

Dividends, withholding, offshore funds

Congress takes on 'enhancements' created by Wall Street to minimize taxes

By Robert N. Gordon

September 28, 2008

For as long as I can remember, there has been a business in helping investors minimize taxes withheld on dividends.

U.S. tax-exempt entities withhold taxes on foreign-share dividends yet can't apply the tax credits generated by that withholding. This creates distortions in trading.

Likewise, foreign investors withhold taxes on dividends paid by U.S. companies.

On Sept. 11, the Senate's Permanent Subcommittee on Investigations held a hearing on the financial services industry's efforts to help foreign investors reduce the effect of withholding taxes.

The subcommittee took aim at the use of equity swaps and stock loans. It also criticized the Internal Revenue Service for being aware of this activity for decades yet doing nothing to change the situation.

Let's explore the issue related to the use of equity swaps.

An equity swap is a derivative that mimics the direct ownership of a particular security.

For example, if an investor enters into an equity swap on Detroit-based General Motors Corp., the counterparty pays the investor if GM goes up, and the investor pays if GM goes down. "Interest" built into the swap is charged depending on the leverage and collateral posted.

Investors are credited for dividends. Taxes aren't withheld from payments received on swaps.

The problem with equity swaps stems from derivatives' being priced to include cash flows from dividends, among other factors.

When investors own a stock through an option position, warrant, structured note (an exchange traded note or equity-linked note), single stock future or equity swap, the cash flows aren't separated out and taxed separately.

I hope that those who make investments through derivatives aren't deemed to have improperly "dodged" taxes. But there are some transactions that were executed in such a way so as to cause some concern.

For example, the subcommittee report shares with us the fact that New York-based Citigroup Inc. voluntarily paid millions in back taxes on some transactions executed in a "circular" manner.

It should be noted that this manner of execution was uncovered in an internal audit and was clearly in violation of Citigroup's internal trading guidelines.

The transactions involved an offshore hedge fund's selling shares just before the record date to Citigroup's trading desk, which then became the hedge fund's counterparty to an equity swap.

At the end of the swap, the Citigroup trading desk sold the shares back to the hedge fund. Although it isn't clear that this situation should require withholding, it is the kind of transaction that gave the subcommittee indigestion.

Certainly, an offshore long-term investor investing in U.S. shares exclusively through a derivative hasn't engaged in tax abuse. Maybe the hearing will prod the issuance of guidance on the issue, as New York-based Lehman Brothers Holdings Inc. requested this year.

The stock-lending issue is much more technical, depending primarily on IRS Notice 97-66, which was intended to prevent multiple levels of withholding. Instead, the notice became the bedrock for a robust business in dividend "enhancement."

Let's not ignore the irony in this situation. The permanent subcommittee's report stated: "The evidence also showed that use of abusive dividend tax transactions is widespread throughout the offshore hedge fund industry."

The industry wouldn't exist without the IRS' unrelated business income tax rules that drive U.S. tax-exempts to invest offshore.

In fact, withholding on these dividends wouldn't even take place if their owners — U.S. pension plans, foundations and endowments — held the shares directly. These tax-exempt investors flock to so-called offshore blocker funds so that they won't run afoul of the UBIT rules and have to pay tax on their profits.

Washington might both stop this dividend activity and diminish the dollars in offshore-fee deferrals by allowing tax-exempt entities to invest in domestic limited partnerships or limited liability corporations and eliminate the need for them to go offshore.

Some transactions may have been executed poorly, which is why further guidance would be appreciated. Millions of dollars belonging to U.S. pensioners hang in the balance.

Robert N. Gordon is chief executive of Twenty-First Securities Corp., a New York-based brokerage firm. He can be reached at bob@twenty-first.com.