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Re: Comments on Proposed Regulations Relating to Deemed Distributions under Section 305(c) (REG-133673-15)

Dear Ladies & Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is submitting this comment letter on the regulations proposed in April 2016 relating to deemed

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $20 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA,

distributions on convertible bonds and other "convertible" securities under section 305(c), and related rules.[2] We appreciate and acknowledge the significant effort that went into the drafting of the proposed regulations and the consideration that the Treasury Department and many different divisions of the Internal Revenue Service ("IRS") gave to the issues that were raised by SIFMA prior to the issuance of the proposed regulations. We also commend the issuance of the proposed regulations on an accelerated basis in order to provide current guidance to taxpayers.

SIFMA members expect to invest considerable time and money to implement the proposed regulations once they are finalized, primarily in their capacity as reporting and withholding agents for convertible securities.[3] A number of issues that need clarification, or that we request be reconsidered, are discussed below. Because the proposed regulations in part clarify existing law, and may be relied upon prior to finalization, SIFMA members are evaluating the proposed regulations with respect to their current, as well as future, operations. Consequently, some of the issues addressed herein are of some urgency, since they affect tax reporting and withholding for the 2016 taxable year.

As described in more detail below, the issues that we consider most important and most urgent are as follows:

- *Actual knowledge standard*. The regulations generally permit withholding agents, other than the issuer of a convertible security, to rely on issuer reporting to determine whether a deemed dividend has taken place, and the timing and amount of that deemed dividend. We believe that is an appropriate rule, given the fact that brokers and custodians typically are merely intermediaries and by definition no cash payment will be made that would alert them to the existence, timing or amount of the deemed dividend.

  However, the proposed regulations also state that a withholding agent cannot rely on issuer reporting if it has "actual knowledge" of the deemed distribution. Since a broker or custodian cannot know the actual amount of a deemed dividend unless the issuer provides that information, typically on an IRS Form 8937, we request that the actual knowledge rule be clarified to state that a broker or custodian will be treated as having actual knowledge of a deemed distribution only if it has received tax information with respect to the deemed distribution from the issuer. In order to ensure that withholding agents know exactly what is required of them and that IRS auditors know when withholding

with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] *Deemed Distributions Under Section 305(c) of Stock and Rights to Acquire Stock (REG-133673-15)*, Internal Revenue Bulletin 2016-18, 697-712 (May 2, 2016);71 FED. REG. 21795 (April 13, 2016).

All citations are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

[3] A reference to "withholding agents" in this letter generally is intended as a reference to brokers and custodians.

tax liability arises and when it does not, the regulations also should state that other types of information, including the mere knowledge that a conversion rate adjustment has taken place, or an estimate by a party other than the issuer of the amount of a deemed dividend, do not constitute "actual knowledge" of a deemed distribution.

- *Timing of broker/custodian withholding.* The proposed regulations provide that a broker or custodian generally is not required to withhold tax on a deemed dividend until after an issuer reports the deemed dividend. We believe that is an appropriate rule since the withholding liability will be based on the information provided by the issuer. However, there should be a minimum period of time – we propose 10 business days – after an issuer reports before withholding is required, so that there is time for the information to get to the withholding agent and for the withholding agent to take the necessary steps to withhold even though there is no cash payment on which to withhold.

  Withholding agents also should be permitted to withhold and deposit tax on deemed dividends at any time on or before March 15 of the following year rather than being required to withhold and deposit at the time when deemed dividends are reported by the issuer. Similarly, no late-payment penalties should apply for deposits of tax made on or before the following-year March 15. If these rules are not adopted on a permanent basis, they should apply until at least 2019 in order to give brokers and custodians the time necessary to build systems to withhold tax on deemed dividends on a real-time basis, *i.e.*, on a specific date.

- *Timing of issuer reporting.* The proposed regulations provide that if an issuer does not report a deemed dividend by a specified cut-off date (currently March 15 of the year following the year in which a deemed dividend is paid), a broker or custodian is not obligated to withhold tax with respect to that deemed dividend. Since the issuer is required to report the information no later than January 15 of the following year under section 6045B, the cut-off date should be January 15, not March 15. A January 15 cut-off date also is more likely to provide brokers and custodians sufficient time to carry out all required withholdings and provide reporting to investors, while a March 15 cut-off date does not.

- *Account closing obligations.* If an issuer reports a deemed dividend after an investor has closed its account with a withholding agent, the withholding agent should not be responsible for withholding tax on that deemed dividend, consistent with the normal withholding tax rules that provide that there is no obligation to withhold when a broker or custodian does not hold any assets of the taxpayer that has earned the relevant income. Since the withholding agent

will still be obligated to report the deemed income, without associated withholding tax, the IRS and investor will be on notice that the tax is due.

These issues and others are discussed in the remainder of this letter. A brief summary of our additional comments is as follows:

- *Requirement to provide copy of Form 8937.* The section 6045B regulations should be revised to clarify that an issuer of a convertible security held in book-entry form, as is ordinarily the case, must post a copy of Form 8937 on its public website unless it has provided a "statement" to every broker that holds its securities, whether directly or indirectly. This should in practice largely obviate the need for brokers to transmit a copy of the Form to each other.

- *1099-DIV reporting.* The regulations under section 6042 should be revised to address the reporting of deemed dividends, and no reporting on IRS Form 1099-DIV should be required until the revisions take place.

- *Securities loans of convertible securities*. The regulations should provide that the custodian or broker for a taxpayer that lends a convertible security in a securities loan transaction remains obligated to collect withholding tax with respect to any deemed dividend that arises during the term of the securities loan. We also make a number of recommendations relating to the coordination of the proposed regulations with regulations under section 871(m).

- *E&P allocable to a deemed distribution*. The regulations should provide rules for how an issuer's earnings and profits ("E&P") are allocated to a deemed distribution, and issuers should be required to report that information on Form 8937.

- *Other technical issues.* The regulations should address when deemed distributions arise in the common situation where the legal terms of a convertible security state that no adjustment is required to be made to the conversion rate until cumulative adjustments reach 1%; should clarify whether deemed dividends can be treated as qualified dividend income; should address whether deemed distributions arise on convertible bonds that are also contingent payment debt instruments; and should explain whether the rules apply to non-option transactions like forward contracts on an issuer's stock.

- *Late reporting or non-reporting by issuers*. If an issuer fails to provide a Form 8937, or does so late, the regulations should clarify whether the issuer is responsible for collecting and paying the withholding tax, or whether the practical obligation to pay the tax shifts to investors.

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I. Principal Comments Regarding The Obligations of Brokers and Custodians of Convertible Securities

The proposed regulations require the issuer of a convertible bond, convertible preferred stock, warrant or other right to receive cash or property in an amount determined in whole or part by reference to the value of a specified number of the issuer's shares (a "convertible security") to report certain information about those securities, pursuant to the cost basis reporting rules of section 6045B.[4] Under these rules, issuer reporting obligations generally apply if an issuer of a convertible security increases the number of issuer shares into which the security is convertible (a "conversion rate adjustment") as a result of making a distribution that is treated as a taxable dividend for U.S. federal income tax purposes.[5] Conversion rate adjustments are typically required under the terms of a convertible security as a result of any of a long list of events that would otherwise dilute the interests of the investor in the security.[6] The type of conversion rate adjustment that is most relevant in this context is an adjustment that is required under the terms of a convertible security when an issuer pays a cash dividend on its common stock at a rate that is higher than the dividend rate on the stock at the time of issuance of the convertible security (or, alternatively, carries out another type of taxable distribution, such as a taxable spin-off). In these cases there will be an increase in the conversion rate.

The preamble to the proposed regulations states that the Treasury and IRS have concluded that it is clear that an adjustment of this kind gives rise under section 305(c) to a deemed distribution to which section 301 applies if certain conditions are satisfied.[7] That is, a conversion rate adjustment gives rise to a deemed distribution that is treated as a dividend for U.S. federal income tax purposes to the extent of the issuer's E&P allocated thereto. Consequently, it is essential for investors, and their brokers and custodians, to know whether a

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[4] Section 6045B requires issuers of specified securities, including stock and bonds, to provide information about any "organizational action" by the issuer that could affect investors' basis in their securities, for example in the case of a stock split. The information must be provided on Form 8937. The purpose of the reporting obligation generally is to give brokers sufficient information so that they can provide more accurate basis information to investors, so that investors can more accurately determine their gain or loss, and to the IRS. The section 6045B rules are described in more detail in Parts I.A.1 and II.A, below.

[5] A deemed dividend could also arise, to common shareholders, if there is a decrease in a conversion rate and no section 305 exception applies. It is rare for a conversion rate to adjust downwards in this way. This comment letter does not discuss such transactions.

[6] Typical corporate events that give rise to conversion rate adjustments on a convertible security are: (a) the distribution of common stock on common stock, or a share split or share combination; (b) the issuance of stock rights or warrants with a below-market strike price; (c) spin-offs; (d) other distributions of securities or non-cash property; and (e) above-market tender offer or exchange offer payments. There may also be a one-time adjustment to the conversion rate under a "make-whole" provision if there is a "fundamental change" to the issuer. An issuer also typically has the right to increase the conversion rate at its election under certain circumstances. Many of these conversion rate adjustments do not give rise to deemed distributions under section 305(c), or may not do so depending on the particular facts giving rise to the adjustment.

[7] This letter primarily addresses the obligations of brokers and custodians when the law treats a deemed dividend as arising. It generally does not address substantive section 305(c) issues, except to the extent those issues are relevant to the obligations of brokers and custodians.

conversion rate adjustment of this kind – that is, one giving rise to a dividend – has taken place; and if so when and in what amount, in order to comply with their tax reporting and payment obligations.

We are pleased and grateful that the proposed regulations generally recognize that withholding agents like brokers and custodians are merely intermediaries, and ordinarily depend on information from others – customers, issuers, and their agents – in order to ascertain the inputs necessary to determine whether withholding is required. In the case of deemed distributions on convertible securities, those inputs are whether there is income to report and/or withhold on, when that income arises; the amount of that income; and when a withholding tax liability arises. Basing compliance obligations on information from issuers of convertible securities is particularly important when reporting and withholding are required for income that does not have an associated cash flow, since cash flows naturally announce their existence, timing and (usually) amount, and leave open only the question of their characterization, while deemed income may arise without triggering any of the typical signals to a withholding tax system that something has happened.

The proposed regulations are crafted with an understanding of the difficulties of withholding tax when there is nothing to withhold upon, which we also appreciate. The substantive rules under section 305(c), reporting rules under section 6045B, and withholding tax rules under section 1441 and related provisions work together in a generally well-integrated and practical manner that take into account the unusual considerations raised by non-cash deemed dividends on convertible securities. We believe, however, that some revisions are needed to the rules in order to fully accommodate these novel issues, as described below.

Briefly, the proposed regulations (a) generally do not require a broker or custodian to report or withhold tax on a deemed dividend until an issuer of a convertible security reports the existence, timing and amount of a deemed dividend on Form 8937; (b) do not require tax to be withheld until a payment subsequently is made on or with respect to the convertible security or until a specified deadline in the following taxable year; (c) state explicitly that, if necessary, a withholding agent may collect tax from other assets of a customer; (d) clarify certain penalty rules; and (e) clarify the application of withholding tax rules to convertible securities that are loaned or rehypothecated. While the obligation to withhold on a deemed dividend generally does not arise until after the issuer reports, the withholding is imposed on the customer that owned the security at the time that the deemed dividend arose. We agree that this is an appropriate rule both substantively and as a way of preventing taxpayers from avoiding the withholding tax by selling a convertible security to a U.S. person after a conversion rate adjustment but before the issuer reports the relevant tax information.

Our comments on these aspects of the proposed regulations are as follows.

A. Actual Knowledge Rule.

1. *The regulations rightly make issuer reporting the basis for withholding tax obligations.*

Section 6045B generally requires an issuer of a specified security to make a return on Form 8937 describing any "organizational action" that affects the basis of the security, and to provide a copy (referred to as a "statement") to holders of record of the security, or alternatively to make that information publicly available, for example by posting it on the issuer's website. Since a deemed dividend increases an investor's basis in a convertible security, there is a need for reporting of this kind. The proposed regulations treat deemed dividends arising from conversion rate adjustments as "organizational actions," and require issuers to report them under section 6045B. More specifically, an issuer is required to report the date and amount of any deemed dividend arising from a conversion rate adjustment on Form 8937.

Implementation of the section 6045B reporting rules for convertible securities is essential to the operation of the reporting and withholding tax rules applicable to deemed dividends arising from conversion rate adjustments, since issuer reporting is the only means by which investors and withholding agents can obtain consistent, complete and reliable information on the existence, timing and amount of a deemed dividend. Our experience, after extensive investigation into historic reporting practices by issuers, is that in the past there was no database containing reliable, timely and wholly accurate information about the fact that a conversion rate adjustment has taken place, and the timing and amount of that adjustment.[8] The application of the section 6045B reporting requirements to section 305(c) deemed dividends is intended to alleviate that lack of information, so that both investors and withholding agents will know the timing and amount of any deemed dividends arising from a conversion rate adjustment on a convertible security and will have that information reasonably soon after the deemed dividend arises. We agree that requiring issuers to provide this information is the best approach to

[8] Issuers of convertible securities to third party investors ordinarily are required under the terms of the security to provide some information about the timing and size of a conversion rate adjustment ("legal entitlement information"). Those contractual provisions do not, however, require the issuer to provide any information about the value of the conversion rate adjustment or any tax-related information, and the standard formulation in a convertible bond indenture does not require the issuer to provide legal entitlement information in a manner that withholding agents can obtain on a timely basis. Issuers also report this information inconsistently. Our members' experience is (a) that the principal publicly available database that historically provided information about securities was both under- and over-inclusive in identifying conversion rate adjustments; (b) the information provided was sometimes late and did not always provide correct information about the value of a conversion rate adjustment; and (c) the information about a conversion rate adjustment could change during the course of a year.

We understand that a number of new vendors are planning to offer more timely information about conversion rate adjustments, and to transmit the information provided by issuers on Form 8937s. However, unless the issues raised in Part II.F.1, below, with respect to the "1% threshold" are addressed by the regulations, it will not be possible to be sure that this information is entirely accurate, since that question affects both the timing and amount of any section 305(c) deemed dividends.

ensuring that all parties understand their reporting and payment obligations, and that taxpayers take consistent approaches to this complex and non-intuitive process.

2. "*Actual knowledge" should be limited to information provided by an issuer to a withholding agent.*

Proposed Treasury regulation section 1.1441-2(d)(4) provides that a withholding agent other than the issuer has an obligation to withhold on a deemed dividend on a convertible security only if (i) the issuer of the security reports the information required under the proposed section 6045B regulations in a timely fashion, or (ii) the withholding agent "has actual knowledge of the deemed distribution" before March 15 of the following year. The "actual knowledge" standard is one that is routinely used in the section 1441 regulations. However, we are concerned that reference to the actual knowledge standard here may lead to confusion and uncertainty on the part of both withholding agents and IRS agents, unless the regulations clarify its meaning as recommended below.

As described above, there is currently no general market practice on the part of issuers to provide tax information with respect to deemed dividends. We expect that issuers will make that information available in the future by providing a copy of Form 8937 in compliance with their section 6045B reporting obligations. Consequently, we believe that the actual knowledge standard will be relevant to deemed distributions on convertible securities only in highly unusual circumstances that may never actually arise, because a withholding agent will not in practice have actual knowledge of a deemed dividend unless the issuer provides that information, in which case the rule described in clause (i) above ordinarily will apply.

In order to ensure that there is no ambiguity for withholding agents, and IRS agents auditing them, as to when a withholding tax liability arises, we request a number of clarifications to the "actual knowledge" rule. The regulations should state that none of the following should be treated as "actual knowledge of the deemed distribution":

- An announcement by the issuer that it has made a conversion rate adjustment to a convertible security (that is, legal entitlement information with no accompanying Form 8937);

- An estimate of the amount of a deemed distribution, including an estimate that is used by a withholding agent to withhold tax on a tentative basis;

- A public statement by the issuer relating to a conversion rate adjustment, for example, a website posting (other than a public posting of a Form 8937), or a press release or a filing with the Securities & Exchange Commission, unless the press release or filing includes a copy of Form 8937 and is posted on the issuer's public website.

The reasons why we believe these clarifications are appropriate are as follows:

An announcement by the issuer that a conversion rate adjustment has taken place without the related tax information should not be treated as actual knowledge, because the announcement does not provide knowledge of the amount of a deemed distribution, which is critical to ascertaining the amount to be withheld. Also, as we have explained before, under current market practice an announcement by an issuer also may be made long after the conversion rate adjustment takes place, and during that period the identity of the owner of a convertible security may have changed. Announcements of this kind thus are not reliable sources of information on the timing or amount of a deemed dividend.

An estimate of the amount of a deemed distribution should not be treated as actual knowledge by a withholding agent, or as a final determination of an investor's taxable income, because estimates are inherently variable. The proposed regulations provide that an "applicable adjustment" to a right to acquire issuer stock (a "stock right") held by a "deemed shareholder," such as an investor in a convertible security, may be treated as a deemed distribution of a right to acquire additional stock (a "mini-option").[9] The proposed regulations further provide that the amount of a deemed distribution of a mini-option is the excess of (i) the value of the stock right immediately after the adjustment, over (ii) the value of the stock right at that time assuming the adjustment had not been made (a "with and without" method).[10] Determining the fair market value of a mini-option under the with and without method requires the application of sophisticated mathematical formulas to a number of inputs. We understand that the most important of those inputs are the long-term future volatility of the underlying stock, and expected dividends on the underlying stock. There is no definitive source of information for either of these inputs. Future dividends on a particular stock are inherently unknowable. There is also no source of objective information on the long-term future volatility of a stock.[11] Taxpayers attempting to value a mini-option thus must make pricing assumptions to replace the missing information. There is no assurance, therefore, that the valuation used to estimate the amount of a section 305(c) deemed dividend will be the same as the valuation ultimately provided by the issuer of a convertible security.[12]

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[9] Proposed Treasury regulation section 1.305-7(c)(1).

[10] We believe that treating the deemed distribution as a distribution of a mini-option, and using a "with and without" methodology for valuing the deemed distribution is workable. While it would be more theoretically accurate to compare the entire convertible security on a "with and without" basis, doing so would be more complex and expensive, since there would be additional components to be valued (the reduction in the strike price of the original embedded option, and the value of the bond or other security that is the real "purchase price" for any shares) and there would be a consequent need for additional information that is not easy to ascertain or to value.

[11] Estimates of long-term volatility for a stock are typically made based on (a) the historic volatility of the stock, which may not be a good predictor of the future, and (b) volatility implied by trading in options on that stock that are traded on exchanges. Options of that kind may not exist for any particular issuer, and if they exist generally do not have a term of longer than two or three years. Determining the future volatility of a particular stock consequently is more art than science.

[12] We understand that one or more of the vendors referred to in note 8, *supra*, may provide estimates of the amount of a deemed distribution. The vendors we are aware of do not have the expertise to provide valuations of a kind that taxpayers normally use for trading purposes. Moreover, we understand that delta information that is publicly available, from the leading database of information on securities traded in the market, is considered

Finally, whether information is publicly available in some form has never been considered "actual knowledge." Withholding agents are not required to scour the Internet or other sources of information on a daily basis in order to determine whether any one of hundreds of issuers may have posted information in some form that may or may not be relevant. A withholding agent must actually know information in order to meet the actual knowledge standard.

We request that the actual knowledge standard be clarified to provide that a withholding agent cannot have actual knowledge of a deemed distribution unless the issuer has provided information about the tax attributes of a conversion rate adjustment (in particular, the timing and amount of any deemed dividend) directly to the withholding agent.[13] As noted above, we expect that this situation will virtually never arise.

The only scenario we can envision where a withholding agent might have some information of this kind is if an issuer consults a bank for assistance in determining the amount of a deemed dividend, and then does not file a Form 8937. That seems quite implausible. If an issuer goes to the trouble of seeking a bank's valuation advice, it will be for the purpose of filing a Form 8937. Moreover, a bank should not be penalized if its bankers provide assistance of this kind – which the bank's tax operations group may well have no knowledge of – by imposing greater withholding tax liability on it than on competing banks. For example, if a bank provides a valuation to an issuer and a payment is made on the convertible security shortly thereafter but before the issuer has issued a Form 8937, the bank should not be expected to withhold on the payment when other banks are not obligated to do so. Consequently, we believe that withholding agents will have "actual" knowledge of a deemed dividend only after an issuer has provided a Form 8937, in which case the actual knowledge rule would never apply.

We have similar concerns about the rule of proposed Treasury regulation section 1.1441-3(c)(5)(i) that provides that a withholding agent may rely on issuer reporting on Form 8937 unless the withholding agent knows that the information is incorrect or unreliable. It would undermine the premise that compliance is based on issuer reporting if this language were read to require a withholding agent to second-guess an issuer's determination of the amount of a deemed dividend. We request that this condition be removed from the regulations. If it is not removed, we request clarification of how a withholding agent could be treated as having the relevant knowledge.

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unreliable by equity option traders, and is not used as a basis for actual trading. Estimates provided by vendors therefore may vary from estimates developed by banks that trade convertible securities, and from the ultimate valuation provided by an issuer.

[13] We also request clarification of how the actual knowledge rule applies to foreign withholding agents. Proposed Treasury regulation section 1.1441-2(d)(4)(i) on its face applies to all withholding agents. However, proposed Treasury regulation section 1.1441-2(d)(4)(iii) states that a foreign withholding agent has an obligation to withhold if it receives a copy of Form 8937 or the issuer has posted the form on its website. This latter regulation does not refer to the actual knowledge rule.

B. Timing of Issuer Reporting and Broker/Custodian Withholding.

The proposed regulations provide that, after an issuer reports deemed dividend information on Form 8937, a broker or custodian is required to withhold tax with respect to its non-U.S. customers on the earliest of (a) the date on which a cash payment is made on the convertible security, (b) the date on which the security is sold or transferred to a different broker or custodian, or (c) the original filing deadline for IRS Form 1042, which is currently March 15 of the following calendar year. These rules are similar to the rules for withholding under section 871(m), other than the last rule. We have several concerns with the rule as proposed.

1. *There should be a compliance bridge period after an issuer reports*.

The first concern is that brokers and custodians will need some time after an issuer reports information to obtain that information from The Depositary Trust Company ("DTC") (as discussed in Part II.A, below) or a data provider and program their systems accordingly. In addition, if the event that triggers the withholding tax liability is not one that gives rise to cash (for example, a transfer of the security to another person in a non-cash transaction, or a case where no cash payment is made and there is no transfer of the securities before the March 15 deadline for withholding tax), the broker or custodian must also determine whether a customer has cash in its account; make a margin call if the customer does not have adequate cash; and/or sell customer assets to raise cash to pay the tax if the customer does not have or provide cash. Under the rule as proposed, if an issuer provides a Form 8937 on Wednesday, and a cash payment on the security or a transfer of the security takes place on Thursday, the broker or custodian could have to dip into its own funds to collect the tax. The preamble to the regulations makes clear that the rules are intended to operate "to avoid [a withholding agent] having to pay the tax out of the withholding agent's own funds."[14]

We request, therefore, that no withholding tax obligation arise until 10 business days after the issuer provides its section 6045B reporting with respect to a deemed dividend. We believe that would provide adequate time. Withholding agents should be permitted, however, to withhold before the expiration of the 10-day period, if they are ready to do so.

2. *The cut-off date for issuer reporting should be January 15*.

The proposed regulations provide that if an issuer does not report a deemed dividend by March 15 of the year following the year in which a deemed dividend is paid, a broker or custodian is not obligated to withhold tax with respect to that deemed dividend. We request that the deadline for issuer reporting be January 15 of the following year, rather than March 15, for the following reasons.

[14] Preamble, Internal Revenue Bulletin 2016-18, at p. 701 (May 2, 2016); 71 FED. REG. 21798 (April 13, 2016).

First, since issuers have a legal obligation to provide reporting by January 15 under section 6045B, we do not see why there should be any other deadline.

Second, in practice a March 15 cut-off date for issuer reporting is not workable. Brokers and custodians must report on many millions of dollars of payments to non-U.S. customers by March 15, as well as make any late deposits of tax. They work intensively over a period of several weeks in order to meet that deadline. This work involves many different people from different departments, in order to chase down all of the details and resolve all of the inconsistencies that creep into even the best-run system. This demanding process relates to payments made and tax withheld or required to be withheld for the prior year. That is, it relates to events that have taken place, or not taken place, generally by December 31 of the prior year. It is neither fair nor appropriate for an issuer that has failed to comply with its legal obligations to unexpectedly cause a withholding tax obligation and related Form 1042 reporting obligation to arise for that prior year in February or March of the following year. Furthermore, for U.S. customers that are entitled to receive Form 1099, brokers and custodians will be obligated to send out Form 1099-DIVs generally by the end of January and Form 1099-Bs by mid-February, once the section 6042 and 6045(g) regulations are revised as discussed in Section II.B, below.

Related to this point is that some brokers and custodians may wish to complete their Form 1042 reporting and payment obligations prior to March 15, for example on March 1.[15] Again, it would be neither fair nor appropriate for an issuer to be able to provide a late report on March 3 that undoes the work that that withholding agent has done.

3. *The deadline for withholding tax should accommodate different factual situations*.

As SIFMA members have started to grapple with the details involved in withholding on non-cash income items on a regular basis, it has emerged that as a result of differences in client bases (for example, retail vs. institutional, or a large number of accounts vs. a small number of accounts) and other considerations, the cost-effectiveness and other trade-offs involved in designing withholding tax systems are quite different for different withholding agents. As a result, some withholding agents prefer to withhold as soon as they become aware of a deemed distribution (for example, at or near the time that a conversion rate adjustment takes place), even if it is necessary to withhold on an estimated basis and later true-up the withholding once the issuer reports on Form 8937; other withholding agents prefer to wait for issuer reporting

[15] As a technical matter, it is not clear whether withholding prior to March 15 is permitted under the proposed regulations, assuming that there has not been a cash payment on or a transfer of the convertible security. Proposed Treasury regulation section 1.1441-2(d)(4)(ii)(C) is written in a manner that suggests that in that situation withholding must take place on March15, but Example 3 to that regulation describes the withholding agent's obligation as withholding "by" March 15. We request that the regulations be revised to require withholding "by" March 15, so that there is no doubt that a withholding agent that withholds the tax on March 1 is in compliance with its obligations.

and to withhold at that time; and yet other withholding agents would prefer to withhold on a periodic basis, for example quarterly or annually.

Since a withholding agent is *liable* for the tax, after the issuer provides Form 8937 reporting, regardless of when it actually withholds, we do not believe these differences would impede the due collection of the tax. We request, therefore, that withholding agents be given flexibility to withhold tax on deemed distributions arising from conversion rate adjustments at any time on or after it is known that there will be a conversion rate adjustment expected to give rise to a deemed dividend, as long as the withholding is on or before March 15 of the following year.

If this rule is not adopted on a permanent basis, we request that it be adopted as a transitional rule. No real-time, automated withholding systems currently exist to withhold tax on section 305(c) deemed dividends. It will take time to build them, after the regulations are issued in final form.[16] In the interim, brokers and custodians will be able to withhold only through a labor-intensive manual process. Many brokers and custodians may wish to limit the number of times during a year that they must carry out that process, or to carry out all of that withholding in the following calendar year. We request, therefore, that the regulations provide that during an appropriate transition period – at least 2 years after the regulations become final – that withholding agents be permitted to withhold tax on section 305(c) deemed distributions reported by an issuer at any time before the original filing date for Form 1042.

As discussed in further detail in Part II.D, below, we also request some related changes to the penalty rules.

4. *Withholding agents should not be required to withhold after an account is closed.*

The preamble to the proposed regulations states that if an issuer reports information about a deemed dividend after a customer has closed its account with a broker or custodian, the broker or custodian remains liable for the withholding tax.[17] We request that the

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[16] Taxpayers ordinarily do not begin the process of building systems to address new rules until the rules are final, to avoid wasting effort if the rules change between proposal and finalization, and to avoid developing systems that fail to address all of their obligations. Then they must (a) scope out the project, (b) develop a budget, (c) obtain internal approvals for the budget – normally this is done as part of a scheduled budget process, not on an ad hoc basis; (d) build, or hire a vendor to build, the system, (e) test the system, and (f) train personnel to use the system.

[17] It is not clear when, after the issuer provides its reporting, the withholding tax liability is intended to arise. For example, if there is a payment on the convertible security after the customer transfers the security to another broker, does the original broker's liability arise at that time? Similarly, if the customer subsequently retransfers it to another broker (a transaction that the original broker or custodian would have no information about), does liability arise at that time? If the account closing rule is not revised, we request clarification that the original withholding agent may withhold at any time on or before March 15 of the following year.

The proposed regulations also provide that a withholding agent remains liable for withholding tax with respect to a convertible security that is transferred by a customer (that does not close its account) after a conversion rate adjustment and before the issuer reports. It would be useful to clarify how this rule applies if the date on which

regulations be revised to reverse this rule, by making clear that the broker or custodian is not liable under those circumstances. If a customer transfers its account at a time when a broker or custodian has no liability for withholding tax, liability should not spring into existence months after the account is closed.

As a general matter, a withholding agent has long been defined as "any person … that has the control, receipt, custody, disposal or payment of an item of income of a foreign person subject to withholding."[18] Once a customer account is closed, a broker or custodian no longer satisfies this standard.

More technically, the proposed regulations modify Treasury regulation section 1.1441-7 to provide that a person that holds a convertible security as an agent or a nominee for a beneficial owner is treated as having custody or control over a deemed distribution on the security. This language has the effect of treating a broker or custodian as a withholding agent with respect to the deemed distribution. That is, it answers the general question of whether a broker or custodian has "custody or control" within the meaning of the regulations over an income item that does not give rise to a cash payment that is actually in the broker's custody or control. We agree that this rule is necessary in order to impose liability with respect to a deemed section 305(c) dividend upon a broker or custodian that holds a convertible security. But it is contrary to decades of withholding tax law to use this expanded definition to treat a broker or custodian who does not actually have dominion over a payment, or the security, or any other assets of a customer at the time when withholding tax liability actually arises as if it did.

We note that the broker or custodian that held the security when the deemed dividend to a foreign investor arose will have an obligation to report the deemed dividend in any event.[19] The reporting would be on an IRS Form 1042-S that will not show any associated withholding tax, so the IRS will be on notice that it should look to the investor to pay the withholding tax. Moreover, many foreign investors that invest in convertible securities do not ordinarily file U.S. tax returns, or file blank protective returns, and will have a strong motivation to ensure that any withholding tax is withheld by a broker or custodian so that they do not have a legal obligation to file a return showing tax due. Those investors may avoid closing an account at a time that could put them at risk of having a filing obligation, or may request that the withholding agent withhold on an estimated basis at the time that the account is closed.

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the conversion rate adjustment takes place after the security has been sold, but before the sale has been completed. For example, if the trade date for a sale is on Monday, the conversion rate adjustment takes place on Tuesday and the security is delivered to the buyer on Thursday (the settlement date), is the buyer or the seller taxed on the deemed dividend?

[18] Treasury regulation section 1.1441-7(a)(1).

[19] The section 1461 regulations were not amended to refer explicitly to deemed distributions or deemed payments. It would add clarity if reporting of those amounts was expressly required.

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II. Other Comments.

In addition to our principal comments above, we have a number of other comments on the proposed regulations.

A. Requirement to Provide Copy of Form 8937 to Foreign Withholding Agents.

The proposed regulations add additional procedural burdens on U.S. withholding agents that hold convertible securities for the account of qualified intermediaries, withholding foreign partnerships and trusts, and U.S. branches (a "foreign withholding agent"). Those foreign withholding agents are ones that have, or have assumed, primary withholding tax liability as a general matter. The proposed regulations provide that a U.S. withholding agent cannot treat a foreign withholding agent as such – that is, the U.S. withholding agent must itself carry out the withholding – unless (i) the issuer has provided public reporting on its website, or (ii) if the issuer instead "furnished a statement" to nominees, the U.S. withholding agent provides a copy of that statement to the foreign withholding agent.[20]

We understand the concern that a foreign withholding agent may not otherwise have access to an issuer's Form 8937 information, but we believe that a better solution would be to ensure that issuers of publicly traded convertible securities make their Forms public by posting them on their websites, as explained below.

In the usual case, a convertible security issued by a U.S. issuer will be held by DTC.[21] In that case, we anticipate that an issuer of a convertible security on which there is a deemed dividend will provide a copy of its Form 8937 to DTC, which we understand is now actively requesting such forms from issuers. DTC in turn will make the form available to its participants, which include major brokers and custodians. There is no current mechanism for any other financial institution, whether U.S. or foreign, to receive that information. That is, if Custodian A is a member of DTC, and it holds securities for customers of U.S. Broker B and non-U.S. Broker C, only Custodian A will receive a copy of the form through DTC. The problem of lack of information by non-members of DTC thus is not limited to foreign withholding agents.

Ideally, issuers would also post a copy of Form 8937 on their public websites. If they do so, any withholding agent, and for that matter any investor, IRS agent or other interested party, will have access to the information. In particular, website postings of Form 8937s would

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[20] Proposed Treasury regulation section 1.1441-2(d)(4)(iii).

[21] DTC was established in 1973 to reduce costs and provide clearing and settlement efficiencies by immobilizing securities and making "book-entry" changes to ownership of the securities. We understand that DTC holds custody of more than 1.3 million securities issues valued at $45.4 trillion including most corporate bonds issued in the U.S. markets. Payments on such bonds typically are made by the issuer to a paying agent or trustee, which pays DTC, which pays the financial institutions that are its members or "participants," which pay investors or other financial institutions holding the bonds for their customers. Through its Legal Notice System ("LENS"), DTC will generally make notices (including Form 8937s) provided by issuers or their agents available to its participants.

be available to vendors that intend to offer to sell tax compliance information on convertible securities to withholding agents.[22] Making Form 8937s as widely available as possible is likely to be the best possible method under existing law for fostering compliance with withholding and reporting obligations. Public reporting by issuers also has the significant advantage of accelerating the date on which withholding obligations arise. For example, if a conversion rate adjustment takes place in January, public reporting to holders must take place in February or March of that year, while "statement" reporting is not required until the following January. We recommend that the IRS take such steps as it can to encourage issuers to post the forms on their websites. We believe that can be accomplished through some clarifications to the section 6045B regulations, as described below.

The section 6045B regulations currently require that an issuer of a covered security provide a copy of the Form 8937 that the issuer filed with the IRS (that is, a "statement") to a "holder of record" or its nominee. It is not clear from the regulations how this rule is intended to apply when securities are held in book-entry form, rather than in physical form. As a legal matter, DTC, or more technically its nominee Cede & Co., ordinarily is the holder of record for all book-entry securities held through DTC, meaning that the only holder recorded on an issuer's books is Cede & Co. holding on DTC's behalf.[23] Since DTC is an "exempt recipient," and under current law no reporting is required to be provided to exempt recipients, treating DTC as a "holder of record" could result in no obligation to provide a "statement" under the general section 6045B rules.

That is presumably not how the regulations are intended to apply. Given the statutory language (which requires that the statement be provided to a "nominee" or a "certificate holder") and the relationship between the section 6045B rules and the other cost basis reporting rules under sections 6045(g) and 6045A, it appears that the term "holder of record" in the section 6045B regulations was intended to refer to an investor, and that the term "nominee" was intended ordinarily to refer to a broker or custodian holding a security for an investor. Assuming this is correct, it should be the case that if an issuer provides its Form 8937 to DTC, and DTC in

[22] As SIFMA has explained in other submissions on the cost basis reporting regulations, the fact that an issuer posts information on its website does not in and of itself mean that withholding agents have practical access to it. Information must be affirmatively sent to the tax compliance operations of a withholding agent. We expect, therefore, that withholding agents that do not have direct DTC access will hire vendors for that purpose. It would be useful if the regulations confirmed that a withholding agent may rely upon Form 8937 information received through DTC or a vendor to the same extent that it would if the withholding agent received the form directly.

[23] Ordinarily, an issuer of a bond will issue one or more "global" certificates in respect of the bond to Cede & Co., as nominee for DTC. The certificate shows Cede & Co. (as nominee for DTC) as the holder of the bond. Alternatively, an issuer may simply record Cede & Co. as the holder of the bond on its books, without issuing a certificate. In either case, DTC then credits the accounts of participants that hold interests in the bond. For example, if an issuer issues a $100 million bond, and the bond is acquired 40% by customers of broker A and 60% by customers of broker B, the issuer will show Cede & Co. as the holder of the bond, and DTC will credit $40 million of the bond to broker A's account and $60 million of the bond to broker B's account.

turn provides the form to its participants, that the issuer should be treated as providing the form to those brokers and custodians.

As the proposed regulations recognize, however, this does not ensure that all brokers or custodians that hold convertible securities for investors will receive the Form 8937. As described above, there may be either domestic or non-U.S. brokers or custodians that hold securities for investors that are not participants in DTC. Consequently, an issuer that provides its Form 8937 to DTC, and does not also post it on its website, cannot be certain that it has complied with its obligation to provide a statement to all nominees holding its securities.

We recommend, therefore, that the regulations clarify the intended operation of the regulations in several ways. First, as a general section 6045B matter, the regulations should clarify that the term "holder of record" means an investor and that DTC is neither a holder of record nor a nominee for those purposes. Second, the regulations should also explicitly provide that an issuer of securities held in book-entry form must report publicly unless it has provided the Form (whether or not through a clearing organization) to all brokers and other nominees holding its securities. This should have the effect of requiring issuers of publicly issued securities to post the Form on their website. That in turn will make it unnecessary in most cases for brokers to transmit a copy of the Form to other brokers or custodians.

B. Section 6042 and Form 1099-DIV Reporting.

Section 6042 provides that "[e]very person … who makes payments of dividends ... to any other person … shall make a return …" and also provide a copy of the return (a Form 1099-DIV) to the payee. For cash dividends, the regulations provide clear rules as to when a cash distribution on stock is treated as a dividend payment reportable under section 6042 or a non-dividend distribution reportable under section 6045B. The preamble to the proposed regulations requests comments on the implementation of Form 1099-DIV to reporting deemed dividends arising in connection with conversion rate adjustments.

At present, it does not appear that any reporting of such deemed dividends is required under section 6042, because while a deemed dividend constitutes a "dividend" for this purpose, there is no "payment" of the dividend.[24] We request that the section 6042 regulations be amended, and that coordination rules be provided under section 6045B, to provide rules for deemed dividends arising under section 305(c) as a result of a conversion rate adjustment that are comparable to current law's rules for cash dividends.

[24] The section 6042 regulations provide that an amount is deemed to have been paid when it is credited or set apart for the payee without substantial limitation or restriction, and is made available so that it may be drawn at any time and its receipt brought within the payee's own control and disposition. Treasury regulation section 1.6042-3(b). This appears to be a rule governing the timing of when payments are treated as received, not a rule that creates a payment where none exists. In any event, the rule would not be satisfied in the case of a deemed dividend.

The regulations should provide that an issuer's reporting of the timing and amount of a deemed dividend on Form 8937 governs the timing and amount of a reportable dividend for section 6042 purposes. Withholding agents will need to build systems that connect Form 8937 basis reporting information to their dividend reporting systems. Consequently, no reporting on Form 1099-DIV should be required until a reasonable period after regulations are issued, or at least until the instructions to the form are revised. Similar coordination is needed for Form 1099-B reporting required under Treasury regulation section 1.6045-1(d).

C. Securities Loans and Swaps.

The proposed regulations modify the rules for substitute dividends, which generally are cash payments made to the transferor under a securities loan or sale-and-repurchase agreement ("repo") in an amount equivalent to a dividend on a share of stock that has been transferred in the securities loan or repo. As modified, the regulations treat a "deemed payment" as a substitute dividend, and define a deemed payment as a payment deemed to have been made in the amount of a deemed distribution on a convertible security.[25] The special withholding tax rules described above generally apply to deemed payments as well as to deemed dividends. Consequently, if a broker or custodian that holds a convertible security on behalf of a non-U.S. investor lends or sells that security (as agent for the investor) to another taxpayer, and a conversion rate adjustment that gives rise to a deemed dividend takes place during the term of the securities loan or repo, tax will be required to be withheld on the corresponding deemed substitute dividend to the non-U.S. investor. The proposed regulations do not address swaps on convertible securities.

1. *The withholding agent on a securities loan or repo on a convertible security should be the custodian for the lender or seller of the security.*

Because there is likely to be a time lag between the date on which a conversion rate adjustment arises and the date on which the issuer reports it, additional guidance is needed to make clear which party to a securities loan or repo is required to withhold with respect to a deemed substitute dividend. For example, assume that the lending agent and custodian for a non-U.S. investor lends the investor's convertible security to a securities borrower, and a conversion rate adjustment arises during the term of the securities loan but the issuer does not provide a Form 8937 until after the securities loan has terminated. At that point in time, the securities borrower will no longer be a party to the securities loan, and there is therefore no future cash or other flow with respect to the security or the transaction from which the securities borrower can withhold. Consequently, in this case, the party that should be obligated to withhold the tax is the custodian of the lender, so long as that party is still the custodian of the lender at the time that the Form 8937 is issued.

Similarly, in the event of a transaction of the same kind where the issuer provides the Form 8937 during the term of the securities loan, we believe that the custodian of the lender

[25] Proposed Treasury regulation section 1.861-3.

is still the right party to withhold tax. That custodian would be obligated to withhold on the deemed dividend if the security had not been loaned out. It is simpler for all parties, therefore, for the custodian of the lender to continue to bear that obligation. Moreover, if there were no coupon payment on the convertible security during the term of the securities loan, and the securities borrower were the withholding agent, there would again be no cash flow on which it could withhold. Furthermore, the custodian for the lender is more likely to have other assets of the lender from which it can withhold. For the avoidance of doubt, similar rules should apply in the case of a repo transaction.

2. *More guidance is needed to clarify the interaction between section 871(m) and section 305(c)-based withholding.*

We also have a number of more technical comments on the proposed regulations as they relate to securities loans, repos and swaps on convertible securities. These principally address the interaction between the proposed regulations and the withholding tax rules applicable to dividend equivalents under section 871(m).

The reason for concern is that there are different rules for determining the timing and amount of deemed dividends under sections 305(c) and dividend-equivalents under section 871(m), and different withholding tax rules apply as well. In addition, as noted above, the proposed regulations address deemed substitute payments on a securities loan or repo, but do not provide for similar deemed payments on a swap. As a general matter, we believe that deemed section 305(c) dividends should be subject to the same withholding and reporting rules regardless of whether an investor directly holds a convertible security, or has exposure to that security through a securities loan, a repo or a swap. If that were not the case, and section 305(c)-based withholding tax rules applied to some of those cases and section 871(m) rules applied to others, there is a potential for either whipsaw or arbitrage. Withholding agents also would have to track the different legal forms that an investor could use to take on exposure to a convertible security, and apply different withholding and reporting methodologies to different legal forms, which would be impractical.

It is helpful to start by recognizing that, subject to a section 305(c) coordination rule referred to below, section 871(m) will require withholding on a securities loan, repo or swap transaction if (i) there is an "underlying security" within the meaning of the section 871(m) regulations, generally meaning a U.S. source dividend-paying instrument; and (ii) there is a payment (including an implied payment) on the securities loan, repo or swap that "references the payment of a dividend" from the underlying security.[26] The issues discussed below are whether the underlying security for such transactions is the convertible bond or the stock that the bond is convertible into, and whether the "payment" conditions are satisfied.

[26] *See* Treasury regulation section 1.871-15(c)(1). If the conditions in the text are satisfied, a securities loan, repo or swap ordinarily would be a section 871(m) transaction.

A direct investment in a convertible bond ordinarily will not be subject to section 871(m) because the delta of the bond at issuance will not exceed .80. There are two technical questions with respect to synthetic exposure to a bond of this kind (a bond not subject to section 871(m)) that is deemed to pay dividends under section 305(c).[27]

The first question is whether the "underlying security" for a securities loan, repo or swap on such a bond is the bond or the underlying stock.[28] If it is the convertible bond, then a section 305(c) coordination rule in the section 871(m) regulations ought to ensure that there are no dividend equivalent payments on the synthetic transaction.[29] If the underlying security were the underlying common stock of the issuer, however, it is not clear how section 871(m) would determine the timing and amount of any dividend equivalent, and therefore it is not certain that the section 305(c) coordination rule would override. Regulations should provide, therefore, that the underlying security for such transactions is the convertible security and not the stock.

Assuming that the underlying security for these transactions security is the convertible security and not the underlying stock, there is a second question in the case of swaps on convertible securities. This question arises because it is not clear whether there is a "payment" on the swap that is subject to withholding under any rule of law. As noted above, the proposed regulations do not provide for a deemed payment on the swap under 305(c)-based rules, unlike the case for securities loans and repos.[30] Consequently, it does not appear that Treasury regulation section 1.1441-2(d)(4) applies. It is conceivable that section 871(m) might apply – which as discussed above, is not desirable – but that would be true only if a 305(c) deemed distribution were treated as a "payment" of a dividend. There is, therefore, considerable

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[27] The discussion below assumes that section 871(m) is intended to apply in such a way that the determination of whether a securities loan, repo or swap on a convertible security is subject to section 871(m) depends on whether the convertible security itself is subject to section 871(m). That is, ordinarily if a security does not pay dividends and is not subject to section 871(m), a synthetic transaction on that security also will not be subject to section 871(m). If that is not correct, we request the opportunity to provide further comments on coordination between section 871(m) and 305(c)-related withholding tax rules.

[28] Treasury regulation section 1.871-15(a)(15) defines an "underlying security" as an interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend under Treasury regulation section 1.861-3.

[29] Treasury regulation section 1.871-15(c)(2)(ii) provides that a dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security. It would be useful to clarify the application of the rules for qualified dividend dealers ("QDDs") as well, so that regulations expressly provide that a QDD that holds a convertible security is subject to the same withholding tax rules with respect to a deemed dividend on that security as it would be if the security gave rise to a cash dividend or a dividend equivalent.

[30] It is possible that the section 871(m) regulations might deem there to be a payment on the swap that is subject to section 871(m) withholding, if a section 305(c) deemed dividend qualifies as a "payment of a dividend." As described above, however, we believe that the appropriate withholding tax rules for a deemed swap payment in respect of a deemed section 305(c) dividend are the section 305(c)-based rules of Treasury regulation section 1.1441-2(d)(4), not the section 871(m) rules.

uncertainty as to what substantive and withholding tax rules would apply to a swap on a convertible security that has section 305(c) deemed dividends.

We request, therefore, coordinating rules that would ensure that deemed distributions and corresponding deemed amounts under a securities loan, repo or swap are subject to withholding tax under the same rules. These coordinating rules should provide:

- For section 871(m) purposes, the "underlying security" for a securities loan, repo or swap on a convertible security is the convertible security itself, and not the underlying stock;

- There is a "deemed payment" on a securities loan, repo or swap on a convertible security that is subject to section 305(c) that has the same timing and amount as the deemed distribution on the convertible security.

- The section 1441 and related withholding and reporting rules provided by the proposed regulations are the sole applicable withholding and reporting rules for such deemed payments. Section 871(m) and Treasury regulation section 1.1441-2(e)(8) do not apply to such deemed payments.

- The regulations should also address how to apply sections 305(c) and 871(m) to a securities loan, repo or swap on an instrument that pays cash dividends or dividend-linked amounts subject to withholding and also is treated as paying deemed distributions under section 305(c). We expect that this would primarily be relevant to "mandatory convertible" or other instruments that make periodic cash payments that are linked to dividends, but could also have deemed section 305(c) dividends.

3. *Regulations should address basis issues under section 1058.*

Guidance should be issued under section 1058 clarifying that a U.S. taxable taxpayer that lends a security and is taxed on a deemed payment is entitled to increased basis on its position in the securities loan, and in the loaned security when it reacquires it, as a result of that deemed payment. Revenue Ruling 76-186 provides for a basis adjustment for a deemed dividend on the security itself, but does not address basis in a securities loan.[31] Section 1058(c) provides that property acquired by a taxpayer in a section 1058(a) transaction has the same basis as the property transferred by that taxpayer. This should not be read to preclude an increase in basis as a result of a deemed dividend during the term of a securities loan that gives rise to taxable income to the securities lender.

[31] Rev. Rul. 76-186, 1976-1 C.B. 86.

D. Underwithholding; Late Withholding; Penalties.

The proposed regulations modify the current law rules addressing circumstances when there has been underwithholding. Under current law, the regulations provide that a withholding agent may top up its withholding by withholding tax from future payments to a customer, or from property of the customer over which it has custody or control.[32] The proposed regulations expressly permit the withholding agent also to make a margin call or the equivalent on the customer for the amount of the tax.[33] We agree with the preamble that this change is merely a clarification and does not change current law.

The proposed regulations go on to state that "[a] withholding agent that adjusts its underwithholding under the procedures described in this paragraph (b) will not be subject to any penalties or additions to tax described in § 1.1461-1(a)(2) [which has a cross-reference to penalties imposed by sections 6656, 6672 and 7202] if it timely deposits the amounts that it withholds" in the manner described above. The preamble describes this new rule as having the effect of not imposing penalties if the withholding agent deposits the tax it has collected for a particular taxable year by March 15 of the following year (that is, the original due date for filing Form 1042). We appreciate the intended result and agree that it is appropriate. For the reasons set forth below, however, we request that the proposed regulations be revised to say more clearly what the preamble says, and that several related changes be made.

In order to explain the reasons for our request, it is useful to consider several related but separate sets of rules. First, there are withholding tax rules, generally set forth in section 1441 and following sections. Second, withholding agents are required under sections 1461 and 6302 to deposit tax that has been withheld.[34] Third, regulations issued under section 6302 require withholding agents to make those deposits by specified deadlines, typically by the 15th of the month.[35] Finally, section 6656 and the regulations issued thereunder impose penalties if tax required to be deposited with the IRS is not deposited by the relevant deadline.[36]

While the preamble describes the new proposed language as permitting deposits of tax to be made by March 15 of the following year without penalties being imposed, the actual proposed language requires "timely" deposits. We request that this language be revised to refer specifically to the Form 1042 original filing deadline; and that the regulations under section 6302 also be revised to make clear that withholding agents may deposit tax withheld on section 305(c) deemed distributions at any time on or before March 15 of the following year without being subject to penalties. Since Form 1042 currently does not provide a line where withholding tax

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32 Treasury regulation section 1.1461-2(b).

33 Proposed Treasury regulation section 1.1461-2(b).

34 Treasury regulation section 1.1461-1(a); Treasury regulation section 1.6302-2. Technically, most taxpayers make the deposit to an approved depositary bank, which then transmits the deposit to the government's Electronic Federal Tax Payment System.

35 *Id.*

36 Sections 6672 and 7202 impose penalties for failures to pay tax, rather than late payments.

deposited in this manner – that is, later than the current section 6302 deadline – can be reported, we request that a new line be added to the form.[37]

E. E&P Allocable to a Deemed Distribution.

A deemed distribution will be treated as a dividend for U.S. federal income tax purposes only to the extent it is deemed paid out of the issuer's E&P. There is no official guidance under current law as to how an issuer should allocate E&P to a deemed distribution, and the proposed regulations do not propose a rule.[38] The proposed regulations also do not specifically require issuers to report that information.

A rule that directs how to allocate E&P to deemed distributions would be useful to issuers. Issuers will need to know how to do so for purposes of their internal E&P calculations and for purposes of determining when cash distributions should be treated as dividends. In addition, since section 6045B reporting is required only when an organizational action affects basis, and a deemed distribution would affect the basis of a convertible security only if it is made out of E&P, an issuer presumably also must make a determination about the allocation of E&P to a deemed distribution in order to comply with its section 6045B reporting obligations.[39] This determination is similar to the determination that an issuer must make when it makes a cash distribution, as section 6045B reporting would be required if a cash distribution were not made out of E&P.[40]

Requiring issuers to report E&P information explicitly would be useful to investors, so that they are taxed only on deemed distributions that constitute gross income, and to

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[37] A similar approach is currently used by withholding agents when they make an adjustment for underwithheld tax on actual corporate distributions made in the prior year based on a reasonable estimate of E&P, if the withholding agents pay the top-up for the underwithheld amounts by March 15th. Currently, a withholding agent can include these amounts on Line 64a of the Form 1042, rather than on Lines 1-60. Assuming the withholding agent made the appropriate deposits on or prior to March 15th, it would not incur late penalties for failure to deposit.

[38] General Counsel Memorandum 36138 (Jan. 15, 1975) provides that E&P should be allocated to deemed distributions that result from a taxable dividend *pro rata* with the allocation of E&P to the underlying dividend. The G.C.M. is not a published ruling and consequently taxpayers may not formally rely upon it.

[39] Issuers generally may use reasonable assumptions about facts for purposes of complying with section 6045B reporting obligations, but must provide a corrected return if the actual facts result in a different quantitative effect on a security's basis than was previously reported. Treasury regulation section 1.6045B-1(a)(2)(ii). If applicable, those general rules would require issuers to make an initial reasonable allocation of E&P to a deemed distribution, and then to correct their Form 8937s after the close of the year. It is not clear, however, whether these general rules apply to section 6045B reporting of deemed distributions. The regulation goes on to say that issuers must treat a payment that may be a dividend consistently with its treatment under section 6042. Since section 6042 does not impose any reporting obligations on issuers whose stock is held in book-entry form, as is usually the case, it is not clear how this additional rule affects an issuer's section 6045B reporting obligations with respect to deemed distributions. It would be helpful if these issues were clarified when final regulations are published.

[40] See Treasury regulation section 1.6045B-1(g), Example 2. A cash distribution must be reported on Form 8937 if it is not made out of E&P, while a deemed distribution must be reported on Form 8937 if it is made out of E&P. In either case, the issuer must make a determination about its anticipated E&P and take appropriate action.

brokers and custodians when they provide information reporting (and potentially, when they evaluate their withholding tax obligations). We request, therefore, that the proposed regulations be revised to provide a rule for how E&P should be allocated to deemed distributions, and to require issuers to report and update that information as part of their section 6045B reporting.

F. Other Technical Issues.

1. *1% threshold*. The legal terms of many convertible bonds provide that the issuer is not required to adjust the conversion rate until cumulative adjustments reach a specified threshold (usually 1 percent of the pre-adjustment conversion rate). We understand the purpose of this provision is to avoid the need for issuers to carry out the administrative steps necessary to adjust a conversion rate for very small adjustments. For example, if a potential conversion rate adjustment of .40 percent of the conversion rate arises in each of March, June and September, the issuer often will not announce a change to the conversion rate until September, when the aggregate amount of the adjustment is 1.20 percent. However, an investor that converts its bond before the threshold is reached – for example, in April – is nevertheless entitled to the additional shares.

The proposed regulations do not explicitly address the question of whether a conversion rate adjustment of this kind should be given effect for tax purposes when it first arises, *e.g.*, in March, or only at the later point when the 1% threshold is reached. It appears, however, that the intent of the proposed regulations is that for tax purposes the adjustment should be taken into account when it first arises, in light of the proposed rule that an applicable adjustment arises no later than when the related underlying dividend is paid.[41] We request that the regulations address this issue explicitly. Silence on this point may confuse issuers, since they are not obligated under the terms of a convertible bond to provide notice of a conversion rate adjustment until September, in the example above. If they must report deemed distributions for tax purposes at an earlier time, the regulations should make that clear.

2. *Qualified dividend income*. Withholding agents must report to investors whether dividends they receive are eligible to be treated as qualified dividend income.[42] We request that the regulations address the eligibility issue so that withholding agents know how to carry out their reporting obligations. SIFMA members generally believe that the appropriate treatment is for deemed dividends to be eligible for qualified dividend income treatment.

3. *Contingent payment debt instruments*. Some questions have been raised as to whether section 305(c) applies to convertible securities that are contingent payment debt instruments ("CPDIs"), since the CPDI rules of Treasury regulation section 1.1275-4 already take the potential for contingencies like conversion rate adjustments into account when a

41 Proposed Treasury regulation section 1.305-7(c)(5).
42 See IRS Form 1099-DIV, box 1(b), and related instructions.

convertible bond is issued. It would be useful for the regulations to address that question, as otherwise different issuers may take different positions.

4. *Forward contracts*. Instruments that are treated for tax purposes as forward contracts on an issuer's stock may also provide for adjustments to reflect a taxable distribution on the issuer's common stock.[43] The regulations should make clear whether they apply to instruments of this kind.

G. Consequences if an Issuer Reports Late, or Does Not Report.

As described above, we understand that DTC recently began to require issuers to provide a copy of Form 8937s in respect of deemed distributions arising as a result of conversion rate adjustments on convertible bonds held through DTC. It is to be hoped, therefore, that in the not too distant future issuers will be providing Form 8937s on a regular basis. To date, however, we understand issuers have provided only a very limited number of Form 8937s relating to conversion rate adjustments. That raises the question of who is responsible for paying the withholding tax for unreported, or late-reported, deemed dividends arising in 2016. That question also will be relevant on a going-forward basis, if an issuer does not comply with its reporting obligations on a timely basis.

Under the proposed regulations, as previously discussed, a broker or custodian generally is not obligated to withhold tax or report on a deemed distribution if an issuer fails to report the deemed distribution, or reports it after a specified deadline. The proposed regulations also permit withholding agents to rely on this rule for conversion rate adjustments arising on or after January 1, 2016. Consequently, some other party must pay the tax if there is a 2016 conversion rate adjustment and the issuer fails to make a timely report on Form 8937. There are a number of possible alternatives, including that non-U.S. investors file tax returns to pay the tax or that issuers withhold and pay the tax.[44] The regulations should make clear who is obligated to do what under these circumstances.

We note in this regard that issuers typically are wholly unfamiliar with withholding obligations of this kind, and that there is no mechanism that we are aware of that would allow issuers to determine on a real-time basis who the investors in their securities are, and to withhold tax only with respect to non-U.S. investors in the securities. Moreover, issuers

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[43] See, for example, the instrument described in Rev. Rul. 2003-97, 1997-2 C.B. 380 (equity unit consisting of forward contract and bond).

[44] Ordinarily, U.S. issuers are not obligated to withhold any tax with respect to items of income subject to section 1441 withholding, because of a broadly applicable special rule that allows payors to treat a payment to a U.S. financial institution that is acting as an agent or nominee for a non-U.S. investor as if the payment were made to a U.S. person, and therefore as not subject to withholding tax. Treasury regulation section 1.1441-1(b)(2)(ii). However, this special rule applies only if the payor does not have reason to believe that the financial institution will fail to withhold the relevant tax. Since brokers and custodians are not required to withhold tax absent timely issuer reporting, it appears that the special rule would not apply if the issuer does not timely report, and that the consequence is that the issuer would be obligated to withhold the tax.

generally do not have Form 1042 or Form 1042-S reporting obligations since they generally do not make payments directly to investors. Consequently, we believe there are unadministrable complexities with any attempt to place the withholding tax burden on the issuer, unless the issuer alone is required to bear the cost of the tax, meaning that it is not permitted to collect that tax from investors. Issuers should, however, have a strong incentive to comply with their section 6045B reporting obligations on a timely basis, perhaps in the form of a penalty if they are not obligated to withhold tax.

On the other hand, many non-U.S. investors may prefer to rely on their brokers and custodians to withhold tax, rather than to file a tax return reporting taxable income. A possible solution might be to allow investors to request their broker and custodian to withhold on an estimated basis, and to treat that withholding as a final tax. We suggest that there be further discussions with investors and SIFMA members on these issues.

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We appreciate your consideration of our views and concerns. Please do not hesitate to contact me at (202) 962-7300 or ppeabody@sifma.org, or our outside counsel, Erika W. Nijenhuis at Cleary Gottlieb Steen & Hamilton LLP, at (212) 225-2980 or enijenhuis@cgsh.com, with any questions.

Respectfully submitted,

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