



Stop Tax Haven Abuse Act: An Attempt to Close Down Dividend “Washing” has New Life with a New Congress and New Administration; If Enacted Would have Broader Implications

On March 2, 2009, Senator Carl Levin (D-Michigan) introduced the Stop Tax Haven Abuse Act (the “Bill”) in the Senate and a day later Representative Lloyd Doggett (D-Texas) introduced the same provision in the House of Representatives. The Bill is based on a previous bill co-sponsored by then-Senator Barack Obama in 2008. In testimony before the House Ways and Means Committee last week, Treasury Secretary Timothy Geithner gave his unqualified support for the Bill. In addition to introducing measures to combat tax evasion, money laundering, and the use of tax shelters, the Bill includes provisions that attempt to “close the offshore dividend tax loophole,” according to Senator Levin.

Background

In September 2008, the Senate Permanent Subcommittee on Investigations released a report entitled “Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends.” The report describes a range of transactions employed by financial institutions aimed at enabling non-U.S. clients to avoid U.S. withholding taxes on dividends paid with respect to U.S. securities. As described in the report, U.S. withholding taxes on dividends are avoided through the use of either swaps¹ or stock lending transactions, or a combination thereof. Transactions involving swaps rely on a Treasury regulation which provides that the source of any payments made pursuant to the swap is determined according to the country of residence of the person receiving the payment.² Although substitute dividend payments made under a stock lending agreement are sourced in the same manner as the dividends with respect to the underlying stock (and would therefore be U.S. source if made with respect to stocks of a U.S. corporation),³ transactions involving stock lending rely on a decade old Internal Revenue Service (“IRS”) Notice to avoid U.S. dividend withholding tax.⁴

Proposed Amendments to the Code

Section 108 of the Bill addresses the above-described transactions by providing that the term “dividend,” for purposes of U.S. withholding tax provisions, includes (i) any dividend equivalent amount (“Dividend Equivalent

¹ Swaps are generally treated as notional principal contracts for U.S. federal income tax purposes.

² Section 1.863-7(b)(1). All Section references are to the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury regulations promulgated thereunder.

³ Section 1.861-3(a)(6).

⁴ Notice 97-66, 1997-48 I.R.B. (1997). The notice addressed the concern expressed by practitioners with respect to a “cascading effect” of dividend withholding tax if the same U.S. securities are the subject of multiple stock lending transactions and therefore multiple substitute dividend payments.

Amount”) paid pursuant to a swap contract⁵, and (ii) any substitute dividend amount (“Substitute Dividend Amount”) paid pursuant to a securities lending transaction or a sale-repurchase transaction. In addition, the Bill provides that any Dividend Equivalent Amount with respect to stock of a domestic corporation is U.S. source and that any Substitute Dividend Amount is sourced in the same manner as the dividend distribution with respect to the underlying stock. As such, any Dividend Equivalent Amounts and Substitute Dividend Amounts paid to non-U.S. persons with respect to stock of domestic corporations would be subject to U.S. withholding tax.

Further, the Bill provides that Dividend Equivalent Amounts and Substitute Dividend Amounts should be considered “dividends” for purposes of any tax treaty. This provision would, however, not seem to provide any relief with respect to payments of Dividend Equivalent Amounts and Substitute Dividend Amounts made between non-U.S. persons as dividends generally must be paid by “a resident of a Contracting State” for a treaty to apply.⁶

The potential “cascading effect” of dividend withholding tax is addressed by a provision in the Bill that provides that the amount of withholding may be reduced pursuant to regulations to the extent the taxpayer can establish that withholding has already occurred. Such regulations must be proposed within 90 days and finalized within 150 days after the enactment of the Bill. These regulations must also provide for rules addressing dividend withholding in cases where (i) Dividend Equivalent Amounts are netted with other payments made pursuant to a swap contract, (ii) fees and other payments are netted to disguise the characterization of a payment as a Substitute Dividend Amount, and (iii) option contracts, forward contracts, or similar arrangements are used to achieve the same or substantially similar economic results as a swap covered by Section 108 of the Bill.

If enacted, the Bill would apply to payments made on or after 90 days after the date of enactment. If the Bill is enacted with this effective date, existing swaps and securities loans would need to be examined to determine which party bears the risk of a U.S. withholding tax and whether the imposition of such a tax creates a right to terminate the contract.

Contacts

Thomas A. Humphreys
(212) 468-8006
thumphreys@mofo.com

Remmelt A. Reigersman
(212) 336-4259
reigersman@mofo.com

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⁵ Thus, as currently drafted, the Bill would change the tax character of Dividend Equivalent Amounts on all equity swaps based on U.S. equities, not merely those designed for tax avoidance.

⁶ See article 10(1) of the United States Model Income Tax Convention of November 15, 2006.