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Re: Notice 2016-42, Proposed Qualified Intermediary Agreement, and Section 871(m) Implementation Delay

Dear Ladies & Gentleman:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to submit comments on the proposed Qualified Intermediary (QI) Agreement

[1] SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving clients with over $16 trillion in assets and managing

published in Notice 2016-42[2] (herein, "Notice" or "proposed QI Agreement"), which includes the requirements for qualified derivatives dealers ("QDDs") pursuant to regulations issued under section 871(m) of the Internal Revenue Code (the "Code").

SIFMA has continuously engaged the Treasury Department (Treasury) and the Internal Revenue Service ("IRS") in an effort to provide constructive recommendations that are operationally administrable. In that same spirit, the members of SIFMA provide the following comments in response to the Notice:

I. Request for section 871(m) implementation delay

The QDD rules require an unprecedented collection of detailed and complex data by non-US entities to determine the QDD tax liability with respect to potential section 871(m) transactions and hedges. In many cases, entities considering QDD status historically have not assumed primary withholding responsibility, and the assumption of withholding has a significant impact, requiring the building of processes and systems. The members of SIFMA have been working ceaselessly to implement the regulations under section 871(m), but it is impossible to implement the complex requirements of QDD by the January 1, 2017, effective date of the regulations, regardless of how quickly Treasury and the IRS finalize these rules. Current systems and workflows are being reengineered to implement the requirements under the section 871(m) regulations. Extending the functionality of these builds to accommodate proposed QDD requirements for potential section 871(m) transactions will further delay the delivery of section 871(m) solutions because of limited availability of capable resources, previously defined builds which will need to be re-defined, and year-end "change freezes"[3] imposed on many institutions. The section 871(m) regulations will not operate as intended without finalized QDD guidance. In the absence of final QDD guidance, there will be cascading withholding, which will be uneconomic and therefore fundamentally disruptive to financial markets.

Moreover, there are critical process issues beyond SIFMA members' control that remain in flux. For instance, the IRS has not published the QDD application form, which will take time to complete and be approved, especially since it is a paper application process. It also currently takes entities and branches two to three months to set up an account with the IRS to make withholding tax deposits. With an influx of entities applying for QI status to qualify as QDDs by January 1, 2017, we are concerned that this process may take even more time. Further, the Form W-8IMY has not been finalized; nor have the Form W-8 requestor instructions been updated. Withholding

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more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, 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, please visit http://www.sifma.org.

[2] I.R.S. Notice 2016-42, 2016-29 I.R.B. 67.

[3] Prohibitions against technological system updates typically begin in early December and are meant to maximize system stability during periods of peak transaction volume and lower personnel availability due to the year-end holidays.

agents need time to program systems to intake the new form, build systems and processes for validation, and collect updated documentation. Revising documentation for specific accounts of legal entities based on the multiple capacities in which they may act requires coordination across the business, the tax department, and other operational areas.

Even without the significant new complexities added by the recently issued proposed QDD rules, SIFMA members will not be able to build automated systems in time to be compliant by January 1, 2017, with all of the requirements in the section 871(m) regulations. SIFMA members are spending significant resources to be prepared for compliance, but there are fundamental open issues related to technical and industry data availability for both delta one and non-delta one transactions that must be resolved before finalizing the withholding process. SIFMA's letter dated June 24, 2016 lists a number of issues that SIFMA members believe require additional guidance. Examples of open areas for concern in the delta one space are structured notes and certain other securities held in custody, where there is a chain of institutions involved,[4] and swaps on potentially covered partnerships, where timely and sufficient data are not available. In the non-delta one space, examples of open areas of concern include withholding for nonqualified indices, obtaining deltas globally for listed options, and implementing the combination rule. Absent additional or final guidance on these issues, the members of SIFMA will not be in a position to implement the regulations in their current form on January 1, 2017.

Accordingly, SIFMA requests a delay of the final and temporary regulations issued under section 871(m) for at least one year from the date of the finalization of the temporary regulations under section 871(m) and QI Agreement. The current QI Agreement would therefore stay in effect until December 31, 2017, with the requirements of the compliance procedure (including the waiver provisions and appendices) under the final QI Agreement being applicable to the certification period ending December 31, 2017.

I. Qualified derivatives dealers

A. QDD tax liability

1. In general

a. Background

SIFMA appreciates Treasury and the IRS's inclusion of the QDD exemption in accordance with the authority granted in the statute to eliminate cascading withholding. Both the statute and the

[4] Products held in custody require the implementation of a very complex chain of data transmission, from the issuers to the custodians, through a series of intermediaries, to bring together the knowledge of the product and that of the client tax status. Despite significant coordination efforts, the industry has not agreed upon a target operating model for all stakeholders in all countries (issuers, data providers, custodians, etc.). The rules will require consistent application and international coordination that cannot be effectively addressed until the section 871(m) regulations and QI Agreement are finalized.

previously released 2013 proposed regulations recognize that dealers generally enter into section 871(m) transactions and underlying securities to mitigate exposure to client trades. The prior proposed regulations would have allowed a "qualified dealer" to receive payments on any potential section 871(m) transaction without withholding or other tax liability provided that the amounts were received in the entity's capacity as a dealer in securities and the dealer was the long party with respect to the underlying security.[5] Changes introduced in the final and temporary regulations, as well as the Notice, generally limit the benefit of the dealer exception. The rules therein often create a tax liability for the non-U.S. dealer merely because the dealer's client trades are out-of-scope for section 871(m) purposes, even when the dealer retains no net long exposure to the underlying securities economically.

The QDD tax liability introduced in the Notice is comprised of three elements: (i) the "section 871(m) amount" arising in connection with the dealer book; (ii) US-source dividends that are not on underlying securities associated with potential section 871(m) transactions and dividend equivalents from non-dealer activities, including investing and proprietary trading; and (iii) other non-dividend, fixed, determinable, annual or periodic income (*e.g.*, interest) associated with potential section 871(m) transactions.[6] The "section 871(m) amount" is computed by determining, for each dividend on each underlying security, the excess (if any) of (A) the amounts the QDD receives in its dealer capacity that are dividend equivalent payments and dividends on underlying securities associated with potential section 871(m) transactions over (B) the dividend equivalent payments and the "qualifying dividend equivalent offsetting payments"[7] that the QDD makes or is contractually obligated to make in its dealer capacity with respect to the same underlying dividend.[8] A "qualifying dividend equivalent offsetting payment" is a dividend equivalent embedded in a client trade with a sufficiently high delta to be in scope for section 871(m) purposes but for the fact the trade was executed with a US person or is effectively connected income to a foreign counterparty.[9] With regard to the section 871(m) amount, as currently drafted, the precise inputs for qualifying dividend equivalent offsetting payments do not take into account members' hedging strategies which often net positions across books (*e.g.*, a delta one single stock book, an options book, and an index book) within a single entity and could result in a tax liability that does not reflect the true economic position of the dealer.

Dealers generally do not take a directional view on an underlying asset, but rather, seek to profit from fees and on the spreads captured between their hedges and client trades. Profit margins are typically slim. To be profitable, dealers must pursue effective hedging strategies as inefficient hedges may be capital intensive and cost-prohibitive. For example, hedging on a gross basis may lead to higher margin and collateral requirements under Financial Industry Regulatory Authority (FINRA) Rule 4210.[10] Even intercompany hedges require the posting of collateral under these

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[5] Prop. Treas. Reg. § 1.871-15(j), 48 Fed. Reg. 73128-01 (December 5, 2013).
[6] Prop. QI Agreement, section 2.67.
[7] Prop. QI Agreement, section 2.79.
[8] Prop. QI Agreement, section 2.80.
[9] Prop. QI Agreement, section 8.03(C).
[10] FINRA Rule 4210 describes margin requirements for various equity and fixed income security and derivative transactions with the goal to minimize counterparty credit risk. Among other things, the rule

rules; it therefore would be inefficient to hedge on a gross basis and post more collateral than would be necessary if hedging were done on a net basis. Effective equity derivative hedging strategies include those done at a macro-level that consolidate overall exposure to a given equity across client trades within one net offsetting position. This strategy is often more efficient than a hedging strategy that requires a back-to-back hedge to be created for every individual client trade, especially after accounting for the personnel time and costs associated with booking each intercompany hedge. Although there are instances when back-to-back micro-hedging is appropriate, there are significant transaction and balance sheet usage costs associated with micro-hedging on a large scale.

When a dealer properly offsets client positions, there should be no (or de minimis) long exposure left to subject to tax, but the section 871(m) amount results in uneconomic tax consequences when, for example –

(1) Grandfathered short positions are hedged with non-grandfathered delta one/high delta positions;
(2) Qualified index short positions are hedged with delta one/high delta positions on a single stock (a component of the index) or non-qualified index; or
(3) Low delta short positions are hedged on a macro basis with a delta one/high delta position.

All three of these examples represent transactions where there will be no withholding tax due on the client leg because the transactions are out-of-scope for section 871(m) purposes. The QDD, on the other hand, will be subject to tax in all three instances merely on account of using an efficient hedge to obtain neutral exposure to the out-of-scope client-driven transaction. If the QDD had instead pursued micro hedges that were inefficient from a business and regulatory perspective (e.g., by entering into back-to-back trades with similarly low deltas or qualified index status), the QDD would not owe any section 871(m) related QDD tax liability. Based on business and regulatory constraints, a QDD does not have the luxury of altering its hedging strategies to obtain a better tax result, especially where the alternative hedge would give rise to the same exposure, or lack thereof. SIFMA members do not believe that Treasury and the IRS intentionally aimed to advance a proposal that would force financial institutions to choose between prudent business practices and fair tax results.

The withholding tax rule under the final regulations provides certainty for long party clients as to the amount of withholding that they will suffer; however, under the proposed QI Agreement QDDs will have uncertainty as to how much tax liability they will incur with respect to trades that are fully hedged from an economic perspective.[11] Even in-scope, non-delta one client trades, which are treated as having static deltas (*i.e.*, fixed at issuance per Treas. Reg. § 1.871-15(g)(2)),

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provides details regarding maintenance of margin and variation margin requirements, risk limit determinations, and concentrated exposures.

[11] The members of SIFMA are also uncertain as to whether they will be able to claim a foreign tax credit in their country of tax residence for U.S. taxes paid with respect to the QDD tax liability.

could give rise to section 871(m) tax amounts because these will be hedged with positions that may need to offset an increased delta over time. This is because economically the client's delta, and therefore the delta of the associated hedge, change over time based on factors such as volatility and time to maturity of the derivative. Dealers subject to the Volcker Rule[12] are required to set limits on the amount, types, and risks of their market-making activities and related risk management and to maintain their portfolios within those limits.

Consider an example where a client approaches a QDD to engage in a section 871(m) transaction involving a 0.8 delta option over 100 shares of IBM. The QDD initially hedges this client transaction by buying 80 shares of IBM but then subsequently adjusts its hedge to 90 shares as the delta of the client position increases to 0.9. IBM pays a $1 dividend. Under these facts, the section 871(m) amount would be $10, computed as follows: $90 in dividends received on the physical shares in the dealer book less $80 deemed paid out of the dealer book. This is not an appropriate result because the net $10 of exposure is solely the result of the fixed delta required to calculate the dividend equivalent payments treated as made out of the dealer book.

a. Request for revisions to the computation of the section 871m amount

The members of SIFMA believe the statute provides broad authority to eliminate cascading withholding in a chain of dividend equivalents[13] and therefore would support aggregating all potential section 871(m) transactions[14] and associated equity positions to determine the section 871(m) amount based on the true economic position of the dealer as described above. Further, a QDD should be permitted to determine its section 871(m) amount by either (1) determining the dividend and dividend-related payments on a transaction-level basis; or (2) utilizing its net delta exposure to an underlying security provided that the QDD determines its net delta exposure for a business or non-tax regulatory purpose.

For determining the section 871(m) amount on a transaction-level basis, SIFMA requests that the offsetting payments be expanded to encompass all client transactions that are potential section 871(m) transactions. Offsets should be allowed to the extent that the client transaction references one or more dividend-paying US equities, regardless of whether the transaction is in scope. Thus, amounts paid with respect to grandfathered trades, trades with a delta of less than 0.8 at issuance, and trades involving qualified indices should all be included as offsets. A conforming expansion

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[12] The so-called "Volcker Rule" is section 619 of the 2010 Dodd-Frank Act and the implementing regulations thereunder. Entities subject to the Volcker Rule are prohibited from engaging in "proprietary trading" or owning or sponsoring "covered funds"(each as defined in the rule), except as otherwise permitted under the rule. The rule includes an exemption for market-making activity on behalf of clients and related hedging activities.

[13] I.R.C section 871(m)(6) states: "In the case of any chain of dividend equivalents one or more of which is subject to tax under subsection (a) or section 881, the Secretary may reduce such tax, but only to the extent that the taxpayer can establish that such tax has been paid with respect to another dividend equivalent in such chain, or is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in such chain."

[14] For this purpose, the term "potential section 871(m) transaction" should be interpreted in a manner that is agnostic to the tax status of the counterparty, consistent with the current draft guidance.

should be made on the incoming side of the dealer book—*i.e.*, amounts received in the dealer book from potential section 871(m) transactions, in addition to dividends and dividend equivalent payments received. The QDD would essentially treat a potential section 871(m) transaction as if it were a section 871(m) transaction. For each potential section 871(m) transaction (including a section 871(m) transaction), the QDD would compute a dividend-related payment by multiplying the live delta[15] as of the close of the day before ex-date of each underlying security by the per share dividend. The section 871(m) amount would be the amount by which (1) the dividends on underlying securities associated with potential section 871(m) transactions and dividend related payments exceed (2) dividend related payments the QDD makes or is contractually obligated to make with respect to the same dividend in its dealer capacity.

Instead of calculating dividend equivalents paid and received on a transaction-level basis, a QDD should be permitted, at its option, to determine its section 871(m) amount by calculating: (1) the net delta exposure (measured in number of shares) of the QDD (aggregated across all US equity and equity derivative transactions entered into in a dealer capacity (whether client or hedge transactions) as of the close of the day before ex-date of each underlying security, multiplied by (2) the relevant dividend amount per share. A sample of the calculation method is detailed in the Attachment to this letter. SIFMA members believe that using the net delta methodology captures the true residual exposure in the hands of the QDD and allows the QDD to leverage a calculation already performed for the following non-tax regulatory purposes:

i. Net delta used for compliance with market risk exposure limits

Generally a regulated dealer entity will have a specific limit for (long or short) delta exposure to any single US equity, as well as similar limits per country, region, sector, etc. Compliance with these limits is monitored in real time by market risk control functions, and any noncompliance with a limit is escalated quickly to senior management. Hence, this information (*i.e.*, net delta by security) is monitored globally on a live basis and is readily available for the section 871(m) component of the QDD tax liability calculation. It also may be easily audited by comparing reported numbers for a given US equity on the close of the day before ex-date to market risk records on the same date.

ii. Net delta used for determination of risk-weighted assets and bank capital requirements

Apart from the market risk concerns associated with a QDD being net long or short equities, there is a direct capital cost associated with this position, which may well exceed any withholding tax charged on such position.

For bank holding companies and many regulated dealer entities that would serve as QDDs, the calculation of risk-weighted assets (RWA) takes into account net delta per equity – any net long or short exposure to an equity attracts RWA – which in turn requires an allocation of capital to support the exposure and thus has a direct cost to the parent firm. At the end of each quarter, net

[15] The live delta is the number of shares hedging the potential section 871(m) transaction.

delta per security is calculated and checked carefully by front office personnel and control functions as it feeds directly into the firm's published results and financial statements.

b. Other adjustments to the section 871(m) calculation

As explained above, QDDs should not be subject to tax simply for making standard hedging adjustments to keep their economic exposure to the underlying security flat, which is precisely what the QDD rules were intended to acknowledge. Accordingly, the computations described above reflect symmetric inputs for delta from a timing perspective—*i.e.*, capture "live deltas" on both the hedge and client legs.

SIFMA also requests that an option should be provided for QDDs either to treat indices and exchange traded funds (ETFs) as an underlying security or to assess each component separately.

2. Timing of deposits

The QDD tax liability related to the QDD's section 871(m) amount and dividend equivalent payments received by the QDD in a non-dealer capacity are due at the time the dividend is paid on the underlying security, as provided in Treas. Reg. § 1.1441-2(e)(4). The members of SIFMA understand that this is intended to be a self-assessment on amounts the QDD receives that otherwise would have been subject to withholding. However, in many cases, the QDD tax liability would be due before the withholding agent would have otherwise been required to withhold on the QDD. Treas. Reg. § 1.1441-2(e)(8) provides the general rule for withholding on dividend equivalent payments and, absent the QDD exception, a withholding agent would have been required to withhold when (1) money or other property is paid; (2) in the case of a section 871(m) transaction described in § 1.871-15(i)(3), a payment is treated as being made at the end of the applicable calendar quarter; or (3) there is a sale, exchange, transfer, or other disposal of the section 871(m) transaction (including by settlement, offset, termination, expiration, lapse, or maturity).

As explained above, the QDD tax liability related to the section 871(m) amount is complex operationally. For administrative ease, SIFMA requests that the QDD be required to calculate its section 871(m) amount on a quarterly basis and deposit accordingly. Further, for dividend equivalent payments received by QDDs in a non-dealer capacity, QDDs should not have to pay their QDD tax liability for such amounts prior to the time the withholding agent would have otherwise been required to withhold. SIFMA requests that the IRS and Treasury allow a QDD to elect to self-assess the QDD tax liability for dividend equivalent payments received in its non-dealer capacity when either the dividend equivalent payment is considered made under Treas. Reg. § 1.1441-2(e)(8) or the dividend payment date for the underlying security that is referenced by the section 871(m) transaction.

SIFMA members will not have automated systems to calculate and self-assess the QDD tax liability by January 1, 2017, and it is likely that members will not have automated systems to withhold tax under section 871(m) with respect to all client transactions. As a result, members will struggle to do manual withholding in the timeframe required by the regulations. Moreover, many

non-US firms are performing US withholding for the first time as part of the section 871(m) regime. Given these facts, SIFMA further requests that the QDD not be liable for any penalties related to failure to pay or deposit if the QDD pays the client's US withholding tax and its QDD tax liability by the due date for filing Form 1042, without extensions. US withholding agents should be provided similar penalty relief. The extraordinary complexity of this withholding regime warrants providing taxpayers with this extra time to comply should a withholding agent need it.

3. QDDs as determining or responsible party for purposes of section 871(m) regulations

Notwithstanding the general rule under the section 871(m) regulations providing that, when there are two broker/dealer counterparties, the short party broker/dealer needs to make the section 871(m) determinations,[16] SIFMA requests that the QI Agreement clarify that:

(1) a short party broker/dealer that faces a QDD that confirms it will not request any section 871(m) information from the short party does not have an obligation to calculate, provide or store section 871(m) information related to any potential section 871(m) transactions it enters into with QDD, unless the short party is itself a QDD with its own obligations to calculate and store such information under the QDD rules; and

(2) a long party that is a QDD may rely on its own section 871(m) determinations for purposes of QDD tax liability calculations.

B. Definition of Eligible Entity

1. Regulatory requirement

SIFMA requests that QDD status be granted to additional "eligible entities," including subsidiaries of regulated securities dealers and bank holding companies provided that the entity at issue regularly engages in issuing potential section 871(m) transactions to customers and receives dividends or dividend equivalent amounts pursuant to potential section 871(m) transactions to hedge those customer transactions.

Treas. Reg. § 1.1441-1T(e)(6)(ii) provides that an "eligible entity" is a QI that is:

> (A) A dealer in securities subject to regulatory supervision as a dealer by a governmental authority in the jurisdiction in which it was organized or operates; or
> (B) A bank subject to regulatory supervision as a bank by a governmental authority in the jurisdiction in which it was organized or operates or an entity that is wholly-owned by a bank subject to regulatory supervision as a bank by a

[16] Treas. Reg. § 1.871-15(p).

> governmental authority in the jurisdiction in which it was organized or operates and that (1) issues potential section 871(m) transactions to customers; and (2) receives dividends with respect to stock or dividend equivalent payments pursuant to potential section 871(m) transactions that hedge potential section 871(m) transactions that it issued.

The proposed QI Agreement clarifies that "wholly-owned" may include both direct and indirect ownership by a bank and foreign branches of US financial institutions may also be considered "eligible entities" but otherwise adheres to the base definition laid out in the regulations under section 1441. The definition of eligible entity does not include other entity types in a financial institution group (e.g., structured note issuers that are outside the direct banking chain) that may not be directly regulated themselves.

As detailed in the SIFMA comment letter on the proposed regulations under IRC Sec. 385 dated July 6, 2016, financial groups that include banks, bank holding companies and dealers in securities, including derivatives, are subject to a number of wide-ranging regulatory regimes and rules that constrain or affect virtually every aspect of their businesses. While these regulatory regimes and rules apply with the greatest force to banks and other fully regulated members of the group, they apply in significant part to or affect all of a regulated financial group's members. For example, bank holding companies with total consolidated assets of $50 billion or more are required to comply with capital planning and stress testing requirements as an enhanced prudential standard. Regulatory rules also require such a bank holding company to adhere to enhanced risk-management and liquidity risk-management standards, conduct liquidity stress tests, and hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event. In addition, a publicly traded bank holding company that exceeds $10 billion in assets is required to comply with certain provisions of the Federal Reserve's enhanced prudential standards, which impose a number of detailed requirements concerning risk management and governance. In many cases, even where there is not a specific regulation or guidance that applies to a transaction, regulators have broad powers, under their consolidated supervisory authority, to encourage or require, or discourage or prohibit, various actions and transactions that the regulator believes may adversely affect the financial position of the parent and/or various members of the group.

Accordingly, SIFMA requests on behalf of our members that an "eligible entity" include subsidiaries of regulated securities dealers and bank holding companies provided that the entity at issue is regularly engaged in issuing potential section 871(m) transactions to customers and receives dividends or dividend equivalent payments pursuant to potential section 871(m) transactions to hedge the transactions issued to customers. Such expansion (or clarification of current applicability) is consistent with the intent of the rule because such entities are generally part of larger financial groups that are heavily regulated.

Further, by becoming QDDs, entities are subject to IRS review through the required compliance procedures. The fact that these entities are certifying directly to the IRS that they are in compliance with the QDD rules and are subject to an IRS correspondence review should provide additional assurance to the IRS that appropriate measures will be undertaken to ensure that withholding and reporting are properly done. Indeed, it may be appropriate to expand the eligible

entity definition further to include entities that are not owned by a regulated entity but that regularly enter into 871(m) transactions, such as a structured note issuer that is a special purpose vehicle[17] owned by a third party that is not regulated.

2. Qualification issues regarding disregarded entities

For an entity to be a QDD, it must be eligible as both a (i) QI and (ii) QDD. Treas. Reg. § 1.1441-1T(e)(6)(i) provides that "to act as a qualified derivatives dealer under a qualified intermediary agreement, a qualified intermediary must be an eligible entity as described in paragraph (e)(6)(ii) of this section…." Treas. Reg. § 1.1441-1T(e)(6)(ii) provides further that "an eligible entity is a qualified intermediary…" The definition of a qualified intermediary is found in Treas. Reg. § 1.1441-1T(e)(5)(ii), which provides that a qualified intermediary means a "person" that is a compliant financial institution for FATCA purposes, a foreign branch of a US financial institution, clearing organization, or foreign corporation presenting claims on behalf of shareholders, or any other "person" acceptable to the IRS.

A disregarded entity is generally not considered to be a person under section 7701(a)(1) ("the term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation"). This would mean that a disregarded entity might not meet the regulatory requirements for QI status. However, in its discretion, the IRS has granted QI status to entities that do not strictly meet the regulatory definition. Notwithstanding the technicalities of being eligible to attain QI/QDD status, SIFMA recommends that Treasury and IRS clarify that an entity engaging in dealer activities involving potential section 871(m) transactions may become a QI/QDD, even if such entity is a disregarded entity. Alternatively, if the regulations require that the single member owner (as opposed to the disregarded entity itself) apply for QI/QDD status, the activities and regulation of the disregarded entity should be sufficient to qualify the single member owner because the disregarded entity should be treated like a branch of the single member owner for U.S. tax purposes.

C. Timing of withholding

The proposed QI Agreement provides: "If QI is acting as a QDD, it must assume primary chapters 3 and 4 withholding responsibility for any dividend equivalent payment that it makes and must withhold with respect to a dividend equivalent payment on the dividend payment date for the applicable dividend (as determined in Treas. Reg. § 1.1441-2(e)(4))." [18] The proposed QI Agreement seems to require self-assessing and withholding by the QDD on the dividend date rather than when a payment of a dividend equivalent is considered made under Treas. Reg. §

[17] It should be noted that the use of special purpose vehicles in these situations is not tax-motivated, but rather, to reduce or eliminate credit risk exposure to the banking chain. Other third parties that are not special purpose vehicles and that issue potential section 871(m) structured notes may also be excluded from the definition of eligible entity. A third party may be used in these cases for non-tax business reasons, including diversification of credit risk. From the issuer's perspective, it receives compensation for the use of its balance sheet through less expensive funding.

[18] Prop QI Agreement, section 3.03(B).

1.1441-2(e)(8). Requiring withholding on the dividend date would cause cashless withholding in many situations, which QDDs would need to address through collateral or similar arrangements. While the temporary and final regulations require a limited amount of cashless withholding (for example, upon lapse of an option), requiring contemporaneous withholding for any trade without current payments (including listed and OTC options, forwards, futures, etc.) is a significant departure from the approach in the final regulations and would require substantial efforts by QDDs to comply without introducing additional credit exposure.

In an effort to comply by January 1, 2017, the members of SIFMA have been developing their systems based on the requirements in the final regulations. They have spent significant time working on systems that will treat the dividend equivalent amount as paid when a "payment" occurs pursuant to Treas. Reg. § 1.1441-2(e)(8). The divergent rules for QDDs would require beginning anew with different systems builds. The members of SIFMA leverage the same withholding system and process for both their US and non-US operations. SIFMA members do not have sufficient time or IT capabilities to build multiple systems or program their systems with different logic for different entities and the appropriate level of associated controls.

More importantly, and consistent with previous comments, SIFMA requests that withholding agents (including QDDs) be allowed to elect to treat a dividend equivalent amount as paid either when a payment occurs under Treas. Reg. § 1.1441-2(e)(8) or on the dividend payment date for the underlying security that is referenced by the section 871(m) transaction. The current rules in the final regulations should remain the default approach as many withholding agents believe that building systems based on payments, as defined in the regulations, remains the most time and cost efficient build. However, for certain transactions, such as structured notes, some withholding agents believe that it will be easier to build systems based on the time of the payment of actual dividends on the underlying security.

D. Reconciliation Schedule

The members of SIFMA cannot decipher the requirements of the reconciliation schedule as currently drafted because the sentence structure does not specify which items need to be stated separately. The proposed QI Agreement provides:

> The reconciliation schedule must separately state total amounts received as a QDD, as well as the dividends, dividend equivalents, and qualifying dividend equivalent offsetting payments for each dividend with respect to each underlying security associated with potential section 871(m) transactions, each dividend that is not with respect to an underlying security associated with potential section 871(m) transactions, or each dividend with respect to each underlying security referenced by a potential section 871(m) transaction received as a QDD or payments that the QDD makes or is contractually obligated to make, and any adjustments thereto, separated by payments made as a dealer and as a non-dealer.[19]

[19] Prop. QI Agreement, section 7.01(C).

The members of SIFMA believe the correct interpretation is that a QDD must show on a dividend-by-dividend basis with respect to each underlying security: (1) the amount of each dividend and dividend equivalent the QDD received; and (2) dividend equivalent payments and qualifying dividend equivalent offsetting payments that the QDD has paid or is contractually obligated to pay.

SIFMA requests that the reconciliation schedule support only the computation of the section 871(m) amount. If the QDD elects to calculate the section 871(m) using a net delta approach described above, SIFMA requests that instead of the reconciliation, a QDD have record- keeping responsibilities to substantiate the calculation of the section 871(m) amount and can also separately substantiate how the net delta was determined for each dividend payment.[20]

Amounts received in a non-dealer capacity or amounts received that are not with respect to an underlying security associated with potential section 871(m) transactions should not be included in any record-keeping or reconciliation schedule because a QDD's tax liability for these amounts is based on the gross payments received. Unlike the section 871(m) amount, these amounts do not require a netting computation.

E. Allowance of a credit forward system

SIFMA requests that Treasury and the IRS permit the credit forward system for securities lending transactions to continue and to expand such allowance to any back-to-back 871(m) transactions. Given the unprecedented nature of the proposed QDD system and section 871(m) generally, it is critical that financial institutions have sufficient alternatives to utilize in order to prevent unnecessary excessive withholding in a chain of transactions to which tax may be applicable. Financial institutions have utilized the credit forward system for securities lending transactions to avoid developing and maintaining costly withholding systems. The removal of this allowance would cause significant increases in transaction costs and prohibit some entities from engaging in these transactions.

The preamble to the section 871(m) regulations states that the IRS has had difficulty verifying that prior withholding in a chain of securities loans had in fact occurred in order to justify the crediting of prior withholding to a subsequent payment.[21] However, the members of SIFMA believe that the revisions that have been made to the Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, in recent years allow the IRS to verify the prior withholding and that the credit forward system therefore should be allowed to continue. In addition, SIFMA requests an expansion of the credit forward system for delta one section 871(m) transactions for this same reason.

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[20] As described above, net delta is computed in a "commercially reasonable" manner and the QDD maintains records to support the net delta calculation for a business or non-tax regulatory purpose.
[21] T.D. 9734, 2015-41 I.R.B. 500.

The Form 1042 now requires an entity to attach the Form 1042-S that it received from another withholding agent to verify the credit amounts claimed for withholding. The Form 1042-S also now includes the primary withholding agent box which requires a withholding agent reporting amounts withheld by another withholding agent to report the name and EIN of the withholding agent that withheld. The addition of this box allows the IRS to confirm the initial withholding agent in a chain of transactions and verify the deposit.

F. Joint Account and Agency Options and QDD

Under section 4.05 of the current QI Agreement, a QI may enter into an agreement with a nonwithholding partnership or nonwithholding trust to apply the simplified joint account documentation, reporting, and withholding procedures. However, the proposed QI Agreement explicitly excludes QIs from entering into such agreements for account holders for which it acts as a QDD. [22] A similar prohibition applies to the use of the agency option when acting as a QDD.[23] Since the joint account or agency option merely provides simplified documentation, reporting, and withholding processes, SIFMA requests that QDDs be allowed to apply the joint account or agency options and the exclusion of QDDs in sections 4.05(A) and 4.06 be removed.

G. QDD withholding exemption

The regulations provide that a QDD must assume withholding responsibility for dividends and dividend equivalents that it receives and makes in its dealer capacity and thus a withholding agent is not required to withhold such amounts paid to a QDD.[24] The Notice expands the scope of payments for which an entity may act as a QDD to payments with respect to potential section 871(m) transactions, whether or not the payments are received or made in its dealer capacity.[25] This expansion requires the QDD to build systems to track and report U.S. source fixed, determinable, annual or periodic income (FDAP) income payments made with respect to potential section 871(m) transactions that are not dividends or dividend equivalents payments and to self-assess tax applicable to these payments.

U.S. withholding agents already have the infrastructure in place to withhold on these payments and QDDs should not have to develop systems to track and assess tax on these payments. SIFMA requests that a QDD not be required to assume withholding responsibility for payments other than dividend and dividend equivalent payments. Accordingly, the QI Agreement should be revised consistent with the regulations.

The members of SIFMA recognize that this request will require a withholding agent to document a potential section 871(m) transaction with multiple withholding certificates, which is challenging to implement from an operational perspective, and further request that the QDD certification be included on the Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax

[22] Prop. QI Agreement, section 4.05(A).
[23] Prop. QI Agreement, section 4.06.
[24] Treas. Reg. §1.1441-1T(e)(6).
[25] Prop. QI Agreement, sections 3.01(B) and 6.01.

Withholding and Reporting (Entities), to eliminate the need to provide multiple withholding certificates.

H. Section 871(m) implications for QIs

Many entities will have both QI obligations as an intermediary and through QDD operations. These activities will often be segregated by business lines or departments within the same legal entity. Typically the custody department deals with private and institutional investors and its systems, processes, and procedures are separate and distinct from those departments engaging in derivatives dealing. It is essential that the QI intermediary activities continue to operate under existing procedures without disturbance from the QDD procedures. More specifically, SIFMA requests the following:

1. Separate Form 1042-S reporting. For financial institutions that have separate back office functions, it will be operationally challenging to aggregate payments made when acting in an intermediary capacity and QDD (principal) capacity. Therefore, SIFMA requests that a QI be able to elect to separately report on Form 1042-S its QI intermediary and QDD activity. We note that the current and proposed QI Agreements allow a QI to report for each branch separately, apparently because of similar concerns about aggregating payments across systems.[26]

2. Clarify that a QI can operate as non-withholding QI for its non-QDD intermediary activity, despite the same legal entity operating as primary withholding agent for its QDD activity;

3. Separate compliance, review and certification requirement. The systems, process, and procedures for QI intermediary activates and QDD activity will be entirely different in many aspects. As many existing responsible officers (ROs) are only familiar with the intermediary business and have no knowledge of the derivatives trading business, a QI should be permitted to appoint a dedicated QDD RO.

4. Separate years for periodic reviews. SIFMA requests that the QI make two separate certifications and that the periodic review be conducted separately and, at the election of the QI, be conducted for differing years. Section 10.05 of the proposed QI Agreement indicates that QI is required to arrange for the performance of one review for the certification period and that if QI is acting as a QDD, this should also include a review of QDD related compliance. It is unclear whether the QI (non-QDD) review and QDD reviews can be conducted for different calendar years within the certification period. Clarification should be provided to confirm that different calendar years may be selected.

[26] QI Agreement, section 8.01.

5. QIs holding Section 871(m) instruments in custody. For QIs acting as an intermediary, although they are a party to the transaction, SIFMA requests that the QI not be held liable if the information is not proactively made available. QIs may hold in custody instruments such as structured notes that are purchased by clients and not issued or distributed through the QI. It is overly burdensome to require QIs to request information on all products to determine which are subject to section 871(m).

II. Issues involving securities lending and sale repurchase-transactions

A. Request for continuation of Qualified Securities Lender (QSL)

The preamble of the section 871(m) regulations and proposed QI Agreement anticipate the end of the Qualified Securities Lender (QSL) regime provided for in Notice 2010-46.[27] SIFMA requests that controlled foreign corporations (CFCs) that engage solely in securities lending and sale-repurchase transactions be allowed to continue to operate under the QSL regime in Notice 2010-46 and not be required to be QIs/QDDs. The QSL regime recognizes that CFCs are subject to audit by the IRS under section 7602 and thus the compliance verification requirements imposed by the QI Agreement are unnecessary.

Further, SIFMA requests that the QDD rules be amended to provide that a QDD solely engaging in securities lending and sale-repurchase transactions covered by section 871(m) should not be required to compute a QDD tax liability (including the section 871(m) amount) since there is always a requirement that the full amount of any dividends received be passed on as substitute dividends. No concept of delta even exists for these transactions in the context of the section 871(m) regulations as they will be fully in scope to the extent they involve a dividend-paying US equity since the transaction requires the complete transfer of an actual dividend payment stream. Accordingly, an identifiable audit trail already exists to prove there is no net exposure for these transaction types without the necessity of introducing additional rigor and complexity into the process.

B. Agency securities lending and sale-repurchase transactions

SIFMA requests confirmation that entities acting as agents of lenders in securities lending or sale repurchase transactions not be required to obtain QDD status. The preamble to the proposed QI Agreement provides seemingly conflicting statements about when an entity is required to act as a QDD for securities lending and sale-repurchase transactions. The preamble first provides the following:

[27] I.R.S. Notice 2010-46, 2010-24 I.R.B. 757.

> The proposed QI agreement will require a QI to act as a QDD for all securities lending and sale-repurchase transactions the QDD enters into that are section 871(m) transactions, in addition to acting as a QDD for payments with respect to other potential section 871(m) transactions and underlying securities as a principal. All securities lending and sale repurchase transactions the QI enters into that are section 871(m) transactions will be deemed to be entered into by the QI as a principal and therefore within the QDD regime.[28]

However, later in the preamble it states:

> A QI, however, may not act as a QDD when it receives or makes a payment with respect to a potential section 871(m) transaction as an intermediary as opposed to as a principal (for example, when the QI acts as a custodian of a structured note with a payment referencing a dividend of a domestic corporation).[29]

These two statements appear to be at odds with one another. The members of SIFMA believe the intent was to clarify that an entity that engages in securities lending and sale-repurchase transactions should be treated as principal where there is any uncertainty as to whether they are treated as principal or an intermediary. However, in instances where an entity is clearly acting as an agent or an intermediary, SIFMA requests clarification that such an entity will continue to be treated as an agent or intermediary. For example, an entity acting solely as an agent with respect to a securities lending transaction should continue to be treated as an agent. In these instances, an intermediary or agent should not be viewed as a principal and should not be required to obtain QDD status.

III. Compliance procedures

A. Certification period and due date of certification and factual information

The current deadline for RO certifications and the completion of the periodic review is far too aggressive, effectively providing just three-and-a-half months for the completion of the first reviews. SIFMA recommends that the IRS extend the completion date by six months, with a further six month extension available (and automatically granted for reviews of 2017) to allow a reasonable time for the reviews and certifications.

Section 10.03 of the proposed QI Agreement requires that ROs of QIs certify the QI's internal controls by July 1 of the calendar year following the end of the three-year certification period. The RO can "rely on any reasonable procedure, process, or review that enables the responsible officer to make the certification." Section 10.04 states that the RO must, at the same time, provide the factual information described in Appendix I of the QI Agreement, which includes information about the required periodic review (unless QI qualifies for a waiver of the periodic review). Thus, any periodic review, and any other procedures, processes or reviews to be relied upon by the RO

[28] Prop. QI Agreement, preamble section 2.01(F).
[29] Prop. QI Agreement, preamble section 2.01(B).

in making the certification of internal controls, would need to be completed within six months of the end of the certification period.

QIs with initial certification periods that end on December 31, 2017 and that act as QDDs are required by section 10.05 to use 2017 as the periodic review year. Even in the absence of this requirement, many QIs would prefer to use 2017, the third and final year of the certification period, as the year of the periodic review. The Forms 1042 and 1042-S for 2017, which must be included in any periodic review of that year, are not due until March 15, 2018. (Indeed, many institutions request an automatic 30-day extension to file Form 1042-S and an automatic six-month extension to file Form 1042, and thus will not complete the filings that would be the subject of the periodic review until September 15.) The effect of the deadlines above and other requirements, assuming all filings are made on an unextended timeline, will be to compress demand for both internal and external resources to verify internal controls and otherwise conduct periodic reviews into the three-and-a-half month period from March 15, 2018, to June 30, 2018. Taking extensions into account, the July 1, 2018 deadline makes even less sense.

SIFMA members believe that it is in the IRS's interest to extend the certification and factual information deadlines. Doing so should result in higher quality submissions by spreading out demand for qualified external resources and by not disrupting QIs' normal filing schedule. SIFMA proposes, on behalf of our members, that the deadline for RO certifications and the submission of factual information be changed permanently to December 31 of the year following the end of the certification period. QIs should also be able to obtain a six-month extension upon a showing of reasonable cause. For reviews of 2017, however, the extension should be automatic in light of the very substantial new requirements.

B. Factual information to be provided to the IRS

Our members note that the factual information required in Appendix I requires a QI to list all PAIs[30] and partnerships and trusts to which it applies the joint account or agency option. Some QIs could have thousands of such accounts. It will be extremely burdensome to provide such information continuously to the IRS. SIFMA requests that this requirement be removed and replaced with a requirement to provide such information upon request.

Our members also note that Part IV.E of Appendix I requires a QI to provide a reconciliation of amounts reported paid to the QI and amounts reported paid by the QI to determine the amount of any unreconciled variance which is to be reported on line 14 of the reconciliation. It appears that line 14 should be the difference, if any, between the total of amounts reported paid to the QI (i.e., the amount reported on line 3) and the aggregate of amounts reported paid by the QI (i.e., the amount reported on line 13). However, the reconciliation in Part IV.E currently excludes the amounts reported on line 15 from the total amounts paid and reported by the QI on line 13. As a result, any amount on line 15 will be incorrectly included in the variance. Therefore, SIFMA

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[30] A PAI is a "private arrangement intermediary." An intermediary is a PAI only if the conditions in Prop. QI Agreement section 4.01(A)-(H) are met.

members believe that the amounts to be reported on line 15 should be included in the total reported on line 13 and that the reconciliation should be adjusted accordingly.

C. Request to exclude QDD activity from first certification period

If the delay of section 871(m) implementation, including QDD, is not granted, SIFMA requests that QIs that become QDDs be allowed to exclude QDD activity from the first certification period. The 2017 year will be the first implementation year for QDDs and due to the complexity of the rules, it will be impossible for an entity to accurately assess its compliance in this initial year.

D. Application of policies, procedures and processes by QI branches

Section 10.03(A)(6) of the proposed QI Agreement requires the RO to certify that the QI's policies, procedures and processes are "applied consistently to all branches covered by the QI Agreement (except as otherwise required by a jurisdiction's AML/KYC procedures, as applicable)." Consistency across branches is not an appropriate criterion because the branches may be engaged in different businesses or have different client bases or systems. Rather than certifying that all branches have consistently applied the same policies, procedures and processes (subject to the AML/KYC exception), the RO should instead certify that branches covered by the QI Agreement have policies, procedures and processes.

E. Independence requirement

Section 10.04(A) of the proposed QI Agreement requires that the reviewer, whether internal or external, performing the periodic review be "independent". Specifically, the reviewer must not be reviewing its own work. An internal reviewer "must not be reviewing its own work, procedures or results. An external reviewer "cannot be reviewing systems, policies, or procedures or the results thereof that it was involved in designing, implementing, or maintaining."

The issue that section 10.04(A) raises is that it seemingly prevents any person or firm involved in developing a QI's procedures, systems, or policies from taking part in the review. This standard is unobtainable, particularly in light of the requirement that the reviewer be competent regarding the requirements of the QI Agreement. The number of employees within a QI that have the requisite knowledge to perform a periodic review is very limited. Employees with requisite knowledge necessarily will be involved in helping management make decisions regarding the implementation of the QI Agreement and, to the extent that the QI uses internal reviewers, they necessarily will have to provide guidance regarding the rules of the agreement. The same problem applies to the use of external reviewers. Many QIs seek the involvement of external advisors to implement the QI Agreement and in many cases they will use multiple advisory firms. The use of the term "independence" in describing the objectivity requirement also raises issues for external advisors, particularly accounting firms, since that term has very specific meanings under the various regulations that apply to such firms.

SIFMA members agree that objectivity by any person or firm involved in the periodic review is a critical element to ensuring the reliability of the periodic review. The members of SIFMA believe

the goal of objectivity can be met by providing that any individual that had management responsibility for implementation of the QI Agreement should not be significantly involved in the periodic review. Further, parties primarily responsible for: (1) reviewing client tax forms; (2) performing the withholding on clients; and (3) calculating the amounts required to be reported should not be a reviewer. On the other hand, internal and external parties that do the following should be allowed to do the QI review: (1) provide advice on what the FATCA / QI rules are and how they are applied to a particular client situation / tax form; (2) provide advice on how the withholding rules apply to a particular client situation or fact pattern, (3) assist in reporting by doing the physical submission of client data to the IRS or local tax authority but without being responsible for the correctness of the underlying data; and (4) provide quality assurance review services to the QI. While the members of SIFMA recognize that such a standard is somewhat imprecise, they believe the interest of the IRS can be protected by providing the IRS with general information regarding the persons or firm involved in the periodic review and whether they had any managerial involvement in the implementation of the QI Agreement. Further, SIFMA recommends on behalf of our members that in describing the objectivity standard, the term "independence" not be used to avoid any inference that professional standards implemented by other regulatory authorities are applicable to the periodic review.

F. Consolidated compliance program – waivers

Section 10.07 of the proposed QI Agreement contains a waiver from the periodic review requirement for certain entities. The waiver is not applicable, however, if an entity is part of a consolidated compliance program. Under the previous QI audit procedures (Rev. Proc. 2002-55[31]) that applied to the 2000 QI Agreement there was no such exclusion. SIFMA believes that there is no disadvantage to the IRS if a QI that otherwise qualifies for the waiver exception is included in a consolidated compliance program if it provides all of the compliance information required under section 10.07.

G. Material failures and event of default

The proposed QI Agreement includes two distinct lists of negative occurrences that trigger further obligations or consequences. "Material failures," defined by section 10.03(D), must be disclosed by an RO in the compliance certification of internal controls if corrected as of the date of the certification or in a qualified certification if not corrected as of the date of the certification, and the QI must pay any underpaid tax and act to prevent a recurrence of the failure. The QI Agreement provides that a failure is material if, among other things, it is due to failure to "establish written policies, procedures, or systems sufficient for the relevant personnel of QI to take actions consistent with QI's obligations under this Agreement…"

The members of SIFMA believe that this sufficiency standard will result in an unintended overreporting of "material failures." Any time there is an error, it is arguably because something was not sufficient. Instead, the standard should be whether there was a "failure to establish a

[31] Rev. Proc. 2002-55, 2002-2 C.B. 435.

policy, procedure, or control…" and that result in a material amount of underwithholding, understatement of the QDD tax liability, or underreporting.

"Events of default" require the RO to make the qualified certification regardless of whether corrected as of the date of the certification and permit the IRS to terminate a QI's agreement under section 11.01 if, in its sole discretion, the IRS determines that termination is warranted. Given the potentially catastrophic consequences of an event of default, the term must be defined by materiality. For example, section 11.06 lists the events of default, including section 11.06(A): "QI fails to implement adequate procedures, accounting systems, and internal controls to ensure compliance with this Agreement." The word "adequate" is a vague standard, and given the dire consequences, a vague standard should not be imposed. SIFMA recommends that the events of default impose of measurement of materiality as it is a standard that is familiar to industry and more in line with the consequences of an event of default. Further, an event of default should only occur in this instance if the QI fails to implement any procedures, accounting systems, and internal controls for compliance with the QI Agreement.

H. Projection method

Appendix II of the QI Agreement provides that if a reviewer has determined that underwithholding has occurred with respect to the sample, the reviewer will determine the total amount of underwithheld tax by utilizing a projection method.[32] SIFMA requests that the reviewer not be required to project underwithholding as a result of a single error. Under the previous QI Agreement, the IRS determined whether or not projection was required based on the results of the external audit report and depending on the number of failures identified in stratum. SIFMA requests that the projection method be done if requested as part of the correspondence review discussions with the IRS.

I. Clarification that underwithholding and underreporting should be determined after remediation efforts but no later than on or before the date of the certification

The regulations under section 1441 contain a procedure for obtaining documentation after a payment is made and relating that documentation back to the date of payment to permit a reduced rate of withholding.[33] Such documentation frequently reduces the withholding agent's liability to zero.

Section 10.06(A) states that the factual information required by Appendix I "should report the results upon initial review (i.e., not reflecting the results after curing) and the curing process should not delay certification of internal controls or factual information required in Appendix I to this Agreement." That section goes on to state that "to the extent necessary," the report should include information about curative documentation and revised withholding calculations.
The members of SIFMA agree with the IRS's sentiment that efforts to cure documentation failures should not delay the periodic review report. However, a report of the liability prior to cures will not show the QI's actual liability, which is calculated as if valid curative documentation

[32] Prop. QI Agreement, Appendix II, Section 3.D.
[33] Treas. Reg. § 1.1441–1T(b)(7)(ii).

was timely received. Accordingly, SIFMA recommends amending section 10.06(A) to provide that any withholding liability included in the report may take into account cures received prior to the date of the report.

J. Statistical sampling

Appendix II describes a safe-harbor statistical sampling method ("Safe-Harbor Method") which borrows heavily from the sampling methods used under the agreed-upon procedures in Rev. Proc. 2002-55 under prior versions of the QI Agreement. The Safe-Harbor Method requires that the QI draw samples from up to three distinct account populations: from its QDD accounts (if any), accounts that received substitute interest payments for which the QI assumed primary withholding responsibility (if any), and from other accounts for which it acts as a QI (but not as QDD or for securities lending purposes).[34]

1. Appendix II sampling methodology be updated to reportable amounts

From the population of all QI accounts, the reviewer is required to use a population that will consist of (1) all accounts held by U.S. persons (or account holders presumed to be U.S. persons) that received a reportable payment and (2) all accounts held by non-U.S. persons (or account holders presumed to be non-U.S. persons) that received a reportable amount.
"Reportable payment" is defined in section 2.75 differently for US payors and non-US payors, and for non-US payors it consists of only reportable amounts, proceeds of securities sales "effected at an office inside the United States," and foreign source income "not paid outside the United States." The terms in quotes are terms of art that are notoriously difficult to apply in practice. For example, they may depend on where the account holder was physically located when it issued an instruction to the QI. The members of SIFMA are concerned that periodic reviews may become unnecessarily focused on whether a particular payment or sale was made inside or outside the US, and thus should or should not be included in the population of accounts for US persons.
The IRS faced the identical issue when drafting the prior audit guidelines and defined "accounts covered by the QI Agreement," and thus subject to review, as those "to which the QI has made payments of reportable amounts during the audit year."[35] Once an account was included in the sample, any reportable payments made to that account were in scope. The revenue procedure says, "The IRS agrees that efficiency may be served by the initial selection of accounts based on receipt of reportable amounts." Those same efficiency concerns exist under the proposed QI Agreement and the Safe-Harbor Method, so the IRS should take the same approach.

2. Allowance for spot checks

Under Rev. Proc. 2002-55, the IRS recognized that running all the agreed-upon procedures on the full sample of accounts would be unnecessarily costly and time consuming, and, moreover, that the root of many compliance failures was inadequate documentation. Accordingly, Rev. Proc. 2002-55 allowed "spot checks" of pooling, withholding and reporting compliance in Phase 1 while

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[34] Prop. QI Agreement, Appendix II section 2(A).
[35] Rev. Proc. 2002-55, 2002-2 C.B. 435.

reserving a full-sample approach for documentation.[36] The spot check approach generally required a minimum of 20 accounts to be selected for a spot check. Full sampling of accounts for all tests was reserved for Phase 2 audits.

The spot check approach is completely missing from the Safe-Harbor Method without explanation. All procedures in the Safe-Harbor Method are performed on all sample accounts. Moreover, the Safe-Harbor Method generally requires a minimum of 50 accounts per stratum (or all accounts in a stratum if there are less than 50).

SIFMA recommends that the IRS incorporate spot checks for pooling, withholding and reporting compliance into the Safe-Harbor Method. The spot check method outlined in Rev. Proc. 2002-55 can guarantee that documentation of a statistically valid sample is subject to the full slate of tests, in recognition of the fact that documentation errors tend to cause other errors. At the same time, the spot check method strikes the proper balance of cost and benefit with respect to other errors – neither ignoring them nor requiring a full-blown statistically valid testing regimen. The IRS could, if it identifies issues that require more complete investigation in the factual disclosures made by a QI, make follow-up inquiries.

3. Stratum

The QI-only sample is subdivided into five distinct strata:

(1) A stratum of accounts held by recalcitrant account holders and non-participating FFI account holders.

(2) A stratum of accounts not included in the previously defined stratum of nonwithholding foreign partnerships and nonwithholding foreign trusts to which the QI applied the joint account option or the agency option.

(3) A stratum of all accounts held by direct account holders that are not U.S. non- exempt recipients and are not included in any previously defined strata.

(4) A stratum of all accounts that are held by direct account holders that are U.S. non-exempt recipients that are not included in any of the previously defined strata.

(5) A stratum of all accounts held by indirect account holders not included in any previously defined strata.

Stratum (1) refers to "recalcitrant account holders," which the QI Agreement defines in section 2.71 by cross-reference to Treas. Reg. § 1.1471-5(g). QIs who are FFIs in IGA countries will not

[36] *Compare, e.g.,* Rev. Proc. 2002-55, Sec. 2.02(ii), 2002-2 C.B. 43, section 10.03(A)(4) (full sample review of treaty statements) *with* 10.03(B)(4)(spot check of withholding rate pools).

be required to follow this regulation and therefore will not have systems to identify such account holders. SIFMA recommends stratum (1)'s description refer to non-consenting accounts as defined in a Model 2 IGA for QIs located in Model 2 jurisdictions. QIs located in Model 1 jurisdictions should be directed into which stratum to include accounts whose holders have not provided documentation when documentation was required to be requested under Annex I of the IGA.

Stratum (5) refers to accounts held by indirect account holders "not included in any previously defined strata."

The members of SIFMA believe that the intention of Stratum (5) is to test underlying indirect account holders of the QI's direct accounts that are flow-through entities and non-QIs documented with W-8IMYs, consistent with the third stratum identified in the audit guidance set out Revenue Procedure 2002-55, which was described as a "stratum of all indirect account holders covered by the QI Agreement."[37] Under this approach, the account for the direct account holder (*i.e.*, the flow-through entity or NQI) would be included in Stratum (3) and the individual indirect account holders of these entities each would be identified individually in Stratum (5).
If this is in fact the intention, we recommend that Stratum (5) be amended to read a "stratum of all indirect account holders." The reference to "not included in any previously defined strata" should also be removed.

Further, SIFMA requests clarification on the purposes of paragraph (G) of Section 1. The first paragraph of paragraph (G) provides a seemingly duplicate rule for stratum with less than 50 sample units. There is a rule provided in paragraph (D) of Section 1 for such instances. The second paragraph makes reference to strata with less than 20 accounts in the sample. However, it is unclear when these comments would apply given separate comments requiring minimum sample sizes of 50 per stratum. It is unclear what is added in paragraph (G).

IV. Other matters under the proposed QI Agreement

A. Limitation on benefits

1. Actual knowledge standard

Section 5.10(A) of the proposed QI Agreement contains rules requiring a QI to obtain a limitation on benefits (LOB) representation from beneficial owners making treaty claims. A QI cannot rely on the representation if it has "actual knowledge" that such claim is incorrect. The same section also states that a QI will be considered to have reason to know that a claim for treaty benefits is unreliable or incorrect if the beneficial owner claims benefits under a treaty that does not exist or is not in force.

[37] *See* section 10.04.4 of Rev. Proc. 2002-55.

The lack of any specific rules about what constitutes "actual knowledge" places QIs at risk for invalid documentation. A QI is unlikely to have the necessary information to determine the applicability of an LOB provision. Moreover, LOB provisions can be complicated even for tax professionals and those responsible for obtaining account opening documentation and validation, who are not tax professionals, cannot be expected to evaluate the applicability of LOB provisions. SIFMA requests that the IRS define "actual knowledge" using the same standard applicable to treaty claims in general; that is, a QI has actual knowledge that an LOB representation is incorrect only if the beneficial owner is claiming benefits under a treaty that does not exist or is not in force.

2. Pre-existing accounts

The Notice states that if a QI has relied on documentary evidence to establish a treaty claim for a pre-existing account, it will have a two-year transition period to obtain LOB information unless there is a change of circumstances that requires QIs to obtain corrected information. SIFMA requests that the pre-existing account rule be eliminated. The members of SIFMA do not believe that the benefit to the IRS of obtaining representations regarding specific LOB provisions is warranted when compared to the costs that the QI community would incur. If, however, the IRS ultimately requires specific LOB representations for specific accounts, SIFMA requests a three year transition period rather than two year so that requests for LOB information can be aligned with timing for existing processes many financial institutions have implemented to resolicit W-8 series forms from clients and counterparties that have made treaty claims for reduced rates of US withholding tax.

B. Term of agreement

The Notice states that the QI Agreement will be effective for three years. Presumably, the three-year period was chosen in relation to any potential FATCA rules relating to gross proceeds and pass-thru payments. SIFMA members believe that the agreement should be effective for 6 years to reduce the costs and burdens of having to renew QI Agreements. The interests of the IRS are sufficiently protected by its ability to amend the QI Agreement if so required by sound administration of the US tax laws.[38]

C. Coordination of Form 1099 and Form 8966 reporting

Sections 8.06(B)(1)-(3) provide a Form 1099 and Form 8966 coordination rule by eliminating the requirement of a QI to report on Form 1099 reportable payments (other than a reportable amounts) paid to a direct account holder that is (or is presumed) a U.S. non-exempt recipient if certain conditions are met. Generally, sections 8.06(B)(1)-(3) reference the conditions provided in Treas. Reg. § 1.6049-4(c)(4)(i) and (ii) which require that an account be reported on Form 8966 or the local law equivalent and that the payment not otherwise be subject to chapter 4 withholding or backup withholding. Backup withholding would be required under Treas. Reg. § 31.3406(g)–1T(e) if the payment is "paid and received outside the U.S." or "effected outside the U.S." and the QI has actual knowledge that the account holder is a U.S. person. As discussed above, the "paid and

[38] Prop. QI Agreement, section 12.02.

received outside the U.S." and "effected outside the U.S." rules are difficult to administer as it requires an analysis of client interactions and payment instructions. It should be sufficient for the account to be reported under the FATCA reporting requirements to alleviate Form 1099 reporting (or backup withholding). Alternatively, the coordination standard should be simplified to require backup withholding and Form 1099 reporting if the QI makes payments of interest, dividends, and sales proceeds to accounts in the U.S.

D. Form 8966 reporting following a merger or acquisition

Revenue Procedure 99-50 contains an election procedure permitting a successor entity of a merger or acquisition transaction to file Forms 1042-S, all forms in the series 1098, 1099, and 5498, and W-2G on behalf of itself and a predecessor entity in certain situations. The revenue procedure provides predecessor and successor entities with a practical alternative where a predecessor's systems, documentation, account information and personnel pass to a successor entity during the calendar year. The revenue procedure has not been updated to reflect FATCA reporting on Form 8966 (FATCA Report). SIFMA requests the IRS to update the revenue procedure to allow successor financial institutions to use the same elective procedure for Form 8966 as currently exists for other information returns.

E. Coordination with IGA due diligence procedures

Many QIs are Partner Jurisdiction Financial Institutions (PJFIs) under a Model 1 or Model 2 FATCA intergovernmental agreement (IGA). IGA Annex 1 establishes procedures for determining the FATCA status of a PJFI's account holders. A PJFI is not necessarily required to obtain documentation from the account holder in order to determine its FATCA status under Annex I. For example:

(1) For a preexisting account, if a PJFI "reasonably determines based on information in its possession or that is publicly available, that the Account Holder is not a Specified U.S. Person," the PJFI can treat the account holder as such

(2) A PJFI can rely on information maintained for regulatory or customer relationship purposes to determine if a preexisting entity account holder is a financial institution, and can rely on a verified GIIN or "information that is publicly available or in the possession" of the PJFI to treat the preexisting entity account holder as nonreportable. "In such a case," the IGAs emphasize, "no further review, identification, or reporting is required with respect to the account."

(3) A PJFI that determines a preexisting entity account holder is not a US person and is not a financial institution can further determine, based on "information in its possession or that is publicly available," that the entity is an active NFFE

(4) A PJFI can determine that a new entity account holder is an active NFFE or a PJFI based on the account holder's GIIN or "other information that is publicly available or in the possession" of the financial institution.

Section 5.01(A)(1) of the QI Agreement states that "QI is required to perform the due diligence procedures for each account holder for whom QI is acting under its FATCA requirements," including under an IGA if applicable. That section goes on to state that "To the extent an account holder receives a payment with respect to which QI has determined that withholding is not required under chapter 4," QI nonetheless should obtain documentation to determine the extent to which chapter 3 or chapter 61 applies. This language strongly implies that a determination of chapter 4 status under the procedures of the IGA also applies for purposes of the QI Agreement. On the other hand, section 5.13(A) states, "QI shall apply the presumption rules of section 5.13(C) of this Agreement if QI cannot reliably associate a payment with valid documentation from an account holder." Those rules in turn require the application of Treas. Reg. § 1.1471-3(f), which provides that an undocumented foreign entity is treated as a nonparticipating FFI. In the examples cited above, a QI would not have valid documentation as defined by the QI Agreement (i.e., a US tax form or documentary evidence), and would therefore be required by the literal language of section 5.13 to treat the account holder as a nonparticipating FFI, notwithstanding that section 5.01(A)(1) allows a QI to establish an account holder's FATCA status using information permitted by the IGA.

Further, the application of the Annex 1 due diligence procedures and local guidance in many Model 1 jurisdictions will generally result in an undocumented entity account being classified as a U.S. Reportable Account or non-consenting US Account. Under the Annex I due diligence procedures nonparticipating FFI status applies only when there is information indicating that the account holder is a financial institution. A QI, including a QI branch of a U.S. financial institution, should be permitted to establish an account holder's FATCA status using the standards of an applicable IGA. The QI should be able to couple that approach with documentary evidence to establish that the entity is a foreign beneficial owner, and should not be required to apply the presumption rules in a way that is contrary to the IGA.

In addition, the proposed QI Agreement would add to section 5.01(A)(1):

If an account holder receiving the payment is not the payee, QI is also required to establish the chapter 4 status of the payee or payees to determine whether withholding applies under chapter 4. See section 5.13(B)(1) of this Agreement for the requirements for QI to reliably associate a withholdable payment with a Form W-8IMY for chapter 4 purposes.

The first sentence does not explain what kind of "payment" it applies to, and if it were applied literally it would go well beyond what is required by the regulations with respect to payments that are not withholdable payments. The second sentence could be read as clarifying the first and limiting its scope to withholdable payments, but this should not be left open to interpretation. The beginning of the first sentence should be changed to read "If an account holder receives a withholdable payment but is not the payee…"

F. Recipient-specific reporting

1. Partnerships and trusts subject to joint account option

The QI Agreement generally permits a QI to report US source income on a pooled basis without identifying individual account holders. For certain kinds of account holders, however, the QI Agreement requires separate, recipient-specific Forms 1042-S for each beneficial owner or payee. Section 8.02(E) of the proposed QI Agreement would impose a new requirement for QIs to file recipient specific Forms 1042-S "for each account holder of QI that is a partnership or trust to which QI applies the joint account option that receives from QI an amount subject to chapter 3 withholding and is allocable to such entity's chapter 3 withholding rate pools." Under the joint account option, an account held by a flow-through entity is treated as a joint account provided all interest holders are properly documented and the QI applies the highest rate of tax applicable to any interest holder. See QI Agreement Section4.05.

Under section 4.05(B)(3) of the current QI Agreement, it is specifically permitted for a QI to report in its chapter 3 pools payments to direct account holders to which the QI applies the joint account rule:

(3) QI may include payments made to the partnership or trust in its chapter 3 reporting pools for direct account holders of QI for Form 1042-S purposes under section 8.03(B) of this Agreement. Indeed, a major incentive to apply the joint account rule, despite possible overwithholding, is to be able to use pooled reporting, which otherwise would not apply because of the requirement under current section 8.02(G) for a QI to file recipient specific forms for interest holders of flow-through entities.

Moreover, the revised version of section 4.05(B)(3) states:

QI may pool report amounts distributed to, or included in the distributive share of, the partnership's or trust's direct partners, beneficiaries, or owners in chapter 3 reporting pools on Form 1042-S as described in section 8.03(B) of this Agreement.

Thus, sections 8.02(E) and 4.05(B)(3) of the proposed QI Agreement seem to be in conflict. Pooled reporting is nominally permitted by section 4.05(B)(3), but it is not clear that a QI would really know whether the amounts were distributed or included in the distributive share of direct interest holders. It may not matter, because section 8.02(E) requires recipient specific reporting. The requirement for recipient specific information will greatly reduce the utility of the joint account option. SIFMA recommends that new section 8.02(E) not be adopted, and that the current version of section 4.05(B)(3) be retained.

2. Passive NFFEs

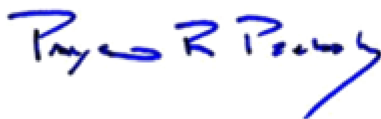
Sec 8.02(l) requires recipient specific reporting for each direct account holder that establishes the status as a passive NFFE but fails to provide the information regarding its owners as required under Treas. Reg. § 1.1471-3(d)(12)(iii) (which refers to "substantial US owners"). If this requirement is also intended to apply in the case of a passive NFFE that fails to identify controlling persons, if required, this provision should be amended.

V. Conclusion

We greatly appreciate your consideration of our members' views and concerns, and we would appreciate the opportunity to discuss the issues in this submission with you and your colleagues.

Please do not hesitate to contact me at (202) 962-7300 or ppeabody@sifma.org, or our outside consultants John Staples or Jeff Levey at Ernst & Young. John can be reached at (202) 337-5662 or john.staples@ey.com and Jeff can be reached at (202) 467-4813 or jeff.levey@wc.ey.com.

Respectfully submitted,



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Managing Director & Tax Counsel
SIFMA

Attachment: Sample Net Delta Calculation[39]

Consider the following scenario in the case of Apple stock:

- It is the day before Apple goes ex with a dividend of $0.57 per share.
- The QDD has 3 Apple-related transactions on its dealer book -
    1. Short 'in-scope' client option with live delta of -250 shares
    2. Long 'out-of-scope' client option with live delta of +50 shares
    3. Long 210 AAPL shares to hedge

The section 871(m) portion of the QDD tax liability, calculated longhand would be –
-$142.5 (-250 shares * $0.57/share)
+$28.5 (+50 shares * $0.57/share)
+ $119.70 (+210 shares * $0.57/share)
= $5.70
Calculated under the streamlined net delta methodology, the section 871(m) amount in the QDD tax liability would be the same, as follows -

1. QDD net share delta to AAPL as of the close of the day before ex-date = 10 shares
2. Section 871(m) amount = 10 shares * $0.57/share = $5.70

For a popular equity such as Apple, a QDD may have 1000s of individual US equity and equity derivative positions. The net delta approach reduces the number of calculations (as well as the audit complexity) significantly. Accordingly, SIFMA requests that this methodology be adopted in the final QI Agreement.

[39] Referring to Section I.A.1 of this letter.