TAXATION WITHOUT AUTHORIZATION: THE PROPOSED "DIVIDEND EQUIVALENT" WITHHOLDING REGULATIONS UNDER SECTION 871(M)

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The currently proposed regulations under section 871(m) of the Internal Revenue Code threaten to impose "dividend withholding" on a broad range of swaps, options, forward contracts, futures contracts, debt, and other financial contracts that reference dividend-paying U.S. stock, even if the contracts do not in fact reference dividends, and even if no party to the contracts ever owned the stock. The proposed regulations create a new withholding regime that is overly broad, lacks clarity, will be difficult to comply with, and may violate the "nondiscrimination" provisions contained in many tax treaties to which the United States is a party. There is no statutory authorization for this new withholding regime.

Section 871(m) was enacted to curtail a specific type of tax-avoidance transaction. In the early 2000s, several banks touted "yield enhancement strategies" that allowed their non-U.S. clients to use derivatives to eliminate or reduce dividend withholding. According to a 2008 report by the Senate's Permanent Subcommittee on Investigations, under these strategies, a non-U.S. client typically transferred U.S. stock to the bank shortly before the stock's ex-dividend date, received a substitute dividend free of withholding, and reacquired the stock shortly after the dividend payment.[1] This report catalyzed section 871(m).

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[1] Staff, U.S. Senate Permanent Subcommittee on Investigations, "*Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*" (Sep. 11, 2008).

Section 871(m) imposes withholding on payments made under "specified" swaps that are contingent upon, or determined by reference to, U.S.-source dividends. Consistent with the 2008 Senate report's description of perceived tax abuses, the statute defines a "specified" swap to include only swaps where the short party is effectively required to acquire the underlying U.S. stock in connection with the transaction. In these situations, section 871(m) recasts the swap as an acquisition of the underlying stock by the short party as an agent of the non-U.S. investor, and treats any substitute dividend paid by the short party as an actual dividend subject to U.S. withholding tax.

The "quasi-agency" test codified in section 871(m) extends dividend withholding to a limited group of transactions that bear indicia of actual stock ownership through an agent. By contrast, the proposed regulations create a brand-new withholding regime. Under the proposed regulations, an instrument that references dividend-paying U.S. stock is subject to withholding if the ratio of the change in the instrument's value to the change in the stock's value—referred to as "delta"—is at least 0.70.

The proposed regulations extend the statute by imposing dividend withholding on instruments that do not have payments that are contingent upon actual dividend payments. For example, a "price return only" contract that exposes a non-U.S. investor to IBM's upside and downside, but not its dividends, is subject to withholding under the proposed regulations, even if the short party never owned any IBM stock in connection with the transaction, and even though the non-U.S. investor is not entitled to receive more or less under the contract if IBM's dividends are greater or less than expected. The "dividend equivalent payment" that is subject to withholding is the difference between the contract's actual price and the (presumably higher) price that the investor would have paid for a contract that exposed her to IBM's dividends as well.

The United States has never before imposed tax on an investor's foregone costs in choosing one investment over another. It is unimaginable that Congress intended the statutory language of section 871(m) to introduce such a tax. Section 871(m) imposes a tax on "payments" that are contingent upon, or determined by reference to, U.S.-source dividends. There is no suggestion in the statute, or in the corresponding legislative history, that Congress was leaving the word "payment" to the Treasury Department's interpretation.

Moreover, the proposed regulations' broad definition of "payment" violates the nondiscrimination provisions of many income tax treaties to which the United States is a party. These provisions generally prohibit the United States from imposing a more burdensome tax on residents of the other signatory state than it imposes on U.S. residents, and U.S. residents are not taxed on their foregone costs in choosing to invest in a "price return only" contract over a "total return" contract.

By adopting a test that would impose withholding on a broad spectrum of transactions that bear little to no resemblance to the "yield enhancement strategies" of the early 2000s, the proposed regulations ignore the 2008 Senate report's admonition not to condemn transactions with "legitimate business purposes such as facilitating capital flows, reducing capital needs, and spreading risk." Ironically, the delta test also fails to impose withholding on some transactions that would have been subject to withholding under the quasi-agency test, even though the statute contemplates withholding on these transactions.

Section 871(m) permits the Treasury Department to impose withholding on dividend equivalent payments under swaps that "have the potential for tax avoidance," and on "substantially similar payments." The proposed regulations read too much into this language. If Congress had wanted its quasi-agency test to be replaced by a far-reaching delta test that contradicts the 2008 Senate report and flouts the traditional definition of "payment," it would have said so. The proposed regulations amount to a new and unauthorized withholding regime.