



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

MEMBER ADVISORY

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For distribution to:

*Securities Lending
QI and Tax Services
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U.S. Government targets substitute dividend and dividend equivalent payments made to non-U.S. persons

Background

In 2008, the U.S. Senate Subcommittee on Investigations released a staff report entitled “*Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*”. One of the Subcommittee’s findings was that financial institutions have been structuring stock swap and loan transactions to enable non-U.S. clients to avoid U.S. taxes on stock dividends. Dividends paid to non-U.S. persons that are not connected with a U.S. business are subject to a tax rate of 30% (absent a tax treaty between the U.S. and the stockholder’s country of residence). This 30% tax must be deducted and withheld at the source of the dividend payment. However, dividend “equivalent” payments made pursuant to a stock swap or loan agreement are not generally subject to any U.S. taxes. The Subcommittee characterized these types of agreements and transactions to be an “abusive dodge” of U.S. tax payments.

Although the Report states that “the IRS does not currently track abusive dividend tax transactions, so the total volume of dividend payments involved and the total amount of lost tax revenues each year are unclear”, the Subcommittee believed that the figures were “substantial”. This report, and other government reports like it, provided the impetus for legislative change.

The responding legislation

On March 18, 2010, H.R. 2847, the “*Hiring Incentives to Restore Employment Act*” (the HIRE Act) was signed into law, adding new section 871(l) to the U.S. Internal Revenue Code. This new section states that all “dividend equivalent” payments made to non-U.S. persons shall be subject to the same U.S. tax withholding requirements as a dividend from a U.S. source.

A “dividend equivalent” will include:

- Any substitute dividend made pursuant to a securities lending or sale-repurchase transaction that is contingent upon, or determined in reference to, the payment of a dividend from sources within the U.S.

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- Any payment made pursuant to a notional principle contract that is contingent upon, or determined in reference to, the payment of a dividend from sources within the U.S.

This legislation is effective for all payments made on or after **September 14, 2010**.

The regulatory guidance

On May 20, 2010, the IRS released Notice 2010-46: “*Prevention of Over-Withholding and U.S. Tax Avoidance with Respect to Certain Substitute Dividend Payments*”, to provide initial transitional guidance with respect to the new legislation and to seek comment on proposed future regulations. The key points from Notice 2010-46 are:

- IRS Notice 97-66 **is withdrawn for all payments made on or after September 14, 2010**. This Notice originally provided “safe harbour” comfort to taxpayers who were concerned that characterizing substitute dividend and interest payments as actual interest and dividends would create a “cascading effect”, resulting in taxation withholding over 30%.
- Effective **IMMEDIATELY** (prior to September 14, 2010), taxpayers may continue to rely on Notice 97-66, except if the relying withholding agent or foreign lender knows or has reason to know that the securities lending transaction has a “principle purpose of reducing or eliminating the amount of gross-basis tax that would have been due in the absence of such transaction”.
- **After September 14, 2010 and before January 1, 2012**, the new legislation will still apply but some basic transition rules have been provided for in the Notice (i.e. how withholding agents should determine the amount of payment and when presumptions can be made that U.S. taxes have been paid. Withholding agents may also implement a system that “reasonably implements” the principles of the “Qualified Securities Lender” exemption during the transition period.

Future regulations will be issued:

- To implement and coordinate the taxes imposed on substitute dividend payments (i.e. with the withholding and QI regimes already in place)
- To exempt withholding on payments made to “Qualified Securities Lenders”, who will make certain certifications to the IRS and will comply with forthcoming regulations, and who are already subject to IRS approved audits

The regulations are expected to provide that a foreign financial institution is a Qualified Securities Lender only if it satisfies **all** of the following conditions:

- It is a bank, custodian, broker-dealer or clearing organization that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized, and is regularly engaged in a trade or business that includes the borrowing of securities of U.S. corporations from, and lending of securities of U.S. corporations to, its unrelated customers;
- It is subject to audit by the IRS, including by an external auditor if it is a Qualified Intermediary (provided that it has appropriately amended its QI

Agreement). The amendment to the QI Agreement will require the QI to report, withhold, deposit and pay U.S. tax as required by Notice 2010-46;

- It will file an annual statement on a form prescribed by the IRS certifying that it satisfies the conditions necessary to be a Qualified Securities Lender.

Notice 2010-46 also provides an automatic six-month extension to withholding agents to file information returns for calendar year 2010 and an automatic extension for making deposits of withheld tax from substitute dividend payments until January 31, 2011 for calendar year 2010.

Assessing the impact

Canadian investment dealers must determine quickly the impact of this legislation upon their businesses.

- 1) Follow the links below to educate yourself and your staff on this issue.
- 2) Contact your tax advisor/counsel to discuss.
- 3) Determine whether your firm engages in stock swap or loan transactions involving U.S. securities that generate “dividend equivalent” payments.
- 4) Consider the implications of increased withholding upon the payments to your clients. Are your clients aware of these changes?

Links to Relevant Documents

U.S. Senate Subcommittee on Investigations: “*Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*”.

<http://levin.senate.gov/newsroom/supporting/2008/091108DividendTaxAbuse.pdf>

H.R. 2847, “Hiring Incentives to Restore Employment Act”.

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h2847enr.txt.pdf

IRS Notice 2010-46: “*Prevention of Over-Withholding and U.S. Tax Avoidance with Respect to Certain Substitute Dividend Payments*”.

http://www.irs.gov/pub/irs-utl/notice_2010_46.pdf

For more information, or to provide comment, please contact Andrea Taylor, IIAC Assistant Director (ataylor@iiac.ca or 416-687-5476).

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