September 24, 2008

TAX ALERT

SENATE SUBCOMMITTEE HOLDS HEARING ON ALLEGED TAX ABUSES INVOLVING DIVIDENDS PAID TO CERTAIN OFFSHORE ENTITIES

In a July 2007 client alert, we reported on an Internal Revenue Service (IRS) effort to investigate the use of derivative transactions by hedge funds and other foreign investors to avoid U.S. withholding tax on U.S. source dividends and certain other types of income. At the time, the scope of the IRS investigation was unclear, but we noted then that it appeared to be focused on so-called "dividend enhancement" trades, such as total return swaps over U.S. publicly traded stock and similar derivatives. In addition, we noted that it remains to be seen whether the investigation would lead to tax audits of foreign funds that entered into tax-advantaged derivative transactions.

The attack on these types of transactions seems to be intensifying. On September 11, 2008, the U.S. Senate Permanent Subcommittee on Investigations, a subcommittee of the Committee on Homeland Security and Governmental Affairs, held a hearing on the transactions; in advance of the hearing, the subcommittee released a staff report entitled "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends." The report and hearing were the subject of numerous high-profile news articles, including articles in the *Wall Street Journal* and *New York Times*. A number of speakers, including IRS Commissioner Douglas Shulman, Professor Reuven S. Avi-Yonah and executives of certain financial institutions and investment funds, testified at the hearing.

BACKGROUND

In general, when a foreign corporation or non-resident alien individual who is not engaged in a U.S. trade or business receives certain types of "U.S.-source" income (including dividends paid by U.S. corporations), the gross amount of such income is subject to a 30 percent tax, collected by withholding, unless the tax is reduced or eliminated by a tax treaty. Since this can seriously reduce the effective rate of return on "inbound" investments, there is obviously a strong incentive to structure investments in such a way to avoid the tax.

THE REPORT

The report began by making several findings of fact. Specifically, the report found that (1) some U.S. financial institutions have been structuring abusive transactions aimed at enabling non-U.S. clients to dodge U.S. taxes on stock dividends; (2) offshore hedge funds are "frequent"

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participants in abusive dividend transactions; (3) such abusive transactions resulted in "billions" of dollars of lost tax revenue for the U.S. Treasury; and (4) Treasury and the IRS have failed to take effective action to stop offshore dividend tax abuses by failing to make certain regulatory changes and failing to take enforcement action.

The report focused on two types of transactions that it identified as potentially abusive. The first such transaction is the use of a "swap" transaction to achieve the economic effect of stock ownership, without actually receiving dividends subject to withholding tax. Under Treasury regulations, payments received by foreign persons under "notional principal contracts" (which include most swaps) are generally treated as foreign-source income, and hence are not subject to withholding tax.

In the variant that the report describes as "one of the most blatant forms of this type of transaction," an offshore investor that actually owns a particular U.S. stock sells such stock to a financial institution a few days before such stock is scheduled to pay a dividend, and the offshore investor enters into a swap agreement (often with the same financial institution), pursuant to which it is synthetically "long" the stock. After the dividend is paid, the offshore investor receives a "dividend equivalent" payment under the swap that is equal to the amount of the dividend. A few days later, the offshore investor terminates the swap agreement and repurchases the stock, leaving such investor in the same position it was in prior to the swap.

The second type of transaction described in the report combines a swap with a "stock loan." In this type of transaction, a foreign investor lends stock of a U.S. corporation to a foreign person (often, an offshore corporation affiliated with a financial institution) a few days before a dividend record date for the stock. The borrower, in turn, sells the stock and simultaneously enters into a swap (often with its affiliated financial institution) referenced by the same stock. When a dividend is paid on the underlying stock, the swap counterparty is required to make a "dividend equivalent payment" to the borrower, which in turn pays the same amount (as a "substitute dividend payment") to the lender (i.e., the offshore investor). The parties take the position that (i) the dividend equivalent payments are free of withholding tax based on the tax regulations governing payments made under swap agreements described above, and (ii) the substitute dividend payments under the stock loan are also free of withholding tax, based on an interpretation (which the report characterizes as a "misinterpretation") of IRS Notice 97-66. That Notice provides a special relief rule that is intended to prevent multiple assessments of the 30 percent withholding tax (known as "cascading withholding") if substitute dividend payments are made several times with respect to the same dividend (such as might be the case if the same share of stock was successively lent to multiple non-U.S. parties). However, the Notice does not explicitly require that there be a showing that the 30 percent withholding tax was paid at least once.

The report goes on to identify a number of "red flags" common to transactions it deemed abusive, regardless of the particular structure of the transaction. These include (1) the short-term nature of the transactions coinciding with a dividend payment; (2) an agreement as to the explicit dividend payment rate that factored in an implicit fee for the swap counterparty (i.e., agreeing to pay 97 percent of the gross dividend amount rather than 70 percent which would have been the net dividend if a 30 percent withholding tax applied); (3) fees tied to tax savings;[1] (4) the reacquisition of stock that was sold shortly before a dividend distribution; (5) prior agreements as to the sale and repurchase of such stock; (6) the coordination of stock sales and repurchase transactions to minimize or eliminate risk of financial loss; (7) the insertion of an offshore shell corporation into a transaction for no apparent reason other than to eliminate dividend withholding; and (8) the fact that the financial institutions at issue treated the nonpayment of dividend taxes as a "tax

[1] Although not mentioned in the report, under current law any transaction in which fees are contingent on tax savings is a "reportable transaction." The effect of this is to impose special reporting requirements on both the taxpayer who enters into such a transaction and its advisors.

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risk" and set limits on the aggregate amount of foregone tax withholding such institution was willing to bear. The report also contained several case studies that typically centered around transactions that were variations of those described above.

THE PROGNOSIS

The report recommended three lines of attack, namely that (1) IRS complete its review of dividend-related transactions and take civil enforcement action against taxpayers and U.S. financial institutions that knowingly participated in abusive transactions; (2) the Treasury Department issue and/or clarify regulations in this area; and (3) Congress enact legislation to require withholding on *all* dividends, dividend equivalent payments and substitute dividend payments. Although it is too early to assess the impact of the report and related hearings, it is possible that we could see activity on each of these three fronts.

On the enforcement front, Commissioner Shulman, under pressure from members of the subcommittee, committed that the IRS "will challenge sham transactions." He also indicated that IRS would not be deterred from challenging transaction structures simply because they are widely used and have not previously been challenged (a notion which the report refers to as the "Wall Street Rule"). While it is not clear whether such challenges would be successful under current law, it is possible that taxpayers who have entered into the types of transactions described above—particularly in their more aggressive variants—will face challenge on audit and may be forced to settle or litigate.

On the regulatory front, Commissioner Shulman specifically committed to revise Notice 97-66, and it is certainly possible that other regulatory changes could be forthcoming. However, the commissioner resisted calls for a blanket regulatory pronouncement that all types of "dividend enhancement" structures are, per se, illegal.

It remains to be seen what, if anything, will happen on the legislative front. The report's legislative recommendations appear to go beyond reforms suggested by the non-industry speakers at the hearing. Moreover, the type of reforms suggested by the report would raise significant policy issues and concerns regarding administrability. For example, Commissioner Schulman's testimony stated that "[w]e must be careful as we look at potential changes in the regulations to ensure that we are driving the proper type of behavior while not impeding legitimate business transactions." Professor Avi-Yonah's written testimony acknowledges that there were valid non-tax policy reasons why the Treasury adopted a policy to exempt many derivative payments from withholding taxes. The committee's minority staff view on the report states that articulating specific legislative or regulatory responses to the documented abuses requires a more comprehensive and in-depth analysis than the report provides. Although the minority joined the majority in identifying the abusive transactions, the minority urged any response to the abuses be carefully targeted to preserve the integrity and efficiency of the capital markets, prevent negative impact on foreign investment in the United States and avoid unintended consequences. While no one can predict how Congress and the IRS will respond to this report, it seems to us that the more likely responses include heightened scrutiny by the IRS of the transactions in this area that are perceived by the report as abusive, rather than imminent legislation designed to attack such transactions. In the interim, we continue to recommend the risk mitigation techniques alluded to in our July 2007 client alert, including possibly restructuring certain derivative transactions and/or using fund structures that reduce or eliminate the need for tax-advantaged derivative transactions.

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AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

CONTACT INFORMATION

If you have questions regarding this alert, please contact—

Patrick B. Fenn........................ pfenn@akingump.com .... 212.872.1040 .... New York
Stuart E. Leblang..................... sleblang@akingump.com .... 212.872.1017 .... New York
Robert Rothman .... rrothman@akingump.com..................... 212.872.7411 .... New York
Peter J. Guy............................. pguy@akingump.com .... 212.872.1024 .... New York
Stephen M. Vine .... svine@akingump.com .... 212.872.1030 .... New York
Prakash H. Mehta .... pmehta@akingump.com .... 202.887.4248 .... Washington, D.C.
Mark H. Barth .... mbarth@akingump.com .... 212.872.1065 .... New York

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