Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **AM2012-009**

Release Date: 11/16/2012

CC:INTL:B5
POSTS-134403-12

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 871.02-03, 881.00-00

date: November 05, 2012

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subject: Securities Lending Transactions Used to Avoid Withholding Tax

This memorandum sets forth the legal analysis with respect to certain securities lending transactions entered into by foreign investors prior to May 20, 2010. See Notice 2010-46, 2010-24 I.R.B. 757 at § 1.B (modifying and withdrawing Notice 97-66, 1997-48 I.R.B. 8, 1997-2 C.B. 328 (1997)). This advice may not be used or cited as precedent.

ISSUE

May a securities borrower and a foreign securities lender be liable for gross basis tax under the common law economic substance doctrine when the borrower and lender enter into a securities lending transaction in order to avoid withholding tax on U.S. source dividends, dividing the avoided tax between the borrower and the lender rather than remitting it to the U.S. Treasury?

SUMMARY CONCLUSION

Depending on the facts of the particular securities lending transaction, the Commissioner may apply the common law economic substance doctrine to disregard the transaction. If a securities loan structured along the lines of the example discussed herein is disregarded as lacking economic substance, reliance on Notice 97-66 would be inappropriate. The nominal securities lender could be treated as having retained ownership of the loaned shares and as having received a U.S. source dividend subject to gross basis tax pursuant to section 871 or section 881. The nominal securities

borrower could be treated as a U.S. withholding agent subject to liability for withholding tax pursuant to section 1441 or section 1442 and section 1461.

FACTS

The Internal Revenue Service ("IRS") is aware of a number of cases in which financial institutions have promoted transactions structured as securities loans to allow foreign clients to claim that Notice 97-66 relieves U.S. withholding tax liability, even though no prior withholding taxes had been paid within a chain of transactions. These facts describe the transactions in general and do not relate to any particular transaction. However, for purposes of demonstrating the application of the legal analysis, Section D describes a hypothetical transaction that is typical of the dividend avoidance transactions. While the legal analysis described in this memorandum will often apply to stock lending transactions similar to the transaction described in Section D, every stock lending transaction must be analyzed based on the relevant facts and circumstances.

A. *Background: Securities Lending Transactions in the Ordinary Course of Business*

In a standard market securities loan,[1] a borrower generally enters into a securities loan to (1) cover a short sale, (2) cover a failure to deliver securities, (3) use in an arbitrage, hedging, or derivatives trading strategy, or (4) on-loan the securities. Mike Gaffney, Cross-Border Securities Lending & Qualified Securities Lender Regime, TAX NOTES TODAY, August 9, 2011, at 2011 TNT 153-4 at 605 (hereinafter "Gaffney"); James R. Hardin, Jr. and David M. Maloney, Cross-Border Securities Lending & the Withholding Tax: The Ambiguity Continues, TAX NOTES TODAY, June 12, 2000, at 2000 TNT 113-84 at 1534 (hereinafter "Hardin and Maloney"). A lender enters into a securities lending transaction to increase the return on an investment by receiving fees without changing its economic exposure to the investment. Hardin and Maloney at 1533.

The fee arrangement in a standard market securities lending transaction depends on whether the borrower posts cash or non-cash collateral. When the borrower posts non-cash collateral, the borrower pays the lender an explicit fee, often referred to as a borrow fee. See, e.g., ISLA, Global Master Securities Lending Agreement, Article 7.1. When the borrower posts cash collateral, the lender may reinvest the cash for its own account while the loan remains outstanding. Hardin and Maloney at 1534. When the lender returns the cash collateral to the borrower, it pays a negotiated rate of interest to the borrower, resulting in a payment that is commonly called a rebate fee. See, e.g., ISLA, Global Master Securities Lending Agreement, Article 7.2. The lender retains the difference between the interest it earns on the cash collateral and the rebate it pays to the borrower. Hardin and Maloney at 1534. The amount of this difference is effectively an implicit or embedded borrow fee for the

[1] This memorandum should not be interpreted as providing any guidance regarding section 1058.

lender. The amount of the borrow fee (whether explicit or implicit) paid to a lender depends on a number of factors, including the expected length of the loan, the amount of collateral, prevailing market interest rates, and the demand for the borrowed securities. Id. While the pricing of a securities loan varies and is not publicly reported, a typical interest rate used to determine a rebate fee will be set 10 to 20 basis points lower than a benchmark interest rate (e.g., the federal funds rate), with an implicit borrow fee resulting from the difference between the rebate fee and the lender's retained earnings on the collateral. Nina Mehta, In the Crosshairs, TRADERS MAGAZINE, Sept. 1, 2008, 2008 WLNR 17509703; Gregory Bresiger, A Securities Lending Exchange? Researcher notes securities lending's large unrealized potential, TRADERS MAGAZINE, Aug. 1, 2007, 2007 WLNR 16166730; Pam Abramowitz, Modern Lending, AR (ABSOLUTE RETURN & ALPHA), Jan. 23, 2007, 2007 WLNR 28080861.

In a standard market securities lending transaction, the lender also receives "substitute payments" equivalent to 100 percent of any distributions on the borrowed securities, such that the lender retains its economic position in the borrowed securities. See, e.g., ISLA, Global Master Securities Lending Agreement, Article 6.2. The borrower may dispose of the borrowed securities. See, e.g., ISLA, Global Master Securities Lending Agreement, Article 4.2. However, at termination of the securities loan, the borrower must return to the lender the same number of equivalent securities as those that were borrowed (however, not necessarily the identical borrowed securities). See, e.g., ISLA, Global Master Securities Lending Agreement, Article 8.3.

B. *U.S. Withholding on Substitute Dividends and Notice 97-66*

Sections 871(a) and 881(a) of the Internal Revenue Code (the "Code") impose a 30 percent tax on U.S. source fixed or determinable annual or periodic gains, profits, and income, including dividend income, received by a nonresident alien individual or a foreign corporation when that income is not effectively connected to the conduct of a U.S. trade or business. This 30 percent tax is generally collected through a withholding regime, whereby a withholding agent deducts and withholds any tax from payments made to the payee. Secs. 1441 and 1442. A withholding agent is "any person, U.S. or foreign, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding . . . ." Treas. Reg. § 1.1441-7(a)(1).

In 1997, final regulations were issued providing that substitute dividend payments made pursuant to securities lending transactions, sale-repurchase transactions, and substantially similar transactions generally are treated as dividends and are subject to tax under sections 871 and 881 and withholding under sections 1441 and 1442 if they are from a U.S. source. Treas. Reg. §§ 1.871-7(b)(2), 1.881-2(b)(2), 1.1441-2(b)(4). Substitute dividend payments are sourced in the same manner as the distributions giving rise to the substitute dividend payments. Treas. Reg. § 1.861-3(a)(6). Accordingly, substitute dividend payments made by reference to the payment of a U.S. source dividend will be U.S. source.

Shortly after these regulations were finalized, taxpayers expressed concern that the total U.S. gross-basis tax paid on a series of securities lending transactions could be excessive if each substitute dividend payment in the series were subject to a separate withholding tax. To provide relief to taxpayers unable to structure transactions to avoid excessive taxation, the Treasury Department and the IRS issued Notice 97-66, 1997-2 C.B. 328 (1997), which limited the aggregate U.S. gross-basis tax on a series of securities lending transactions to no more than 30 percent of the amount equivalent to the dividend distribution on the underlying transferred security. The Notice implemented this limitation using a formulary method to calculate the amount of U.S. tax imposed on a foreign-to-foreign substitute dividend payment. Under this method,

> the amount of U.S. withholding tax to be imposed under §§ 1.871-7(b)(2) and 1.881-2(b)(2) with respect to a foreign-to-foreign payment will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment.

Notice 97-66 at § 3, 1997-2 C.B. 328 (1997).

C. *The Tax Avoidance Securities Lending Structure*

Following the publication of Notice 97-66, a number of financial institutions marketed securities lending transactions to their clients as a way to avoid U.S. withholding tax on U.S. source dividends. Unlike the transactions described in Notice 97-66, these transactions entirely eliminated U.S. withholding tax on substitute dividends. See Notice 97-66 at § 5, 1997-2 C.B. 328 (1997). In fact, the parties to these securities lending transactions entered into the transactions solely or primarily to avoid U.S. withholding tax, unlike the parties to the transactions in Notice 97-66.

Some U.S. financial institutions described the transactions to their customers in detailed memoranda, emphasizing the after-tax "enhancement" to dividend yields. In some transactions, the foreign customers or U.S. financial institutions (or their foreign affiliates) have retained internal documents, including marketing materials, tax analyses and e-mails, indicating that the foreign customers entered into these transactions primarily to enhance their after-tax dividend yield by eliminating U.S. withholding tax.

In a typical transaction, a foreign customer transferred a dividend-paying stock issued by a U.S. corporation to a foreign affiliate of a U.S. financial institution in a securities lending transaction.[2] The U.S. financial institution usually used a foreign

[2] Although many of the securities lending structures designed to avoid withholding tax were structured by U.S. financial institutions, foreign financial institutions engaged in similar tax-motivated securities lending transactions. Depending on the relevant facts and circumstances, the analysis described herein may apply to transactions structured by foreign financial institutions.

affiliate organized in a low tax jurisdiction as the nominal securities borrower. Pursuant to the transaction, the foreign affiliate paid substitute dividends to the foreign customer in an amount equal to 70 percent of any dividend paid on the underlying loaned shares, which is the cash amount of the dividend that the foreign customer would have received if U.S. tax had been withheld. Both the foreign customer and the foreign affiliate were subject to 30 percent U.S. withholding on U.S. source dividends and substitute dividends. The foreign affiliate took the position that, because both the foreign affiliate and the foreign customer were subject to the same 30 percent U.S. withholding tax rate, Notice 97-66 permitted the foreign affiliate to pay the substitute dividend to the foreign customer without withholding and paying any U.S. tax. The foreign affiliate also agreed to pay the foreign customer a fee (sometimes called an "enhancement fee"), which typically equaled approximately 20 percent of any dividend paid on the underlying loaned shares, or two-thirds of the avoided U.S. withholding tax. The enhancement fees took different forms in different transactions; some foreign customers received explicit fees, some received increased interest income through over-collateralization of the stock loans, and others paid below-market rebate fees that resulted in above-market borrow fees. The analysis herein is unaffected by the form a particular enhancement fee took; the enhancement fee was designed to split the tax savings between the foreign affiliate and foreign customer.

On the same date, to hedge its exposure to the stock loan without retaining record ownership of the underlying loaned shares on the dividend record date, the foreign affiliate sold the underlying loaned shares to a swap dealer at fair market value and concurrently entered into a total return swap, often with the same swap dealer.[3] The notional amount of the total return swap equaled the price at which the foreign affiliate sold the underlying loaned shares. The total return swap provided for: (i) payment to a foreign affiliate by the swap dealer equal to any dividends paid on the underlying loaned shares plus any increase in the notional value of the underlying loaned shares; and (ii) payment to the swap dealer by the foreign affiliate equal to a specified interest rate applied to the notional amount plus any decrease in the notional value of the underlying loaned shares. Typically, the U.S. financial institution guaranteed its foreign affiliate's obligation under the total return swap.

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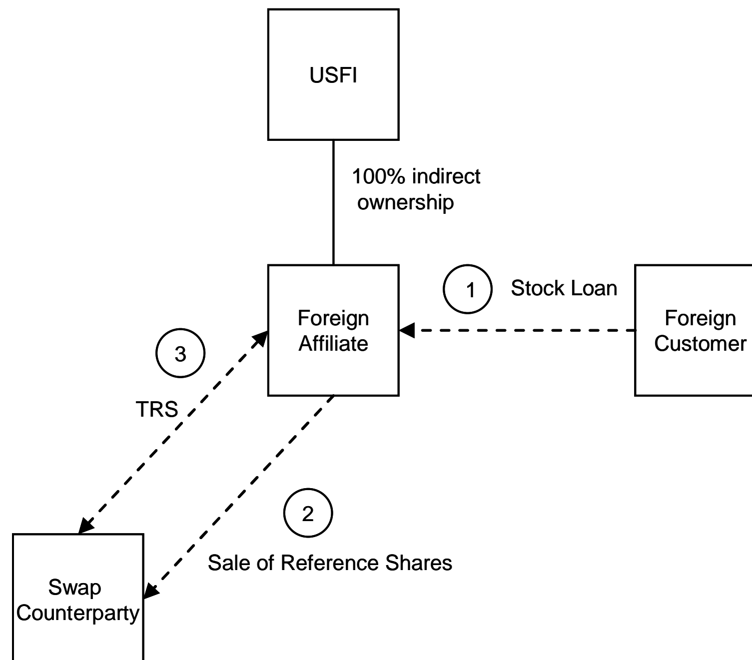
[3] In some transactions, the swap counterparty was an affiliate of the U.S. financial institution. In other transactions, the foreign affiliate sold the shares to an inter-dealer broker. In the latter transactions, the inter-dealer broker purchased the shares on behalf of the swap counterparty. Generally, an inter-dealer broker is a brokerage firm that acts as an intermediary between major dealers to facilitate an inter-dealer transaction.

The swap effectively eliminated U.S. withholding tax.[4] When a dividend was paid by the issuer with respect to the underlying loaned shares, the swap dealer paid the foreign affiliate a swap payment equal in amount to 100 percent of the dividend. This swap payment was made to the foreign affiliate without withholding U.S. tax. See Treas. Reg. §1.863-7(b)(1) (providing that the source of income from a notional principal contract is generally determined by reference to the residence of the recipient). The foreign affiliate made a substitute dividend payment to the foreign customer equal to 70 percent of the dividend paid with respect to the underlying loaned shares. The foreign customer then terminated the securities loan, which required the foreign affiliate to return the underlying loaned shares and pay the foreign customer an enhancement fee equal to 20 percent of the dividend (2/3 of the avoided withholding tax). The foreign affiliate or U.S. financial institution retained the remaining swap payment in an amount equal to 10 percent of the dividend (1/3 of the avoided withholding tax).

D. *Example of a Stock Loan Entered into for Tax Avoidance*

The following example illustrates a typical tax avoidance transaction undertaken by a foreign customer ("Foreign Customer") and a foreign entity ("Foreign Affiliate") wholly owned by a U.S. financial institution ("USFI"). At all relevant times, both Foreign Affiliate and Foreign Customer were subject to 30 percent U.S. withholding tax on U.S. source dividends and substitute dividends. Foreign Customer owned 3 million shares of X Corporation, a U.S. corporation (the "Reference Shares"). The Reference Shares had a fair market value of $24 million. On March 30, 2007, X Corporation declared a quarterly dividend of $0.06 per share payable on May 4, 2007, to shareholders of record as of April 20, 2007 (the record date). The following diagram outlines the steps of the illustrative transaction, which is described in detail below:

[4] Similar transactions utilized forward contracts or other derivative contracts to eliminate withholding on payments to the foreign affiliates that borrowed and sold the dividend-paying shares. The specific type of derivative used generally should not affect the analysis herein, provided the contract was used to eliminate withholding tax. Moreover, depending on the particular facts and circumstances, the IRS could also challenge the foreign affiliate's hedging transactions. For example, a foreign affiliate may be treated as having retained beneficial ownership of the shares that were nominally sold to a swap counterparty. See, e.g., Industry Director Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax, LMSB- 4-1209-044 (Jan. 14, 2010).



On April 17, 2007, after reviewing a memorandum prepared by USFI describing the use of certain stock loan transactions to eliminate U.S. withholding tax on dividend payments, Foreign Customer loaned the Reference Shares to Foreign Affiliate (the "Stock Loan"). See Step 1 in the diagram above. Pursuant to the Stock Loan, Foreign Affiliate was required to pay Foreign Customer a substitute dividend payment equal to 70 percent of any actual dividend attributable to the Reference Shares. Foreign Affiliate posted cash collateral with Foreign Customer equal to 102 percent of the fair market value of the Reference Shares ($24,480,000).

Foreign Affiliate also agreed to pay Foreign Customer an enhancement fee equal to $36,000, which equaled 20 percent of the gross dividend attributable to the Reference Shares (the "Enhancement Fee").[5] The parties agreed to structure the Enhancement Fee as an implicit borrow fee. To achieve this, Foreign Customer and Foreign Affiliate established the rebate rate such that Foreign Customer would earn the pre-determined Enhancement Fee amount ($36,000). Foreign Customer loaned the collateral received from Foreign Affiliate to a third party, which paid Foreign Customer interest equal to 5.2 percent, the federal funds rate on April 17, 2007.[6] Foreign Customer and Foreign Affiliate informally agreed that Foreign Customer would demand return of the Reference Shares after the Stock Loan had been outstanding for 20 days.

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[5] Foreign Customer loaned 3 million shares to Foreign Affiliate, and X Corporation declared a $0.06 dividend per share. As a result, the gross dividend attributable to the Reference Shares was $180,000 (3 million shares * $0.06). The Enhancement Fee was set at 20 percent of the gross dividend, or $36,000 ($180,000 * 20 percent).

[6] The above example assumes that the Reference Shares do not change in value over the course of the Stock Loan (or that collateral is not marked to market), and that Foreign Customer invests the collateral at a fixed 5.2 percent interest rate.

Therefore, Foreign Customer and Foreign Affiliate agreed to a rebate rate equal to 2.51616 percent to ensure that the retained portion of the interest earned on the collateral (i.e., the Enhancement Fee) equaled $36,000.[7] On April 17, 2007, the market rebate rate for an ordinary loan of X Corporation shares was 5.0 percent, which would have resulted in a stock lender receiving an implicit borrow fee of approximately $2,683 for a stock loan lasting 20 days.[8]

On the same date, Foreign Affiliate sold the Reference Shares to a swap dealer ("Swap Counterparty") for $24 million. See Step 2 in the diagram above. At the same time as the sale, Foreign Affiliate, as the long party, and Swap Counterparty, as the short party, entered into a total return swap referencing the Reference Shares (the "TRS"). See Step 3 in the diagram above. The notional amount of the TRS equaled the price at which Foreign Affiliate sold the Reference Shares to Swap Counterparty. The price used to determine any appreciation or depreciation in the value of the Reference Shares equaled the price at which Swap Counterparty purchased the Reference Shares from Foreign Customer.

Neither Foreign Customer nor Foreign Affiliate was the record owner of the Reference Shares after these transactions on April 17, 2007. On May 4, 2007, X Corporation paid the dividend to holders of X Corporation shares as of April 20, 2007 (the record date), requiring Foreign Affiliate to pay Foreign Customer a substitute dividend equal to $126,000. On May 7, 2007, Foreign Affiliate terminated the TRS with Swap Counterparty and repurchased the Reference Shares from Swap Counterparty. Upon termination, Foreign Affiliate received a net payment equal to the dividend payment ($180,000) and appreciation (if any) less depreciation (if any) and interest, plus a fee. Also on May 7, 2007, Foreign Customer terminated the Stock Loan. Foreign Customer returned the cash collateral to Foreign Affiliate, plus any applicable rebate fee. Foreign Customer retained $36,000 of the interest earned on the collateral as an Enhancement Fee. Foreign Affiliate returned the Reference Shares to Foreign Customer. Foreign Affiliate retained $18,000 of the payment received pursuant to the TRS, equaling 10 percent of the underlying dividend.

LAW AND ANALYSIS

Depending on the facts developed in specific cases, the economic substance doctrine may apply to disallow avoidance of U.S. tax in transactions similar to the Stock Loan. In these cases, the foreign customer may be liable for U.S. gross basis tax and

[7] Because Foreign Customer invested the collateral at 5.2 percent for 20 days, Foreign Customer would have earned approximately $69,751 on the collateral ($24,480,000 * 5.2 percent * 20/365). To earn an implicit borrow fee equal to $36,000, Foreign Customer had to pay Foreign Affiliate a rebate fee equal to $33,751 ($69,751 - $33,751 = $36,000). Therefore, the parties agreed to a 2.51616 percent rebate rate ($24,480,000 * 2.51616 percent * 20/365 = $33,751).

[8] Assuming a lender invested the collateral at 5.2 percent for 20 days, the lender would have earned approximately $69,751 on the collateral ($24,480,000 * 5.2 percent * 20/365). If the lender determined its rebate fee using a rebate rate equal to 5.0 percent, the rebate fee would equal $67,068, yielding an implicit borrow fee of $2,683.

the financial institution may be liable as a withholding agent. See Secs. 871(a), 881, 1441, 1442, and 1461. The following analysis considers whether the Stock Loan lacks economic substance. While this memorandum primarily considers the application of the economic substance doctrine to the Stock Loan and similar transactions, it does not purport to consider all judicial doctrines that may apply in the alternative to the Stock Loan and similar transactions. The Stock Loan and similar transactions may be challenged using other judicial theories, including those described in Part B of this section; if one or more of those doctrines are applicable to the relevant transaction, foreign taxpayers who participated in such transactions may have relied inappropriately on Notice 97-66 to avoid U.S. withholding tax.

A. Economic Substance

A transaction may be disregarded for tax purposes and a taxpayer denied a tax benefit resulting from the transaction when it lacks economic substance.[9] Gregory v. Helvering, 293 U.S. 465 (1935); Coltec Industries, Inc. v. United States, 454 F.3d 1340, 1352 (Fed. Cir. 2006). A transaction will be respected when it is "a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978). "The tax statutes apply only 'to transactions entered upon for commercial purposes and 'not to . . . transactions entered upon for no other motive but to escape taxation.''" ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (internal citation omitted). Where transactions have satisfied the technical requirements of the Code or published guidance but frustrated the purpose of the relevant statute or administrative guidance, courts have applied the economic substance doctrine to disregard those transactions and disallow the taxpayers' claimed tax benefits. See, e.g., In re: CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002); Coltec Industries, Inc., 454 F.3d at 1354.

[9] Section 1409 of the Health Care and Education Reconciliation Act of 2010 (Act), Pub. L. No. 111-152, added section 7701(o) to codify the economic substance doctrine and amended penalty provisions under sections 6662, 6662A, 6664, and 6676. The transactions described in this memorandum occurred prior to March 31, 2010, the effective date of section 7701(o). For examination guidance regarding the codified economic substance doctrine, please refer to the Directive for Industry Directors regarding "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties" (LB&I-4-0711-015 (July 15, 2011)) and the Office of Chief Counsel Notice regarding "Coordination Procedures for the Economic Substance Doctrine and Related Penalties" (CC-2012-008). Although the LB&I Directive addresses the codified economic substance doctrine, advice regarding the common law economic substance doctrine should consider the broad list of factors in the LB&I Directive that suggest when the application of the economic substance doctrine may be appropriate. Many of those factors, which are derived from the common law economic substance doctrine, are likely to be present in the case of the stock loan transactions described herein. As described below, those transactions were typically developed and promoted by outside advisors, are highly structured, include unnecessary steps, offered no meaningful potential for incremental profit aside from tax benefits, involve no risk, and lack a credible business purpose. Several other factors suggesting that the application of the economic substance doctrine is appropriate may be present depending on the relevant facts and circumstances.

Whether a particular transaction lacks economic substance is a question of fact. Rice's Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985). Taxpayers bear the burden of showing that a transaction has economic substance. See Coltec Industries, Inc., 454 F.3d at 1355. To evaluate economic substance, courts typically apply a two-pronged inquiry to the facts: (1) the business purpose, or subjective, inquiry into whether the taxpayer carried out the transaction for a valid business purpose other than to obtain tax benefits, and (2) the economic substance, or objective, inquiry into whether the transaction had meaningful economic consequences apart from its tax effects. See, e.g., Rice's Toyota World, 752 F.2d at 91-92. Some courts apply the test conjunctively and respect a transaction as having economic substance only if both factors are present. Pasternak v. Commissioner, 990 F.2d 893, 898 (6th Cir. 1993). A minority of courts interpret the two-factor test disjunctively and respect a transaction as having economic substance if it has either objective economic substance or a nontax business purpose. See, e.g., Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006). Other courts regard the economic substance doctrine as requiring a flexible analysis that considers both a business purpose and an economic substance inquiry. See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3rd Cir.1998).

There is no precedent that directly addresses the application of the economic substance doctrine to transactions like the securities lending transactions at issue here. This analysis, therefore, relies on the principles and standards adopted by the courts with respect to other types of transactions and applies those standards to the facts of the transaction at issue. The following analysis shows that in the assumed facts and circumstances, the Stock Loan fails under both the subjective analysis and the objective analysis of the economic substance doctrine.

i. *Subjective Economic Substance of the Stock Loan*

A transaction must be disregarded if it lacks economic substance compelled by business or regulatory realities, even if a taxpayer claims to have a genuine business purpose without tax-avoidance motivations. Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 544 (5th Cir. 2009). Several facts demonstrate that Foreign Customer lacked a nontax business purpose: the Stock Loan had off-market terms; USFI marketed the Stock Loan as a way to avoid U.S. withholding tax; Foreign Customer could demonstrate no bona fide reason for lending the Reference Shares; and the Stock Loan lacked profit potential. Each of these facts demonstrates Foreign Customer's lack of a nontax business purpose.

For purposes of the subjective economic substance analysis, only the transaction giving rise to the alleged tax benefit should be analyzed. See Coltec Industries, Inc., 454 F.3d at 1356. Thus, although Foreign Customer may have loaned other stock in normal market transactions, only Foreign Customer's motives for entering into the Stock Loan itself are relevant.

a. The Securities Loan Had Off-Market Terms

"Courts … compare the transaction in question with transactions that might usually be expected to occur in bona fide business settings." See Merryman v. Commissioner, 873 F.2d 879, 881 (5th Cir. 1989). The Stock Loan differs from ordinary course securities loans in two critical respects: (1) Foreign Customer received a fee that was substantially greater than the borrow fee paid in a typical bona fide securities loan (with a corresponding below-market rebate fee earned by Foreign Affiliate) and (2) Foreign Affiliate received implicit compensation in the form of the retained dividend.

The Enhancement Fee paid to Foreign Customer was substantially higher than a borrow fee that would be paid in a bona fide securities loan. As described above, an ordinary borrow fee on any easy-to-borrow stock generally ranges from 10 to 20 basis points.[10] Foreign Customer loaned shares worth $24,000,000 for 20 days, which would generate a borrow fee equal to approximately $2,683 in an ordinary course stock loan. Instead, Foreign Affiliate paid Foreign Customer an above-market fee of $36,000 – more than thirteen times the market borrow fee for Corporation X stock at the time. Foreign Customer, having received collateral equal to 102 percent of the value of the Reference Shares, incurred no risk that would distinguish the Stock Loan from an ordinary course stock loan and justify an above-market fee. Foreign Affiliate willingly paid this excessive fee to Foreign Customer because it was not out-of-pocket for the fee: the cash that would otherwise have been remitted to the U.S. Treasury funded this fee.

Moreover, in an ordinary course securities loan, a securities lender is entitled to payments equal to all distributions on the underlying shares, reduced by amounts actually withheld. Ordinarily, a securities lender does not surrender a portion of the substitute dividend to the borrower. By contrast, in the Stock Loan, Foreign Customer was entitled to only 70 percent of the underlying dividend, even though no tax was actually withheld and, pursuant to the TRS, Foreign Affiliate received a payment equal to 100 percent of the underlying dividend on the Reference Shares. Foreign Affiliate split the remaining 30 percent with Foreign Customer. As shown below, Foreign Customer received the $36,000 Enhancement Fee and Foreign Affiliate retained $18,000, or one-third of the avoided withholding tax, as an implicit fee:

	Foreign Affiliate
Gross Dividend Equivalent Swap Payment	$180,000
Substitute Dividend Paid to Foreign Customer	($126,000)
Enhancement Fee Paid to Foreign Customer	($36,000)
Net Proceeds Retained by Foreign Affiliate (i.e., Fee)	**$18,000**

[10] In a particular case, the examination team should develop facts to determine the typical borrow fee or the typical range of borrow fees with respect to the particular reference securities lent in contemporaneous securities lending transactions. Borrow fees a foreign customer receives in the ordinary course of business may also provide a helpful frame of reference.

Foreign Customer consented to the implicit fee paid to Foreign Affiliate because it was not out-of-pocket; this fee was financed by the U.S. Treasury.

b. Foreign Affiliate Participated in the Stock Loan to Facilitate Foreign Customer's Tax Avoidance

Foreign Affiliate participated in the Stock Loan to receive payment for facilitating Foreign Customer's avoidance of U.S. withholding tax. Generally, stock borrowers enter into securities lending arrangements for a number of reasons, including to (1) facilitate a short sale, (2) cover a failure to deliver securities, (3) use in an arbitrage, hedging, or derivatives trade strategy, or (4) on-loan the securities. Gaffney at 605; Hardin and Maloney at 1534. Foreign Affiliate did not enter into the Stock Loan for any of those reasons. Further, Foreign Affiliate fully hedged its exposure in the transaction by selling the Reference Shares to Swap Counterparty and immediately entering into the TRS.[11] Foreign Affiliate's lack of any of the legitimate business reasons for borrowing the shares demonstrates that Foreign Affiliate participated in the Stock Loan to facilitate Foreign Customer's tax avoidance.

In exchange for structuring transactions to facilitate Foreign Customer's tax avoidance, Foreign Affiliate effectively retained a portion of the avoided tax as an implicit fee. In ordinary market stock loans, lenders are not required to pay any similar fee because their counterparties have nontax uses for the borrowed securities. Foreign Affiliate's receipt of a fee for administering a highly structured transaction that lacked a nontax business purpose is evidence of a lack of economic substance. See Coltec Industries, Inc., 454 F.3d at 1355; Saba Partnership v. Commissioner, T.C. Memo 1999-35 at 51; Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties, LB&I-4-0711-015 (July 15, 2011).

c. Internal Documents Fail to Show a Business or Regulatory Purpose

Subjective economic substance is lacking if a taxpayer enters into a transaction without analyzing the profit potential beyond tax savings. See Rice's Toyota World, 752 F.2d at 93. Having based its decision to enter into the Stock Loan on tax considerations (including the memorandum prepared by USFI describing the use of stock loan transactions to eliminate U.S. withholding tax on dividend payments), Foreign Customer's internal documents fail to show business or regulatory realities for entering into the dividend enhancement strategy apart from its tax-avoidance features. Moreover, Foreign Customer's reliance on marketing materials emphasizing the Stock Loan's tax benefits demonstrate that Foreign Customer failed to analyze the transaction's profit potential beyond the tax savings. See Yosha v. Commissioner, 861 F.2d 494, 500-01 (7th Cir. 1988) (finding that investors had no potential for gain or loss

[11] In fact, Foreign Affiliate's transaction costs (such as inter-dealer broker fees) would have ensured that Foreign Affiliate incurred a loss in the transaction absent Foreign Customer's payment of an implicit tax promoter fee to Foreign Affiliate.

from a transaction and that the broker sold tax losses based, in part, on explicit and implicit promises by the brokers of certain tax results).

d. Pre-tax and Post-tax Profit Comparison Demonstrates a Lack of Nontax Motivation

Courts have inferred that a taxpayer entered into a transaction to capture a tax benefit by analyzing the transaction's objective nontax profit potential. See Yosha, 861 F.2d at 502 (holding that a transaction failed the subjective test because, inter alia, the taxpayer agreed that any profits generated by the transaction would be retained by a broker as a commission in exchange for a tax benefit); Rice's Toyota World, 752 F.2d at 94 ("[a]ll in all, [taxpayer's] failure seriously to evaluate the likely residual value of the computer, its willingness to pay an inflated purchase price, and its use of nonrecourse debt that would facilitate abandonment of the transaction provide ample support for the tax court's finding that [taxpayer] did not have profit motivation apart from tax benefits."). As described in the following section, Foreign Customer could not have profited from the Stock Loan absent the tax savings the transaction presented.

ii. *Objective Economic Substance of the Stock Loan*

In evaluating objective economic substance, courts "have refused to recognize the tax consequences of transactions that were devoid of 'nontax substance' because they 'did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax.'" ACM Partnership v. Commissioner, 157 F.3d at 248 (internal citations omitted). A transaction fails to satisfy the objective prong of the economic substance inquiry if the transaction would not yield a profit aside from tax benefits, or would yield a profit that was not substantial relative to the claimed tax benefits. See, e.g., Rice's Toyota World, 752 F. 2d at 94-95; Hines v. United States, 912 F.2d 736, 740 (4th Cir. 1990) (finding a lack of economic substance when a transaction presented a potential profit that was minimal relative to the tax benefits the taxpayer sought).

Aside from allowing Foreign Customer to avoid withholding tax on the X Corporation dividend, the Stock Loan was not incrementally profitable for Foreign Customer. Under the terms of the Stock Loan, Foreign Customer received two payments: the $126,000 substitute dividend, and the $36,000 Enhancement Fee. Unlike a typical borrow fee, the Enhancement Fee was calculated by reference to an agreed split of avoided withholding tax. In substance, the Enhancement Fee was simply Foreign Customer's share of the avoided U.S. withholding tax.

In fact, the only other meaningful pre-tax economic effect of the Stock Loan was that it reduced Foreign Customer's entitlement to the dividend on the Reference Shares.[12] Because Foreign Customer agreed to accept a substitute dividend equal to

[12] Because the Stock Loan required that the Reference Shares be returned to Foreign Customer at the end of the transaction, Foreign Customer's exposure to changes in value of the Reference Shares was unchanged by the Stock Loan. Such changes, therefore, do not affect the Stock Loan's profitability.

70 percent of the underlying dividend (notwithstanding the absence of any prior withholding), Foreign Customer earned $54,000 less in income than Foreign Customer would have earned by holding the Reference Shares ($180,000 dividend income if Foreign Customer held the Reference Shares less $126,000 in substitute dividend income on the Stock Loan), and $56,683 less in income than Foreign Customer would have earned by entering into an ordinary course stock loan (assuming $2,683 in borrow fee income plus $180,000 in substitute dividend income on the ordinary course stock loan less $126,000 in substitute dividend income on the Stock Loan).[13]

Although the Stock Loan was not incrementally profitable before tax effects were taken into account, Foreign Customer realized a tax benefit by sharing in the avoided withholding tax through the Enhancement Fee. By sharing in avoided withholding tax, Foreign Customer received $162,000 after the tax benefits of the transaction are taken into account (the $126,000 substitute dividend plus the $36,000 Enhancement Fee). This amount – inflated by Foreign Customer's share of avoided withholding tax – greatly exceeded the $126,000 in after-tax profit Foreign Customer would have received had it retained the Reference Shares (70 percent of $180,000) or the $128,683 in after-tax profit Foreign Customer would have received in an ordinary course securities loan ($126,000, plus a $2,683 market borrow fee).[14]

In sum, the Stock Loan did not improve Foreign Customer's pre-tax return or appreciably affect Foreign Customer's beneficial interest in the Reference Shares. Foreign Customer improved its after-tax return on the Reference Shares, but solely by sharing in avoided U.S. withholding tax. Foreign Customer's acceptance of an incremental pre-tax loss to achieve a tax benefit indicates that the Stock Loan lacked objective economic substance. Cf. ACM Partnership, 157 F.3d at 249 (comparing the interest rate on purchased notes with the interest earned by the taxpayer on the cash when it held the cash in deposit accounts; holding that the transaction lacked objective economic substance due in part to the transaction's lack of a meaningful incremental profit).

iii. *The Stock Loan Should Be Disregarded*

When a transaction lacks economic substance, the Commissioner may disregard the parties' characterization of the transaction and treat the transaction according to its substance. See Rice's Toyota World v. Commissioner, 752 F.2d at 95 ("[w]here a transaction is properly determined to be a sham, the Commissioner is entitled to ignore the labels applied by the parties and tax the transaction according to its substance."). Based on the facts described above, the Stock Loan may be disregarded as lacking economic substance. As a result, the Commissioner may tax the transaction in

[13] Even if the entire Enhancement Fee could be treated as a pre-tax item, Foreign Customer's pre-tax income from the Stock Loan ($162,000) would be lower than its pre-tax income had Foreign Customer held the Reference Shares ($180,000) or entered into an ordinary course stock loan ($182,683).

[14] Solely for purposes of simplifying the analysis of the Stock Loan, this memorandum ignores any U.S. withholding tax on the market borrow fee that may apply.

accordance with its substance. Because Foreign Customer retained the economic benefits and burdens of the Reference Shares, the Commissioner may tax Foreign Customer as though Foreign Customer retained ownership of the securities and received a payment (via Foreign Affiliate) that, in substance, was the payment of a U.S. source dividend with respect to the Reference Shares. Therefore, the payment from Foreign Affiliate to Foreign Customer would be subject to a 30 percent U.S. gross basis withholding tax. While Foreign Customer may be treated as having received a U.S. source dividend, Foreign Affiliate paid this amount to Foreign Customer. Because Foreign Affiliate had "control, receipt, [and] custody" of a payment which, in substance, was a U.S. source dividend payment, Foreign Affiliate was a withholding agent with respect to the payment. Treas. Reg. § 1.1441-7(a)(1). As a withholding agent, Foreign Affiliate is liable for the 30 percent tax. Sec. 1461.

B. *Other Judicial Doctrines*

Other judicial doctrines may also apply in the alternative to disregard or recharacterize the Stock Loan and, depending on the relevant facts and circumstances, transactions similar to the Stock Loan. For example, under the step transaction doctrine, a series of formally separate steps may be disregarded for tax purposes if the steps can in substance be integrated and focused toward a particular result. Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983); Crenshaw v. United States, 450 F.2d 472, 475 (5th Cir. 1971). In the assumed facts and circumstances, Foreign Affiliate's sale of the Reference Shares to Swap Counterparty, the TRS, and the repurchase of the Reference Shares by Foreign Affiliate from Swap Counterparty may be disregarded as unnecessary steps included in the transaction solely to eliminate U.S. withholding tax. If these steps are ignored for tax purposes, Foreign Affiliate may be treated as owning the Reference Shares under the Stock Loan. As a result, Foreign Affiliate would be subject to 30 percent tax under sections 871(a) or 881(a) on dividends that it received on the Reference Shares.

Alternatively, the Commissioner may determine that the Foreign Affiliate held the Reference Shares as an agent of the Foreign Customer, with the Foreign Customer retaining beneficial ownership of the Reference Shares. See, e.g., Ach v. Commissioner, 358 F.2d 342, 345 (6th Cir. 1966); Amerco v. Commissioner, 82 T.C. 654, 670 (1984); Meagher v. Commissioner, T.C. Memo. 1977-270. Other theories may also be appropriate, depending on the relevant facts and circumstances.

The TRS entered into by Foreign Affiliate and Swap Counterparty may also be challenged on a number of grounds. For example, Foreign Affiliate may be treated as having retained the beneficial ownership of Reference Shares. Alternatively, Foreign Affiliate and Swap Counterparty may be treated as maintaining a principal-agent relationship such that Swap Counterparty may be treated as having held the Reference Shares on behalf of Foreign Affiliate. See Industry Director Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax, LMSB- 4-1209-044 (Jan. 14,

2010) (discussing total return swaps used to avoid withholding tax on U.S. source dividend payments).

CONCLUSION

The Commissioner may, depending on the relevant facts and circumstances, use the economic substance doctrine to disregard or recharacterize certain securities lending transactions structured to avoid U.S. withholding tax. In those cases, taxpayers would not be permitted to rely on Notice 97-66. The foreign customers that loaned stock to the financial institutions or their affiliates in those transactions may be liable for U.S. gross basis tax on the dividend payment or substitute dividend payment pursuant to section 871 or 881. As withholding agents with respect to U.S. source dividend payments or substitute dividend payments, the financial institutions and their affiliates that borrowed stock in those transactions may be liable for U.S. withholding tax pursuant to sections 1441, 1442, and 1461.

Although other transactions may be similar, each securities lending transaction or program will be factually unique and the analysis will depend on the specific facts in question. In addition, consideration must be given to the case law precedent that is binding on whichever court has jurisdiction over the case, including the particular variation of the economic substance doctrine adopted by the court.

Other judicial theories may apply to the Stock Loan and transactions similar to the Stock Loan, although the applicability of any additional theory varies based on the facts of the particular transactions. Under those judicial theories, either the foreign customers or the financial institutions' affiliates may be liable for U.S. gross basis tax on the dividend payment or substitute dividend payment pursuant to section 871 or 881.

Please call Mark Erwin, Peter Merkel, or Raymond Stahl at (202) 622-3870 if you have any further questions.