding payments under this Agreement.</i>	<i>(i) Before the first Payment Date under this Agreement, (ii) before December 31 of each third succeeding calendar year, (iii) promptly upon reasonable demand by Party A, and (iv) promptly upon learning that any such Form previously provided by Party B has become obsolete or incorrect.</i>

- Situation: Non-Treaty Resident Foreign Counterparty That May Act Through Branches,

### Offices or Agencies Located In or Outside the United States

For the purpose of Section 3(f) of this Agreement, Party B makes the following representations:

(i) (A) Party B will identify by prior written notice or in the relevant Confirmation each Transaction as to which Party B is acting through an Office or agent located in the United States (including only the States thereof and the District of Columbia).

(B) With respect to such Transactions, each payment received or to be received by Party B in connection with this Agreement will be effectively connected with its conduct of a trade or business in the United States.

(ii) The following representation applies to Party B, and only with respect to Transactions that Party B has not identified pursuant to clause (b)(i)(A) of Part 2 hereof:

(A) Each payment received or to be received by it in connection with this Agreement will not be effectively connected with its conduct of a trade or business in the United States.

(B) Party B is a “non-U.S. branch of a foreign person” for purposes of sections 1.1441-4(a)(3)(ii) and 1.6041-4(a)(4) of the United States Treasury Regulations.

- This representation in paragraph (B) avoids the requirement to treat NPC payments as effectively connected with a U.S. trade or business even if the foreign counterparty has not provided (or has not timely provided) a withholding certificate representing that the payments under the Master Agreement are not effectively connected with the conduct of a U.S. trade or business, thereby eliminating the U.S. payer’s requirement to report such payments on IRS Form 1042-S.

(C) Party B is not (i) a bank that has entered into this Agreement in the ordinary course of its trade or business of making loans, as described in section 881(c)(3)(A) of the Internal Revenue Code of 1986, as amended (the “Code”), (ii) a 10-percent shareholder of Party A within the meaning of Code section 871(h)(3)(B), or (iii) a controlled foreign corporation related to Party A within the meaning of Code section 881(c)(3)(C).

- The parties to the Master Agreement should know whether these relationships exist *ab initio*.

Part 3. Agreement to Deliver Documents. For the purpose of Section 4(a)(i) and (ii) of this Agreement, each party agrees to deliver the following documents as applicable:

(a) Tax forms, documents or certificates to be delivered by Party B are:

<b><i>Form/ Document/Certificate</i></b>	<b><i>Date by Which to be Delivered</i></b>
<i>With respect to Transactions <u>not</u> identified pursuant to clause (b)(i)(A) of Part 2, a correct, complete and executed U.S. Internal Revenue Service Form W-8BEN (with Part III marked) or W-8IMY, or any successor thereto, and appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.</i>	<i>(i) Before the first Payment Date under this Agreement, (ii) before December 31 of each third succeeding calendar year, (iii) promptly upon reasonable demand by Party A, and (iv) promptly upon learning that any such Form previously provided by Party B has become obsolete or incorrect.</i>
<i>With respect to Transactions identified</i>	<i>(i) Before the first Payment Date under</i>

<b><i>Form/ Document/Certificate</i></b>	<b><i>Date by Which to be Delivered</i></b>
<i>pursuant to clause (b)(i)(A) of Part 2, a correct, complete and executed U.S. Internal Revenue Service Form W-8ECI (or any successor thereto) in duplicate, including appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.</i>	<i>this Agreement, (ii) before December 31 of each third succeeding calendar year, (iii) promptly upon reasonable demand by Party A, and (iv) promptly upon learning that any such Form previously provided by Party B has become obsolete or incorrect.</i>

## **VII. CONCLUSIONS**

As this article illustrates, the disparate results in cross-border derivatives taxation are in large part attributable to the historical development of separate U.S. tax rules governing specific derivative instruments. The current patchwork of U.S. withholding tax rules is ill-equipped to address the issues raised by derivative products, and U.S. income tax treaties negotiated to date fail to provide sensible results for treaty partners engaging in cross-border derivative transactions. Treasury is, and has for some time been, well aware of these shortcomings of the U.S. tax rules and treaties, but to date has failed to propose a workable set of tax rules to govern the use of derivative products. Until that goal is achieved (if ever), well-advised taxpayers will continue to choose the specific form of derivative transaction that produces the desired economic result with the most favorable U.S. tax consequences.