United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

March 5, 2014

VIA ONLINE SUBMISSION (www.regulations.gov)

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: 2013 Proposed Rule on Dividend Equivalents From Sources Within the United States, IRS REG-120282-10

Dear Commissioner Koskinen:

The purpose of this letter is to express support for the 2013 proposed rule on taxation of dividend equivalent payments from sources within the United States.[1] The proposed rule tackles a complex set of issues arising from a 2010 law[2] seeking to strengthen enforcement of the tax code's longstanding requirement that foreign investors pay tax on any dividend income received from their U.S. stock holdings.[3] Prior to its enactment, too many foreign investors were using a variety of financial transactions, from equity swaps to stock loans, to profit from U.S. stock dividends without paying U.S. taxes. The 2010 law was passed to stop that circumvention of the law, and the proposed rule offers an efficient and workable means to accomplish that objective.

Subcommittee Investigation. In 2008, the U.S. Senate Permanent Subcommittee on Investigations, which I chair, concluded a year-long investigation into how some U.S. financial institutions were using complex financial transactions to enable their offshore clients to avoid paying U.S. taxes on U.S. stock dividends. The Subcommittee issued over a dozen subpoenas, conducted interviews with numerous financial institution executives, consulted with tax and securities experts, and reviewed hundreds of thousands of pages of legal and financial documents. In September 2008, it held a hearing and released a bipartisan report detailing how some U.S. financial institutions used equity swaps, stock loans, and other financial mechanisms to enable foreign clients – primarily offshore hedge funds, tax haven banks, and other sophisticated foreign investors – to dodge U.S. taxes owed on U.S. stock dividends. Essentially, those U.S. financial institutions provided their foreign clients with "dividend equivalent" payments instead of actual stock dividends, and claimed no tax was due on them. The

[1] "Dividend Equivalents from Sources within the United States," Internal Revenue Bulletin: 2013-52, (Dec. 2013) (TD 9648).

[2] §541 of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, P.L. 111-147.

[3] See 26 U.S.C. §§871(a)(1)(A) and 881(a)(1) imposing the dividend tax on non-U.S. persons, and §§1441(a) and (b) and 1442(a) requiring the tax amount owed to be withheld and remitted to the Internal Revenue Service (IRS) prior to the dividend payment's leaving the United States.

investigation provided extensive documentation and information about how those offshore dividend tax abuses were responsible for lost tax revenues totaling billions of dollars.[4]

In 2010, in response to the Subcommittee's work, Congress enacted legislation aimed at ending the tax losses attributable to offshore stock dividend tax abuses.[5] The statute established a new tax code provision, codified at §871(m), to ensure that, not only stock dividends, but also "dividend equivalent" payments, would be taxed in an equal manner. In 2012, the U.S. Department of the Treasury proposed a rule to implement the law, spelling out when payments on certain derivative instruments, termed a Notional Principle Contract (NPC) or Equity Linked Instrument (ELI), would be subject to taxation as dividend equivalent payments under §871(m).[6] While the 2012 proposed rule provided a solid foundation for implementing the 2010 law, after receiving extensive comments on the proposal, in 2013, the IRS issued a revised proposal with a simpler and more coherent set of implementing principles that ought to be adopted.

In support of the revised rule, this letter resubmits a copy of the Subcommittee's hearing record, which includes the bipartisan report authored by myself and Senator Norm Coleman, to be made part of the administrative record for the 2013 proposed rule. The Levin-Coleman hearing and report demonstrate that, without strict rules governing dividend equivalent payments from sources within the United States, foreign investors can and will engage in derivative transactions that lack a substantial purpose other than to avoid taxation of U.S. stock dividends. These abusive transactions lead to inefficient market outcomes, lost tax revenues, and taxpayer equity concerns, all of which would be addressed by the revised rule.

Promotes Clarity, Consistency, and Efficiency. The 2012 proposed rule enumerated seven different factors that would have to be considered to determine whether payments associated with a specified NPC or ELI would be subject to taxation. While those factors identified key considerations, the resulting rule was not only complicated and reliant on nontransparent factual findings and subjective analyses, but also opened the door to abusive transactions focused on manipulating one or more of the seven factors. The proposed rule had the potential to correctly identify many NPCs and ELIs, but it also would have been difficult to administer.

The 2013 proposed rule would take a much simpler approach by using a single, objective metric – the delta – to determine when an NPC or ELI payment would be subject to U.S. taxation. The delta would measure the ratio of change in the fair market value of the NPC or ELI contract compared to the change in value of the property referenced by the NPC or ELI contract at the time of acquisition by the long party. NPCs or ELIs that produced a delta of .70 or greater at the time of acquisition would be subject to taxation. In other words, NPC or ELI instruments

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[4] See "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends," S. Hrg. 110-778 (Sept. 11, 2008) (hereinafter "Subcommittee Hearing on Dividend Tax Abuse"), at 10, 14, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:45575.pdf.

[5] See §541, "Substitute Dividends and Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends," HIRE Act of 2010, P.L. 111-147.

[6] "Dividend Equivalents from Sources within the United States," Internal Revenue Bulletin: 2012-11, (March 12, 2012) (REG 120282-10). At the same time, the IRS issued an interim final rule to end the more flagrant abuses pending completion of the more detailed regulation. See "Dividend Equivalents from Sources within the United States," Internal Revenue Bulletin: 2012-11, (March 12, 2012) (TD 9572).

that offered at least 70% of the expected returns of stock dividends as assessed when the long party acquired the property would be treated as dividend equivalents – an objective test capable of relatively quick and easy analysis.

Using this single metric would reduce the complexity of the rule and strengthen its clarity, consistency, and predictability, making it easier for taxpayers to understand and comply with its requirements. The new approach would also make the rule easier for the IRS to administer and enforce. Dividend equivalent payments often involve complex and individualized financial instruments, embedded stock values, and rapid trading, so it is important for the implementing rule to be one that is relatively easy to understand and apply, without the types of nontransparent details or subjective elements that invite investigations, analytical disagreements, and litigation.

In addition, because the new metric focuses on economic reality – cold hard facts about whether returns from specified NPC or ELI instruments reflect particular stock dividend payments – the proposed rule would more efficiently and effectively identify derivative payments which are equivalent to stock dividends and merit equivalent taxation. By focusing directly on the economics of particular transactions, the proposed rule would also make it more difficult for taxpayers to circumvent or manipulate its requirements.

Furthermore, the delta standard would promote efficiency by minimizing the need for market participants to set up procedural safeguards that insure against future tax liability for payments whose status as taxable dividend equivalents may be unclear. In the past, some financial institutions that were uncertain about whether particular dividend-linked payments were taxable established a limit on the amount of financial exposure that could be incurred by the institution from transactions where no taxes were withheld.[7] To calculate their "withholding tax risk," the financial institution determined the amount of dividend tax that should have been withheld in the transactions and which the institution might have to pay the IRS in the future if the transactions were invalidated or recharacterized. The financial institution also established the total amount of withholding tax it was willing to risk leaving uncollected. It then restricted the number and size of the transactions it executed to avoid exceeding its self-imposed limit, and operated under an ongoing burden of uncertainty with respect to its total potential tax liability. This practice demonstrates the economic distortions that can arise from an unclear rule on the taxation of dividend equivalents. In contrast, because of its relatively straightforward nature, the delta standard would help ensure that NPCs and ELIs whose payments are attributable to U.S. sources will be taxed in a predictable manner that provides clarity to market participants, limits distortions due to uncertainty, and minimizes revenue loss.

Provides Similar Treatment for Similar Investments. In addition to simplifying and clarifying the rule, the 2013 proposal would also promote equitable treatment of taxpayers, by subjecting foreign investors in U.S. stocks to the same tax treatment whether they receive their stock dividends directly or through a U.S. financial institution using an NPC or ELI to provide dividend equivalent payments. Both direct dividends and dividend equivalents produce payments that reflect U.S. stock payouts. There is little economic justification for treating those foreign investors differently, simply because one group uses financial intermediaries and

[7] See Subcommittee Hearing on Dividend Tax Abuse, at 111.

derivative financial instruments to obtain their payments. The proposed rule would not only ensure that the similarly situated investors are treated in a similar manner for tax purposes, but would also provide a more focused and efficient way to identify the NPC or ELI payments that warrant similar taxation.

The 2013 proposed rule would prevent under-inclusion of the NPC and ELI payments that should be taxed like stock dividends by better identifying the NPC and ELI payments that have the potential for tax avoidance. By focusing on those NPC and ELI instruments whose expected returns correspond at least 70% with direct dividend payments at the time of acquisition by the long party, the 2013 proposed rule would help ensure that all of those payments are taxed in a similar manner to U.S. stock dividends, no matter how the payments are structured in the relevant financial instruments or transactions. Foreign investors who receive those payments would be subject to a uniform rule for tax purposes.

The 2013 proposed rule would also limit over-inclusion by better identifying which NPCs or ELIs have only a limited potential to serve as vehicles for tax avoidance. NPC or ELI instruments whose expected returns reflect less than 30% of the actual dividend payments payable on a U.S. stock at the time of acquisition by the long party are unlikely to have been structured to avoid dividend taxation, and so would be exempt from the proposed rule's equivalent taxes. The market-based delta standard would thereby help ensure that the statute would not penalize foreign investors using derivatives to make equity investments in ways that are unrelated to stock dividend tax avoidance. The delta standard's increased accuracy would thereby further the tax code's general goal of treating similar entities similarly and different entities differently, providing greater equity for all parties.

Addresses Stock Index Abuse. The 2013 proposed rule would also minimize potential abuses of stock indices as methods of escaping U.S. dividend tax treatment by establishing guidelines for when an index may be excused from dividend taxation. Under the proposed new rule, a qualified stock index would be treated as a single security that does not produce taxable U.S. source dividends if it: (1) referenced 25 or more underlying securities, (2) referenced only long positions in the underlying securities, (3) contained no underlying security that represented more than 10% of the index's weighting, (4) was rebalanced based on objective rules at set intervals, (5) did not provide for a high dividend yield, and (6) was referenced by futures or options contracts that trade on a national exchange or a domestic board of trade. These strict criteria would provide a reasonable method for identifying legitimate index funds that have not been designed to avoid dividend taxes, and would excuse most index products traded on U.S. stock exchanges from dividend taxation. At the same time, it would prevent financially engineered index funds from becoming the next vehicle designed to dodge U.S. dividend taxes.

Minimizes Revenue Loss and Receipt of Unearned Benefits. The 2013 proposed rule would better ensure that foreign investors who benefit from U.S. stocks, and from the U.S. economic, financial, legal, and governmental systems supporting U.S. capital markets, are held accountable for their proportionate share of the taxes needed to safeguard those systems. Subcommittee documents show that foreign investors who received U.S. stock dividends through dividend equivalent payments have failed to pay billions of dollars each year in taxes that would otherwise have supported the functioning of U.S. capital markets.

While the IRS does not collect overall data on revenue loss attributable to dividend equivalents, a 2007 report by the Government Accountability Office calculated that in 2003, then the latest year with available data, about $42 billion in U.S. stock dividends were paid to non-U.S. corporations, from which only about 4.5% or $1.9 billion was withheld, even though the applicable tax rates ranged from 15% to 30%.[8] The Subcommittee investigation also disclosed the extensive nonpayment of tax on financial transactions arranged by individual firms required to act as withholding agents. The investigation found that, for example, from 2000-2007, Morgan Stanley's dividend equivalent transactions enabled investors to escape payment of dividend taxes totaling at least $300 million.[9] An internal Lehman Brothers presentation estimated that, in 2004 alone, its foreign clients used dividend equivalent transactions to avoid tax liability of roughly $115 million.[10] Likewise, from 2004-2007, UBS enabled non-U.S. clients to use dividend equivalent transactions to escape tax liabilities estimated at $62 million.[11] Together, these three financial firms enabled their foreign clients to avoid paying hundreds of millions of dollars of tax liability simply by structuring their payments through derivative financial instruments, rather than as direct stock dividends.

The proposed new rule would put an end to this tax dodging, which allows foreign investors to circumvent their U.S. tax obligations and shift their tax burdens onto the shoulders of everyday Americans. The 2013 proposed rule would instead use a delta-based metric to better identify those who benefit from American stock dividends and, by law, are required to pay a share of the taxpayer costs to maintain U.S. capital markets.

Recognizes U.S. Source Income. By treating swap payments that reflect U.S. stock dividends as taxable U.S. income, the proposed rule would also help implement the precedent set by the 2010 law for treating U.S.-based swap payments as taxable U.S. source income. Right now, a twenty-year-old IRS regulation inexplicably deems swap payments sent from the United States to foreign investors as non-U.S. source income, turning the meaning of the word "source" on its head.[12] Correcting that approach for swap payments that include dividend equivalents is a critical first step toward reforming the source rule for all U.S.-based swaps.

Thank you for the opportunity to comment on this matter.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations

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[8] "Tax Compliance: Qualified Intermediary Program Provides Some Assurance that Taxes on Foreign Investors are Withheld and Reported, But Can be Improved," Government Accountability Office, Report No. GAO-08-99 (Dec. 2007), at 23-24.
[9] See Subcommittee Hearing on Dividend Tax Abuse, at 112.
[10] Id.
[11] Id.
[12] See Treas. Reg. § 1.863-7(b)(1), which was first promulgated in 1991.