ABCs OF CROSS-BORDER DERIVATIVES©

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TABLE OF CONTENTS

Page

Page

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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.[1] A specific example of this inconsistent treatment is illustrated by the comparison below of the tax consequences of certain 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

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* My thanks to Richard Andrade for contributing Section VI, and to my partner Gary T. Silverstein and our colleagues Janicelynn Asamoto and Shlomo Boehm 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.

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

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 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."[2] Despite several spates of rulemaking, eighteen years later, Treasury has not yet proposed 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.[3]

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.

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2 Kathleen Matthews, "U.S. Branch IFA Meeting Highlights Cross-Border Corporate Reshufflings, Tax Treaties, APAs," 94 TNI 54-3 (1994).

3 Taxpayers are forewarned that Schedule UTP (Form 1120) requires certain taxpayers to report their "uncertain tax positions"—those for which the taxpayer has recorded a reserve in its audited financial statements—to the IRS. *See* 2011 Instructions for Schedule UTP (Form 1120) (Feb. 2012).

- First, payments on notional principal contracts ("NPCs") that do not have an embedded loan component ("non-amortizing swaps") generally are sourced to the recipient's residence.[4] However, payments that are deemed to be interest on NPCs with embedded loans ("self-amortizing swaps") are sourced according to general rules for interest payments.

    - Under the Hiring Incentives to Restore Employment Act (the "HIRE Act"),[5] enacted March 18, 2010, dividend equivalent payments made after September 14, 2010 pursuant to certain NPCs that reference U.S. source dividends and satisfy any of five criteria discussed below are treated as U.S. source income and subject to withholding.[6] Final regulations extend the current HIRE Act rules through the end of 2015.[7] Beginning in 2016, dividend equivalent payments under *any* NPC that references U.S. source dividends will be treated as U.S. source income and subject to withholding, except to the extent that the IRS issues new regulations that provide that the NPC does not have the potential for tax avoidance. Proposed regulations, if finalized in their current form, would extend dividend equivalent withholding to a broader class of equity swaps than are currently subject to withholding, as well as to other equity-linked instruments, beginning in 2016.[8] However, IRS

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4 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.

5 Pub. L. No. 111-147.

6 I.R.C. § 871(m); *see also* T.D. 9648 (Dec. 5, 2013) (describing final and proposed regulations issued under section 871(m) and changes to the section 1441 withholding regulations).

7 Treas. Reg. § 1.871-16T.

8 Notice of Proposed Rulemaking, 78 Fed. Reg. 73,128 (Dec. 5, 2013). The current proposed regulations under section 871(m) replace regulations that were proposed in 2012. *See* 77 Fed. Reg. 3,108 (Jan. 23, 2012). For a thorough discussion of the new proposed regulations, see Jason Schwartz, Mark Howe and Daniel Mulcahy,

officials have indicated that the current dividend withholding rules would be extended to January 1, 2017.[9]

- Second, "substitute payments" on securities loans are sourced in the same manner as actual dividends or interest payment on the borrowed securities, while 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. The HIRE Act may also alter the applicable sourcing rules for classes of options, forwards, and regulated futures contracts beginning in 2017, and U.S.

"Proposed Regulations Under Section 871(m) Introduce a 'Delta' Test for Withholding on U.S. Equity-Linked Instruments—Expect Turbulence Ahead," 31 Journal of Taxation of Investments 3 (Spring 2014).

9 *See* A. Bennett, "Government Will Postpone Effective Date of Dividend Equivalent Rules Until Jan. 1, 2017," 90 *BNA Daily Tax Report* at G-2 (May 8, 2015) (citing statement by Treasury Department International Tax Counsel Danielle Rolfes). The IRS' decision appears to have been motivated in part by a letter from the International Swaps and Derivatives Association ("ISDA") requesting a delay in finalization of the proposed regulations described immediately below. *See* ISDA, "Request for Delay in the Application of Final Regulations under Section 871(m)" (Feb. 10, 2015) (expressing concern that "application of the regulations to payments made prior to January 1, 2017, and to certain instruments entered into or issued prior to such date, will make compliance with such regulations extremely challenging and potentially cause market disruptions that were not intended by Congress or the Treasury Department and Internal Revenue Service"), *available at* < https://www2.isda.org/functional-areas/accounting-and-tax/tax/>.

source dividend equivalent payments under these contracts could be subject to withholding.[10]

A. Notional Principal Contracts

1. Definition NPCs include swaps, caps, and floors whereby a party agrees to make periodic payments reflecting the value of a "specified 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.[11] 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.[12] 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

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10 Pub. L. No. 111-147.

11 Treas. Reg. § 1.446-3(c)(1); *see* discussion regarding timing in section II.A.2 below.

12 *See* Treas. Reg. § 1.446-3(c)(3). Note, however, that proposed regulations permit the IRS to recharacterize a transaction based on its substance. The anti-abuse rule would allow separating a single contract into a series of contracts or treating part or all of the contract as a loan. Prop. Treas. Reg. § 1.446-3(c)(3). Commentators have noted that the anti-abuse rule could plausibly affect swaps that provide taxpayers with exposures to different and successive investment strategies, particularly when the period of exposure to one strategy is less than the holding period for long-term capital gains. *See* Mark Leeds and Yoram Keinan, "Sometimes a Vague Notion: IRS Proposes To Update Rules for Swaps and Futures," *BNA Daily Tax Report* (Sept. 27, 2011).

and sells a floor, or purchases a floor and sells a cap, are known as collars; although collars are not themselves NPCs, taxpayers are permitted to treat the cap and the floor that together form a collar as a single notional principal contract.[13] An option to enter into an NPC is not considered an NPC.[14]

Regulations proposed in 2011 would clarify that a "specified index" (essentially, non-financial indices) includes any indices that (i) are based on objectively determinable non-financial information, (ii) are not within the control of either counterparty nor unique to a party's circumstance, and (iii) are not reasonably expected to front-load or back-load the payments accrued under the swap.[15] This expanded definition of "specified index" would explicitly bring weather-related, catastrophe-related, and mortality swaps within the ambit of NPC treatment.[16]

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13 Treas. Reg. § 1.446-3(c)(1)(i). The IRS has also concluded that an instrument issued by a corporation referencing the price of another corporation's stock (held by the issuer) constituted equity rather than debt, and was part of a straddle that could 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.

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

15 Prop. Treas. Reg. § 1.446-3(c)(2)(ii).

16 Although the treatment of weather-related swaps moving forward is clear, language in the Preamble of the proposed regulations has raised concerns that the past market practice of treating weather-related metrics as objectively determined economic information may not be respected by the IRS. *See* Preamble to Proposed Regulations (Swap Exclusion for Section 1256 Contracts), 76 Fed. Reg. 57,684 (Sept. 16, 2011) (noting that a "weather-related swap currently is not a notional principal contract because a weather index does not qualify as a 'specified index'").

The proposed regulations also address ambiguity with respect to bullet swaps[17] by redefining "payment" to include "an amount that is fixed on one date and paid or otherwise taken into account on a later date."[18] Under this definition of payment, bullet swaps and other contracts that provide a single payment at maturity (such as accumulated dividends) that was fixed on one or more earlier dates during the contract will be subject to the NPC rules.[19]

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."[20] 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.[21] Periodic payments (payable

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[17] Bullet swaps are swap-like contracts that accrue payments based on a specified index that references a notional principal amount but provide only for a single payment at contract maturity. Because payments under such contracts were not periodic, many practitioners had applied a wait-and-see principle for tax purposes (deferring any income accrued under the contract until its maturity). *See, e.g.*, Stevie D. Conlon, "New Proposed Regulations Defining Swaps Create Controversy," *J. of Tax*. (Nov. 2011).

[18] Prop. Treas. Reg. § 1.446-3(c)(1)(ii).

[19] *See*, *e.g.*, Stevie D. Conlon, "New Proposed Regulations Defining Swaps Create Controversy," *J. of Tax.*, at 272-74 (Nov. 2011); Anthony Tuths, "Fundamental Tax Reform of Derivatives," *Tax Notes*, at 436-38 (Jan. 23, 2012) (discussing the proposed regulation's deemed payment rule).

[20] *See* Treas. Reg. § 1.446-3(b).

[21] *See* Treas. Reg. § 1.446-3(e)(1).

at least annually) accrue ratably over the period to which they relate.[22]

- *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 substance.[23] In this regard, subject to the "embedded loan" rule described immediately below, 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.[24] 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.[25] 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.[26]

    - Certain swaps with non-periodic payments are bifurcated into an on-market, level payment swap and a separate "embedded

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[22] *See* Treas. Reg. § 1.446-3(e)(2).

[23] *See* Treas. Reg. § 1.446-3(f).

[24] *See* Treas. Reg. § 1.446-3(f)(2).

[25] *See* Treas. Reg. § 1.446-3(f)(2)(iii)(B).

[26] *See* Treas. Reg. § 1.446-3(f)(2)(iii)(B).

loan."[27] 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.[28] Deemed payments on the loan are calculated by assuming the loan is an installment obligation with level payments and a constant yield to maturity.[29]

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27 *See* Temp. Treas. Reg. § 1.446-3(g)(4) (discussed in greater detail below).

28 *See* Temp. Treas. Reg. § 1.446-3(g)(4); *see also* Rev. Rul. 2002-30, 2002-1 C.B. 971.

29 *See* Temp. Treas. Reg. §§ 1.446-3(g)(4), (6), Ex. 2.

Because swaps that provide for significant non-periodic payments may be treated in part as loans, foreign persons that make non-periodic payments to U.S. persons pursuant to a swap may be subject to withholding tax on deemed interest inclusions unless the withholding tax is reduced or eliminated under a treaty or the interest qualifies as "portfolio interest." Moreover, under section 956, a "United States shareholder" in a "controlled foreign corporation" (a "CFC") generally is required to include as ordinary income its *pro rata* share of the CFC's earnings that are invested in U.S. property. For this purpose, U.S. property includes certain loans that the CFC makes to U.S. persons. Accordingly, a CFC's execution of an off-market swap with a U.S. person could trigger income inclusions for the CFC's United States shareholders. Temporary Treasury regulations provide a limited "safe harbor" exception for non-periodic payments made by CFCs that are securities or commodities dealers (within the meaning of section 475) if each party is required to post cash margin or collateral in an amount that fully collateralizes its mark-to-market exposure on the swap (including the non-periodic payment) on a daily basis for the entire term of the swap. *See* Temp. Treas. Reg. § 1.956-2T(b)(1)(xi). This rule generally adopts the approach taken under the temporary regulations published in 2012. *See* T.D. 9589 (May 11, 2012); *see generally* W. Pomierski, "Off-Market Payments on Cleared Swaps Characterized as 'Loans': Temporary Section 956 Regulations Establish Dealer Safe Harbor, 38 *International Tax Journal* 33 (July 2012), *available at* <http://www.mwe.com/files/Publication/de4bc411-9be1-4abd-9920-623ad47fc773/Presentation/PublicationAttachment/9d2e97e0-2722-45d7-b429-66f486bb07a2/ITJ_38-04_Pomierski.pdf>.

- Under Treasury regulations published in 1993, the embedded loan rule applied only to swaps with "significant" non-periodic payments.[30] It was not clear at what level a non-periodic payment was treated as significant.[31]

- Temporary regulations published on May 8, 2015 extend the embedded loan rule to *all* swaps with non-periodic payments,[32] unless:

    - The swap has a stated term (including extensions) of not more than one year;[33] or

    - Each party is required to post cash margin or collateral in an amount that fully collateralizes its mark-to-market exposure on the swap (including the non-periodic payment) on a daily basis for the entire term of the swap.[34]

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30 *See* 58 Fed. Reg. 53125 (Oct. 14, 1993). The embedded loan rule for "significant" non-periodic payments appeared in prior regulations section 1.446-3(g)(4).

31 The examples to the prior regulations indicated that 9% was not "significant," and that 40% was.

32 *See* Temp. Treas. Reg. § 1.446-3(g)(4)(i), T.D. 9719 (May 8, 2015).

33 Temp. Treas. Reg. § 1.446-3(g)(4)(ii)(A)(1). An anti-abuse rule provides that two or more contracts may be treated as a single contract if a principal purpose of entering into separate contracts is to qualify for the short-term exception. *See* Temp. Treas. Reg. § 1.446-3(g)(4)(ii)(A)(2).

34 Temp. Treas. Reg. § 1.446-3(g)(4)(ii)(B). The rationale for this exception is that, if swap counterparties are required to provide daily variation margin to fully collateralize their potential obligations under the swap, then the recipient of a non-periodic payment does not have unrestricted use of the payment, and the payment does not resemble a loan. *See* Preamble to T.D. 9719 (May 8, 2015) ("[C]ommenters have argued that receiving an upfront payment and posting cash margin back to the payor of the upfront payment lacks

- The temporary regulations are intended to simplify the embedded loan rule in light of the increasing prevalence of up-front non-periodic payments in swap contracts.[35]

    - In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[36] which requires certain swap contracts to be cleared through registered derivative-clearing organizations. Because cleared swap contracts have standardized terms, one party often is required to accept a below-market rate. Cleared swaps generally provide for an up-front non-periodic payment to compensate that party for the below-market rate.

    - Parties also are increasingly standardizing the terms of their uncleared swaps.[37]

- The temporary regulations treat a non-periodic swap payment as an embedded loan, without regard to whether the non-periodic payment is "significant," if the swap was entered into after November 3, 2015. The two exceptions described above generally apply to swaps entered into after May 7, 2015, though taxpayers may elect to apply the exceptions to swaps entered into before that date. If not finalized, the temporary regulations would expire on May 7, 2018.[38]

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the most important attribute of indebtedness because the recipient lacks discretion as to the payment's use.").

35 *See* Preamble to T.D. 9719 (May 8, 2015).

36 Pub. L. No. 111-203, 124 Stat. 1376.

37 *See* Preamble to T.D. 9719 (May 8, 2015).

38 Temp. Treas. Reg. § 1.446-3(h)(2).

- *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.[39]

- 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,[40] (ii) a hedge or part of a straddle,[41] (iii) held by a taxpayer required (or

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[39] *See* Treas. Reg. § 1.446-3(h).

[40] The proposed swap regulations would apply to most foreign currency denominated NPCs that reference currency or property whose value is determined by reference to an interest rate. Prop. Treas. Reg. §§ 1.446-3(c)(1)(iii)(B), 1.988-1(a)(2)(iii)(B)(2).

[41] 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 duration of 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").[42] 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.[43]

    - 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

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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.

42 69 Fed. Reg. 8886 (Feb. 26, 2004).

43 The IRS has publicly confirmed that it is still working on NPC guidance. , and has indicated that it intends to issue new proposed regulations in 2015. *See* J. Herzfeld, "IRS Official Says Guidance on Notional Principal Contracts May Be Issued Soon," 06 *BNA Daily Tax Report* at G-4 (Jan. 8, 2015) (quoting Helen Hubbard, IRS associate chief counsel (financial institutions and products), as stating that June 30, 2015 was "still a safe target time frame" for the issuance of new proposed swap regulations).

method, and (iv) mark to market method.[44] 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.[45]

- Most significantly, the preamble to the Proposed Contingent Non-Periodic Regulations declares the "wait and see approach" to be "inconsistent" with existing authorities.[46] 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

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44 Notice 2001-44, 2001-2 C.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 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.

45 *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>.

46 69 Fed. Reg. 8886 (Feb. 26, 2004), preamble.

the contingent payment under a "reasonable amortization method."[47]

- If adopted, the Proposed Contingent Non-Periodic Regulations would require taxpayers to report income using one of 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,[48] or

    - 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

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47 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 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. *See also* L. A. Sheppard, "ABA Meeting: Financial Guidance Update," *Tax Analysts* (Sept. 28, 2012) (noting that, because the IRS has not issued guidance that permits a taxpayer to automatically change its accounting method, many taxpayers continue to use the "wait and see approach").

48 Prop. Treas. Reg. § 1.446-3(g)(6).

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.[49]

- 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 reflect the economic substance of the NPC.[50] 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).[51] 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.[52]

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49 Prop. Treas. Reg. § 1.446-3(i)(2); *see also* Erika Nijenhuis, "New Tax Issues Arising From Derivatives Regulatory Reform", 2010 TNT 114-3 (June 14, 2010) (arguing that the section 1256 mark-to-market rule as a policy matter should not apply to cleared or exchange traded swaps).

50 Rev. Rul. 2002-30, 2002-1 C.B. 971.

51 Presumably, the treatment of the contingent non-periodic component would be governed by the Proposed Contingent Non-Periodic Regulations, if adopted.

52 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).

- 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.[53] 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.

- Subsequently, the IRS issued Notice 2006-16, limiting the scope of Notice 2002-35.[54] 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.

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[53] Notice 2002-35, 2002-1 C.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), *BNA Daily Tax Report* No. 8, at G-4 (Jan. 12, 2005).

[54] Notice 2006-16, 2006-1 C.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.

3. Character of Income Termination payments produce capital gain or loss where the contract is held as a capital asset.[55] 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,[56] capital gain or loss arguably may result where payments relate to rights with respect to a capital asset.

   However, if a taxpayer holds a long position under a contract with respect to certain pass-thru "financial assets" under the constructive ownership rules,[57] the amount the taxpayer could recognize as long-term capital gain upon a termination of the contract is

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[55] 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; *see also* Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* 73-74 (Dec. 2, 2011).

[56] 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 payments, including up-front 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).

[57] *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.

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 rise to ordinary income or loss.[58] In addition, the preamble to the Proposed Contingent Non-Periodic Regulations effectively requires any taxpayer that is a party to a contingent payment NPC after March 27, 2004, and that has not yet adopted a method of accounting, to accrue the non-periodic contingent payment over the term of the NPC. However, terminations of swaps prior to their scheduled maturity will continue to give rise to capital gain or loss, as under current law.[59] Accordingly, holders could generally elect ordinary or capital treatment simply by terminating the NPC early or holding it to maturity.

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58 *See* Prop. Treas. Reg. § 1.162-30(a).

59 *See* Prop. Treas. Reg. § 1.446-3(g)(6)(i).

4. Source of Income Prior to the 2010 enactment of section 871(m),[60] payments under all NPCs (other than contracts with accelerated or uneven payments, such as swaps with an embedded loan component) were sourced according to the residence of the recipient.[61] Thus, most payments under an NPC received by a foreign holder were foreign source income not subject to U.S. withholding tax, except, under certain circumstances, when the foreign holder was engaged in a U.S. trade or business.[62] This sourcing rule applied to NPCs with respect to debt, commodities, and likely, stock,[63] which permitted foreign holders of dividend-paying stocks who were 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 was a powerful incentive to forego the voting rights associated with a direct investment in stock.[64] However, as discussed below, although this sourcing rule still applies with respect to certain NPCs, section 871(m) (which originally was

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60 Pub. L. No. 111-147, enacting § I.R.C. 871(l); *see also* Pub. L. No. 111-226 (redesignating section 871(l) as section 871(m)).

61 *See* Treas. Reg. §§ 1.863-7(b)(1), 1.988-4(a).

62 T.D. 8491, 1993-2 C.B. 215, preamble.

63 The current section 446 regulations do not explicitly refer to equity swaps that reference a single stock, but the language of the regulation, and the examples in Treasury Regulation section 1.446-3(c)(1)(ii) suggest that equity swaps that reference a single stock 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 that reference a basket of equity securities. *See* Prop. Treas. Reg. § 1.446-3(g)(7), *Exs*. 6-9; Rev. Rul. 2002-30, 2002-1 C.B. 971.

64 *See* Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* 75-76 (Dec. 2, 2011) (describing income-conversion opportunities for foreign investors seeking equity-based returns).

designated as section 871(l) until January 2011) now treats certain dividend equivalent payments made to a foreign counterparty after September 14, 2010 that are determined by reference to U.S. source dividend payments as U.S. source income, subject to a 30% U.S. withholding tax (which may be reduced under an applicable treaty).[65]

- 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)."[66] 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.[67] 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.[68]

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[65] *See generally* L. A. Sheppard, "News Analysis: Adjusting to Withholding on Total Return Swaps," 130 *Tax Notes* 533 (Jan. 31, 2011); L. A. Sheppard, "Grieving for Total Return Equity Swaps," 2010 TNT 89-H (May 17, 2010).

[66] Treas. Reg. § 1.863-7(b)(3).

[67] Treas. Reg. § 1.864-4(c).

[68] Treas. Reg. § 1.863-7(a)(1).

- By imposing a withholding tax on substitute dividend payments made under an equity swap between a foreign party and a domestic party, Treasury has addressed the formerly disparate tax treatment of payments received under an equity-linked swap and payments received by a foreign party holding the underlying equity directly.[69]

- Despite the residence-based sourcing rule for NPCs, certain payments may be subject to the general source and withholding rules. For example, if an NPC with 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.[70] This withholding tax might be reduced or avoided under a tax

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[69] Nonetheless, section 871(m)'s imposition of withholding tax on all dividend equivalent payments made pursuant to specified equity swaps is overly broad since depending on market movements, the foreign party may never earn any income over the life of the swap. *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).

[70] *See* I.R.C. §§ 871(a)(1)(A), (C), 881(a)(1), (3), 1441(a), (c), 1442(a). Practitioners have raised concerns that the up-front payments required by ISDA to clear swaps could be treated as a deemed loan under Treasury Regulations section 1.446-3(g)(4), which might raise U.S. trade or business concerns for hedge funds and other offshore investors. In public comments, Treasury has done little to assuage these concerns, noting that common law dictates whether an activity rises to the level of a trade or business and that if swaps were excluded from the deemed loan rule, it would provide incentives for investors to disguise their loans as swaps. *See* L. A. Sheppard, "The Ramifications of the Expanded NPC Definition," 2012 TNT 11-1 (Jan. 18, 2012) (reporting comments by Karl Walli, Senior Counsel (financial products), Office of Tax Legislative Counsel).

treaty, and such payments may also be exempt from withholding tax as portfolio interest. Further, as described below, final and proposed regulations issued pursuant to section 871(m) subject certain swap payments that are directly or indirectly contingent on, or determined by reference to, U.S. source dividends to a 30 percent tax.

- 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 the contracts are characterized as "interest" on an embedded loan that does not qualify as portfolio interest because it is received by a bank on an "extension of credit."[71]

- 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."[72] 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

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71 I.R.C. § 881(c)(3)(A).

72 T.D. 8491, 1993-2 C.B. 215, preamble.

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, a swap 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).

- It is difficult to conceive of a principled distinction whereby Treasury characterizes certain 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.

- 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.[73] 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

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73 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); L. A. Sheppard, "Derivatives Used to Beat Tax on Effectively Connected Income," 2006 TNT 219-5 (Nov. 13, 2006).

a U.S. real property interest under section 897 of the Code.[74]

- The IRS has emphasized its desire to issue more (and more timely) financial product guidance to practitioners.[75] At the same time, the IRS warned taxpayers to expect increased enforcement in this area.[76] Congress has also emphasized the need for greater enforcement in this area.[77]

- 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 reference dividend payments on U.S. equity securities.[78]

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74 Rev. Rul. 2008-31, 2008-26 I.R.B. 1180. Although foreign payees might avoid the FIRPTA rules in this context, depending on the source of payments, withholding could be required under either section 871(m) or FATCA.

75 *See* S. Young & L. A. 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).

76 *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); H. Rothman, "Shulman Says Service Will Challenge Swap Securities Lending Transaction," *BNA Daily Tax Report* No. 177 at GG-1 (Sept. 12, 2008).

77 *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).

78 S.506, 111th Cong., 1st Sess. (2009).

- President Obama's budget proposal for fiscal year 2011 also contained a provision to impose a 30% withholding tax on substitute dividend payments made on equity swaps or other NPCs that reference U.S. equity securities.[79]

- Building on this foundation, section 871(m) imposes a 30 percent U.S. withholding tax on any payment made beginning September 14, 2010 through March 18, 2012 to a foreign counterparty on an equity swap (or any substantially similar payment on any financial instrument) that directly or indirectly is contingent upon, or determined by reference to, the payment of a U.S. source dividend if: (i) the foreign counterparty transferred the underlying stock to its counterparty in connection with the transaction, *i.e.*, the underlying stock "crossed in", (ii) the counterparty transfers the underlying stock to the foreign counterparty at the termination of the transaction, *i.e.*, the underlying stock "crosses out", (iii) the underlying stock is not readily tradable on an established securities market, (iv) the underlying stock is posted as collateral to the foreign party, or (v) the equity swap or other transaction is otherwise identified by Treasury as subject to withholding.[80]

- Final regulations extend the date on which withholding would apply to all swaps (unless specifically identified by Treasury as not having the "potential for tax avoidance") to January 1,

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[79] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, *available at* < http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2011.pdf>.

[80] IRC § 871(m)(2)(B), (m)(3)(A); *see also* L. A. Sheppard, "No Total Return Equity Swaps Guidance, Treasury Says," 127 *Tax Notes* 856 (May 24, 2010) (describing practitioners' concern that the common practice of hedge funds selling shares into the market and dealers buying them in the market would be considered crossing in).

2016,[81] and, as mentioned above, IRS officials have indicated that this date would be further extended to January 1, 2017.[82]

- If regulations are finalized as proposed,[83] the 30 percent withholding requirement would then extend to dividend equivalent payments made to a foreign counterparty on any swap whose "delta" is at least 0.70.[84]
    - A swap's "delta" is the ratio of the change in the swap's fair market value to the change in the fair market value of the reference assets.[85]
    - If a swap's delta is not reasonably expected to vary throughout the swap's term, the swap would be treated as having a delta of 1.0 with respect to an adjusted number of reference shares.[86]

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81 IRC § 871(m)(2)(B), (m)(3)(B); Treas, Reg. § 1.871-15(d)(1) (deferring to January 1, 2016 the implementation of section 871(m) for additional NPCs); Treas, Reg. § 1.1441-2(b)(6) (extending withholding to dividend equivalents described in section 871(m)).

82 *See* A. Bennett, "Government Will Postpone Effective Date of Dividend Equivalent Rules Until Jan. 1, 2017," 90 *BNA Daily Tax Report* at G-2 (May 8, 2015).

83 *See* David Hariton, "Will the New Swap Regs Work to Implement Section 871(m)?," *Tax Notes* (Jan. 20, 2014) (expressing doubt that the new proposed regulations will be finalized in their current form). *But see* A. Bennett, "Government Comfortable with 0.7 Delta Standard in Section 871(m) Dividend Rules," 18 *BNA Daily Tax Report* at G-6 (Jan. 28, 2014) (quoting a Treasury Department official's statement that the government is "very comfortable" with the proposed regulations).

84 Prop. Treas. Reg. § 1.871-15(d)(2). For this purpose, a swap's delta would be calculated at the time the swap is entered into or acquired.

85 Prop. Treas. Reg. § 1.871-15(g)(1).

86 Prop. Treas. Reg. § 1.871-15(g)(2). For example, if a swap provides 50% upside, downside, and dividend exposure to 100 shares of stock, and the swap's fair market value is expected to appreciate or depreciate by $0.50 for every $1 that the stock appreciates or

- If a swap references the stock of more than one issuer, the swap's delta generally would be determined separately with respect to each stock, "without taking into account any other stock or other property or liability."[87] However, no withholding would apply to dividend equivalent payments made with respect to a "qualified index."[88]

- The proposed regulations define dividend equivalent payments to include actual dividends, estimated dividends, and adjustments to an instrument's interest rate, notional amount, purchase price, premium,

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depreciates, then the swap would be treated as having a delta of 1.0 with respect to 50 shares of the stock (instead of having a delta of 0.50 with respect to 100 shares of the stock). *See* Prop. Treas. Reg. § 1.871-15(g)(3), Ex. 3.

87 Prop. Treas. Reg. § 1.871-15(g)(1).

88 Prop. Treas. Reg. § 1.871-15(k)(1). There are two types of qualified indices. The first is an index that (i) references at least 25 securities, (ii) references only long positions with respect to its component securities, (iii) contains no component security that represents more than 10% of its weighting, (iv) is modified or rebalanced only according to predefined objective rules at set dates or intervals, (v) does not provide a dividend yield from component securities that exceeds 150% of the dividend yield reported on the S&P 500 index for the month immediately preceding the date that the swap is entered into or acquired, and (vi) is referenced by futures or option contracts that trade on either a national securities exchange that is registered with the Securities Exchange Commission, or a domestic board of trade that is designated as a contract market by the Commodity Futures Trading Commission. Prop. Treas. Reg. § 1.871-15(k)(2). The second type of qualified index is one composed solely of long positions in assets, with no more than 10% of the index's weighting attributable to U.S. stock. Prop. Treas. Reg. § 1.871-15(k)(3). *See also* L. A. Sheppard, "Naughty or Nice? The New Dividend Equivalent Withholding Rules," *Tax Notes* (Dec. 16, 2013) (noting concern among practitioners that the definition of "qualified index" may be too narrow to include even large, commonly referenced indices).

strike price, or other terms to account for actual dividends or estimated dividends.[89]

- Thus, a "price return only" swap that exposes a non-U.S. investor to IBM's upside and downside, but not its dividends, would be subject to withholding under the proposed regulations if the swap's actual price is less than the price that the investor would have paid for an otherwise identical swap that also provided exposure to IBM's dividends.[90]

- The amount of a dividend equivalent payment is the product of (1) the amount of the relevant per share dividend,[91] (2) the number of reference shares,[92] and (3) the swap's delta.[93]

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89 Prop. Treas. Reg. § 1.871-15(h)(1).

90 *See* Mark Leeds, "The 2013 IRS Cross-Border Dividend Equivalent Regulations," *Tax Notes* (Apr. 7, 2014) (expressing concern over this "implicit payment rule").

91 If a swap provides for a dividend equivalent payment based on an estimated dividend that is not adjusted to reflect the amount of the actual dividend, and the formula for determining the estimated dividend is specified in the relevant offering document or operative document, then the amount of the per share dividend would be the lesser of the estimate and the actual dividend. *See* Prop. Treas. Reg. § 1.871-15(h)(2)(iii)-(iv).

92 The proposed regulations generally provide that the number of reference shares is adjusted to take into account any "leveraging" provided under the swap. *See* Prop. Treas. Reg. § 1.871-15(i)(1)(i)(B)(ii).

93 For this purpose, if a swap has a term of more than one year, its delta would be calculated at the earlier of the stock's ex-dividend date and the record date of the dividend. Prop. Treas. Reg. § 1.871-15(i)(2)(i). If a swap has a term of one year or less, its delta would be calculated when the investor disposes of its position. Prop. Treas. Reg. § 1.871-15(i)(2)(ii).

  - The proposed regulations clarify that gross-up payments relating to section 871 withholding would be treated as dividend equivalent payments that are subject to 30 percent withholding if made to a foreign party.[94]

  - The proposed regulations also provide that dividend equivalent payments made under an "equity-linked instrument" would be subject to 30 percent withholding if made to a foreign party.[95]

  - The proposed regulations contain an anti-abuse rule that would permit the IRS to treat any payment with respect to a transaction that is entered into with a principal purpose of avoiding the proposed regulations as subject to a 30% withholding tax.[96]

- Sourcing income on a gross basis can lead to practical problems. For example, in scenarios with intermediate payers, gross-basis taxation results in cascading withholding. The IRS has acknowledged this problem; however, the proposed regulations under section 871(m) do not adequately address the problem.[97]

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[94] Prop. Treas. Reg. § 1.871-15(f)(1).

[95] Prop. Treas. Reg. § 1.871-15(e) (equity-linked instruments). An "equity-linked instrument" includes financial instruments that reference one or more U.S. stocks. The definition in the proposed regulations specifically contemplates futures, forwards, and options. Prop. Treas. Reg. § 1.871-15(e). Withholding would apply to dividend equivalent payments made under equity-linked instruments that are issued at least 90 days after the proposed regulations are finalized. *See* IRS Notice 2014-14, 2014-13 I.R.B. 881.

[96] Prop. Treas. Reg. § 1.871-15(n).

[97] *See, e.g.*, prior proposed FATCA regulations, REG-121647-10 (Feb. 2012); T.D. 9572 (Jan. 23, 2012) (noting that Treasury and the IRS "anticipate issuing proposed regulations addressing" the cascading of withholding obligations); New York State Bar Association Tax Section, *Report on Proposed and Temporary Regulations Under*

- The currently proposed regulations under section 871(m) replace regulations proposed in 2012, which would have applied a seven factor test to determine whether a swap was subject to withholding tax.[98]

- In addition to the final and proposed 871(m) regulations, FATCA may also impose withholding tax on payments on notional principal contracts. Very briefly, FATCA is a cross-border information reporting regime intended to reduce tax evasion that requires most foreign financial institutions (as defined in

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Section 871(m) (Apr. 25, 2012) (discussing this and other recommendations related to the temporary and prior proposed 871(m) regulations). The new proposed regulations under section 871(m) would exempt dividend equivalent payments (but not actual dividend payments) to a foreign dealer from withholding tax if the dealer certifies to its counterparty in writing that the dealer is entering into the transaction in its capacity as a securities dealer and will withhold any tax imposed under section 871(m) on transactions that it enters into as a short party in its capacity as securities dealer. *See* Prop. Treas. Reg. § 1.871-15(j)(1). This exemption may eliminate cascading withholding tax on dividend equivalent payments to foreign dealers, but would not eliminate all cascading withholding tax. *See* J. Arora, "Multiple Withholdings on Dividend Equivalents May Be Unavoidable," *Tax Notes Today* (Oct. 8, 2014) ("Although the government is considering how to minimize the possibility of multiple withholdings on a single dividend equivalent payment, it may not be possible to prevent that in every situation, an IRS official said."); New York State Bar Association Tax Section, *Report on Proposed Regulations Under Section 871(m)* (May 20, 2014) (discussing this and other recommendations related to the proposed 871(m) regulations), *available at* < http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1306.html >; "Final and Proposed Regulations Address U.S. Withholding Tax on U.S. Equity Derivatives," *Cadwalader Clients & Friends Memo* (Dec. 13, 2013) (discussing the cascading withholding problem in the new proposed section 871(m) regulations); Mark Leeds, "Holiday Party: IRS Releases Final Regulations on Cross-Border Dividend Equivalents Paid on Swaps and in Security Lending Transactions," 242 *BNA Daily Tax Report* at J-1 (Dec. 17, 2013).

98 78 Fed. Reg. 73,128 (Dec. 5, 2013), *withdrawing* 77 Fed. Reg. 3,108 (Jan. 23, 2012).

the Code) to provide the IRS or the jurisdiction in which they are organized with information about their U.S. account holders. Foreign financial institutions that choose not to enter into a FATCA agreement with the IRS, or that fail to comply with local law enacted pursuant to an "intergovernmental approach" to FATCA, will be subject to a 30 percent withholding on the receipt of: (i) U.S. source fixed or determinable, annual or periodical income ("FDAP income") that is not effectively connected with a U.S. trade or business, (ii) gross proceeds on the sales of U.S. assets, and (iii) foreign source "passthru payments" that are attributable to U.S. assets.[99]

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[99] T.D. 9610 (January 17, 2013). The FATCA regulations phase in the withholding as follows: U.S. source FDAP income (July 1, 2014), gross proceeds from the sale of U.S. assets (January 1, 2017), foreign passthru payments (January 1, 2017 or later). *See also* "The Final FATCA Regulations: Applications to Foreign Investment Vehicles," *Cadwalader Clients & Friends Memo* (Jan. 31, 2013); L. A. Sheppard, "FATCA Transition Relief and Good News for Withholding Agents," *Tax Notes* (June 20, 2011).

Under the intergovernmental approach to FATCA, foreign governments may enter into an agreement with Treasury under which they agree to enact legislation that requires resident financial institutions (or resident branches of financial institutions) to report information directly to them, and to forward the information to the IRS. *See* "U.S. Treasury Department Releases Model FATCA Intergovernmental Agreements," *Cadwalader Clients & Friends Memo* (Aug. 10, 2012); "United States and United Kingdom Sign Intergovernmental Agreement Under FATCA," *Cadwalader Clients & Friends Memo* (Sept. 20, 2012). The text of the model intergovernmental agreements issued by Treasury, and the joint statements and bilateral agreements issued to date under FATCA, are available online at Treasury's FATCA Resource Center, <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx>. Foreign financial institutions (or branches thereof) that are resident in a jurisdiction that has entered into such an intergovernmental agreement generally are exempt from FATCA withholding on U.S. source FDAP income until January 1, 2015. *See* IRS Notice 2013-43, 2013-31 I.R.B. 113 (July 12, 2013).

- Under the final FATCA regulations, if a foreign payee is a financial institution that does not sign a FATCA agreement with the IRS, does not comply with local law enacted pursuant to an intergovernmental agreement under FATCA, or otherwise fails to establish an exemption from FATCA, then, beginning no earlier than 2017, payments it receives from a FATCA-compliant foreign financial institution (including payments made under an NPC) may be subject to foreign source passthru payment withholding.[100] However, the FATCA regulations do not define the scope of foreign source passthru payment withholding. Moreover, the regulations provide a "grandfathering" rule that generally exempts NPCs and other obligations from passhthru payment withholding if the obligations are entered into earlier than six months after the issuance of future regulations that define the term "foreign passthru payment."[101] Finally, the intergovernmental agreements under FATCA do not require foreign passthru payment withholding, and instead provide that the governments will work together to develop an "alternative approach" to foreign passthru payment withholding.

5. <u>Derivatives Transfer Regulations</u> Dodd-Frank affects NPCs in two significant ways. First, Dodd-Frank requires that all financial derivatives pass through clearing organizations. Although dealer-to-dealer exchanges had been exempted from deemed sale treatment,[102] practitioners worried that, because clearing organizations were unlikely to qualify as

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[100] *See* Treas. Reg. § 1.1471-4(b)(4).

[101] *See* Treas. Reg. § 1.1471-2(b)(2)(i)(B). The grandfathering rule does not apply to instruments that lack a fixed term or are treated as equity for U.S. federal income tax purposes.

[102] *See* Treas. Reg. § 1.1001-4(a) (revoked).

dealers for federal income tax purposes, transfers by a dealer to a clearing organization could be treated as a deemed exchange resulting in a taxable realization event. Second, Dodd-Frank's clearing requirement seems to sweep swaps and other over-the-counter NPCs into the definition of a section 1256 contract.[103] Although Dodd-Frank modified the definition of section 1256 contracts to exclude most swaps, certain contracts—including commodities swaps—were still governed by the plain text of section 1256.

To address concerns that "the assignment of derivative contracts may create a taxable event for the nonassigning counterparties to the assigned contracts,"[104] the IRS issued regulations to ensure that, if the following three conditions are satisfied with respect to transfers or assignments between dealers and clearing organizations, such transfers will not be treated as deemed exchanges.[105] First, both parties to the transfer or assignment must be either a dealer or a clearinghouse.[106] Second, the contract must allow the assignment.[107] Third, no other modifications that would otherwise cause a

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[103] Contracts subject to section 1256 must be marked-to-market, and gains and losses receive a blended capital gains rate: 60% is treated as long-term and 40% is treated as short-term. I.R.C. § 1256.

[104] Preamble to T.D. 9538 (July 22, 2011). Treasury Decision 9538 contained temporary regulations that ultimately were adopted as Treasury Regulations section 1.1001-4.

[105] Treas. Reg. § 1.1001-4(a), T.D. 9639 (Nov. 5, 2013) . These rules are effective for transfers or assignments beginning July 22, 2011.

[106] Treas. Reg. § 1.1001-4(a)(1).

[107] Treas. Reg. § 1.1001-4(a)(2). This rule seems to arbitrarily distinguish between contracts written to permit consent to transfer (but require the consent of another party), and contracts that prohibit transfers, but permit amendments (which could then be employed to change a document to permit transfers). *See, e.g.*, Stevie D. Conlon, "New Swap Assignment Temp. Regs. Address Dodd-Frank Issue and Other Concerns," *Journal of Taxation*, at 128 (Sept. 2011).

deemed exchange may occur.[108] The IRS has also clarified that commodities swaps, among others, will qualify for the dealer-to-clearinghouse transfer rule.[109]

6. Credit Default Swap Issues 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 either the maturity of the CDS or the occurrence of a credit event. Following the occurrence of a credit event, the protection seller typically either pays the protection buyer an amount reflecting all or part of 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

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[108] Treas. Reg. § 1.1001-4(a)(3). Changes made pursuant to contract provisions are unlikely to be modifications, and Treasury representatives have indicated that Treasury Regulations section 1.1001-3 may be instructive on the significant modification issue. *See* L. A. Sheppard, "The Ramifications of the Expanded NPC Definition," *Tax Notes Today* (Jan. 18, 2012) (discussing comments made by Karl Walli, Senior Counsel (Financial Products), Office of Tax Legislative Counsel).

[109] Although when first released, the temporary regulations appeared to exclude certain contracts, including commodities swaps, the IRS retroactively corrected the regulation to apply to additional derivative contracts, including swaps referenced by commodities. *See* I.R.S., Modifications of Certain Derivative Contracts; Correction, Fed. Reg. Doc. No. 2011-21180, 76 Fed. Reg. 161 (Aug. 16, 2011). The final regulations incorporate these corrections.

further information and submissions.[110] 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).[111]

- Nevertheless, practitioners are concerned by the possibility that CDS transactions could be recharacterized as guarantees, or possibly, as insurance contracts.[112] 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).[113] Moreover, characterization of

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110 Notice 2004-52, 2004-2 C.B. 168.

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

112 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). *See* D. S. Miller and S. Boehm, "New Developments in the Federal Income Tax Treatment of CDSs," 7 *Journal of Taxation of Financial Products* 9, Issue No. 4 (Jan. 2009).

113 Guarantee fees paid from sources within the United States generally are treated as U.S. source income and are therefore subject to withholding. *See* I.R.C. § 861(a)(9), *enacted by* Pub. L. 111-240. However, if a guarantor is a qualified resident of a country with a relevant treaty, it is possible that the guarantee fees will be characterized as foreign source income under the treaty. *See* Amy S.

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 CDSs meeting certain criteria either as an option or as an NPC and not as an insurance policy, guarantee, letter of credit or similar contract.[114]

- Proposed swap regulations would ostensibly treat most CDSs, other than single-payment physically-settled CDSs, as notional principal contracts.[115] However, the proposed swap regulations do not specifically define credit default swaps.[116] Treasury officials indicated that no CDS definition was necessary as most practitioners are generally aware of what constitutes a CDS, and that if the characterization of a contract was ambiguous, a facts and circumstances test may be used,[117] which

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Elliott, "Guarantee Fees May Not be Considered U.S.-Source if the Guarantor is a Qualified Resident of a Treaty Country," 2010 TNT 215-4 (Nov. 8, 2010) (reporting a statement by Robert Driscoll, withholding technical adviser for the IRS Large Business and International Division, that the terms of a treaty's "other income" provision could cause guarantee fees to be taxable only in the recipient's country).

114 *See* NYSBA Report on Credit Default Swaps, 2005 TNT 176-21 (Sept. 13, 2005).

115 Prop. Treas. Reg. § 1.446-3(c)(1)(iii). The deemed payment rule would treat physically settled CDSs with two or more payments as governed by the NPC regulations.

116 *See*, *e.g.*, V. Barnes, "IRS Proposal Answers Some Questions on Taxation of Credit Default Swaps," *BNA Daily Tax Report* (Oct. 14, 2011) (noting the omission); L. A. Sheppard, "Getting a Handle on Credit Default Swaps," *Tax Notes* (Oct. 10, 2011) (same).

117 Marie Sapirie, "Derivatives Transfer Regs, Credit Default Swaps Rules Discussed," 2012 TNT 8-3 (Jan. 12, 2012) (reporting comments made by Diana Imholtz, branch 1 chief, IRS Office of Associate Chief Counsel (Financial Institutions and Products)).

could except certain CDS-like financial instruments from swap characterization.[118]

- Relying on 2004 proposed regulations and a 2001 Notice that outline different reporting requirements for periodic, non-contingent non-periodic, and contingent periodic payments, taxpayers currently report their CDS income in various ways.[119] By contrast, the proposed regulations would preclude CDSs that are notional principal contracts from being treated as options or guarantees, treatments historically adopted by practitioners.[120] However, until final regulations are adopted, Treasury has publicly stated that taxpayers may continue reporting income from existing contracts using any reasonable method (*i.e.*, methods provided in prior guidance) so long as both counterparties to the CDS report income congruently.[121] The IRS intends to issue further guidance regarding the accounting method for CDSs before the end of 2014.[122]

B. Cross-Border Securities Loans

1. <u>Definition</u> Payments a lender is entitled to receive under the terms of a typical securities loan that are

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[118] *See*, *e.g.*, L. A. Sheppard, "Proposed Derivatives Regulations Defend," *Tax Notes*, at 937 (Nov. 21, 2011).

[119] *See* Notice 2001-44, 2001-30 I.R.B. 77 (describing accounting for non-contingent swap payments); V. Barnes, "IRS Proposal Answers Some Questions on Taxation of Credit Default Swaps, *BNA Daily Tax Report* (Oct. 14, 2011).

[120] Prop. Treas. Reg. § 1.446-3(c)(1)(iv).

[121] *See* L. A. Sheppard, "Getting a Handle on Credit Default Swaps," *Tax Notes*, at 124-25 (Oct. 10, 2011); L. A. Sheppard, "Proposed Derivatives Regulations Defend," *Tax Notes*, at 937 (Nov. 21, 2011) (reporting comments made by Karl Walli, Senior Counsel (Financial Products), Office of Tax Legislative Counsel). In the meantime, however, the IRS allows taxpayers to request changes to their present accounting methods that conform to the proposed regulations.

[122] *See* U.S. Treasury, 2013-2014 Priority Guidance Plan (Aug. 9, 2013), *available at* < http://www.irs.gov/pub/irs-utl/2013-2014_pgp.pdf >.

equal to any dividends or interest paid by an issuer on the borrowed securities are typically termed "substitute payments."[123] 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.[124]

2. <u>Timing of Income</u> A lender should accrue substitute payments in income as received.[125] Likewise, a borrower should accrue fees in income as received.

3. <u>Character of Income</u> Revenue rulings treat substitute payments with respect to securities

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[123] For a 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).

[124] *See generally* NYSBA Tax Section Report Addresses Treatment of Securities Loans, 2011 TNT 112-22 (June 9, 2011).

[125] *See* Prop. Treas. Reg. § 1.1058-1(d) (generally providing that substitute payments "shall be treated by the lender as a fee for the temporary use of property"). *But See* J. Maddrey, "Accounting for Income from Securities Lending Transactions," 12 *Journal of Taxation of Financial Products* 5 at 6 (July 2014) (arguing that (1) "if the underlying security is stock on which there is a return-of-capital distribution, the portion of the in-lieu-of payment reflecting the return-of-capital distribution ought to be treated as a return of capital (and not income) by the securities lender," (2) "if the underlying security is a debt instrument, in-lieu-of-payments that reflect principal payments likewise ought not to be income to the securities lender," and "the securities lender could choose to determine its income in the same manner, and based on the same accounting methods, as it would have had the lender simply continued its direct investment in the security" (e.g., by accruing original issue discount)).

lending transactions as fees paid for the use of the securities that constitute ordinary income to the securities lender.[126] 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.[127] Further, substitute payments in lieu of dividends do not qualify for the lower 15% tax rate[128] on "qualified dividends."[129] Similarly, a securities lender is not entitled to treat substitute payments received for tax-exempt interest as the receipt of such interest in order to exclude the

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126 *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), the RIC may treat its position in a repurchase (repo) transaction with respect to a government security as though the repo itself were a government security. *See* Rev. Proc. 2004-28, 2004-21 I.R.B. 984 (May 6, 2004).

127 *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).

128 The Obama Administration has proposed taxing qualifying dividends at the ordinary income rate beginning in 2013. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* (Feb. 2012).

129 *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 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).

payments from income under section 103(a)(1).[130] 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 section 871(m) and applicable Treasury regulations, as discussed below.[131] Second, substitute payments are essentially characterized as dividends or interest, as the case may be, in the hands of RICs and tax-exempt lenders.[132]

- As discussed in more detail below in the section of this outline dealing with forward contracts,[133] 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.[134]

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

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130 *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).

131 *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").

132 *See* I.R.C. §§ 512(b)(1), 851(b)(2).

133 *See* Section II.D.

134 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).

securities loans, since the location of securities may be unknown 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.[135] The regulations have eliminated taxpayers' ability to rely on these theories for substitute payments, other than fees or interest paid to transferees. Further, section 871(m) treats substitute dividend payments determined by reference to U.S. source dividends as U.S. source dividend payments.[136] However, the following theories have continuing applicability to the fees and interest components of securities loans and sale-repurchase transactions that are not addressed by section 871(m) or the Substitute Payment Regulations.

- Some lenders sourced substitute payments based on the physical location of the securities, relying on the rental income source rules.[137] 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 the borrower 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

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135 As might be expected, the chosen method of sourcing generally depended on an individual taxpayer's facts and circumstances. *See generally* M. Gaffney, "Cross-Border Securities Lending & Qualified Securities Lender Regime," *Tax Notes* (Aug. 8, 2011) (providing a history of securities lending and recent history, tax law, and policies behind the securities-lending taxation regime).

136 I.R.C. § 871(m)(1), (2).

137 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).

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).

- Substitute payments were also sourced according to the location where the securities lending transaction occurred, consistent with the source rules for services and other financial transactions.[138] Another sourcing alternative was the location of the securities issuer, based on the dividend and interest source rules. Finally, payments were sourced on the basis of the residence of either the borrower[139] or the lender.[140] Commentators consistently suggested sourcing fees according to the lender's residence, which would be consistent with the sourcing rules applied to payments under NPCs.[141]

- Prior to the issuance of the Substitute Payment Regulations and section 871(m), U.S. lenders 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

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[138] *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).

[139] *See* I.R.C. § 988(a)(3)(B) for a definition of residence for this purpose.

[140] *See* Treas. Reg. § 1.863-7.

[141] 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").

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 were exempt from foreign withholding as business profits. Thus, substitute payments were treated as foreign source income that was not 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.[142] 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.

5. 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.[143] However, these

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[142] 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.

[143] 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

regulations are not comprehensive, and thus uncertainty persists with respect to certain payments and transactions that are not within the scope of the regulations.[144]

- 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 limitations on deductions, including the limitations on miscellaneous itemized deductions).[145] 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.[146] Corporations that are traders

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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.

[144] *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). If the tax treatment of a position is uncertain, taxpayers are advised to report these positions on Schedule UTP (Form 1120), as required by law.

[145] *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).

[146] *See* Gen. Couns. Mem. 37,513 (Apr. 25, 1978) (stating that all profit-making activities of a corporation are conducted as part of a

or dealers in stock or securities should be able to deduct substitute dividend or interest payments, subject to other restrictions on a corporation's ability to deduct such expenses.[147]

- 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.[148] 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.[149] Whether the look-through

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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).

147 *See*, *e.g.*, I.R.C. § 163(j).

148 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.

149 The adoption of this look-through rule ensures 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.

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.

- 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.[150] 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 and 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."[151] 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

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withholding tax, but many qualified residents of countries with U.S. tax treaties would pay a reduced amount.

[150] *See* Treas. Reg. § 1.894-1(c).

[151] *See, e.g.*, United States-Trinidad and Tobago Income Tax Convention, Article 12(3).

payments constitute "business profits" or "other income" to the lender.

- 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.[152]

  - 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.[153] In one ruling the IRS concluded that borrow fees received in connection with a taxpayer's trade or business may constitute "industrial and commercial profits" for income tax

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[152] 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.

[153] *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).

treaty purposes.[154] Notably, however, the IRS no longer rules on this issue,[155] 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.[156] 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.[157] 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.[158] 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

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[154] Priv. Ltr. Rul. 88-22-061 (Mar. 7, 1988).

[155] *See* Rev. Proc. 2010-7, 2010-1 I.R.B. 231 (Dec. 31, 2009) (IRS ordinarily will not rule on source, character or income tax treaty treatment of any payments in securities lending transactions).

[156] *See* I.R.C. §§ 1441, 1442.

[157] *See* 1992 NYSBA Report.

[158] This result would make loans of foreign securities to U.S. borrowers less attractive to U.S. lenders in an excess foreign tax credit position that are seeking to generate additional foreign source income.

result that would not have been consistent with the intent of the branch profits tax, because the 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.[159]

- 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,[160] 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.[161] 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

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[159] *See* T.D. 8735, 1997-2 C.B. 73, preamble.

[160] 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.

[161] *See Deputy v. Du Pont*, 308 U.S. 488 (1939).

underlying debt security is in either registered or bearer form) or short-term original issue discount.

- 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.[162]

- 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.[163] 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.

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[162] *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.

[163] T.D. 8735, 1997-2 C.B. 73, preamble.

- 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 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.[164] However, the resulting withholding tax may be reduced or eliminated to the extent that total withholding payments on all legs of

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[164] Because the formula provided in Notice 97-66 effectively reduces the amount of withholding tax required on a substitute dividend payment by the amount of withholding tax that *would be* imposed on the payer (*i.e.*, the securities borrower) with respect to the dividend, without regard to whether that tax actually is imposed, some taxpayers adopted a strategy pursuant to which, very generally, (i) the securities borrower sold the securities to a U.S. swap dealer before the relevant ex-dividend date, (ii) the securities borrower entered into a total return swap with the swap dealer with respect to the securities that provided the securities borrower with any appreciation and the amount of any dividend payments on the securities, and (iii) the securities borrower retained a portion of the synthetic dividend payment from the total return swap as a "fee," and passed on the remainder to the securities lender, without paying or withholding any tax with respect to the dividend. In AM 2012-009, the IRS held that the transaction lacked economic substance, and that taxpayers therefore could not rely on Notice 97-66 to avoid withholding under the transaction. *See* AM 2012-009 (Nov. 5, 2012); *see generally* J. Cummings, Jr., "Withholding on Cross-Border Derivatives," *Tax Notes* (Mar. 11, 2013); *see also* M. Gaffney, "Stock Lending Notices, Unwritten Intent, and Economic Substance," *Tax Notes* (Dec. 22, 2014) (arguing that the economic substance doctrine should not apply to cross-border stock lending transactions entered into before the effective date of section 871(m), and that AM 2012-009 should be withdrawn).

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.[165]

- In May 2010, the IRS issued Notice 2010-46, which supersedes Notice 97-66.[166] Notice 2010-46 provides that taxpayers may generally continue to rely on Notice 97-66 for payments made before September 14, 2010, absent a tax avoidance motive. However, for payments made after September 14, 2010, Notice 2010-46 provides that the maximum amount of aggregate tax due with respect to a series of lending transactions, will be determined by the tax rate paid by the lender bearing the highest U.S. tax rate. Therefore, with respect to a series of securities lending transactions, the aggregate U.S. tax due should not exceed 30% of the substitute dividend payment.[167] The IRS intends to issue regulations that will be effective for transactions entered into after December 31, 2011 that will replace the formulary approach of Notice 97-66 with a documentation-based system under which withholding agents will be able to reduce withholding to the extent that they can demonstrate that appropriate U.S. tax was withheld on another substitute payment with respect to identical securities.[168] This shift from a formulary to documentation-based system is designed to coordinate the tax that section 871(m) imposes on substitute payments with the U.S. withholding tax rules contained in

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[165] *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).

[166] Notice 2010-46, 2010-24 I.R.B. 757.

[167] Notice 2010-46, 2010-24 I.R.B. 757.

[168] Notice 2010-46, 2010-24 I.R.B. 757.

section 1441 et. seq. The preamble to the temporary regulations previously issued pursuant to section 871(m) indicated that guidance regarding the withholding applicable to a series of securities lending or sale-repurchase transactions would be forthcoming; in the meantime, taxpayers may continue to rely on the Notice 2010-46 transition rules.[169]

- 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 such authority permits inconsistent determinations of the character of securities loan substitute payments for foreign and domestic tax purposes in the absence of legislation.[170] 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.[171] It is also not clear whether and to what extent the Substitute Payment Regulations will operate to characterize substitute payments as dividends under the

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[169] T.D. 9572 (Jan. 23, 2012). As mentioned above, the new proposed regulations under section 871(m) would exempt dividend equivalent payments (but not actual dividend payments) to a foreign dealer from withholding tax if the dealer certifies to its counterparty in writing that the dealer is entering into the transaction in its capacity as a securities dealer and will withhold any tax imposed under section 871(m) on transactions that it enters into as a short party in its capacity as securities dealer. *See* Prop. Treas. Reg. § 1.871-15(j)(1). This exemption may eliminate cascading withholding tax on dividend equivalent payments to foreign dealers, but would not eliminate all cascading withholding tax.

[170] *See generally* 1992 NYSBA Report.

[171] I.R.C. §§ 512(b)(1), 851(b)(2).

terms of tax treaties with the United States, as discussed above.[172]

- If A loans an equity security 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.[173]

- Prior to the enactment of section 871(m) the treatment adopted by the Substitute Payment Regulations was inconsistent with the treatment of dividends and interest employed in other cross-border financial transactions, most notably those involving NPCs. For example, dividend equivalent payments made in connection with equity index swaps were not treated as dividend payments for purposes of determining the character and source of the payments.[174]

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[172] *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.

[173] David Hariton, "Equity Derivatives, Inbound Capital and Outbound Withholding Tax," *Tax Forum* No. 594 (Nov. 6, 2006).

[174] *See* Treas. Reg. §§ 1.863-7, 1.988-4. In addition, if the option in effect lacks "optionality" (for example, because the option holder is economically disincentivized to allow the option to lapse unexercised), ownership of the option will be treated as ownership of the underlying assets. *See* AM 2010-05 (Dec. 17, 2010) (transaction was styled as a call option, but required the holder to bear economic

> Section 871(m) reduces this inconsistency by treating divided equivalent payments made pursuant to certain NPCs as U.S. source dividends.

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 bets, options may also constitute straddles and/or hedges.[175]

2. Timing of Income 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).[176] The writing and purchase of an option is generally treated as an open transaction until a further event

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losses equal to any losses on the underlying, thereby ensuring that the holder would exercise the option to recoup a portion of its investment); *see generally* "IRS Rule on Non-Publicly Traded REIT's Elective Dividends," 114 *J. Tax'n* 59 (Jan. 2011).

175 *See*, *e.g.*, Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* 32-36 (Dec. 2, 2011).

176 *See* Rev. Rul. 85-87, 1985-1 C.B. 269; Rev. Rul. 82-150, 1982-2 C.B. 110.

establishes gain or loss.[177] 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.[178]

- 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.[179] 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.[180] 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 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

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[177] *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.

[178] *See* I.R.C. § 1256(a), (b), (g)(3)-(6); I.R.C. § 475(a), (c)(2)(E). On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173) ("Dodd-Frank") into law. Dodd-Frank added section 1256(b)(2), which lists certain contracts and swaps that will not be subject to the mark-to-market rules, including interest rate swaps, currency swaps, equity swaps, credit default swaps, and other types of derivatives.

[179] 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.

[180] *See* Rev. Rul. 88-31, 1988-1 C.B. 302.

put option adds the option premium to the basis of any property that is delivered on the exercise of the put option.[181] 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.[182] 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.[183]

3. <u>Character of Income</u> An option purchaser's gain or loss with respect to an option is treated as derived from a sale of the optioned property.[184] Whether such gain or loss is long-term or short-term capital gain or loss depends on the option purchaser's holding period.[185]

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[181] *See* Rev. Rul. 71-521, 1971-2 C.B. 313. The IRS has indicated in published guidance that a taxpayer cannot defer gain recognition indefinitely by settling a put option with borrowed shares. *See* Tech. Adv. Mem. 2012-14-021 (taxpayer that exercised a put option and delivered borrowed shares recognized gain equal to difference between cash received and the fair market value of the shares at settlement); *see generally* R. Willens, "Settling a Put Option with Borrowed Shares," 89 *BNA Daily Tax Report.* at J-1 (May 9, 2012).

[182] *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.

[183] *See* Rev. Rul. 82-150, 1982-2 C.B. 110.

[184] I.R.C. § 1234(a).

[185] *See* Treas. Reg. § 1.1234-1(a).

- An option grantor (writer) generally recognizes short-term capital gain or loss with respect to an option on stocks, securities or commodities, unless (i) the option is inventory of the grantor, (ii) the 60/40 blended rate of section 1256 applies because the option is marked to market,[186] (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.[187] 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.[188] Treasury Regulations provide that regardless of their character, option premiums do not constitute FDAP income.[189]

- 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[190] 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

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[186] Note, however, that under the proposed swap regulations, an option on a notional principal contract is excluded from section 1256 contract status and may not receive the blended capital gains rate. *See* Prop. Treas. Reg. 1.1256(b)-1(a) (a contract that qualifies as both an NPC and a section 1256 contract will be treated as an NPC).

[187] *See* I.R.C. § 1234(b); Treas. Reg. §§ 1.1234-3, -4.

[188] I.R.C. § 1234A.

[189] Treas. Reg. § 1.1441-2(b)(2)(i).

[190] I.R.C. § 1260.

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 of the option at a constant rate.[191] However, these rules would not apply if both options are marked to market.[192]

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.[193]

   As mentioned above, beginning in 2017, proposed regulations issued pursuant to section 871(m) generally would treat dividend equivalent payments under options that reference U.S. stock as U.S. source dividends, even if the holder is a foreign holder.[194]

   Further, as described more fully in the text above, to the extent a foreign financial institution does not sign a FATCA agreement with the IRS (or is not otherwise exempt from withholding under FATCA), certain payments made to that institution (including foreign source passthru payments beginning no

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191 *See* I.R.C. § 1260(b).

192 *See* I.R.C. § 1260(d)(2).

193 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.

194 *See* Prop. Treas. Reg. § 1.871-15(e). Withholding would apply to dividend equivalent payments made under equity-linked options that are issued at least 90 days after the proposed regulations are finalized. *See* IRS Notice 2014-14, 2014-13 I.R.B. 881.

earlier than 2017) could be subject to U.S. withholding tax.

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. Forward contracts are excluded from the definition of a notional principal contract.[195] Because forward contracts are not regulated, they entail counterparty credit risk not present in exchange traded futures contracts.

2. Timing of Income 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 section 1259.[196] At that point, the deliverer, but not

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[195] This remains true in the proposed swap regulations, and the IRS intends to issue guidance on forward contracts before the end of 2014. *See* U.S. Treasury, 2013-2014 Priority Guidance Plan (Aug. 9, 2013), *available at* < http://www.irs.gov/pub/irs-utl/2013-2014_pgp.pdf >; L. A. Sheppard, "What is a Forward Contract?," *Tax Notes* (Oct. 31, 2011).

[196] 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

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.[197] 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.[198]

- 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.[199] However, under President Obama's budget proposal for fiscal year 2013, a portion of the forward payment received by a corporation on a forward contract

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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, 2002-2 C.B. 84. 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.

197 *But see* ILM 2011-04-031 (Sept. 17, 2010) (physical settlement of a short forward contract was a realization event, and economic built-in gain or loss should not merge into the settled property); *see also* J. Coder, "IRS Official Defends Advice on Cash From Forward Contract," *Tax Notes* (May 30, 2011) (discussing comments made by Treasury officials regarding the memorandum). For further discussion regarding this memorandum, *see* section II.E.3.

198 I.R.C. § 988(c)(5); Treas. Reg. § 1.988-2(d)(2)-(4).

199 *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).

to sell its own stock would be treated as an interest payment.[200]

3. Variable Prepaid Forward Contracts Variable prepaid forward contracts, designed to allow shareholders to monetize a significant portion of the appreciation on publicly traded stock while deferring tax liability, have been a widely employed planning technique. Whether this intended tax treatment would be respected 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.[201] Thus, the parties typically treat the arrangement as a financing secured by, and payable in, the pledged shares.[202]

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200 Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, *available at* < http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf >.

201 *See* Rev. Rul. 2003-7, 2003-1 C.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).

202 However, in an internal legal memorandum, the IRS prohibited permanent tax deferral by a taxpayer that closed out a collateralized variable prepaid forward contract with identical shares borrowed in a short sale, concluding that the recognition event occurred upon the closing of the variable prepaid forward contract, and that replacing an open transaction with another open transaction does not permanently defer gain recognition. ILM 2011-04-031 (Sept. 17, 2010); *see also* L. A. Sheppard, "Can the Tax Law Handle Short Derivatives?," *Tax Notes* (Mar. 5, 2012) (reporting statements by Michael Novey, Treasury associate tax legislative counsel, to the

- 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.[203]

- The IRS limited the highly taxpayer favorable treatment outlined in Revenue Ruling 2003-7 in its subsequent guidance. For example, in a 2006 Technical Advice Memorandum, the IRS ruled 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.[204] The IRS restated its position and

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effect that the IRS "was skeptical of claims for perpetual deferral" and would try to attack transactions that are "of the sort that Congress did not like," even if those transactions appear to be technically sound); J. Coder, "IRS Says Clear Basis for Taxing Gain When Cash Received From Forward Contract," 2011 TNT 103-1 (May 27, 2011); L. A. Sheppard, "Variable Prepaid Forward Guidance Dashes Perpetual Tax Deferral Hopes," 2011 TNT 89-1 (May 9, 2011); L. A. Sheppard, "No Perpetual Deferral on a Prepaid Forward Contract," *Tax Notes* (May 16, 2011).

203 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 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).

204 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); L. 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

expanded its analysis slightly in generic legal advice memorandum AM 2007-004.[205] 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 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.[206] 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.[207]

- Although until recently, these transactions were largely non-controversial, emerging case law suggests that taxpayers who enter into a forward contract coupled with a securities lending arrangement may invite an IRS challenge.[208]

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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* L. A. Sheppard, "Your Government at Work On Financial Products," 2007 TNT 89-3 (May 7, 2007).

205 AM 2007-004 (Jan. 24, 2007).

206 *See* L. A. Sheppard, "Your Government at Work On Financial Products," 2007 TNT 89-3 (May 7, 2007).

207 Coordinated Issue Paper LMSB-04-1207-077 (Feb. 6, 2008).

208 *See* J. Coder, "More Taxpayers Settling Their Variable Prepaid Forward Contract Cases," *Tax Analysts*, Doc 2012-9 (noting that Liberty Media Corp., Clear Channel Communications, Inc. co-

> The Tax Court has held in two cases that a securities-lending contract coupled with a forward contract is properly treated as a sale.[209] Because both cases addressed unusual facts, practitioners have requested guidance regarding market-standard securities loans.[210] Until the IRS releases further guidance, however, the Tax Court's decisions in Anschutz and Calloway curtail a taxpayer's ability to defer the recognition of gain on appreciated securities by entering into a variable prepaid forward contract if the taxpayer simultaneously enters into a securities loan with respect to those securities unless the cases can be distinguished on their facts.[211]

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founder Billy Joe McCombs, and other taxpayers are settling their disputes due to unfavorable judicial precedent).

209 *See Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), *aff'd* 664 F.3d 313 (10th Cir. 2011) (concluding that a purported securities lender "must recognize gain in an amount equal to the up-front cash payments received upon entering into the transactions" because the purported securities borrower "received the benefits and burdens of ownership"); *Calloway v. Commissioner*, T.C., 135 T.C. 26 (2010); *see generally* R. Willens, "Derivium Agreement Ruled a Sale in *Calloway*," 151 DTR J-1 (Aug. 9, 2010); "Tax Court Finds *Anschutz* Cannot Use Prepaid Variable Forward Contracts to Avoid Gains," 140 DTR K-3 (July 23, 2010); L. A. Sheppard, "Tax Court Shams Securities Loan Shelter in *Calloway*," 2010 TNT 137-1 (July 19, 2010).

210 *See* New York State Bar Association, *Report of the Tax Section of the New York State Bar Association on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058* (June 9, 2011) (requesting, in part, that section 1058 be treated as a safe harbor rather than the only way to avoid deemed sale treatment and that no integration apply in third-party lending transactions); *see also* J. Coder, "News Analysis: Practitioners Seek Clarity on Stock Lending After *Anschutz*," 2011 TNT 142-3 (July 25, 2011).

211 *But see* R. Willens, "Capital Gains and Losses: Variable Prepaid Forward Contract + Share-Lending Agreement = Current Sale," *31 Tax Mgmt. Weekly Rp. 111* (Jan. 23, 2012) (noting that plain vanilla prepaid variable futures contracts remains a viable monetization strategy until the I.R.S. withdraws Revenue Ruling 2003-7).

- 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.[212] 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,[213] and the introduction of legislation that would require investors to accrue interest on ETNs at the applicable federal rate.[214] Pending further guidance or legislation, the status of ETNs linked to other assets remains unclear.[215]

4. <u>Character of Income</u> Taxpayers holding forward contracts as capital assets will recognize capital

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[212] *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* L. A. 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).

[213] 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).

[214] H.R. 4912 (introduced Dec. 19, 2007). For a discussion of the bill, *see* L. A. Sheppard, "Are Exchange-Traded Notes Too Good to be True? Part 2," 118 *Tax Notes* 1172 (Mar. 17, 2008).

[215] *See* Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* 86-90 (Dec. 2, 2011) (describing ETNs generally and associated tax-treatment issues).

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.[216]

5. Source of Income Currently, gain on the disposition of forward contracts is generally sourced according to the residence of the contract holder receiving the gain.[217] 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.[218]

   As mentioned above, beginning in 2017, proposed regulations issued pursuant to section 871(m) generally would treat dividend equivalent payments under forward contracts that reference U.S. stock as U.S. source dividends, even if the holder is a foreign holder.[219]

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[216] In addition, it is possible that dividend equivalent amounts paid under a forward contract are treated as ordinary income, rather than capital gain.

[217] *See* I.R.C. § 865.

[218] 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.

[219] *See* Prop. Treas. Reg. § 1.871-15(e). Withholding would apply to dividend equivalent payments made under equity-linked forward contracts that are issued at least 90 days after the proposed

Further, as described more fully in the text above, to the extent a foreign financial institution does not sign a FATCA agreement with the IRS (or is not otherwise exempt from withholding under FATCA), certain payments made to that institution (including foreign source passthru payments beginning no earlier than 2017) could be subject to U.S. withholding tax.

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.[220] Futures contracts are usually settled in cash and have standardized contract terms. Because futures contracts are regulated by exchanges, counterparty credit risk is greatly reduced.

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.[221] Each holder takes any resulting gain

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regulations are finalized. *See* IRS Notice 2014-14, 2014-13 I.R.B. 881.

220 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.

221 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).

Proposed swap regulations redefine the scope of a regulated futures contracts by treating only those futures contracts that need not be reported to the Commodity Futures Trading Commission as section 1256 contracts. Effectively, reportable swaps would be or loss into account, after adjusting the current year gain or loss for gain or loss previously accounted for.[222] 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.[223] Where a straddle includes two or more futures contracts, for example, taking delivery on any single contract terminates the other contracts on that date.[224]

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,[225] 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,[226] (ii) if the contract is a business hedge governed by

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neither marked to market nor receive the blended capital gains rate. Prop. Treas. Reg. § 1.1256(b)-1(b); *see also* L. A. Sheppard, "The Ramifications of the Expanded NPC Definition," 2012 TNT 11-1 (Jan. 18, 2012).

222 I.R.C. § 1256(a)(2).

223 I.R.C. § 1256(c).

224 I.R.C. § 1256(c)(2).

225 I.R.C. § 1256(a)(3).

226 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).

section 1221(a)(7), gain or loss may be ordinary,[227] and (iii) if the contract is part of a conversion transaction under section 1258, part of any capital gain will be recharacterized as ordinary income.[228] However, under President Obama's budget proposal for fiscal year 2015, the 60/40 rule would be replaced with a rule taxing 100% of the gain as ordinary income.[229]

  - "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.[230]

- Notice 2007-71 corrects prior IRS guidance concerning the treatment of over-the-counter ("OTC") foreign currency options as section 1256

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227 I.R.C. § 1256(e).

228 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. 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.

229 Department of the Treasury, General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals, *available at* < http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf > (requiring "mark-to-market" treatment for derivative contracts and tax at ordinary income rates).

230 *See* I.R.C. § 1234B(a).

contracts.[231] 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.[232] 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.[233] 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 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. The Tax Court recently confirmed the IRS' position that a foreign currency option cannot be a foreign currency contract.[234]

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[231] *See* Notice 2007-71, 2007 I.R.B. 35 (Aug. 10, 2007), *modifying and supplementing* Notice 2003-81, 2003-2 C.B. 1223.

[232] *See*, *e.g.*, F.S.A. 2000-25-020 (Mar. 17, 2000).

[233] 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.

[234] *See Garcia v. Commissioner*, T.C. Memo. 2011-85 (Apr. 13, 2011) (taxpayer could not assert mark-to-market treatment with respect to a long position in a transaction involving offsetting positions in OTC foreign currency options); *see also* Marie Sapirie, "Garbled Reasoning in *Garcia*," 2011 TNT 79-1 (arguing that the Tax Court reached the right result through weak legal reasoning).

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.[235] 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.[236]

    - 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 by Party B 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 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.

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[235] *See* I.R.C. § 865.

[236] 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.

As mentioned above, beginning in 2017, proposed regulations issued pursuant to section 871(m) generally would treat dividend equivalent payments under futures contracts that reference U.S. stock as U.S. source dividends, even if the holder is a foreign holder.[237]

Further, as described more fully in the text above, to the extent a foreign financial institution does not sign a FATCA agreement with the IRS (or is not otherwise exempt from withholding under FATCA), certain payments made to that institution (including foreign source passthru payments beginning no earlier than 2017) could be subject to U.S. withholding tax.

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 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. Moreover, because section 871(m) imposes a withholding tax on certain dividend equivalent payments made pursuant to certain instruments, treaty qualification is an important means of reducing or eliminating withholding tax in connection with swaps.[238]

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[237] *See* Prop. Treas. Reg. § 1.871-15(e). Withholding would apply to dividend equivalent payments made under equity-linked futures contracts that are issued at least 90 days after the proposed regulations are finalized. *See* IRS Notice 2014-14, 2014-13 I.R.B. 881.

[238] 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

- 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.[239] 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 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 dividend equivalent payments under certain equity swaps and payments under interest rate 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.[240] Similarly, the Technical Explanation to the 2006 Model Treaty does

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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.

239 For an example of inconsistent treatment of repos in the case of Canada, *see* L. A. Sheppard, "Blame Canada Part 3: Cross-Border Repos," 118 *Tax Notes* 782 (Feb. 18, 2008).

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

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.[241] 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."[242] 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 rationale for limiting the provision only to fees received by institutional investors.[243]

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 are generally sourced according to the residence of the recipient, and therefore are not subject to U.S. withholding if the

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[241] *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>.

[242] 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.

[243] *See* "NYSBA Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006," 2007 TNT 72-15 (Apr. 13, 2007).

recipient is a foreign party. However, dividend equivalent payments on certain equity swaps (and possibly other equity-linked instruments) and payments that are treated as interest on an embedded loan are treated as U.S. source income and therefore are subject to withholding unless the withholding is reduced or eliminated under a treaty or the interest qualifies 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. However, under the proposed section 871(m) regulations, dividend equivalent payments on certain equity-linked instruments may be treated as U.S. source income beginning in 2017, and therefore may be subject to withholding unless the withholding is reduced or eliminated under a treaty.

- This summary suggests that certain 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 interest payments on the securities of a U.S. issuer held by the counterparty, in 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.[244] That result applies

[244] Derivatives also may be used by U.S. investors to (i) "cherry-pick" the character of their income, gain, or loss (*i.e.*, to treat gains as capital gain and losses as ordinary loss), or (ii) avoid current

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).[245]

- Treasury has taken strides in bridging the gap between taxation of foreign investors holding dividend-paying U.S. equity interests and foreign investors whose investments merely reference U.S. equity. Under section 871(m), dividend equivalent payments on certain equity swaps are subject to a U.S. withholding tax, and dividend equivalent payments on various equity-linked instruments (including options, forwards, futures, and certain debt instruments) also may be subject to withholding.[246]

- 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

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recognition of trading gains that would result from an actual investment in a partnership or other "pass-through" entity. *See generally* M. Stevens, "Taxing Derivatives: Do Look-Through Rules Work?," 91 *Taxes—The Tax Magazine* 35 (Mar. 2013).

245 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.

246 For example, because they are treated as section 892 investment income, dividend equivalent payments would not be taxable to sovereign wealth funds. In addition, the temporary and proposed regulations specifically prevent multiple or cascading withholding for certain related parties engaging in back-to-back derivative transactions. *See* T.D. 9572 (Jan. 23, 2012).

transactions.[247] 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.[248]

- 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 the 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. The 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, President Obama's budget proposal for fiscal year 2010 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.[249]

- 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.[250] In response to pointed questions from Congress as to Treasury's authority (or

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[247] 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).

[248] *See* Notice 98-11, 1998-1 C.B. 433.

[249] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, *available at* < http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf >.

[250] *See* Notice 98-11, 1998-1 C.B. 433.

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.[251] 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 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.[252]

- 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.[253] 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

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[251] *See* Notice 98-35, 1998-2 C.B. 34.

[252] *See* Notice 98-35, 1998-2 C.B. 34.

[253] *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/corporations/article/0,,id=200567,0000.html>. 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).

treatment is reversed.[254] 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.[255] The directive instructs field agents to 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 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.[256] Commentators have criticized

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[254] Industry Director Directive #1 on International Hybrid Instrument Transactions, LMSB Control No. 04-0407-035 (June 15, 2007).

[255] *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 offsetting obligations of the parties under the agreements either cancelled out or were disregarded, prohibiting a finding of debt.

[256] 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

> 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 economic substance.[257] Diana Wollman also observed

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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). *See also See* U.S. Treasury, 2013-2014 Priority Guidance Plan (Aug. 9, 2013), *available at* < http://www.irs.gov/pub/irs-utl/2013-2014_pgp.pdf > (priority includes addressing legislation enacted that limits the use of the foreign tax credit).

257 *See* L. A. 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* L. A. 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).

On March 30, 2010, President Obama signed the Health Care and Education Reconciliation Act (Pub. L. No. 111-152), which codified the economic substances doctrine as section 7701(o). *See also* Notice 2010-62, 2010-40 I.R.B. 411 (preliminary guidance). If a court or the IRS determines that the economic substance doctrine is "relevant" to a transaction, a strict liability penalty will be assessed against the taxpayer unless the transaction meaningfully changes the taxpayer's economic position (without regard to income tax liability) (*i.e.*, an objective test), while also serving a substantial non-tax purpose (*i.e.*, a subjective test). *But see* M.A. Jackel, "When is the Economic Substance Doctrine Relevant?", *Tax Notes: State of the Tax Practice* (July 4, 2011) (noting that courts inconsistently raise the economic substance doctrine, muddying expectations of when economic substance is "relevant" to a transaction).

Treasury has unequivocally stated that no "angel list" of permissible transactions will be provided, but an IRS field directive provides a that the proposed regulations appear to be inconsistent with prior IRS guidance dealing with similar transactions.[258] 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.[259]

- In January 2010, the LMSB issued an industry directive to the field to provide guidance on the investigation of total return swaps. The LMSB identified the following

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list of factors or circumstances that could suggest a lack of economic substance. LB&I Directive from Heather C. Maloy, Commissioner, Large Business & International Division, Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (July 15, 2011); *see also* S. Trivedi, "Wilkins Defends Economic Substance Doctrine," *Tax Notes Today*, 2011 TNT 209-3 (Oct. 28, 2011) (reporting the comments of IRS Chief Counsel, William J. Wilkins, regarding the economic substance doctrine). By requiring the prior approval of a director of field operations, the guidance appears to discourage field agents from asserting the economic substance doctrine, but Treasury officials indicate that its internal procedures for levying the penalty may change in the future. *See* L. A. Sheppard & J. Coder, "What Does the Economic Substance Directive Mean?", *Tax Notes* (Oct. 31, 2011).

It is unclear whether codification will affect the frequency which the IRS applies the economic substance doctrine to challenge the asserted treatment of derivative transactions. Practitioners may, however, take comfort in the fact that violations of similar rules or doctrines, such as the step transaction doctrine, substance over form, or recharacterization doctrine, will not be subject to the penalty imposed by the law. *See* Y. Keinan & M.H. Leeds, "Know it When I See It: IRS Issues Guidance on When the Economic Substance Doctrine is Relevant," *Practical U.S./Domestic Tax Strategies 2* (June 2011).

[258] *See* "Practitioner Examines IRS Position on Foreign Tax Credits," 2007 TNT 171-8 (Sept. 4, 2007); *see also* L. A. Sheppard, "Banks' Foreign Tax Credit Arbitrage, Part 3," 2007 TNT 171-7 (Sept. 3, 2007).

[259] *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).

> four scenarios in which exam agents should further investigate the transaction: (i) a foreign person who owns a U.S. equity security transfers the security to a U.S. financial institution and then enters into a total return swap with the U.S. financial institution and then repurchases the security after the swap terminates (cross-in, cross-out); (ii) same facts as the first scenario except the foreign person uses a third party, such as an interdealer broker, to repurchase the security; (iii) a foreign person enters into a swap with a foreign affiliate of a U.S. financial institution and then the foreign affiliate enters into a back-to-back swap with its U.S. affiliate; and (iv) a fully synthetic swap transaction where the foreign person never had ownership of the underlying security and did not engage in a repurchase after the swap ended.[260]

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. 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

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[260] *See* "Industry Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax," LMSB Control No. LMSB-4-1209-144 (Jan. 14, 2010); *see also* "LMSB Highlights Some Total Return Swaps As Tiered Withholding Issue," 2010 TNT 12-2 (Jan. 19, 2010).

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").[261] 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.[262] 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 correct measure of income together with the most consistent treatment.

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[261] 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).

[262] The recommendation also notes that fiscal authorities should recognize that taxation has a significant effect on the efficiency and economic results of derivative transactions.

- 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, and this practice "should be universally adopted." More generally, it is not appropriate to impose withholding tax on derivative payments at source. 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 residency 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, dividend equivalent payments on NPCs (and other equity-linked instruments) 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.[263]

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[263] 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); L. A. Sheppard, "Cricket and Cross-Border Taxation at the Crossroads," 49 TNI 995 (Mar. 24, 2008). *See also* D. Shapiro, "FDAP Withholding on Derivatives? A Comparative Perspective," 29 *Journal of Taxation of Investments* 51 (Fall 2011) (proposing derivatives withholding on the amount representing a "high content" of net income, approximately 75% of the net payments).

On February 26, 2014, Congressman Dave Camp, Chairman of the U.S. House Committee on Ways and Means, released a discussion draft of a bill that would impose a mark-to-market regime for all derivatives. *See* Ways and Means Discussion Draft, 113th Cong. § 3401 (Feb. 21, 2014), *available at* <http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft__022614.pdf>. This draft updates a prior draft released on January 24, 2013. *See* Ways and Means Discussion Draft, 113th Cong. § 401 (Jan. 23, 2014), *available at* < http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf >; *see also* D. S. Miller, "Toward an Economic Model for the Taxation of Derivatives and Other Financial Instruments," 3 *Harvard Business Law Review Online* 108 (2013), *available at* <http://www.hblr.org/?p=3134>; Securities Industry and Financial Markets Association Report on Financial Products Discussion Draft (Apr. 15, 2013), *available at* <http://waysandmeans.house.gov/uploadedfiles/sifma_2.pdf >. President Obama's budget proposal for fiscal years 2014 and 2015 also would impose a mark-to-market regime for all derivatives. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, *available at* < http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>; Department of the Treasury, General Explanations of the Administration's Fiscal

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) ISDA Master Agreement ("Master Agreement"), which is commonly used to document many of the cross-border derivatives discussed in this outline.[264]

- 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. Under section 871, however, a gross-up payment relating to withholding on dividend equivalent payments may itself be treated as a dividend equivalent that is subject to withholding.[265]

- This general rule is subject to three important exceptions:

  - 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

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Year 2015 Revenue Proposals, *available at* < http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>.

264 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.

265 *See* Prop. Treas. Reg. § 1.871-15(f)(1).

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.

- Therefore, if a foreign person entered into an equity swap under a standard ISDA Master Agreement prior to March 18, 2010 that is subject to withholding under section 871(m) (for example, an equity swap where the foreign party transferred the underlying stock to its counterparty in connection with entering into the swap), the foreign counterparty would be entitled to a "gross-up" payment but the Affected Party could terminate the swap subject to the provisions in the Master Agreement.[266] However, if the swap was entered into after March 18, 2010 and is subject to withholding under section 871(m), the foreign party would be entitled to a gross-up, and the counterparty would not have the right to terminate the swap (because the withholding does not result from a change in tax law that occurred after the swap was entered into) under the terms of the Master Agreement.[267]

- Similarly, if a foreign person entered into a swap under a standard ISDA Master Agreement

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[266] Section 871(m) was codified on March 18, 2010. *See* Pub. L. No. 111-147.

[267] In light of the burden of a possible U.S. withholding tax, U.S. parties to cross-border equity swaps entered into after March 18, 2010 that reference U.S. equity securities should consider modifying the ISDA Master Agreement by including a provision to the following effect:

> The parties to this Agreement agree that the amendments set out in the Attachment to the ISDA 2010 Short Form HIRE Act Protocol published by ISDA on November 30, 2010 and available on the ISDA website (http://www.isda.org/) shall apply to this Agreement. The parties further agree that this Agreement will be deemed to be a Covered Master Agreement and that the Implementation Date shall be the effective date of this Agreement for the purposes of such Protocol amendments, regardless of the definitions of such terms in the Protocol.

The effect of this provision is to exclude any withholding taxes imposed under section 871(m) from the U.S. party's gross-up obligations. The 2010 HIRE Act Protocol and the 2010 Short Form HIRE Act Protocol are discussed below.

prior to March 18, 2010 and payments that are governed by the Master Agreement become subject to withholding under FATCA,[268] the foreign counterparty would be entitled to a "gross-up" payment but the Affected Party could terminate the swap subject to the provisions in the Master Agreement.[269] However, if the swap was entered into after March 18, 2010 and payments that are governed by the Master Agreement become subject to withholding under FATCA,[270] the foreign party would be entitled to a gross-up, and the counterparty would not have the right to terminate the swap (because the withholding does not result from a change in tax law that

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[268] This may occur, for example, if the foreign person is a "nonparticipating foreign financial institution" and makes one or more significant nonperiodic payments to a U.S. person under the swap, so that payments by the U.S. person are treated in part as U.S. source interest, or transfers securities to the U.S. person as collateral, and the securities provide for U.S. source payments. However, temporary Treasury regulations provide that a payment made before 2017 by a secured party with respect to a commercially reasonably amount of collateral that secures one or more transactions under a collateral arrangement will be exempt from FATCA withholding. Temp. Treas. Reg. § 1.1473-1T(a)(4)(vii).

[269] FATCA was codified on March 18, 2010 as part of the "Hiring Incentives to Restore Employment Act," which also codified section 871(m). *See* Pub. L. No. 111-147

[270] The potential for withholding on swap payments under FATCA may increase after final regulations are enacted that define the scope of foreign source passthru payment withholding. As discussed above, regulations under FATCA provide a "grandfathering" rule that generally exempts swaps from passhthru payment withholding if the swaps are entered into earlier than six months after the issuance of future regulations that define the term "foreign passthru payment." *See* Treas. Reg. § 1.1471-2(b)(2)(i)(B). However, as discussed above, the intergovernmental agreements that the Treasury Department has entered into under FATCA do not require foreign financial institutions (or branches thereof) that are organized in signatory countries to withhold on foreign passthru payments, and instead provide that the signatory countries will work together to develop an "alternative approach" to foreign passthru payment withholding.

    occurred after the swap was entered into) under the terms of the Master Agreement.[271]

    - 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.

- Enactment of the HIRE Act, as well as final and proposed regulations issued pursuant to section 871(m), has shifted the parties' obligations under the ISDA

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[271] In light of the burden of a possible U.S. withholding tax, swap parties that expect not to be subject to withholding tax under FATCA should consider modifying the ISDA Master Agreement by including a provision to the following effect:

> "Tax" as used in Part 2(a) of this Schedule (Payer Tax Representation) and "Indemnifiable Tax" as defined in Section 14 of this Agreement shall not include any U.S. federal withholding tax imposed or collected pursuant to Sections 1471 through 1474 of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), any current or future regulations or official interpretations thereof, any agreement entered into pursuant to Section 1471(b) of the Code, or any fiscal or regulatory legislation, rules or practices adopted pursuant to any intergovernmental agreement entered into in connection with the implementation of such Sections of the Code (a "FATCA Withholding Tax"). For the avoidance of doubt, a FATCA Withholding Tax is a Tax the deduction or withholding of which is required by applicable law for the purposes of Section 2(d) of this Agreement.

The effect of this provision is to exclude any withholding taxes imposed under FATCA from the parties' respective gross-up obligations. In addition, on August 15, 2012, ISDA published the 2012 FATCA Protocol. *See* ISDA, 2012 FATCA Protocol (Aug. 15, 2012), *available at* < http://www2.isda.org/functional-areas/protocol-management/protocol/9>. The protocol generally incorporates the above provision into any Master Agreement that was entered into by two adhering parties before both parties adhered to the protocol.

Master Agreement. The regulations are not prospective; thus payments made after March 18, 2010 on applicable pre-existing swaps could be subject to withholding under 871(m). To address those concerns, ISDA published the 2010 HIRE Act Protocol.[272] Parties that sign on to the protocol agree that the ISDA Master Agreement will be amended as follows:

- A foreign investor must represent that it will not cross-in, cross-out, or act in a way that results in section 871(m) withholding on the swap;[273]

- No gross-up will be required and any withholding tax will be factored into net payments made for swaps subject to section 871(m) withholding;

- The withholding agent may terminate an equity swap if there is a substantial likelihood that the IRS will require withholding on the next payment date; and

- When a swap is subject to 871(m) withholding, either party may terminate the swap.

The 2010 HIRE Act Protocol, however, has not been widely adopted by market participants.[274] Hedge funds

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272 ISDA, 2010 HIRE Act Protocol (Aug. 23, 2010), *available at* <http://www.isda.org/isda2010hireactprot/docs/2010-HIRE-Act-Protocol-Text.pdf>.

273 This representation conforms to Treasury's expectation that long parties would request representations from foreign parties that they were not "in the market." The representation would be sufficient to protect the long party unless they had reason to know the representation was false. *See* L. A. Sheppard, "Regulatory Update at NYSBA Looks at Cross-Border Equity Swap Withholding," 2012 TNT 16-2 (Jan. 25, 2012) (describing comments made by Mark Perwien, Special Counsel, I.R.S. Office of Associate Chief Counsel (Financial Institution and Products)).

274 The deadline to submit an adherence letter with respect to the 2010 HIRE Act Protocol was December 15, 2010. In an unsuccessful bid to attract more adherents, ISDA also released a 2010 Short Form HIRE Act Protocol, which excluded mutual termination rights. *See* ISDA, 2010 Short Form HIRE Act Protocol (Nov. 30, 2010),

in particular appear resistant to standardizing swaps under the Protocol.[275]

- The following section sets forth sample tax representations and requests for tax forms to be made 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:

      Part 2. Tax Representations

      (a) Payer Tax Representations. 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

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available at <https://www.isdadocs.org/isda2010shortformhireactprot/docs/Short-Form-Hire-Act-Protocol-Text.pdf>.

275 *See* L. Rodriguez, Jr., "The Withholding Tax Treatment of Total Return Equity Swaps: New Answers, but New Questions, Too," *Journal of Taxation and Regulation of Financial Institutions*, at 5 (May/June 2011) (describing ISDA's responses to the HIRE Act); M. Sapirie, "Many Questions Remain on Expected Dividend Withholding Guidance," 2012 TNT 12-1 (Jan. 19, 2012) (discussing limited support for ISDA protocol).

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

Part 2. Tax Representations

(b) Payee Tax Representations. 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:

Form/ Document/Certificate	***Date by Which to be Delivered***
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) 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.*

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

Part 2. Tax Representations

(b) Payee Tax Representations. 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:

Form/ Document/Certificate	***Date by Which to be Delivered***
A correct, complete and executed U.S. Internal Revenue Service Form W-8BEN (including a claim of treaty benefits under Part II) or Form W-8BEN-E (including a claim of treaty benefits under Part III), as applicable, or any successor thereto, including appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.	*(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.*

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

Agencies Located Within or Without the United States

Part 2. Tax Representations.

(b) Payee Tax Representations. 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:

Form/ Document/Certificate	***Date by Which to be Delivered***
With respect to Transactions not 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) or Form W-8BEN-E (including a claim of treaty benefits under Part III), as applicable, or any successor thereto, including appropriate attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.	*(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.*
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	*(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.*

Form/ Document/Certificate	***Date by Which to be Delivered***
attachments, that eliminates U.S. federal withholding tax and backup withholding tax on payments under this Agreement.	

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

  Part 2. Tax Representations.

  (b) Payee Tax Representations. 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:

Form/ Document/Certificate	***Date by Which to be Delivered***
A correct, complete and executed U.S. Internal Revenue Service Form W-8BEN, W-8BEN-E or W-8IMY, or any successor thereto, and appropriate attachments, that eliminates U.S. federal withholding and backup withholding payments under this Agreement.	*(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.*

- Situation: Non-Treaty Resident Foreign Counterparty That May Act Through Branches, Offices or Agencies Located In or Outside the United States

Part 2. Tax Representations.

(b) Payee Representations. 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:

Form/ Document/Certificate	***Date by Which to be Delivered***
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, W-8BEN-E or W-8IMY, or any successor thereto, and appropriate attachments, that eliminates U.S. federal withholding tax and backup	*(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.*

Form/ Document/Certificate	***Date by Which to be Delivered***
withholding tax on payments under this Agreement.	
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) 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.*

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 despite extensive rulemaking, no workable set of tax rules yet governs 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.