Holding Period Requirements for Qualified Dividend Income

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Dividend income is sometimes treated favorably for Federal income tax purposes. For example, "qualified dividend income" ("QDI") of individuals is taxed at the preferential rates applicable to long-term gain, rather than at the usual rates applicable to ordinary income. Under IRC section 1(h)(11), one requirement for this favorable treatment is that the owner of the shares with respect to which the dividend is paid hold them for more than 60 days proximately to the dividend payment date. There are similar holding period requirements for a shareholder to qualify for a foreign tax credit under IRC section 901 with respect to foreign taxes withheld on dividends and for a corporation to qualify to claim a deduction for dividends received from another corporation.

For these purposes, an owner's holding period is reduced for any period during which the owner has diminished its risk of loss with respect to the dividend-paying stock by holding offsetting positions with respect to "substantially similar or related property" ("SSRP"). Detailed rules implementing this principle are set out in IRC section 246(c) and regulations under that provision.

In *SIH Partners LLLP v. Commissioner*, 167 T.C. No. 8 (2026), the Tax Court recently applied an anti-abuse rule in those regulations and determined that a partnership owning stock in four Swiss companies had diminished its risk of loss through a single portfolio swap transaction that had established a short position with respect to a combination of stock of the four companies and a group of market indices. Under that anti-abuse rule, portions of that single swap position were considered to be positions in SSRP. This caused dividends received on the stock of the Swiss companies to not constitute QDI and prevented the partnership from qualifying for foreign tax credits with respect to Swiss tax withheld on the dividends.

Facts in *SIH*

SIH Partners, LLLP ("SIHP") was a partnership formed under the laws of Delaware and affiliated with Susquehanna International Group, LLP ("SIG"), a privately held global trading firm. During 2012, the tax year at issue, SIHP was owned by six corporations. Although the tax classification of the partners of SIHP is not discussed in the opinion, the fact that one of the adjustments asserted by the IRS was to QDI, a category of dividend income relevant to the computation of the income tax for individuals, is consistent with at least some of the partners' being S corporations, which are pass-through entities for income tax purposes.

SIG participated in options and future markets on many exchanges and, throughout the years, regularly and consistently maintained what is referred to in the opinion as the "Firm Hedge," a short position in with respect to broad market indices, intended to hedge risks with respect to its other positions in the event of a broad economic downturn. The Firm Hedge took various forms over the years; during the year at issue, it included short positions in three index funds to mitigate risk in the event of an economic downturn.

In 2010 SIHP purchased publicly traded stock (the "Swiss Equities") in four large Swiss companies. Simultaneously with that purchase, SIHP entered into a single portfolio swap arrangement that established short positions in the Swiss Equities and also continued to hedge risk through positions with respect to market indices representing hundreds of underlying stocks. The long position in the Swiss Equities and the related short positions were maintained throughout the year in issue.

During 2012 SIHP reported $171 million of QDI attributable to dividends paid on the Swiss Equities and $26 million of foreign tax credits relating to Swiss taxes withheld from those dividends.

Beginning in 2010, the equity finance group manager for SIG had annually prepared an analysis of the expected pretax profit from the long positions in Swiss Equities and related short positions and of the expected tax savings from associated QDI and foreign tax credits. His estimates for 2012 indicated an expected pretax profit of $2.4 million and expected tax savings of $22.2 million.

Several years after the filing of the Form 1065 partnership return of SIHP for 2012, the IRS issued a Notice of Final Partnership Administrative Adjustment that reclassified the $171 million of dividends from the Swiss Equities as dividends other than QDI and denied the foreign tax credit claimed with respect to Swiss taxes withheld on those dividends.

Discussion

The government first argued that, under substance over form principles, the “Transaction” – that is, the acquisition of the Swiss Equities and the portfolio swap that provided SIHP with short positions in the Swiss Equities and certain market indices – should be disaggregated, such that the short position against the Swiss Equities and the short position against the market indices would be treated as separate positions for purposes of Treasury Reg. section 1.246-5. If those broad classes of positions were disaggregated, then, under a rule governing positions that relate to more than one stock but not to a “portfolio” of stocks, the short position with respect to each of the Swiss Equities would be further disaggregated and treated as a separate position with respect to each of the Swiss Equities. The result would be that SIHP would be considered to have diminished its risk of loss with respect to each of the Swiss Equities, and the holding period requirement for QDI would not be met.

The court declined to apply substance over form principles to disaggregate the position with respect to the Swiss Equities from the position with respect to the market indices, as sought by the government. The court reasoned that the form of the Firm Hedge, as a part of an overall transaction, was appropriate and consistent with its substance. Based on the reports of Petitioner’s experts, it was common practice for different types of equities to be included in a swap arrangement in order to appropriately manage positions in equities and related risks of market value fluctuation. The court also concluded that applying substance over form principles would effectively override a key principle in the regulation under IRC section 246(c)(4), namely, that a position that reflects the value of a “portfolio” (20 or more stocks) should not be treated as SSRP to a taxpayer’s stock holdings unless there is "substantial overlap" (as discussed in the regulation) between the stock holdings and the portfolio position.

The court then analyzed the application of the “portfolio” rules of Reg. section 1.246-5(c)(1)(ii)-(iv) that determine whether (or not) there is “substantial overlap” between stocks held by a taxpayer and a short position of the taxpayer reflecting the value of a portfolio of stocks. Under those rules, if the overlap is 70% or more, the position and the taxpayer's stocks are considered to substantially overlap.

The court concluded that the overlap between the ownership of the Swiss Equities and the portfolio swap was only 64%, because the portfolio swap, once defined to include the Firm Hedge, included significant positions with respect to other securities. Indeed, the government had conceded that, if the transaction were viewed as a single swap that was a unitary portfolio position for purposes of the regulation, the Transaction complied with the substantial overlap test.

The government, however, made one additional argument, and it proved decisive. Section 1.246-5(c)(1) includes an anti-abuse rule under which, without regard to the result under the portfolio rules in the same regulation, a position will be considered to be SSRP to a portion of the taxpayer's stock holdings if (i) changes in the value of the position are "reasonably expected to virtually track" changes in the value of the taxpayer's stock holdings, and (ii) "[t]he position is acquired or held as part of a plan a principal purpose of which is to obtain tax savings (including by deferring tax) the value of which is significantly in excess of the expected pretax economic profits from the plan."

The court rejected a narrow reading of the "reasonably expected to virtually track" requirement offered by SIHP. It concluded that the first requirement for applying the anti-abuse rule was met, because SIHP owned the Swiss Equities and had short positions with respect to those stocks that were reasonably expected to track the value of the stocks.

As to the second requirement of the anti-abuse rule, the court found, based on the report of one of the government's experts and the internal analyses prepared by the SIG equity finance group manager for 2012, that the expected pretax profit from the Swiss Equities positions included in the Transaction for 2012 was expected not to exceed $2.4 million, while the expected tax savings were more than $22 million. Because the value of the expected tax savings was significantly in excess of the expected pre-tax economic profit, the court found the anti-abuse rule to be applicable, and, therefore, that SIHP's position with respect to the Swiss Equities was SSRP. Accordingly, the dividend income from the Swiss Equities was not QDI.

IRC section 901(k)(1) bars a credit for foreign taxes withheld with respect to dividends if the taxpayer does not meet a specified holding period requirement. Periods during which the taxpayer is protected against risk of loss under the criteria of section 246(c) are excluded for purposes of determining whether the taxpayer satisfies the holding period requirement. On the basis of its analysis of that issue with respect to QDI, the court concluded that the holding period requirement for the foreign tax credit was not met, and, therefore, that the tax credits reported by SIHP for Swiss tax withheld on dividends from the Swiss Equities were not allowable.

Observations

In light of the large amounts involved, SIHP may well appeal the decision of the Tax Court, and the Tax Court's decision may not be the final word with respect to the scope of the anti-abuse rule discussed in the decision. Regardless, the decision is a reminder of the potential impact of holding period requirements in the Internal Revenue Code that limit or deny tax benefits where the risk of loss with respect to the ownership of stock or other property is reduced through offsetting short sales or other positions, including associated anti-abuse rules.

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