

October 21, 1997

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Ladies and Gentlemen:

We are writing to request a delay in the effective date for the application of recently issued regulations to certain substitute payments made pursuant to securities lending transactions. We refer specifically to the payments made by foreign persons to other foreign persons ("foreign-to-foreign payments"), as opposed to the payments made by U.S. persons to foreign persons ("outbound payments"). The new regulations are effective for substitute payments made on or after November 13, 1997.

As you know, prior proposed regulations, which were not currently effective, dealt only with outbound substitute payments and generally proposed to impose U.S. withholding tax

on such payments as if they were actual outbound payments of U.S. source dividends or interest. The new regulations also impose U.S. withholding tax on substitute payments made by one foreign person to another.

For the reasons set out below, we believe that the immediate imposition of U.S. withholding tax on foreign-to-foreign payments would prove a substantial hardship for the securities industry and be virtually impossible to comply with on such short notice. In addition, such treatment, without further modification, would effectively impose multiple U.S. withholding taxes in respect of one outbound dividend payment. This would penalize bona-fide foreign investors in U.S. equities and needlessly impede the functioning and liquidity of capital markets. As a practical matter (and as explained more fully below), the multiple U.S. withholding taxes could not be avoided through restructuring, e.g., by directing foreign customers to maintain their accounts with U.S. broker/dealers, rather than with local foreign broker/dealers.

In any event, the securities industry has been taken completely by surprise by the extension of U.S. withholding tax to foreign-to-foreign substitute payments, and to our knowledge there have been no public comments on the subject. Members of the staff of the Treasury Department and the Internal Revenue Service appear to agree, moreover, that imposition of multiple U.S. withholding taxes on outbound substitute payments is not a desirable result, from either a technical, policy or practical perspective, and that a workable solution can be found. We therefore urge the Treasury Department to give itself enough time to find that solution, and we pledge our assistance in this regard.

More specifically, the problems with application of the new regulations to foreign-to-foreign substitute payments include the following:

First, such application would for the first time require foreign securities dealers (whether or not they are controlled by U.S. securities dealers) to comply with the complex and detailed regulatory regime that is currently imposed only on U.S. securities dealers in connection with outbound payments of dividends and interest. As you know, this regime is designed to police and protect not only the U.S. withholding tax on outbound dividend payments but also the U.S. income tax on outbound interest payments which might ultimately find their way into the hands of U.S. persons.

Under the new regulations, foreign securities dealers would for the first time be required to collect Form W-8s from all of the counter-parties to whom they make substitute interest payments verifying that these counter-parties are not U.S. persons. In the case of matched-book repo and similar high-volume transactions, this could include a very substantial number of persons who do not maintain custodial accounts with the dealer. Foreign securities dealers would likewise be required for the first time to monitor the treaty-eligible status of counter-parties to whom they make substitute dividend payments. Foreign securities dealers would in any event be required to take appropriate compliance measures, including hiring staff familiar with U.S. tax compliance, instituting appropriate compliance practices, maintaining appropriate books and records, and where necessary, adapting relevant computer programs. None of this could possibly be accomplished by the November 13th effective date of the regulations.

Furthermore, the implementation of these regulations more than a year before the Section 1441 regulations are scheduled to become effective would not be an efficient use of the securities industry's resources. Systems modification and development is a high but costly priority for most financial companies. It would be much more practical to make any substantial changes in withholding and documentation practices that are necessary to comply with new regulations as part of a single project.

Second, such application would impose multiple U.S. withholding taxes in any case where a foreign person lends U.S. stock to another foreign person. In the simplest case, where foreign person A lends U.S. stock to a foreign broker/dealer for sale to foreign person B, U.S. withholding tax would be imposed on both the outbound dividend payment from the relevant U.S. corporation to foreign person B and on the substitute dividend payment made by the broker/dealer to foreign person A. While we view this result as unfair, however, we are mainly concerned with duplication of U.S. withholding tax in the more common case under which the borrowed U.S. stock is ultimately sold to a U.S. person.

This includes primarily the case in which a U.S. broker/dealer borrows U.S. stock for sale to a U.S. person from one of its foreign broker/dealer subsidiaries, which in turn borrows the stock from one of its foreign customers. Under the new regulations, U.S. withholding tax would in this case

be imposed on both the outbound substitute payments made from the U.S. broker/dealer to the foreign broker/dealer and on the substitute payment made from the foreign broker/dealer to the original foreign customer. It is not reasonable to suppose that the double withholding tax could be avoided by requiring foreign customers to maintain their U.S. stocks in accounts with U.S. broker/dealers, rather than with their related local foreign broker/dealers. Apart from the numerous regulatory, accounting and similar issues that such a proposal would raise, it is simply true as a matter of practice that people do business with the local institutions with which they are familiar, and they will not change their business practices merely to give their bankers an opportunity to borrow their U.S. stocks.

We are likewise concerned with the case in which the related foreign broker/dealer cannot borrow the relevant U.S. stock from any direct foreign customer and therefore borrows the U.S. stock from an unrelated foreign broker/dealer, which in turn borrows the stock from one of its foreign customers. Application of the new regulations would in this case impose three U.S. withholding taxes: one on the outbound substitute payment, one on the substitute payment from the related foreign broker/dealer to the unrelated foreign broker/dealer, and one on the substitute payment from the unrelated foreign broker/dealer to its customer.

We recognize the interest which the Treasury Department has in assuring that foreign persons who are not entitled to the benefits of an income-tax treaty with the United States do not obtain the equivalent of such benefits by lending their U.S. stock to other foreign persons who are entitled to such treaty benefits, which foreign persons may then lend the stock to U.S. persons. We believe that imposition of multiple U.S. withholding taxes on the same outbound dividend payment is far too broad a solution, however. We likewise do not believe that such a solution is justified by the grant of regulatory authority under Section 7701(l). Section 7701(l) permits the Treasury Department to determine who is the true recipient of an outbound dividend payment, not to treat each leg in a series of cash flows through which a foreign person receives a U.S. source dividend as a separate dividend and impose multiple U.S. withholding taxes accordingly. Moreover, we believe such an approach is particularly unfair as a practical matter: foreign broker/dealers that are not controlled by U.S. persons are unlikely to comply with these new requirements, not out of

intentional disregard for the U.S. Treasury Department, but because it will never occur to them that another U.S. withholding tax might be due on a substitute payment made between foreign persons where one U.S. withholding tax has already been collected. As a practical matter, therefore, these regulations will merely serve to drive U.S. controlled foreign broker/dealers out of the inbound U.S. stock lending market.

We believe, moreover, that there are reasonable alternatives. We have already suggested as one possible solution, for example, granting each foreign broker/dealer a credit against remittance of U.S. withholding tax collected on payments made to another person to the extent of the U.S. withholding tax already collected on related payments received by such foreign broker/dealer. Apart from avoiding duplication of U.S. withholding tax, this would permit collection and remittance obligations to continue to rest primarily with the U.S. broker/dealer making the outbound payment, who is best equipped to meet these obligations.^{1/}

We in any event look forward to working with you to find an acceptable solution. In order to have time to do

^{1/} We note that in some cases, the ultimate customer might not be subject to any U.S. withholding tax on dividends received from U.S. sources (e.g., where the ultimate customer is a U.S. person). In such cases, we believe that a foreign broker/dealer should be permitted, as an alternative, to pass through documentation both establishing an exemption from U.S. withholding tax (e.g., a Form W-9 establishing that the ultimate customer is a U.S. person) and indicating that the foreign broker/dealer is a mere intermediary in the deemed receipt by the ultimate customer of the outbound substitute payment directly from the U.S. broker/dealer. We believe that such treatment would be consistent with the authority vested by Section 7701(l) of the Internal Revenue Code under which the new regulations are adopted as a whole. We note, however, that in many cases it will not be possible to establish a direct link between outbound substitute payments and the ultimate foreign customers who receive them (e.g., because foreign securities dealers borrow U.S. stocks held with them on margin account on a "random" basis), and it may therefore be necessary to rely in most cases on a credit system.

this, however, and equally important, in order to permit the securities industry to meet its compliance obligations, we view it as essential that the new regulations not be made effective on November 13th for anything other than the outbound payments that were referenced in proposed regulations.

Thank you for your consideration.

Yours sincerely,

Anthony J. Cetta
Chairman, Committee on
the Federal Taxation of
the Securities Industry