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Look out for hidden swap taxes

Changes will affect U.S. tax-exempt entities that invest overseas

By Robert N. Gordon

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Buried in the jobs creation law signed by President Barack Obama last month were a number of tax and reporting provisions that have nothing to do with employment opportunities.

One such provision (the new Subsection K of Internal Revenue Code 871) provides for withholding on those "owning shares synthetically" through swaps. The Hiring Incentives to Restore Employment Act treats as dividends both "substitute dividends" and "dividend equivalent payments" received by foreign persons. Thus, such payments will be subject to a 30% withholding tax.

The swap provisions in the HIRE Act cover swap payments on single stocks, as well as swaps on an index or a basket of securities. One wonders how these rules might affect U.S. tax-exempts — notably the pension plans, foundations and endowments that advisers serve — which own foreign dividend-paying shares synthetically through swaps.

The law specifically includes any payment under a "specified notional principal contract" (a swap) that is directly or indirectly determined by the payment of a dividend from sources in the U.S., as is the case with an equity swap. Adding insult to injury, payments are determined on a gross basis. Thus, because a payment is defined as "any gross amount which is used in computing any net amount which is transferred to or from the taxpayer," a party could be liable for a withholding payment even though it may have received no payments from the swap.

These provisions are the culmination of congressional discomfort with this type of trading activity. On Sept. 11, 2008, 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. The concern was with transactions entered into in a circular manner.

The legislation targets transactions such as one described by the subcommittee, in which an investment bank bought shares from an offshore hedge fund just before the record date, after which the hedge fund became the same bank's counterparty to an equity swap on the security.

At the end of the swap, the bank's trading desk sold the shares back to the hedge fund. At the time, it was thought that the transaction did not require withholding, because payments from the swap were not dividends.

Under the new law, a “specified notional principal contract” will be subject to the 30% withholding tax if any of the following apply:

• The long party transfers the underlying security to the short party to the contract.

• In connection with the termination of the contract, any short party transfers the underlying security to any long party to the contract.

• The underlying security is not readily tradable on an established securities market.

• The security is posted as collateral by any short party to the contract with any long party to it.

• Treasury identifies the contract as covered.

Interestingly, Treasury did propose in its Green Book more-encompassing requirements that, as of now, are not part of the HIRE Act. The Treasury Department, and therefore the IRS, has the authority to look for additional transactions close enough to these so that the same withholding rules can be applied. Avoiding fitting within the five types of “specified notional principal contracts” might be possible, say, with an underlying security that is publicly traded, since Treasury would have to take action to -implement the fifth category. The effective date for this new provision is Sept. 14, which is 180 days from enactment of the HIRE Act.

Ironically, the swap issue wouldn't exist without the 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 held the shares directly. Tax-exempt investors flock to so-called “offshore blocker funds” so that they won't run afoul of the UBIT rules and be forced to pay tax on their profits. If the government didn't have those rules, the tax-exempts would invest in domestic funds, and this “problem” would disappear.

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