
UPDATE 1-U.S. IRS directs agents to focus on equity swaps

Thu, Jan 21 2010

- * Tax agents to watch for dividend tax avoidance
- * Issue labeled a priority at IRS
- * Market valued at \$1.7 trillion (Adds tax attorney comment in paragraph 7)

By Kim Dixon

WASHINGTON, Jan 21 (Reuters) - U.S. tax regulators are cracking down on certain derivatives commonly used by offshore hedge funds and private equity firms, in attempt to catch investors improperly using the investments to avoid U.S. tax.

The Internal Revenue Service instructed examiners to be on the lookout for suspicious activity in which equity swaps are entered to avoid taxes on dividends, according to an industry directive issued earlier this month.

An equity swap lets an investor bet on changes in a company's stock and be paid similar returns, including capital gains and dividends, without actually owning the security or disclosing the stake to regulators.

The IRS has identified the abuse of equity swaps as one of its top priorities, a so-called Tier 1 issue.

In a notice to IRS field staff dated Jan. 14, the agency said it was providing guidance on "uncovering and developing cases related to TRS (total return swap) transactions that may have been executed in order to avoid tax with respect to U.S. source dividend income paid to non-resident alien individuals."

The Bank of International Settlements estimated the market for equity-linked forwards and swaps at around \$1.7 trillion as of June 2009, its most recent survey.

"It's hard for me to say how much of an impact this will have, but the financial wizards on Wall Street would not have been cooking up these structures if they didn't think there was real savings there," said Michael Dunworth, a tax lawyer at Pryor Cashman who represents investors.

Another tax lawyer said the agency said it is a non-issue because single-digit dividend payouts in the United States would make the 30 percent tax negligible, and the current law allows the practice.

"The bank charges you a lot more than that to enter into the swap," said Roger Lorence, a tax lawyer at Sadis & Goldberg, who represents hedge funds and private equity firms.

The derivatives are also targeted in legislation working its way through Congress that would require foreign banks to collect information from their clients to ensure they pay their U.S. taxes.

The swaps have also come under scrutiny for allowing investors to take large positions in companies without being required to disclose their full holdings.

In late 2006 a group of funds used equity swaps to build a large position in CSX Corp, which led to a proxy contest in which they sought to replace five of the company's 12 directors.

The Securities and Exchange Commission has called for the regulation of equity swaps, saying they are the economic equivalent of owning shares. (Additional reporting by Karen Brettell in New York; Editing by Leslie Adler and Dan Grebler)

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