


## JCT Counsel Talks Withholding on Cross-Border Derivative Flows

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As practitioners await the release of final regulations under the dividend equivalent withholding provision of [section 871\(m\)](#), Joint Committee on Taxation Legislative Counsel Viva Hammer gave them some food for thought by proposing alternatives to the regime.

Not speaking on behalf of any member, Hammer said at the Practising Law Institute seminar in New York on the taxation of financial products that Congress went after the use of equity swaps by foreign investors trying to avoid dividend withholding but that section 871(m) is widely disliked.

The usual customers for the total return equity swaps to which section 871(m) is directed are hedge funds organized in tax havens, so are not eligible for dividend withholding relief. They turned to swaps to replicate ownership because a regulation gives the payments foreign source ([reg. section 1.863-7\(b\)](#)) and badly drafted guidance meant to prevent cascading implied that withholding could be avoided at all stages (Notice 97-66, 1997-2 C.B. 328 .

Hammer said that tax reform might be an opportunity to rethink the regime and that an alternative regime might be one that sources derivative flows with the payer, treats foreign taxpayers trading in derivatives with U.S. counterparties as engaged in a U.S. trade or business, and treats the derivative flow as effectively connected with that business. Investors in treaty countries could get withholding relief because payments would be covered by the business profits or other income articles (articles 7 and 21 of OECD model treaties, respectively).

Most hedge funds are set up as master-feeder structures. Most investors in the foreign feeder -- a foreign blocker corporation -- are U.S.-tax-exempt institutions such as pension funds, looking to avoid the debt-financed income prohibition ([section 514](#)). Hammer suggested that the unrelated business taxable income rules don't make sense because they're easily avoided.

Hammer offered some questions that might be considered in a more comprehensive approach to cross-border derivative flows. "Do swaps encourage U.S. investment? There is no investment in swaps. Do they reduce capital costs for U.S. business? Should we collect revenue where there's low elasticity of responsiveness to the imposition of tax?" Hammer asked rhetorically.

Hammer argued that the source regulation was not graven in stone. She said that the current source regulations for swaps could be changed by Congress.



Hammer noted that the debate that took place in the 1980s when the source rule for swaps was put into regulations to provide a market boost for a new product "is

immaterial to what the necessities are today in a world in which it's very difficult to tax cross-border flows and every civilized country ruled by law is struggling with that."

Withholding policy raises the question of which country has tax jurisdiction over income from swaps. "Countries with the rule of law are claiming it's hard to catch the cash. In countries unburdened by the rules of law, it's not so hard," Hammer said. The latter was an allusion to tax havens. Historically, OECD model treaties were drafted with equal economies that had real tax systems in mind.

Larry Salva of Citigroup indicated that he thought Congress was wrong to step in. (The IRS was auditing total return swap abuses at the time.) "There are shared responsibilities in administering the law. If the old law was not properly administered or taxpayers were too aggressive, that's an enforcement matter," he said. "It seems that there is existing law that says that a swap does not result in UBTI."

Julio Jimenez of PricewaterhouseCoopers LLC agreed. "I personally think the statute was perhaps not necessary," he said, adding that he thought Congress took it too far. "What started as trying to address a particular transaction, a particular play, has now turned into a new view of what's income and how to tax it."

Salva said that the delta test in the proposed regulations will require traders to create and track a cash flow that's relevant for tax purposes only. He said that new withholding agent compliance systems will take time and money to implement and that work can't start until the final regs come out. The proposed (REG-120282-10 ) and temporary (T.D. 9572 ) regulations treat high-delta dividend equivalents as dividends subject to U.S. withholding tax.