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In this installment of Reflections With Reuven Avi-Yonah, Avi-Yonah responds to a recent article on the application of withholding taxes on derivatives and questions the current state of U.S. rules.

In their excellent *Tax Notes* article on the application of withholding taxes on derivatives, Lorenz F. Haselberger and Michael B. Shulman write that:

> A taxpayer entering into a derivative may derive income of a kind that is different from the kind of income that would have been realized had the taxpayer instead acquired the underlying asset, resulting in different U.S. withholding tax treatment.
>
> For example, when a foreign taxpayer enters into a swap referencing an equity security or interest rate, amounts it receives that correspond to dividends or interest generally are characterized as periodic payments on a financial contract rather than as dividends or interest for federal income tax purposes. This characterization can result in different withholding treatment because swap payments generally are sourced to the jurisdiction of the recipient, whereas dividends and interest generally are sourced to the jurisdiction of the payer. . . .
>
> In some cases, Congress has enacted legislation to conform the withholding tax treatment of income from the underlying asset and the treatment of the corresponding income from a derivative referencing the underlying asset. For example, under section 871(m), enacted in 2010, the withholding treatment of dividend equivalent amounts payable or imputed with respect to certain U.S. equity derivatives generally conforms to the withholding treatment of dividends paid on the underlying physical equity security. *In the absence of a provision like section 871(m), however, there is no overriding principle that would require withholding tax on derivative income simply because withholding would apply to income from the underlying asset*.[1] [Emphasis added.]

My question is, why is there no such overriding principle?

In general, as the authors point out, when there is no source rule for a particular type of income, the source is generally determined by looking to the source of income that is most closely analogous to the income in question.[2] This treatment would typically result in income from derivatives being sourced in the same way as income from the underlying asset. But "that approach should have no relevance when income from the derivative either is properly characterized as gain (and thus not [fixed or determinable annual or periodic] income) or is

[1] Lorenz F. Haselberger and Michael B. Shulman, "Holding Nothing Back: Everything We Know About Withholding on Derivatives," *Tax Notes Int'l*, Apr. 29, 2024, p. 715.

[2] See *Container Corp. v. Commissioner*, 134 T.C. 122, 131 (2010).

addressed by a specific source rule (for example, income from notional principal contracts (NPCs)).”[3]

This is because Treasury adopted a regulation in 1991 that sources income from NPCs to the residence of the recipient.[4] Under reg. section 1.863-7(b)(1), the source of NPC income generally is determined by reference to the residence of the recipient, so foreign recipients of NPC income generally are not subject to FDAP taxes on that income. This source rule applies to most conventional interest rates, foreign currency, and equity swaps because they qualify as NPCs within the meaning of reg. section 1.446-3.

Adopting the NPC source rule resolved significant uncertainty as to the sourcing of income from NPCs. Because the normal rule is sourcing by analogy, and the most common types of NPCs (interest and equity swaps) would result in analogies to interest and dividends that are both sourced to the residence of the payer, taxpayers and their advisers were concerned before 1991 that withholding would apply to payments under NPCs that economically were interest and dividend equivalents.

One solution was to rely on the “other income” article in U.S. tax treaties, which in some cases provides for residence-based taxation. As Gregory May wrote at the time:

> The other-income article in most U.S. income tax treaties recognizes the source country’s right to tax unspecified other income. Fifteen U.S. treaties, however, yield the right to tax other income to the country of residence. Among them are the treaties with several important U.S. commercial partners. The protection offered by such treaties was critically important in the early development of the swaps market. Before the source of notional principal contract payments was resolved, foreign persons for whom the payments were not business profits relied on preclusive other-income articles to avoid U.S. withholding tax. The residence-based sourcing rule now makes the other-income articles largely irrelevant.[5]

But the question remains, was Treasury right to adopt the NPC source rule?

The NPC source rule is strange; generally, source rules are adopted by legislation, not regulation. This is true both for the old source rules in section 861 and for some newer rules like section 863(d) (space and ocean activities) and 863(e) (international communications income). It is unclear how Treasury derived the authority to adopt the NPC source rule, but because the rule only reduces U.S. taxing jurisdiction, nobody has standing to complain.

It is also unclear that the NPC source rule was needed to reduce uncertainty and transaction costs. Certainly, in the absence of any source rule, there was uncertainty that payments on NPCs might be subject to withholding, although no taxpayers actually withheld. But that uncertainty could also have been eliminated had the new source rule stated that the sourcing for payments on NPCs was the same as the sourcing on payments on the underlying asset, and that rule has the advantage of being based on the case law, as well as being the same as the source rule for dividend equivalents in securities lending transactions.[6]

Another policy issue is that adopting a rule that requires withholding could spur the market for derivatives to move elsewhere, like the invention of the Eurobond market in London after the U.S. adopted the interest equalization tax in the 1960s. But given the size and sophistication of the U.S. derivatives market in 1991, that result seems less likely, especially because the market did not move in response to the pre-1991 uncertainty. Also, this type of policy consideration seems more appropriate for Congress than Treasury.

[3] *Id.*

[4] This NPC source rule derives from Rev. Rul. 87-5, 1987-1 C.B. 180, introduced as temp. reg. section 1.863-7T in 1989 and finalized in 1991. The reason for the special rule was to permit cross-border NPCs without the impediment of a withholding tax. *See* H. David Rosenbloom, “Source Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions,” 50 *U. Miami Bus. L. Rev.* 597 (1996); Yoram Keinan, “Mark-to-Market for Derivatives,” *Tax Notes Federal*, Sept. 20, 2010, p. 1269.

[5] Gregory May, “The U.S. Taxation of Derivative Contracts,” *Tax Notes Federal*, Sept. 25, 1995, p. 1619. *See also* Avi-Yonah and Linda Z. Swartz, “U.S. International Treatment of Financial Derivatives,” *Tax Notes Federal*, Mar. 31, 1997, p. 1703.

[6] On the difference between these two rules, see Avi-Yonah and Swartz, *supra* note 5.

As Haselberger and Shulman point out, there is an important exception to the NPC source rule that was enacted by Congress, namely section 871(m). That section states that "for purposes of subsection (a), sections 881 and 4948(a), and chapters 3 and 4, a dividend equivalent shall be treated as a dividend from sources within the United States." Dividend equivalent is then defined as:

> (A) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States,
>
> (B) any payment made pursuant to a specified notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and
>
> (C) any other payment determined by the Secretary to be substantially similar to a payment described in subparagraph (A) or (B).

Section 871(m) was enacted in 2010 as a result of an investigation by the Senate Permanent Subcommittee on Investigations that revealed a broad practice of avoiding withholding on dividends by using equity swaps.[7] Specifically, if a foreign investor were to invest directly in the stock of a U.S. publicly traded corporation, any dividends would be subject to withholding at 30 percent (if there is no treaty) or 15 percent (if there is a treaty). But if the investor entered into a total return equity swap with a U.S. bank and the bank invested in the stock of the U.S. corporations, there would be no withholding because (a) the payment of a dividend by the corporation to the bank would be a domestic payment not subject to withholding, and (b) the payment of the dividend equivalent by the bank to the foreign investor would be considered foreign-source income under reg. section 1.863-7(b)(1), also not subject to withholding.

The Permanent Subcommittee on Investigations hearing revealed that this technique was not just used by investors who did not hold the underlying stock, but even by investors who held the stock but sold it to the domestic bank just before the dividend payment, received the dividend equivalent, and then bought the stock back. Congress responded by enacting section 871(m).

I testified in the PSI hearing in favor of imposing withholding on dividend equivalents, but now I believe that was a mistake.[8]

First, as I have written elsewhere, the hearing focused on the misbehavior of taxpayers and the inaction of the IRS, not on the policy issue of why the NPC source rule was adopted, even though this rule led to the problem.[9] In the hearing, PSI chairman Sen. Carl Levin and ranking member Sen. Norm Coleman explicitly expressed their opposition to the dividend tax-dodging acts. Levin said, "What I oppose is the misuse of financial transactions to undermine the tax code, rob the U.S. Treasury, and force honest Americans to shoulder the country's tax burden."[10] Coleman described the abusive financial transactions as "shameless and cynical abuse of U.S. tax policy," and condemned that "inappropriate tax avoidance by a privileged few force[d] millions of honest American taxpayers to shoulder a disproportionate share of the tax base."[11] They were unsatisfied that "for the last 10 years, as dividend tax dodging took hold and became an open secret among market insiders, the U.S. Treasury Department and the IRS sat on their hands." The focus on the lack of enforcement led

[7] U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends" (Sept. 11, 2008).

[8] *See* Avi-Yonah, "Avi-Yonah Testimony for Hearing on Dividend Tax Abuse U.S. Senate Permanent Subcommittee on Investigations" (Sept. 11, 2008); Avi-Yonah, "House Committee on Ways and Means Statement of Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law, University of Michigan Law School Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means" (Mar. 5, 2008); Avi-Yonah, "Enforcing Dividend Withholding on Derivatives," *Tax Notes Federal*, Nov. 10, 2008, p. 747; *but see* David Hariton, "Taxing Equity Swaps: Don't Throw Out the Baby With the Bath Water," *Tax Notes Federal*, Sept. 22, 2008, p. 1203.

[9] *See* Avi-Yonah and Kaijie Wu, "Behavioral Biases and Political Actors: Three Examples From US International Taxation" in *Behavioural Public Finance: Individuals, Society, and the State* (2020).

[10] Opening Statement of Sen. Carl Levin, PSI Hearing Record, *supra* note 7, at 6.

[11] *Id.* at 7-8.

the PSI not to ask the more fundamental question of whether the NPC source rule was justified.

Second, the resulting section 871(m) and the regulations under it are horribly complicated, primarily because of the need to prevent avoidance through a definition of "any other payment determined by the Secretary to be substantially similar to a payment described in subparagraph (A) or (B)." As Haselberger and Shulman explain, this rule has led to an elaborate attempt to define "substantially similar" using mathematical concepts:

> Under the final section 871(m) regulations, a "simple" derivative — generally, a contract that references a single, fixed number of underlying shares — gives rise to dividend equivalent amounts in respect of an underlying U.S. equity if it has a delta with respect to that U.S. equity of at least 0.8 at inception. For these purposes, delta is defined as the ratio of a change in the fair market value of the derivative relative to a small change in the fair market value of the notional number of shares referenced by the derivative. The conceptual underpinning of this delta-based approach is that when a derivative provides the long party with an economic profile that is sufficiently close to the underlying equity security, the FDAP tax consequences to the long party generally should be the same as ownership of that security.
>
> For a "complex" derivative — that is, a contract that is not a simple derivative — delta may be indeterminate, since the contract definitionally has no single, fixed number of notional shares to use as the denominator for computing the delta fraction (consider, for example, an accelerated return note that entitles its holder to any increase in value on 150 notional USCo shares and requires the holder to bear any decrease in value on 100 notional USCo shares). Accordingly, the final section 871(m) regulations provide a substantial equivalence test under which a complex contract is in scope if the absolute value of the price variation between the complex contract and the dealer's initial hedge at various testing prices is equal to or smaller than the absolute value of the price variation between an equivalent simple contract benchmark with a delta of 0.8 and its initial hedge at those prices. The substantial equivalence test appears to reflect an understanding that the most economically sensible manner by which to determine a delta-equivalent for a complex contract is by reference to how a dealer actually hedges the equity price risk embedded in the contract.[12]

This is an awfully complicated method, but it may be necessary to prevent avoidance of the basic rule by using "baskets" of similar stocks. The need to adopt and comply with this rule raises doubts about whether the whole exercise is worth it, especially because it may be possible to avoid section 871(m) by not having an NPC at all (for example, in treaty cases when the NPC source rule may not be needed to avoid withholding).

Finally, there is an underlying policy problem: Why enforce withholding on dividends that are not deductible and not on interest that is deductible? The answer is that portfolio interest is not subject to withholding under section 871(h) (the portfolio interest exemption), but that leads to strange results: An interest payment is fully deductible (subject to the constraints of section 163 and the base erosion and antiabuse tax) and therefore reduces the corporate tax and is also not subject to withholding, while a dividend payment does not reduce the corporate tax and is subject to at least 15 percent withholding. Moreover, it may be possible to convert dividends to interest by using financial instruments.[13] In that case, why focus so much effort on enforcing withholding on dividends?

The whole problem could have been avoided if Treasury had not adopted the NPC source rule and instead had adopted the principle "that would require withholding tax on derivative income simply because withholding would apply

[12] Haselberger and Shulman, *supra* note 1.

[13] *See* May, "Flying on Instruments: Synthetic Investment and the Avoidance of Withholding Tax," *Tax Notes Int'l*, Nov. 11, 1996, p. 1625.

to income from the underlying asset."[14] It did not do so even though it adopted the opposite rule for dividend equivalents in securities lending transactions, which were treated as dividends subject to withholding before section 871(m). While it seems unlikely that Treasury could now reverse the rule, Congress can reassert its authority over sourcing income by abolishing the NPC source rule generally, just like it did for equity swaps in enacting section 871(m). Admittedly, a rule requiring withholding if the income from the underlying asset is U.S.-source would offer little guidance if there is no determinate location for the underlying asset, but it would allow sourcing by analogy, and it would address the basket issue (because all the equities in the basket have the same source rule) without relying on complex mathematics. ■

[14] Haselberger and Shulman, *supra* note 1.