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IRS May Apply Economic Substance Doctrine to Securities Lending Transactions Entered to Avoid U.S. Withholding Tax

In generic legal advice released in November 2012 (AM 2012-009), the Chief Counsel's Office, applying the economic substance doctrine, disregarded a typical securities lending transaction entered into before May 20, 2010, to avoid U.S. withholding tax. The IRS stated that it was aware of cases where financial institutions promoted such securities lending transactions to foreign customers as a way to avoid U.S. withholding tax based on Notice 97-66, despite the fact that no prior withholding tax was paid within the chain of transactions. AM 2012-009 concludes that, if the IRS determines that such a transaction lacked economic substance, (i) the lender may be treated as retaining ownership of the securities, and thus receiving a U.S.-source dividend subject to U.S. withholding tax under Code Section 871 or 881; and (ii) the borrower may be treated as the withholding agent with respect to the dividend and thus subject to U.S. withholding tax under Code Section 1441 or 1442 and 1461.

Notice 97-66 and the Transaction

Notice 97-66 (since withdrawn by Notice 2010-46) limited U.S. withholding tax imposed by regulation Sections 1.871-7(b)(2) and 1.881-2(b)(2) on securities lending transactions between foreign persons to no more than 30 percent of the dividend on the underlying securities. Under the Notice, the amount of U.S. withholding tax imposed by the regulations was equal to the underlying dividend multiplied by a rate equal to the excess of (i) the rate of U.S. withholding tax that would apply to U.S.-source dividends paid by a U.S. person directly to the payee of the substitute payment over (ii) the rate of U.S. withholding tax that would apply to U.S.-source dividends paid by a U.S. person directly to the payor of the substitute payment. This amount could be reduced if U.S. tax actually withheld on the underlying dividend and any prior substitute payments exceeded the amount of U.S. withholding tax that would have been imposed on U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. As a result, substitute dividend payments that did not reduce overall U.S. withholding tax generally were not subject to withholding tax.

Following the release of Notice 97-66, some financial institutions marketed securities lending transactions that completely eliminated U.S. withholding tax, interpreting the Notice as not literally requiring tax to be withheld in the chain of the stock loan transactions. The facts of a typical transaction (the "Stock Loan") are outlined in AM 2012-009:

Foreign customer (FC) owned 3 million shares of a U.S. corporation (the "reference shares"), with a fair market value of \$24 million. On March 30, 2007, the U.S. corporation declared a dividend of \$0.06 per share, payable on May 4, 2007, to shareholders of record as of April 20, 2007. On April 17, FC loaned the shares to a foreign affiliate (FA) of a U.S. financial institution, a decision influenced by a memorandum prepared by the U.S. financial institution describing how stock loan transactions could be used to avoid U.S. withholding tax.

Under the stock loan, FA would pay FC a substitute dividend equal to 70 percent of any actual dividend attributable to the reference shares, post cash collateral with FC equal to 102 percent of the shares' fair market value and pay FC an "enhancement fee" of \$36,000 (20 percent of the \$180,000 dividend on the shares) to be treated as an implicit borrow fee. FC would loan the collateral to a third party, earning interest until the return of the reference shares 20 days later (May 7, 2007). FC and FA agreed on a rebate rate that would yield FC \$36,000 retained interest (i.e., the enhancement fee). On the same day as the stock loan, FA simultaneously sold the shares to

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a swap dealer at their fair market value and entered a total return swap (with a notional amount equal to the sales price) with the same swap dealer. As a result of the swap dealer transactions, neither FC nor FA would be the record owners of the reference shares on the record date.

When the U.S. corporation paid the dividend on May 4, FA had to pay to FC a substitute dividend of \$126,000 (70 percent of the underlying dividend). On May 7, FA terminated the total return swap, repurchased the reference shares, and received a net payment equal to the gross dividend payment, plus any appreciation, less any depreciation and interest, plus a fee. FA retained \$18,000 (10 percent of the underlying dividend) of the payment from the total return swap. Also on May 7, FC terminated the stock loan, receiving the reference shares from FA, returning the cash collateral to FA and retaining the \$36,000 of interest as the enhancement fee. The \$18,000 retained by FA, plus the \$36,000 retained by FC, represented 30 percent of the gross dividend (as well as the U.S. withholding tax avoided).

Application of the Economic Substance Doctrine

The Chief Counsel's Office concludes that, depending on the facts, the economic substance doctrine can be used to disregard securities lending transactions like the Stock Loan and disallow reliance on Notice 97-66. There is no precedent applying the economic substance doctrine to securities lending transactions like the Stock Loan. Instead, the memorandum cites judicial authorities for the general proposition that a transaction may be ignored for tax purposes if it lacks economic substance and then applies the principles of those cases to the Stock Loan transaction.

AM 2012-009 explains that the Stock Loan failed both the subjective business purpose and the objective economic substance prongs of the economic substance doctrine and, consequently, should be disregarded. The transaction failed the subjective test because the foreign customer lacked a non-tax business purpose for the Stock Loan, based on several facts: the "off-market terms" of the Stock Loan, the foreign affiliate's lack of business reasons (e.g., to facilitate a short sale or hedging position) for borrowing the stock, and a lack of internal documentation reflecting legitimate business or regulatory purposes for the transaction.

The transaction failed the objective test because, the Chief Counsel believes, the foreign customer could not have profited from the Stock Loan apart from tax savings (a fact that also supported the subjective test analysis). The Stock Loan neither improved the foreign customer's pre-tax return nor significantly affected the foreign customer's beneficial interest in the reference shares. The foreign customer's acceptance of a pre-tax loss to realize a tax benefit showed a lack of objective economic substance.

Because the Stock Loan lacks economic substance, the memorandum concludes that the IRS can tax the transaction in accord with its substance. A 30 percent gross basis withholding tax can apply under Section 871 or 881 because, in substance, the foreign customer retained ownership of the reference shares and received a U.S. source dividend (via the foreign affiliate). The foreign affiliate could be liable for the tax as a withholding agent, under section 1441 or 1442 and 1461, because it had control, receipt and custody of a payment that, in substance, was a U.S. source dividend.

AM 2012-009 further states that other judicial doctrines might apply to challenge transactions like the Stock Loan. For example, applying the step transaction doctrine, the foreign affiliate's sale of the reference shares, total return swap and repurchase of the shares might be ignored, with the result that the foreign affiliate is treated as owning the reference shares and thus receiving a U.S. source dividend subject to withholding tax. Alternatively, a determination that the foreign affiliate acted as an agent for the foreign customer (or that the swap counterparty acted as an agent of the foreign affiliate) could result in the foreign customer (or the foreign affiliate) being subject to withholding tax. The applicability of other doctrines would depend on the facts and circumstances of a particular transaction.

Conclusion

The analysis of AM 2012-009 is limited to transactions entered prior to May 20, 2010, the date Notice 97-66 was withdrawn by Notice 2010-46. Significantly, AM 2012-009 does not say that the parties' interpretation of Notice 97-66 (as not requiring tax to be withheld somewhere in the chain of transactions like the Stock Loan) was incorrect. Rather, the Chief Counsel simply asserts that reliance on the Notice was "inappropriate" because the transaction lacked economic substance. On the one hand, despite its scope limitation, the Chief Counsel's position in the memorandum represents an unprecedented extension of the economic substance doctrine to securities lending transactions. On the other hand, the IRS' resort to the judicial economic substance doctrine may be because the transaction described in AM 2012-009 predated the effective dates of both Section 871(m), which could obviate the need to attack stock loan transactions with the economic substance doctrine, and Section 7701(o), which codified the economic substance doctrine.

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