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Invested in America

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Re: Submission on Proposed Regulations under Section 871(m)

Ladies & Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to submit comments on the new proposed regulations implementing Section 871(m) of the Internal Revenue Code (the "Proposed Regulations"). The members of SIFMA are fully committed to helping you make this approach work, and we have therefore focused our efforts on making constructive and practical recommendations that are designed to ensure its success.

In this regard, one of our primary concerns has been to ensure that the Proposed Regulations are operationally administrable. As currently drafted, the Proposed Regulations would base withholding tax liability on the continual application of newly-determined deltas to large volumes of financial transactions, and this liability might bear little relation to payments actually made. We are concerned that the information needed to support this approach would be difficult and costly to obtain and communicate. Likewise as currently drafted, the Proposed Regulations require actual withholding in the absence of actual payments. We do not think this

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. 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, visit http://www.sifma.org.

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would be practical in the case of traded financial instruments, and it would be difficult in other cases, for the reasons set out below.

SIFMA believes that it is in a unique position to make practical suggestions relating to implementation, because it generally represents the broker-dealers that execute U.S.-equity-linked financial transactions and that are obligated to withhold in respect of them. Moreover, our members have made special efforts to coordinate with each other to ensure that we have thought through our recommendations as fully as possible.

In brief summary of the discussion below, we are making the following recommendations which are further illustrated in the attached appendix:

## Executive Summary

### I. Overall Approach.

Because the Proposed Regulations chart new waters, the drafters should focus on the practical aspects of their implementation. In particular, the Proposed Regulations will not be operationally administrable unless some of our recommendations below are adopted. The Proposed Regulations should in any case seek to strike a careful balance between minimizing the risk of tax avoidance and minimizing the risk of market disruption. They should also seek to limit the imposition of withholding tax on deemed dividend equivalent payments to transactions that are within the reasonable bounds of economic equivalence to the ownership of U.S. stock, for we understand such economic equivalence to be the guiding rationale of the Proposed Regulations.

### II. Computation of "Delta".

Under the Proposed Regulations, a derivative long position in a U.S. equity-linked transaction is subject to withholding under Section 871(m) if its "delta" is above a specified threshold. "Delta" is defined as the relation of the change in value of the derivative to the change in value of the property (i.e., shares of U.S. stock) that it references.

The Proposed Regulations should provide a clear, objective rule for determining how many shares of stock a derivative long position is deemed to reference in any given case. Otherwise it will not be possible to determine delta in many cases.

However, the Proposed Regulations should also include an anti-abuse rule that would treat a derivative as subject to withholding under Section 871(m) even though it passed the "delta test" if it was substantially equivalent to a delta-one position, taking account of future expectations. This rule would be designed to deal with more complex derivatives (and with combinations of derivatives treated as being entered into in connection with one another as set forth below) and would limit any potential for tax avoidance through manipulation of the delta test.

We flesh this approach out in Section 2A below.

III.  Combinations of Transactions.

The Proposed Regulations should clarify that two derivative transactions are not entered into "in connection with" each other merely because they are entered into at approximately the same time.  Rather, the foreign investor must *intend* for the two transactions to operate together in meeting the foreign investor's financial objectives.

Moreover, the Proposed Regulations should clarify that for purposes of withholding under Section 1441, a broker-dealer does not have "knowledge" that two transactions entered into by one of its customers are entered into "in connection with" each other unless the broker-dealer prices, markets or sells the transactions as operating together.  The IRS should be required to prove that this has occurred, rather than be allowed to presume that it has occurred in light of the customer relationship.  We believe the IRS should have the burden of proof in this regard, because a broker-dealer would never be able to prove the "negative" proposition—i.e., that it did not have such knowledge.

In addition, a broker-dealer's obligation to *report* two transactions as subject to withholding based on their being entered into "in connection with" each other should be conformed to its obligation to withhold on that basis—i.e., it should be based on an actual knowledge standard, rather than on a "reasonable diligence" standard.  Otherwise the "actual knowledge" standard will be substantially undermined.

IV.   Withholding Tax Liability Based on Delta.

We believe that the threshold for determining whether a financial instrument or transaction is subject to withholding under Section 871(m) should be increased from delta .70 to delta .90.  Otherwise we believe that withholding tax liability would not be primarily targeted towards transactions that reflect economic equivalence to long stock ownership (as we believe the Proposed Regulations intend).  We also believe that the Proposed Regulations would otherwise result in unintended market disruption.  We explain our reasoning in Section 4A below.

We further believe that the status of an equity-linked financial instrument as subject to withholding should be based on its delta at the time of its initial pricing, rather than at the time of its acquisition in the secondary market.  We are concerned that absent this change, the Proposed Regulations would not be administrable as a practical matter, given the logistical necessities for implementing withholding and given the requirements for trading in secondary markets.  We explain this further in Section 4B below.

We are also concerned that absent this change, the Proposed Regulations would not be consistent with other Congressional mandates and would give rise to surprising results.  For example, the law generally treats a convertible debt instrument as a debt instrument unless and until it is converted into equity, even though the value of the stock that it references has risen since its issuance date.  Requiring foreign investors to pay withholding tax in respect of dividends deemed received on such an instrument does not seem consistent with this approach.

Moreover, as discussed below, we believe there is little risk that such an instrument would be used to avoid U.S. withholding tax.

Finally, we feel strongly that the amount of dividends deemed to accrue on an instrument or transaction subject to Section 871(m) should not vary as delta varies over the life of the transaction. Rather, the amount should always be based on the delta at the time the instrument is priced or the transaction is entered into.[2]

Absent this change, the Proposed Regulations would be exceedingly difficult to implement as a practical matter, given the relevant logistical necessities. We explain this concern more fully in Section 4C below.

Moreover, this change would be more consistent with the overall approach of the Proposed Regulations, which as noted above is to impose withholding tax by reference to economic equivalence. An actual investor in shares of U.S. stocks does not earn more or less dividends, and pay more or less withholding tax, merely because the value of the shares changes.

V. <u>The Implementation of Withholding by Agents Under Section 1441</u>.

In the case of an equity-linked financial instrument, we think the Proposed Regulations should clarify that tax need only be withheld from payments actually made on the instrument. Thus, in the case of an instrument that makes a payment only at maturity, tax should only be withheld at maturity (or upon prior sale or exchange), notwithstanding that it has accrued prior to maturity.

We are concerned that given the logistical requirements for implementing withholding, that is the only administrable alternative. We explain this in detail in Section 5A below.

Moreover we note that in analogous cases, such as the accrual of interest on zero-coupon and contingent debt instruments, Congress and Treasury have provided for withholding only out of the proceeds of redemption at maturity or prior sale or exchange of the instrument.

(If for any reason you do not adopt this recommendation, we believe you should at least clarify that the withholding agent for dividends deemed paid under Section 871(m) is still the withholding agent for dividends that are actually paid, as set out in the regulations under Section 1441. Language in the Proposed Regulations might otherwise seem ambiguous in this regard, and as discussed in Section 5C below, an approach potentially involving dual withholding agents, or treating issuers as withholding agents, would be complex, confusing and impractical to implement.)

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[2] In the case of an instrument that is subject to Section 871(m) withholding based on application of the additional conceptual test that we recommended in Section 2A below, rather than on the delta test, the amount should be based on the number of shares that the short party must initially acquire to hedge its initial position in the transaction.

We further believe that this approach should extend to U.S.-equity-linked financial transactions generally. As discussed in Section 5B below, there are serious practical impediments to an approach that would require U.S. withholding agents to withhold tax out of unrelated accounts and seek to recoup that tax from counterparties under contractual arrangements.

## VI. The Exclusion for "Qualified Indexes".

For reasons set out in Section 6 below, we believe the following modifications should be made to the qualified index exclusion:

- The exclusion for "qualified indexes" should be broadened to effectuate its purpose, which is presumably to help target the Proposed Regulations towards their intended objective of minimizing the risk of tax avoidance without needlessly interfering with the operation of routine financial markets or creating unnecessary administrative burdens.

- The "objectivity" requirement for a qualified index should be that there is an exchange-traded fund or cleared derivative that tracks that index. The current requirement--that the index is traded on a national securities exchange through futures or option contracts--excludes many indexes that are commonly relied upon, including most global indexes.

- A foreign investor in a qualified index should be allowed to diminish risk of loss with respect to some relatively small percentage of the value of the stocks of the index. Otherwise a withholding agent may be forced in numerous cases to compute delta with respect to hundreds of stocks in an index.

- The Proposed Regulations should provide an exclusion for global stock indexes where U.S. stocks comprise less than 50 percent of the index's weighting.

- The maximum weighting of a company in a qualified index should be increased from 10 percent to 20 percent, to accommodate indexes based on smaller numbers of components, such as the Dow Jones Industrials Average.

- The allowable dividend yield on a qualified index should be increased from 1.5 to 2.5 times the dividend yield of the S&P 500 Index, to accommodate indices reflecting particular industries, as well as the fact that the value of stocks may fall substantially at times.

- The language of the objectivity requirement for the rebalancing of the components of a qualified index should be modified to better suit current rebalancing procedures, including those that govern such indexes as the S&P 500 and the Dow Jones Industrials Average.

- The Proposed Regulations should include an "angel's list" of qualified indexes, to minimize the administrative burdens associated with ensuring that such indexes always meet all of the requirements for being a qualified index.

- To further minimize such burdens, the Proposed Regulations should specify a period of time for which an index will be treated as qualified. For example, an index that is determined to be a qualified index based on facts in existence on January 1st of any given year will be treated as a qualified index for all transactions entered into the remainder of the year, regardless of changes in facts.

- The Proposed Regulations should include an exemption for derivatives on funds that themselves invest in stocks comprising qualified indexes or that reference qualified indexes.

VII. Cascading Withholding and the "Qualified Dealer" Exception.

To prevent duplicative (or "cascading") withholding tax, an exemption from withholding is provided for dividend equivalent payments received (or deemed received) by "qualified dealers". We believe that this exemption should be broadened to better accommodate typical hedging transactions.

For example, a "qualified dealer" should include a "qualified affiliate" of an affiliated group of broker-dealers that meets the requirements for the exemption as a whole. In light of current regulatory requirements and market realities, equity derivative operations supporting foreign customers cannot readily be structured such that each individual affiliate meets these requirements on its own.

The definition should also be broad enough to encompass a foreign entity that is acting in concert with an affiliated group of broker dealers (as further explained in Section 7B below), provided that the latter meets all of the foreign entity's withholding obligations in a manner satisfactory to the IRS.[3]

Unlike analogous rules for substitute dividend payments under Notice 2010-46, the exclusion for "qualified dealers" appears to require a qualified dealer to certify that it is acting in a dealer capacity with respect to each dividend equivalent payment that it receives. We believe that this requirement should be eliminated, because it is impractical to implement, and it is not needed to help ensure compliance.

Likewise unlike Notice 2010-46, the exclusion for "qualified dealers" lacks a back-up "credit-forwarding" approach. We believe that such an approach should be included, because it

[3] If this is not provided for, then the Proposed Regulations should at least clarify that the grandfathering rule of Notice 2014-4 extends to contracts entered into by such a foreign corporation to hedge U.S.-equity-linked financial instruments that it issues prior to 90 days after the Proposed Regulations are finalized.

is essential for cases where a foreign broker-dealer hedges its short position with a customer by actually buying U.S. stocks.

VIII. Constructive Ownership through Non-corporate Entities.

The Proposed Regulations provide for the "constructive ownership" by foreign partners of positions in U.S. equities held by their partnerships, unless U.S. stocks represent less than 10% of the value of the partnership. Foreign partners will likely lack the information required to comply in these circumstances (or may be unwilling to share this information for commercial reasons). Such constructive ownership should therefore apply if U.S. stocks represent more than 50% rather than more than 10%, of the value of the partnership, unless the taxpayer otherwise controls the partnership.

IX. Financial Instruments that are Treated as Debt (or Preferred Stock) for Tax Purposes.

In our view, the Proposed Regulations should not apply to financial instruments that are treated as debt instruments for U.S. tax purposes, including both convertible debt and contingent debt. The holders of such instruments are not in financial positions that are economically similar to the ownership of referenced underlying stocks. Treating holders of such debt instruments as subject to U.S. withholding tax in respect of deemed income inclusions does not seem consistent with such express Congressional mandates as the portfolio interest exemption and related treaty obligations. Moreover, we believe the risk that such instruments will be used to avoid Section 871(m) withholding tax is minimal.

For similar reasons, the Proposed Regulations should not apply to convertible preferred stock. Otherwise an investor might pay withholding tax twice in respect for the same financial investment: once for actual dividends received on the preferred stock, and once for dividends deemed received in respect of the conversion option.

X. Employee Compensation Arrangements.

The Proposed Regulations should clarify that mere employment arrangements, including employee stock options and restricted stock units, are not "financial transactions" and are therefore not subject to withholding as "equity-linked financial instruments". There is no reason to disturb the very detailed, carefully considered and long-settled law that governs such arrangements.

XI. Relief for Information Sharing for Exchange Traded and Cleared Products.

We are concerned about the administrative challenges particular to sharing information among market participants for listed (i.e., exchange traded and cleared) derivatives, such as listed options. To reduce the volume of information needed to be shared and, therefore, ease administrative burdens, we believe that delta for listed derivatives should be based on the prior trading day's market close; however, we continue to have serious concerns about how to implement Section 871(m) withholding in this context.

<u>Discussion</u>

I. Overview

<u>Because the Proposed Regulations chart new waters, it is important to focus on practical issues in crafting the details of their implementation. In particular, changes should be made to ensure that they are operationally administrable. In any case, the Proposed Regulations should strike a considered balance between minimizing the risk of tax avoidance and minimizing market disruption, and they should limit the imposition of withholding tax on deemed dividend equivalent payments to transactions that are within the reasonable bounds of economic equivalence to the ownership of U.S. stock</u>.

Both the statutory language and the prior proposed regulations under Section 871(m) focused on circumstances suggesting that a foreign investor might effectively own U.S. stocks but be holding them through an agent and might therefore actually be earning U.S. source dividends. By contrast, the Proposed Regulations will impose withholding tax in circumstances where a foreign investor clearly does not own any U.S. stock and is clearly not earning actual dividends. As explained in their preamble, the Proposed Regulations do this by reference to economic equivalence.[4] For example, the foreign holders of some deep-in-the-money options, or structured notes, may not own any U.S. stock, but they are in a financial position that is economically very similar to owning U.S. stock, and so it is reasonable to tax them as if they actually owned such stock and were actually earning dividends from it.[5] In effect, the Proposed Regulations treat such foreign investors as "constructively owning" U.S. stock and "constructively receiving" U.S. source dividends.

We acknowledge this approach but we wish to point out that it raises many novel issues. For example, as discussed below, today's detailed rules and systems for implementing withholding on dividends actually received by foreign investors were not designed to deal with dividends that are merely deemed received by reference to economic equivalence. Likewise, systems are not currently designed to implement withholding on financial transactions in the absence of actual payments, and it would be especially difficult to accomplish this under an approach that required withholding agents to re-determine and apply new deltas to large volumes of transactions at transaction-specific periodic intervals. Careful thought will therefore need to go into revising and further developing rules and systems to accommodate the new approach.

[4] See page 16 of the preamble to the Proposed Regulations: "A transaction has the 'potential for tax avoidance' if it approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security. In many cases, a long party is indifferent as to whether to invest in a derivative or a physical position because the derivative and the physical position provide comparable economic returns. . . . Accordingly, the Treasury Department and the IRS favor a delta approach that objectively identifies transactions in which the long party is able to sufficiently approximate the economic returns associated with an underlying security."

[5] Cf. Rev. Rul. 82-150, 1982-2 C.B. 110, treating certain deep-in-the-money options as currently exercised.

Moreover, we assume that the Proposed Regulations are not seeking to apply this approach to transactions that are beyond the reasonable bounds of economic equivalence to the ownership of U.S. stock. This would be consistent with other statutory regimes that similarly impose constructive regimes based on economic equivalence in order to limit a potential for tax avoidance. For example, Section 1259 of the Code treats a taxpayer as having "constructively sold" appreciated stock if the taxpayer uses derivative transactions to eliminate "substantially all" of the burdens and benefits of ownership of the stock, but not if the taxpayer retains meaningful burdens or benefits of ownership. Likewise, Section 1260 of the Code effectively treats gain from a derivative position as gain from the "constructive ownership" of its underlying constituents if a taxpayer has substantially all the burdens and benefits of ownership of those constituents, but not if the taxpayer has less than substantially all of them.

We believe that the line between transactions that are subject to withholding on this basis (i.e., because they are economically similar to owning U.S. stock) and those that are not needs to be further developed. Otherwise, the imposition of withholding tax will not be adequately targeted towards those transactions that *are* economically similar to the ownership of U.S. stock and that *do* present the greatest potential for tax avoidance.

More broadly, we believe that the Proposed Regulations should seek to strike a balance between minimizing the risk of tax avoidance and minimizing the risk of market disruption, unintended or unnecessary administrative burdens, and transaction costs. Unlike the prior regulations or the statute, the Proposed Regulations will apply (or could apply) to a broad range of cases having little to do with tax avoidance. For example, most cross-border swaps, forwards and futures contracts that reference U.S. equities will now be subject to withholding, regardless of the purpose for which they were entered. And unlike the prior regulations, the Proposed Regulations will apply to many financial instruments that are acquired in the retail market, including to structured and exchange-traded notes. Our recommendations below are intended to help Treasury and the IRS deal in a balanced and effective way with the practical realities of the new approach.

## II. Recommendations Relating to the Computation of Delta

2A—<u>For purposes of determining "delta", the Proposed Regulations should adopt a simple rule to determine how many shares of stock are referenced by a derivative. However, the delta rule should be backstopped by an anti-abuse rule that also treats a derivative as subject to withholding if it is substantially equivalent to a delta-one position, based on future expectations.</u>

The Proposed Regulations seek to provide a sharp, objective line between derivatives that are subject to withholding and those that are not, based on whether or not their "delta" exceeds a specified number. "Delta" is defined for this purpose as the ratio of the change in value of the derivative to the change in value of the shares of stock that the derivative references. Thus, delta cannot be determined unless one knows how many shares of stock the derivative references. Unfortunately, as the Proposed Regulations are currently drafted, this is not clear in a significant number of cases.

For example, many of today's structured notes that reference U.S. stocks have the following profile. The holder receives a "leveraged" upside return (e.g., twice the increase in value of the referenced stock) up to a specified cap (e.g., the holder can receive no more at maturity than 180% of the original issue price). The holder is exposed to an unleveraged downside return. It is not clear whether this note references one share of stock or two shares of stock and therefore what its delta is.

The same problem arises with complex derivatives (such as options and swaps) that are entered into between counterparties, and with combinations of derivative transactions that are entered into "in connection with" each other. To the extent that there is a residual risk of tax avoidance after the regulations are finalized, it might arise in precisely this area, because foreign persons seeking to avoid U.S. withholding tax might seek to construct aggregate positions that are economically similar to the ownership of U.S. stocks.

The members of SIFMA have approached this problem both individually and collectively and have not been able to devise an ideal objective solution. Some have proposed more complicated objective definitions of delta that might serve to better target derivative transactions resembling the ownership of U.S. stock, but the complexity of these definitions has seemed undesirable to others as applied to a broad range of non-abusive cases. Others have tried to develop objective rules for "ordering" particular subsets of financial relationships and applying the delta test separately to these subsets, but these have not worked in a clear and objective fashion.

On balance, the members of SIFMA therefore believe that a simple rule is called for, particularly because the delta test must be applied in a broad range of non-abusive cases. We therefore propose that a derivative transaction (or combination of derivatives entered into in connection with each other) be deemed to reference the highest possible number of shares of stock that it could reference, based on the returns that it provides for at maturity of the contract. We propose that this rule apply even if the returns at maturity of the contract vary with the higher number of shares only over a limited price range or for a limited period of time. Thus, the structured note described above would be deemed to reference two shares of stock because its returns at maturity will vary with two shares of stock over a specified range in value of the underlying stock (i.e., between 100% and 180%).

We recognize, however, that the simple rule described above may not be wholly satisfactory, because a derivative that references more shares will result in a higher denominator and thus a lower delta. Unless the simple rule is backstopped by an anti-abuse rule, therefore, taxpayers might seek to avoid withholding tax by adding into the terms of a derivative an increase in variation over a very limited or unlikely price range.

Moreover, in some cases it will simply not be possible to identify any single number of shares of stock that the derivative transaction references, because, for example, the relevant derivative (or derivative combination) references a number of shares that varies continually over a range of prices or over a period of time, or because the return on the derivative is not correlated to a number of shares (as is true in "digital options" commonly used in many retail products).

We therefore believe that an anti-abuse rule should also be used to identify transactions that are substantially equivalent to delta-one long positions, even though they have deltas below the relevant threshold. This anti-abuse rule should be as objective as possible.

Although there might be various ways for a taxpayer or a withholding agent to apply this anti-abuse rule -- i.e., to conclude that a derivative was substantially equivalent to a delta-one position -- one way might be to apply a "proportionality test". More specifically, the taxpayer (or withholding agent) would compare the expected change in value over the life of the derivative of two things: (1) the relevant derivative, and (2) the "initial hedge" of the relevant derivative (i.e., the number of underlying referenced shares that the short party would need to acquire to hedge its initial position in the relevant derivative). If the expected changes in value of these two were substantially the same, the relevant derivative would be subject to withholding under Section 871(m).

2B—<u>The Proposed Regulation should specify the percentage change in value of underlying shares in respect of which delta is calculated</u>.

As noted above, the Proposed Regulations define delta as the ratio of the change in the fair market value of the relevant derivative to the change in the fair market value of the shares of stock referenced by the derivative. This ratio may be different, however, depending on the degree of change in the latter. For example, the change in value of the derivative for each 10 percent change in the value of the referenced underlying shares of stock may differ significantly from the change in value of the derivative for each 1 percent change.

Most securities dealers compute delta by reference to a relatively small increase or decrease in the value of the referenced underlying shares, such as 1 percent or less. We recommend that the Proposed Regulations require that 1 percent or less be the standard for determining delta, so as to help ensure the most uniform possible determination of delta for substantially similar derivative transactions.

III. Recommendations Relating to Combinations of Transactions

3A—<u>For purposes of determining when transactions are combined, two transactions should be deemed entered into "in connection with" each other only if they were *intended* to operate together.</u>

Under the Proposed Regulations, if a foreign investor enters into two long derivative transactions that reference the same underlying U.S. stock, the transactions are combined for purposes of applying Section 871(m) if they are entered into "in connection with" each other. The language of the Proposed Regulations itself does not define "in connection with" for this purpose. However, the accompanying examples imply that the concept relates to the foreign investor's intention that the two transactions operate together.

More specifically, in Examples 2 and 3, the taxpayer enters into a second position in connection with a *reevaluation* by the taxpayer of its position arising from the first transaction.

In Example 1, such an intention is inferred because the two transactions are entered into simultaneously.

Many foreign investors enter into large numbers of derivative transactions through large numbers of trading employees assigned to loosely coordinated trading desks. In some cases two of these traders may enter into positions in the same U.S. stock at substantially similar times, although the relevant facts may make it clear that neither trader intended for the two transactions to operate together (or indeed, even knew about the other's trade).

In light of the above, we are concerned that the mere words "in connection with" may not be enough to guide IRS agents in this area. In particular, we are concerned about the implication of Example 1 that temporal proximity might be a primary desideratum. For example, an agent might conceivably ask a large foreign investor for aggregate transaction records and seek to combine any transactions referencing the same U.S. equity if one transaction occurred within a specified period of time of the other. But given the transaction costs associated with entering into separate transactions with different counterparties using different trading desks, it is unlikely that these transactions will have been entered into with any tax avoidance intent.

In any case, this is clearly not a temporal question. Indeed Example 2 of the Proposed Regulations combines transactions that were entered into months apart because the second transaction arose from a reevaluation of the first transaction. What is presumably required, then, is that the taxpayer *intends* for the two transactions to operate together—not more, but also not less. We believe that this point should be expressly clarified in the governing language of the Proposed Regulations.

3B—<u>The IRS should be required to demonstrate that a withholding agent had actual knowledge that two transactions were entered into "in connection with" each other, rather than base this on a presumption that cannot easily be disproven.</u>

The Proposed Regulations under Section 1441 provide that "if a transaction is only a section 871(m) transaction as a result of applying Section 1.871-15(l) (combined transactions) and the withholding agent did not *know* that the long party (or a related person) entered into the potential section 871(m) transaction in connection with any other potential section 871(m) transactions, the potential section 871(m) transaction is exempt from withholding under section 1441(a)."[6] This is a very important rule for securities dealers, because securities dealers do not have any means of tracking the intentions or operations of their customers and counterparties. This will be true even where a foreign counterparty enters into transactions with the same securities dealer. Although a securities dealer tracks its overall exposure to a particular equity, it does not track and analyze particular transactions that reference that equity across its various domestic and foreign trading desks. And even if it could, it would not have any means of knowing when two or more such transactions had been entered into "in combination with" each other based on the intentions or objectives of the relevant counterparty.

[6] Prop. Reg. Sec. 1.1441-1(b)(4)(xxiii).

We are concerned that IRS field agents may not fully understand this. If, for example, a foreign counterparty intended to enter into two transactions "in connection with each other", and a field agent observes that both transactions were entered into with the same U.S. securities dealer, the field agent may go on to *presume* that the U.S. securities dealer "knew" that the transactions were entered into in connection with each other and conclude that the U.S. securities dealer should have withheld accordingly. We note in this connection that the IRS has in the past been willing to deem broker-dealers to have knowledge of the transactions entered into by their customers, including the circumstances relating to their withholding tax obligations.[7] For the reasons set out above, however, U.S. securities dealer and other U.S. withholding agents will not only lack this knowledge, but they will also lack any means of proving that they lacked this knowledge, because they will not have any records or information pertaining to the question.

A securities dealer should be deemed to have knowledge of a foreign counterparty's intentions if the securities dealer actually prices two transactions based on the assumption that they both will be entered into, markets them as achieving a single economic objective or otherwise promotes or sells them as operating together. We think it important to clarify, however, that the IRS must prove the existence of such facts before such knowledge can be deemed to exist. Otherwise securities dealers might be forced to implement procedures designed to proactively investigate the intentions of foreign counterparties, and we believe that such procedures would not prove coherent or effective in practice.

3C—<u>The reporting standard for combinations should be conformed to the withholding standard.</u>

Under the Proposed Regulations, a broker-dealer that enters into an equity-linked transaction with a foreign counterparty is required to determine whether or not the transaction is subject to withholding under Section 871(m).[8] If it is, the broker-dealer must report this fact to the counterparty and determine the timing and amount of the dividend equivalent payments that are deemed to be made to the counterparty in respect of the transaction.

In doing this, the Proposed Regulations provide that the broker-dealer must exercise "reasonable diligence" to determine the status of the transaction and the amount of the deemed dividend equivalent payments. This could be interpreted to mean that the broker-dealer must use "reasonable diligence" to determine whether or not the transaction is part of a combination of transactions entered into in connection with each other that might in the aggregate constitute a Section 871(m) transaction. Such reasonable diligence could conceivably include, for example, investigating the intentions or operations of the foreign counterparty.

Yet such a reading would seem to completely undermine the knowledge standard discussed above and effectively subject securities dealers to a much broader "reasonable diligence" standard. For it goes without saying that if a broker-dealer using "reasonable diligence" determines that there is a combination giving rise to 871(m) withholding (and reports

[7] See e.g., Notice 99-8, I.R.B. 1999-5 (January 15, 1999).

[8] Prop. Treas. Reg. Sec. 1.871-15(o).

that fact to the counterparty), then it will also have actual *knowledge* of this fact that requires it to withhold.

In light of the above, we urge you to conform the reporting standard to the narrower withholding standard, so that the Proposed Regulations accomplish their intended result.

IV. Recommendations Relating to the Imposition of Withholding Tax Under the Delta Standard.

4A—The threshold for treating a derivative transaction as subject to withholding under Section 871(m) should be delta .90, rather than delta .70.

Under the Proposed Regulations, a foreign investor or counterparty is subject to U.S. withholding tax in respect of a U.S.-equity-linked financial instrument or transaction if its "delta" is .70 or greater. "Delta" is defined for this purpose as the ratio of the change in value of the instrument or transaction to the change in value of the underlying shares of stock that it references.

A long position in a derivative with a delta of .70, however, is not within the reasonable bounds of economic equivalence to the ownership of U.S. stock. To the contrary, an "at-the-money" call option can have a delta of .70, and such an option will expire worthless unless the referenced stock increases in value. If the option expires worthless, the foreign investor will not have participated in any sense in the economic change in the value of the stock.

As noted above, we assume that Treasury is not seeking to impose withholding tax under this new approach to transactions that are not economically similar to owning U.S. stock. Indeed, the explanation of this approach in the preamble to the Proposed Regulations begins with the following observation: "A transaction has the 'potential for tax avoidance' if it approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security."

The adoption of such a low delta threshold would cause Section 871(m) withholding to apply to a large number of commercial transactions that have nothing to do with tax avoidance. Moreover, there is little risk that foreign investors seeking to avoid U.S. withholding tax will use delta .70 options for this purpose. The bid-ask spread on an option is much higher than the bid-ask spread for acquisition of the underlying stock that the option references. Moreover, the change in the value of an option relates to factors that do not correlate with the change in value of the underlying stock, including changes in the perceived volatility of the referenced stock, and systematic "decay" in the value of the option that owes to the systematic decrease in the remaining term of the option and the associated loss of "optionality". In light of these costs and differences, it would be too costly for a foreign investor seeking to maintain a long position in a U.S. equity to instead hold a delta .70 option in that equity merely to avoid U.S. withholding tax.

We understand that outside the tax arena (e.g., in connection with efforts to comply with the requirements of Dodd-Frank), securities dealers and their counsel have generally viewed derivatives with a delta of .90 or greater as being reasonably within the bounds of economic equivalence to the ownership of U.S. stock. We therefore urge you to adopt this threshold in implementing regulations under Section 871(m).

4B—<u>The status of an equity-linked financial instrument as subject to withholding should be based on its delta at the time of initial pricing, rather than at the time of its acquisition.</u>

Under the current Proposed Regulations, the status of a financial instrument as subject to withholding is based on its delta at the time the instrument is acquired.[9] This means that U.S.-equity-linked financial instruments trading in secondary markets outside the United States would change their withholding status as they were acquired by different holders at different times, and particular instruments could be subject to different amounts of withholding at maturity, depending on when they had been acquired, and for how long they had been held, by prior investors.

Such an approach is in our view not workable as a practical matter. No one now has, and no one could reasonably develop, the technology required to mark and label each financial instrument held by each individual investor and assign to it a unique withholding tax liability that was recalculated as withholding tax liabilities accrued over time. Neither are current financial markets and current laws and regulations capable of accommodating such an approach. At present the fact that financial instruments are fungible (i.e., do not have different after-tax payouts depending on whom they are acquired from) is what allows them to trade freely in financial markets. For precisely this reason, issuers of debt instruments must take great care to ensure that a reopening of bonds previously issued at par is a "qualified reopening" that does not have original issue discount (i.e., is tax fungible with the originally issued securities) notwithstanding an intervening change in interest rates.[10] Conversely, the legal entitlements of an investor who acquires a security in the secondary market relate to the terms of the instrument and not to its trading history.

As discussed more fully below under "Recommendations Relating to Withholding by Agents under Section 1441", it would not be feasible to maintain fungibility by somehow collecting withholding tax from public investors on a current basis in the absence of any payments made on the instrument. And even if it were, it would be exceedingly difficult for broker-dealers to obtain and maintain changing real-time delta information with respect to each of the U.S.-equity-linked financial instruments that their customers acquired so that they could determine de novo, with respect to each such customer, whether the instruments they had acquired were subject to withholding under Section 871(m). As discussed below under "Recommendations Relating to Withholding by Agents under Section 1441", withholding mechanics in public markets are generally set up at the time of issuance, because they rely on the cooperation of a chain of financial participants and intermediaries.

[9] Prop. Treas. Reg. Sec. 1.871-15(d)(2).

[10] Cf. Treas. Reg. Sec. 1.1275-2(k).

Moreover, such an approach would diverge from long-established principles that govern the taxation of financial instruments generally. The delta of an equity-derivative financial instrument changes as the value of the stock that it references changes. For example, a convertible debt instrument that is out of the money when issued may be deeply in the money by the time it matures. But the status of a financial instrument as equity or debt, as having original issue discount or not, as representing current ownership of the underlying or not, as resulting in the deconsolidation of the issuer or not, etc., does not change over time merely because the value of the instrument changes over time. It would be difficult to predict tax consequences otherwise, and we believe the tax law generally takes this approach precisely because it would be so impractical to do otherwise.

Thus, regardless of how deep in the money the conversion option embedded in a convertible debt instrument becomes over time, such an instrument has never been treated as equity of the issuer for tax purposes unless and until its conversion right is exercised. But as discussed more fully in Section IX below, the Proposed Regulations as currently drafted would in effect treat such an instrument as converted in the hands of an acquiring foreign investor for purposes of applying Section 871 of the Code, because it would in effect treat the investor as earning dividends subject to withholding tax, rather than interest exempt from withholding tax under the portfolio interest exemption. We are not sure this is consistent with the tax treatment that has been directly mandated by Congress under Section 871 of the Code, which effectively exempts contingent and convertible debt instruments from the imposition of U.S. withholding tax unless they provide for payments that are determined by reference to the income of the issuer (or the value of property owned by the issuer).[11] Similarly, we are not sure that it would be consistent with numerous tax treaties entered into by the United States that provide that there will be no U.S. withholding tax imposed on such instruments in the absence of such contingent payments.

We are also concerned that such an approach would chill the secondary markets in U.S. equity-linked securities in an unintended fashion. Once delta rose above the relevant threshold, foreign investors would in effect be locked in, because no one would be willing to purchase the instrument in the secondary market and thereby become subject to withholding tax. Indeed, the mere risk that the instrument might be subject to withholding (because of an increase in the values of underlying stocks) might be enough to significantly chill secondary market trading. It would be difficult for broker-dealers and other market participants to obtain real-time delta information with respect to particular instruments, and prospective purchasers might not be willing to risk learning after the fact that they had purchased an instrument that was subject to U.S. withholding tax.[12]

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[11] See Section 871(h)(4).

[12] Moreover, we note that tax disclosure to foreign investors is drafted at the time an instrument is issued, not at the time it is acquired. We think it might prove complex and confusing to warn foreign secondary investors that they might be subject to a withholding tax that did not apply to primary investors, to explain that this would depend on future valuations in effect at the time they acquired their instruments, or to alert them that they might not be subject to such tax even though primary investors were, again depending on future valuations.

In any event, we think there is little risk of tax avoidance relating to such instruments that would be mitigated by the currently proposed shift in their 871(m) withholding status, based on changes in their deltas. We do understand that a foreign investor who owns shares of U.S. stock and wishes to avoid U.S. withholding tax might "cross in" those shares to a U.S. broker-dealer and enter into a forward contract with that broker-dealer over the same shares. But we do not think such a foreign investor could alternatively acquire notes from that broker-dealer that referenced the relevant shares (and that were originally issued with a delta below the threshold but were now trading in secondary markets with a delta above the threshold). Where would the broker-dealer get such a note? Further, the transaction costs associated with borrowing or otherwise acquiring such a note probably would reduce or eliminate any tax advantage.[13]

For all of these reasons, we urge you to base the determination of whether or not a financial instrument is subject to withholding on its delta at the time of pricing.

4C—<u>The amount of dividends deemed to accrue on an instrument or transaction that is subject to withholding under Section 871(m) should be determined by reference to its delta at the time it is issued or entered into (i.e., is priced), rather than at the time a dividend is paid on the underlying shares that it references.</u>

Under the Proposed Regulations, the amount of the dividend equivalent payment on an equity-linked financial instrument or transaction equals the amount of the dividends paid on the underlying referenced shares multiplied by the delta of the transaction *at the time the amount of the dividend is determined*.[14] This means that the percentage of payments that must be withheld will vary with each payment, based on facts in existence at the time of the payment.

This approach would be very complex as applied to financial instruments, such as structured and exchange traded notes, and it would be unworkable. Changing real-time delta information would presumably have to be determined and maintained by the issuer of the instrument and then communicated effectively to all of the broker-dealers that hold such instruments for the accounts of customers, so that the latter could implement proper withholding. As discussed below under "Recommendations relating to the implementation withholding", however, various systems, rules, regulations, procedures and practices designed to implement

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[13] Perhaps the concern is instead that foreign investors who owned shares of U.S. stock would sell those shares into the U.S. market and instead buy such notes from other U.S. investors to hold for the long term. Yet it seems unlikely that a long-term investor in U.S. shares would be willing to accept (a) forced realization (and associated local taxation) at maturity of such notes, (b) credit exposure to the issuer of the notes, (c) the transaction costs and bid/offer spreads (which are likely to be much greater for such notes than they are for the underlying stock) and (d) all the costs associated with divergence of the terms of the notes from the economics of actual ownership of the relevant shares, merely to avoid U.S. withholding tax on dividends. And even if they did in some cases, that would seem less a manifestation of tax avoidance than a mere example of an investment decision.

[14] Prop. Treas. Reg. Sec. 1.871-15(i)(1)(ii).

withholding have been developed in connection with the original issuance of the security, and the relevant procedures generally require the cooperation of various participants in a chain of financial intermediaries. We do not see how such procedures could be implemented and followed anew with respect to every single payment made on an underlying U.S. equity, and even if they could be, we think the administrative costs would outweigh any benefit.

We think the implementation of such an approach would be equally problematic as applied to financial transactions between counterparties--such as equity swaps, options and forward contracts—because the market for those transactions is so large. The Proposed Regulations will already require broker-dealers to develop new systems that can compute and track withholding obligations that will bear no relation to payments actually made under the contract, because they will arise solely from the fact that dividends are paid on referenced underlying equities. The cost and complexity of doing this in respect of an enormous volume of routine daily transactions cannot be underestimated. Yet it would increase this burden exponentially to require that these systems re-compute delta for every relevant equity derivative transaction every time that dividends were paid on the underlying referenced equity and then apply this unique recomputed delta to each particular equity derivative transaction to determine its resulting withholding obligation. And the burden would be even greater when it came to dealing with combined transactions or complex transactions that included multiple embedded derivatives. In such a case, systems would have to be able to re-compute delta separately for each embedded derivative or transaction that was combined and compute withholding separately on the basis of these separate amounts.[15]

We understand that this more complex approach of the Proposed Regulations may have been implemented partly with a view to taxpayer equity. Suppose, for example, that a foreign investor acquired a deep in-the-money option with a delta above .90 that nevertheless ultimately expired worthless. If the referenced underlying stock paid dividends before the option expired, the foreign investor would be subject to withholding tax even though the foreign investor never ultimately acquired any stock or received any payments.

But the complex approach of the Proposed Regulations does not serve to solve this problem. The foreign investor described above would still have to pay some amount of withholding tax, because delta (albeit lower) would still be positive at the time dividends were paid on the underlying shares.

Moreover, we think the payment of full withholding tax is a natural consequence of the general approach of the Proposed Regulations. If a foreign investor actually buys shares of U.S. stock, the investor is liable for withholding tax on dividends received notwithstanding that the relevant shares of stock may have declined in value and may ultimately prove worthless. As discussed above, the Proposed Regulations impose withholding tax on the holder of a derivative (such as the deep-in-the-money option described above) because the holder is in an economic position that is similar to actually owning U.S. stock. It doesn't follow, therefore, that unlike an actual shareholder, the derivative investor should pay withholding tax by reference to the delta of the position at the time the dividend is paid.

[15] See Prop. Treas. Reg. Sec. 1.871-15(l)(5).

In any case, we believe we have a solution that takes this concern into account but that is simpler, more practical and better suited to the approach of the Proposed Regulations: withholding should simply be based on the delta of the relevant instrument or transaction at the time it is issued or entered into. For example, if a foreign investor buys an in-the-money option that references 100 shares of U.S. stock and that has an initial delta of .91, then the investor should pay withholding tax in respect of the dividends paid on 91 shares of stock, and this should apply for the entire life of the option. (In cases where a more complex derivative transaction was subject to withholding under Section 871(m) by reason of the application of the proposed additional conceptual test described in Section 2A above, withholding would similarly be based on the number of shares required by the short party to the transaction to hedge its position in the transaction. For example, if the short party would have to purchase 91 shares of stock to hedge its issuance of a complex long-term option, the investor would pay withholding tax in respect of the dividends paid on 91 shares of stock for the entire life of the transaction.)

This approach would take account of the risk that the option might ultimately expire worthless by reducing withholding by 9% as compared with the withholding liability that would arise from actually buying 100 shares of U.S. stock. It would not make further adjustments, however, to account for changes in the value of such stock over the life of the transaction. As noted above, this is consistent both with the current law treatment of foreign investors in U.S. stock and with the tax law in general.

## V. Recommendations Relating to Withholding by Agents Under Section 1441

5A—<u>In the case of equity-linked financial instruments, the Proposed Regulations should clarify that tax is withheld only from payments actually made on the instrument</u>.

It is not clear under the Proposed Regulations as currently drafted how Section 1441 withholding is meant to operate in the case of an equity-linked financial instrument that makes payments only at maturity.[16] For several reasons, however, we think the answer *has* to be that tax is withheld only from payments actually made on the instrument (i.e., in this case, from the payment made at maturity), or from the proceeds of sale of the instrument prior to maturity. We urge you to make this clear in revised regulations.

First, we do not see how any other approach could be feasible as a practical matter. It is normally a foreign broker-dealer holding securities on behalf of its local customer who maintains information about the customer upon which withholding is based. In some cases the foreign broker-dealer acts on behalf of the IRS as a "withholding qualified intermediary" and withholds

[16] The Proposed Regulations provide that a withholding agent must withhold immediately if "the section 871(m) transaction provides for an upfront payment or prepayment of the purchase price even though an actual payment has not been made at the time the amount of a dividend equivalent is determined." Prop. Reg. Sec. 1.1441-2(d)(5). It is not clear whether the issuance proceeds of an equity-linked financial instrument might be viewed as an upfront payment for this purpose. The language suggests, however, that the drafters had equity swaps and similar counterparty transactions in mind, not the issuance of financial instruments.

(at appropriate treaty rates) based on that information. In other cases, it passes the information on to a financial intermediary "above" the foreign broker-dealer, such as DTC, that in turn withholds based on information provided by the foreign broker-dealer. In either case, these withholding agents cannot effect such withholding in the absence of any payments made on the instrument.

We do not see how such withholding responsibility could be transferred to someone farther up the chain of financial intermediaries, such as the issuer of the instrument. The issuer would lack any knowledge about the status of the holders of the instrument upon which to base such withholding. Moreover, the issuer would also lack any funds from which to withhold.

With regard to the latter point, we note more specifically that the proceeds of issuance of a financial instrument are received by the issuer in exchange for issuing the instrument and are to be used by the issuer for the intended business purposes of the issuance, including to acquire related hedging positions. They are not intended as a reserve for payment of the investor's taxes. An issuer would not be able to issue a U.S.-equity-linked financial instrument in foreign markets were it held otherwise, for the issuer would have no practical means of recouping its lost issuance proceeds. As noted above, an issuer could not possibly label and track each individual security acquired by a foreign individual through a network of foreign broker-dealers and financial intermediaries, let alone assign to each such security an appropriate withholding tax liability that changes over time and that has to be individually deducted out of each payment made on each instrument at maturity. Even if it could, the associated trading markets would grind to a halt, because the relevant instruments would no longer be fungible with each other.

Second, Congress and Treasury have already dealt with this issue in connection with the accrual of original issue discount on zero-coupon and low-coupon debt instruments, as well as on contingent debt instruments. Section 871 of the Code pointedly refrains from imposing withholding tax on the mere accrual of original issue discount, presumably because it would be impossible to collect the tax as a practical matter. Rather, it imposes withholding in respect of such accrual out of the final payment at maturity of the instrument, or out of the proceeds of any sale or exchange of the instrument.[17]

Likewise, Treasury has already fleshed out in regulations how withholding agents must deal with securities held by foreign persons that have accrued U.S. withholding tax liabilities under Section 871. These regulations provide that a withholding agent must withhold out of the proceeds of redemption of the instrument, and must also withhold on any proceeds of a sale or exchange of the instrument if it knows, or has reason to know, that the sale or exchange is part of a plan the principal purpose of which is to avoid tax. Moreover, if a withholding agent cannot determine the amount of original issue discount that accrued while the instrument was held by the relevant seller, then it must withhold on the entire amount of original issue discount accruing from the date of issuance.[18]

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[17] IRC Section 871(a)(1)(C).

[18] Treas. Reg. Sec. 1.1441-2(b)(3)(ii).

These rules could easily be adapted to deal with dividend withholding tax liability accruing under the Proposed Regulations in the absence of actual payments. We recognize that unlike accruals of deemed dividend income, accruals of interest and original issue discount income are generally exempt from withholding tax under the portfolio interest exemption of current law. If necessary, however, procedural requirements could be made broader to account for this difference. For example, a foreign broker who effects the sale of a U.S. equity-linked financial instrument on behalf of a customer could be required to withhold U.S. tax out of the proceeds of the sale regardless of whether the sale is part of a plan the principal purpose of which is to avoid tax.

5B—<u>In the case of equity swaps, options and other financial transactions, the Proposed Regulations should likewise provide that tax is withheld only from payments actually made to the foreign investor under the terms of the transaction</u>.

As currently drafted, the Proposed Regulations would appear to require a broker-dealer to withhold tax accruing in respect of dividends paid on referenced underlying U.S. equities out of any up-front proceeds received by the broker-dealer in exchange for entering into the transaction.[19] We do not think this is the right answer as a procedural or substantive matter.

An up-front payment is received from a foreign counterparty because the terms of the financial transaction are "off market" and the broker-dealer would therefore not be willing to enter into the transaction unless it received such proceeds in exchange. It is not money held for the benefit of the foreign counterparty, or as collateral for the foreign counterparty's obligations in connection with future payments to be made on an equivalent *at*-the-market transaction. Thus, requiring the U.S. counterparty to pay withholding currently out of such proceeds would in effect be shifting the economic burden of withholding tax liability from the foreign counterparty to the U.S. counterparty. The U.S. counterparty could seek to recoup its loss from future payments to the foreign counterparty under the terms of the transaction. If no such future payments materialized, however (e.g., because the value of the referenced equity declined), then the U.S. counterparty would be forced to seek mere recompense from the counterparty under contract for the withholding tax liability that it had already suffered. This is not in our view a procedural regime for enforcing withholding tax liabilities of the foreign counterparty. It is rather a shifting of substantive tax liability to the U.S. counterparty.

Moreover, such up-front proceeds are not set aside in segregated accounts for the purpose of meeting withholding tax liabilities. They are used for general business purposes or to enter into offsetting hedging transactions and are therefore not available for withholding in any sense. As an extreme example, an options clearinghouse typically receives a premium for the issuance of a longer term option but pays this premium through to the corresponding short party to that option. While the clearinghouse is the legal counterparty to the holder of the option, the clearinghouse is in no position to meet the holder's tax obligations by making tax payments out of option premium that it doesn't have.

[19] Prop. Treas. Reg. Sec. 1.1441-2(d)(5).

In the absence of any such up-front payments, the Proposed Regulations require a broker-dealer to withhold out of any money or other property of the long party that the agent has custody or control over.[20] But there are likewise practical difficulties with this approach.

First, it is not clear that a broker-dealer would be legally entitled in any given case to offset withholding tax liabilities in respect of one account against cash or property in another account, particularly if the property in the other account had to be sold (at whatever price the market would bear) to effect the withholding. This would likely be a case-specific matter of federal, state, foreign and regulatory law as applied to a variety of different investment and financial businesses, including securities law, banking law and insurance law. Second, foreign counterparties often hold accounts at a broker-dealer through a variety of different affiliates. It is not clear to what extent withholding agents would be required to determine the existence of affiliated relationships and apply set-off rules on that basis.

In any case, it would be exceedingly difficult and costly for broker-dealers to develop systems that deducted withholding tax liabilities out of unrelated accounts, such as out of funds of the broker-dealer itself, or out of unrelated funds of affiliates of the customer, and then later sought to recoup these payments (with interest) out of subsequent payments made to the customer.

Similar reasoning applies in the case of bilateral transactions, such as forward contracts and bullet swaps, that simply do not provide for any payments prior to maturity. It is not consistent with the general approach of the law to effectively shift the burden of current taxation from the relevant foreign investor to the relevant U.S. withholding agent by requiring the latter to withhold out of payments that it is not making and that it does not have.

For all of these reasons, we urge you to provide that tax must be withheld only from payments actually made to a foreign counterparty under the terms of a financial transaction.

5C—<u>If our recommendation in 5A above is not fully adopted, the Proposed Regulations should at least clarify that the Section 1441 withholding agent for payments made on an equity-linked financial instrument does not change merely because the relevant dividends are deemed dividends under Section 871(m), rather than actual dividends under Section 871 generally</u>.

As noted above, based on the current language of the Proposed Regulations (and in particular the language that directs withholding out of money or other property that an agent has custody or control over),[21] it is not entirely clear who the technical withholding agent might be for dividends deemed paid under Section 871(m) on an equity-linked financial instrument. As discussed above, however, only the relevant dividend withholding agent under current law (either the local foreign broker-dealer holding the securities for the foreign investor's account or a financial intermediary that receives information from that broker-dealer) has the customer information required to implement proper withholding. Moreover, fully fleshed out procedures

[20] Id.

[21] Prop. Treas. Reg. Sec. 1.1441-2(d)(5)(ii)

that have developed over time, and that are implemented by long established regulations, govern the means by which withholding agents obtain, maintain and pass on this information to relevant parties.

As noted above, we therefore do not think that the withholding agent could reasonably be a party other than the withholding agent for actual dividends as already provided for under Section 1441. The issuer of the instrument, for example, knows nothing about the relevant customers and has no procedures in place to withhold upon them. We assume there was no such intent on the part of the drafters of the Proposed Regulations. To avoid any risk of confusion or duplicative withholding, however, we urge you to make this clear in revised regulations.

VI. Recommendations Relating to the Exclusion for Qualified Indexes

6A—<u>The exclusion for "qualified indexes" should be made broader to effectuate its purpose.</u>

The Proposed Regulations exempt from withholding derivatives with payments determined by reference to a "qualified index".[22] A "qualified index" is generally intended to describe a broad-based equity index, but it currently includes a number of qualifications and limitations that we believe are too narrow to effectuate the purposes of the exclusion, as discussed further below. This exclusion is logical and important, for the following reasons. It should therefore be broadened in accordance with the recommendations below.

First, diversified stock indexes are broadly used by both individual investors and businesses to achieve routine business and investment objectives that are completely unrelated to tax avoidance. The cost of market disruptions arising from the incidental application of rules relating to tax avoidance is therefore especially high where broad-based stock indexes are involved.

Second, in the absence of such an exclusion, the administrative burden associated with the calculation of deemed dividends on hundreds of stocks comprising an index would be excessive; for it would be necessary to calculate delta, and apply it to underlying dividends, in respect of each such underlying equity.

Third, retail foreign investors often use such indexes to invest in U.S. equities, so as to obtain the benefits of diversification. For example, retail foreign investors often invest in structured and exchange-traded notes that reference such indexes. The tax avoidance concerns that animate Section 871(m) of the Code relate primarily to efforts at tax avoidance by sophisticated foreign counterparties, not to retail investment in U.S. equities.

For all of these reasons, a broad exemption for derivatives based on such indexes serves to better target the Proposed Regulations towards their objective and minimize the extent to which they interfere with routine market practices.

[22] Prop. Treas. Reg. Sect. 1.871-15(k).

6B—The "objectivity" requirement for a qualified index should be that there is an exchange-traded fund or traded or cleared derivative that tracks or references that index, rather than that the index is traded on a national securities exchange through futures or option contracts.

Under the current Proposed Regulations, an index is not a qualified index unless "futures contracts or option contracts on the index trade on a national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission."[23] The purpose of this requirement appears to be to ensure that the relevant index is an objective index that is generally recognized as a means of allowing retail investors to participate in equity markets on a diversified basis, rather than privately developed in a way that might potentially accommodate tax avoidance.

We note, however, that many broad-based stock indexes (especially global stock indexes) do not have futures or options contracts that trade on national securities or commodities exchanges. We therefore believe that the purpose of this requirement can better be met by requiring that there be either an exchange traded fund that tracks the relevant index or that there be a derivative contract referencing the index that is traded or cleared on an exchange (whether domestic or foreign). In either case, it will be clear that the index is generally recognized in the markets, rather than privately developed with a potential view to tax avoidance.

6C—A qualified index should not be disqualified merely because an investor diminishes risk of loss with respect to a very small percentage of the index components.

Under the Proposed Regulations, if in connection with investing in a qualified index, an investor enters into a transaction that diminishes risk with respect a single stock out of hundreds of stocks in a qualified index, the index will cease to be a qualified index in that investor's hands.[24] As noted above, however, the determination of withholding tax liabilities in respect of a diversified equity index that is not a qualified index will be exceedingly complex.

We therefore note, in our capacities as broker-dealers and withholding agents, that this is a very high bar with severe consequences insofar as compliance is concerned. We are concerned that we will lack the capacity to deal with customers who diminish risk of loss with respect to only one or two stocks in connection with entering into a derivative on an index that references hundreds of stocks. This concern could be ameliorated by allowing an investor to diminish risk of loss with respect to some small percentage of value of the stocks in the index before the index ceases to be a qualified index in the investor's hands. We do not think such an exception would open the door to any sort of meaningful tax avoidance potential or significantly undermine the objective of the qualified index exclusion.

[23] Prop. Treas. Reg. Sec. 1.871-15(k)(2)(vi).

[24] Treas. Reg. Sec. 1.871-15(k)(6).

6D—The current safe harbor for indexes where U.S. stocks comprise 10 percent or less of the index's weighting should be expanded into an exclusion for global stock indexes where U.S. stocks comprise 50 percent or less of the index's weighting.

Foreign investors do not often invest in U.S. equity indexes per se. Rather they typically invest in global indexes that include U.S. equities (which can represent up to 50% of their weighting). The "qualified index exception" would accomplish little if it still required most foreign investors to pay deemed withholding tax in respect of the U.S. equity components of their derivative investments in global stock indexes, and if it still required broker-dealers to calculate such deemed dividends with respect to hundreds of embedded U.S. stocks. As noted above, however, global stock indexes are not typically traded on U.S. securities or commodities exchanges, so they do not meet the requirements for a qualified index exception under the current Proposed Regulations.

The Proposed Regulations do contain a blanket exclusion for indexes consisting solely of long positions where U.S. equities constitute 10 percent or less of the index's weighting.[25] The simplest solution to the above problem would be to expand this exclusion to cover global indexes where U.S. equities constitute 50 percent of less of the index's weighting.

6E—The maximum weighting of a company in a qualified index should be increased from 10 percent to 20 percent.

Under the Proposed Regulations, an index would not be a qualified index if the stock of a single company represented more than 10 percent of the weighting of the companies in the index.[26] However, many diversified equity indexes do not include large numbers of stocks. The most obvious example is the Dow Jones Industrials Average, which includes 30 stocks. We therefore think 10 percent is too low to accommodate indexes with fewer than 100 stocks and should be increased to 20 percent.

For example, we understand that one stock in the Dow Jones Industrials Average currently represents 8.4 percent of its aggregate weight. If that stock appreciated further, it would be counter-intuitive to discover that the Dow Jones Industrials Average was not a qualified index, and such a result would run counter to the intension of the exclusion.

6F—The allowable dividend yield on a qualified index should be increased.

Under the Proposed Regulations, an index is not a qualified index if it provides a dividend yield that is greater than 1.5 times the dividend yield of the S&P 500 Index. We note that this could easily and quickly happen if the stocks comprising the relevant index were to depreciate significantly relative to the general U.S. stock market. Moreover, there are market sectors, such as real estate and utilities, where companies routinely pay dividends at a rate that is

[25] Prop. Treas. Reg. Sec. 1.871-15(k)(3)

[26] Prop. Treas. Reg. Sec. 1.871-15(k)(2)(iii)

more than 50% of the average rate in the U.S. market. We therefore believe that the allowable dividend yield should be increased to 2.5 times the dividend yield of the S&P 500 Index.

6G—<u>The language of the requirement for the rebalancing of the components of a qualified index should be modified to better suit current procedures</u>.

Under the Proposed Regulations, an index is not a "qualified index" unless it is "modified or rebalanced only according to predetermined objective rules at set dates or intervals." This language is not well suited to the means by which most diversified equity indexes are modified or rebalanced. For example, new components of both the Dow Jones Industrials Average and the S&P 500 Index are selected by a committee that takes into account a broad range of criteria in making an ultimately subjective determination about which new company to include in the index. The committee does seek to select companies that are representative of the industries in the United States economy, but a broad range of companies meet the minimum requirements for market capitalization and trading float. The timing of such selection is not at set intervals and often relates to market-related events (e.g., the value of the stock of one of the component companies has fallen significantly, and it therefore needs to be replaced).

In light of the above, we would recommend modifying the requirement as follows: "A qualified index means an index that is modified or rebalanced based on guidelines or procedures that are designed to maintain the diversification of the index and its representation of the market or sector as a whole, rather than to choose stocks that are expected to outperform the market or based on other directional criteria."

6H—<u>To help reduce administrative burdens, the Proposed Regulations should include an "angel's list" of qualified indexes and provide for periodic testing dates.</u>

We recognize that one of the principal objectives in setting out the requirements for a qualified index was to define a qualified index in an objective manner, so that it is clear whether or not any given index qualifies. One consequence of this approach, however, is that an index may sometimes not meet the requirements of a qualified index even though it should. For example, as noted above, even the Dow Jones Industrials Average could fail to qualify as an index under the objective rules if one of its components increased significantly in value. Moreover, the need to meet objective requirements imposes an administrative burden on taxpayers and their withholding agents to be sure that all outstanding indexes are still qualified. For example, to be sure that a particular index did not flunk the maximum limitation on the value of a component, the relative values of index components would need to be weighed on a periodic basis.

To help ameliorate some of these concerns, we think the Proposed Regulations should include a list of indexes that will in all cases be treated as qualified indexes. Taxpayers and withholding agents would then not have to worry that the most commonly used indexes would fail to qualify. We think that this list should be updated periodically. The Proposed Regulations should make it clear, however, that this list is intended as a non-exclusive safe harbor and provides no negative inference that an index not on the list is not a qualified index.

We think the Proposed Regulations should also specify a period of time for which an index will be treated as qualified, to further minimize such burdens. For example, an index that is determined to be a qualified index based on facts in existence on January 1st of any given year should be treated as a qualified index for transactions entered into over the remainder of the year, regardless of subsequent changes in facts.

6I—<u>The Proposed Regulations should include an exemption for derivatives that reference the value of exchange-traded funds that have an investment objective of tracking qualified indexes</u>.

We note that structured or exchange-traded notes often promise returns that are referenced to the value of an exchange-traded fund that invests in the stocks comprising a qualified index, or that otherwise has an investment objective of tracking a qualified index. We believe that the rationales cited above for the exclusion from withholding of instruments making payments determined by reference to qualified indexes would also apply to instruments linked to such exchange-traded funds. We therefore believe that a financial instrument that promises payments that reference the value of such an exchange-traded fund should itself be deemed to be making payments determined by reference to a qualified index.[27]

VII. Recommendations Relating to the Qualified Dealer Exception

7A—<u>The rule for "qualified dealers" (which is designed to deal with "cascading withholding tax" issues) should be broadened to accommodate routine hedging of derivative positions</u>.

The Proposed Regulations exempt from withholding under Section 871(m) a long position entered into by a "qualified dealer" that is (a) subject to regulatory supervision in the jurisdiction in which it is organized, and (b) certifies to the otherwise withholding short party that is acting in its capacity as a dealer and that it will withhold and deposit any tax imposed by Section 871 on its related transaction with a customer.[28] This rule appears to be designed to resemble the rule of Notice 2010-46, which deals with substitute payments on stock and securities loans, but it is narrower in several key respects, as described below.

We appreciate the inclusion of this rule, as it is exceedingly important. As described below, however, the narrowness of its current drafting would prevent the rule from applying in many of the routine cases where it is intended to apply. This is particularly true of the typical case where a local foreign customer enters into a U.S.-equity-linked derivative transaction with a local foreign broker-dealer, which local foreign broker-dealer then hedges its position with a U.S. affiliate, a U.S. unrelated party, or through a physical purchase of U.S. stocks in the marketplace. The rule should therefore be broadened in the manner described below.

[27] For example, the derivative could be deemed to reference the stocks that the relevant fund invests in and could therefore be deemed to itself be referencing a qualified index.

[28] Prop. Treas. Reg. Sec. 1.871-15(j)(1).

7B—<u>The exemption for "qualified dealers" should be broadened to include an exemption for "qualified affiliates" of "qualified dealers", in light of the regulatory and other requirements for how the equity derivatives business is currently conducted</u>.

A rule that literally requires each entity that enters into a long position in U.S. equities to itself be subject to regulatory supervision by the governmental authority in which it is organized, to itself be acting in its capacity as a dealer, and to itself withhold and deposit the tax imposed by Section 871(m) is unfortunately too narrow to accommodate many current business arrangements and operations. Most broker-dealers that make a market in equity-linked derivative transactions consist of a network of affiliates located in different countries that either operate directly with local foreign customers or that serve as coordination centers or hubs for accomplishing specified tasks. The requirements of Dodd-Frank and other regulatory regimes, as well as current market realities, dictate the means by which both customer-facing transactions and hedging and other transactions are entered into, by which legal structures are organized and by which compliance is implemented. It would simply not be possible, within the constraints of these requirements, to reorganize to allow each entity that that enters into a long position in U.S. equities to independently meet the "qualified dealer" requirements.

For example, a transaction entered into between a foreign broker-dealer and its local foreign customer, and an offsetting hedging transaction between the foreign broker-dealer and an otherwise-withholding U.S. short party, may both, as a technical matter, be booked in a subsidiary of that foreign broker-dealer that is organized in a different foreign jurisdiction. Such a subsidiary will not itself be acting in a dealer capacity. Moreover, the subsidiary will likely be subject to regulation in the jurisdiction of its customer-facing broker-dealer parent, rather than in the jurisdiction in which the subsidiary is organized. Similarly, it will likely be the broker-dealer (or even another related affiliated), not the booking subsidiary, that ensures compliance with the Proposed Regulations and other dictates of U.S. law. And it may even be yet another affiliate located in a different foreign jurisdiction that actually withholds and remits payments to the U.S. Treasury in respect of deemed dividend equivalent payments.

We therefore think it is essential to extend the dealer exclusion to any long transaction entered into by a "qualified affiliate" of a group of affiliated securities dealers, provided that the group of affiliated securities dealers meets the requirements for the exclusion as a whole. We note that there is precedent for this approach in the regulations under Section 1296 dealing with active and passive income for PFICs, and in the regulations under Section 904 defining "financial services income". The complexities and limitations associated with those regulations, however, relate to the fact that they serve to characterize income for various substantive tax purposes. By contrast, this rule would only serve to ensure compliance by the relevant group of affiliated securities dealers and so should not require any more detail than is needed to define when qualified affiliates are treated as related to each other.

We further note that an unrelated foreign corporation sometimes acts in concert with an affiliated group of securities dealers in providing services to foreign customers. For example, rather than issue equity-linked foreign securities to foreign customers itself, an affiliated group of dealers may allow an unrelated foreign corporation to routinely issue equity-linked securities to foreign customers of the group and then hedge its position by entering into offsetting equity-linked derivative contracts with a member of the affiliated group.

We believe that a foreign corporation acting in this manner should likewise be treated as a qualified dealer, provided that the affiliated group meets all of the foreign corporation's withholding obligations in a manner that is satisfactory to the IRS. If this is not provided for, then the Proposed Regulations should at least clarify that the grandfathering rule of Notice 2014-14 extends to contracts that are entered into by such a foreign corporation to hedge U.S.-equity-linked financial instruments that it issues prior to 90 days after the Proposed Regulations are finalized. Otherwise, such a foreign corporation would be subject to duplicative tax on dividends it was deemed to receive in respect of its hedging positions.

7C—<u>The Proposed Regulations should eliminate the requirement that a qualified affiliate be acting in its capacity as a dealer and that it provide a written certification to that effect to the withholding short party</u>.

Under Notice 2010-46, a qualified securities lender can only avoid withholding on a substitute dividend payment if it provides the relevant withholding agent with a statement confirming that it is a qualified securities lender and that it will withhold and remit or pay the proper amount of U.S. gross-basis tax with respect to any substitute dividend payments that it receives or makes. The qualified securities lender need not tell the withholding agent whether it is receiving any particular substitute dividend payment in its capacity as a dealer (in which case it will withhold on corresponding payments it makes to its foreign customer) or for its own account (in which case it will remit withholding tax in respect of its own liability). (Notice 2010-46 does make it clear that a qualified securities lender will be subject to substantive withholding tax liability on its proprietary positions and may be monitored to ensure its compliance in this regard.)

By contrast, the exclusion rule of the Proposed Regulations requires a qualified dealer to certify to the relevant short party that it is acting in its capacity as a dealer in entering into the relevant long position; and indeed, the exclusion itself does not apply if the qualified dealer's position is "proprietary". This could be read to mean that qualified dealers are not allowed to take responsibility for paying withholding tax on their own proprietary positions and must rather rely on short parties to withhold on their behalf.

We note first that such a transaction-specific identification and certification procedure would not be possible to implement as a practical matter. Most foreign securities dealers determine proprietary positions, if any, on a net basis—i.e., the amount of a foreign affiliate's proprietary position in a given U.S. stock is, by definition, its net long position after taking all offsetting positions into account. Its computer systems have limited means of tracking individual positions with particular related or unrelated U.S. broker-dealers and matching them up with particular positions with foreign customers.

Moreover, we do not see any need for bifurcating the responsibility to ensure compliance in this manner. If a qualified securities dealer can be trusted to withhold on its customers, it can presumably be trusted to withhold on itself.

In short, so long as the IRS has the ability to audit qualified dealers and other means are in place to ensure their substantive compliance, we do not see the value of requiring such a transaction-by-transaction certification procedure, a procedure which cannot readily be implemented in complex, large-volume markets. We therefore recommend that the requirement that a qualified dealer make a transaction-specific certification to a withholding short party be replaced with a broader certification (which can be made periodically) that it will meet its withholding obligations generally, consistent with the approach of Notice 2010-46.

7D—Like Notice 2010-46, the provisions designed to prevent cascading withholding should include a backup credit-forwarding system to cover hedging with physical positions.

A foreign qualified dealer will often hedge its short U.S.-equity derivative positions with long foreign customers by directly acquiring U.S. equities in the marketplace. In such cases, the foreign qualified dealer will be subject to withholding tax in respect of the dividends it receives on these stocks, as there are no arrangements for avoiding cascading withholding that apply to dividends actually received on actual U.S. stocks. In such cases, the foreign qualified dealer needs the ability to rely (as it would under Notice 2010-46) on a right to credit this withholding tax against its obligation to remit withholding tax in respect of the offsetting dividend equivalent payments that it makes to its foreign customers. Otherwise, the foreign qualified affiliate will in effect be paying two withholding taxes in respect of the same long position of its foreign customer.

7E—The Proposed Regulations should clarify that the exclusion for qualified dealers extends to hedges of the issuance of equity-linked securities.

Foreign affiliates of broker dealers often issue U.S.-equity-linked structured notes, exchange traded notes or similar securities to foreign investors and then hedge their positions by entering into long derivative positions with related or unrelated U.S. securities dealers. The Proposed Regulations should clarify that such foreign affiliates are acting in their capacities as qualified dealers, rather than hedging "proprietary" positions. It should further clarify that such foreign affiliates can rely on the Proposed Regulations in this regard for periods prior to the date of their finalization.

We note that this means that in light of the delayed effective date for equity-linked securities, no withholding tax will be imposed in respect of the ownership of such securities that are issued before 90 days after the Proposed Regulations are finalized.

## VIII. Recommendations Relating to Constructive Ownership Through Non-corporate Entities

8A—The threshold for application of the proposed look-through rule for partnerships should be 50%, rather than 10%, unless the taxpayer controls the partnership.

For purposes of applying Section 871(m), the Proposed Regulations would treat a foreign investor as owning an allocable portion of the U.S. stocks owned by any entity that is not a C corporation, unless U.S. stocks represent 10 percent or less of the value of the interest in the entity. This would extend, for example, to a foreign investor's interests in a U.S. master limited partnership.

Unfortunately, a passive foreign investor has no means of finding out what corporate interests such a partnership or other pass-thru vehicle owns. Neither would a broker-dealer or other potential withholding agent who holds such securities on the foreign investor's behalf.

If a pass-through entity is primarily a U.S. investment fund, then presumably it can and should be required to provide its foreign investors with the information they need to determine their withholding tax liabilities. We believe this might reasonably be the case if U.S. stocks represent more than 50% of the value of its assets.

## IX. Recommendations Relating to Instruments that are Treated as Debt or Preferred Stock for Tax Purposes

9A—<u>The Proposed Regulations should not apply to financial instruments that are treated as debt instruments for U.S. tax purposes</u>.

Foreign investors acquire various structured notes, exchange-traded notes and other derivative financial instruments that are linked to the performance of U.S. equities. Where these instruments leave the investor with unlimited downside exposure, they are generally treated as pre-paid forward contracts or other equity-linked derivatives for U.S. tax purposes. Where they guarantee the investor a return of at least 80 percent of the original issue price, however, they are normally treated as debt instruments subject to interest accrual under the contingent debt regulations. Likewise, foreign investors acquire debt instruments that are convertible into the stock of the issuer, and the conversion right is normally not in the money, let alone deep in the money, at the time of issuance.

As we discussed in the introduction above, we think the Proposed Regulations should seek to strike a balance between minimizing the risk of tax avoidance and minimizing the risk of unintended market disruption. We also do not think withholding tax on deemed accruals of dividend equivalent income should apply to financial instruments that are beyond the reasonable bounds of economic equivalence to the ownership of U.S. stock, or in circumstances that are clearly not contemplated by the tax law in general. For these reasons, we do think the Proposed Regulations should apply to require the accrual of phantom dividend income in respect of any instrument that is treated as a debt instrument for U.S. federal income tax purposes.

More specifically, first, the risk of tax avoidance using such instruments is exceedingly low. An investor in such an instrument pays very high transaction costs to acquire and sell the instrument, and also pays for undesired protection from a decline in the value of the referenced stock below the instrument's original issue price. No one invests in contingent or convertible debt to avoid the withholding tax on dividends on the stock that is referenced by the conversion option.

Second, such a debt instrument is not economically similar to the ownership of U.S. stock. As noted above, unlike direct ownership, such an instrument offers a great deal of protection from a decline in the value of the referenced stock. Moreover, unlike stock, such an instrument offers the investor a senior position and creditor's rights in the event of the issuer's default. Similarly, unlike an investment in stock, a debt instrument matures, forcing the investor to realize gains, rather than allowing for the perpetual deferral of unrealized appreciation. Most important, unlike stock, a contingent or convertible debt instrument doesn't entitle the investor to receive any of the dividends paid on the stock that is referenced by the conversion option, and it is therefore not appropriate to impose withholding tax in respect of their deemed receipt.

Third, under Section 871(h)(4) of the Code, Congress has already set out in considerable detail the circumstances under which contingent interest received by a foreign investor in respect of an investment in a U.S.-equity-linked debt instrument is subject to U.S. withholding tax. We think it would contradict clearly evidenced Congressional intent to provide that an instrument that is exempt from the imposition of U.S. withholding tax under Section 871(h)(4) is nevertheless subject to U.S. withholding tax in respect of a deemed accrual of dividend equivalent payments under the Proposed Regulations. Such deemed accruals could ultimately be received only as contingent interest that has already been exempted from withholding tax by clear Congressional mandate.

Likewise, the tax law has consistently treated convertible debt instruments as debt instruments, rather than as stock, since the inception of the income tax, and interest received on a convertible debt instrument has consistently been treated as eligible for the portfolio interest exemption. Prior to conversion, an investor in such an instrument has no right to receive dividends paid on the stock referenced by the conversion right, and such dividends are not received indirectly as an economic matter.

Fourth, most of our tax treaties exempt payments of interest on convertible debt instruments from outbound withholding tax, and many of them extend this exemption to contingent interest paid on such instruments, notwithstanding that they may be linked to the performance of U.S. equities. Imposition of U.S. withholding tax under the Proposed Regulations would seem to us to contradict the spirit, if not the letter, of many of these treaties. Nor would it be within the spirit of these treaties to force foreign investors to parse their language on a case-by-case basis to weight their rights to exemption.

Finally, we note that many convertible debt instruments are held by offshore arbitrage funds that are long the instrument and short the underlying stock. These funds do not maintain net long positions in the underlying referenced stocks and are therefore not avoiding withholding tax in any sense. Because they are not dealers, however, they would not be eligible for the qualified dealer exemption. Thus, extension of U.S. withholding tax to convertible debt instruments would effectively drive such funds out of the market by imposing withholding tax in respect of income that is not earned as an economic matter. Evidence from the financial crises suggests that these funds play an important role in maintaining liquidity in equity capital markets. Needlessly forcing them out of the market would therefore result in unintended market disruption.

9B—The Proposed Regulations should likewise not apply to convertible preferred stock.

The reasoning set out above applies equally to preferred stock that is convertible into the common stock of the issuer. Unlike a foreign investor in convertible debt, moreover, a foreign investor in convertible preferred stock receives dividends currently paid on the preferred stock and pays current U.S. withholding tax in respect of it. (There is of course no portfolio income exemption for stock.)

It would therefore seem particularly inappropriate to require such a foreign investor to pay a second U.S. withholding tax in respect a deemed accrual of dividend income arising from the mere right to convert the preferred stock into common stock of the issuer. The hypothetical imposition of two withholding taxes in respect of a single financial investment serves to us to underline how far the Proposed Regulations would be straying from the bounds of their own intent if they were applied to such instruments as convertible debt, contingent debt and convertible preferred stock.

X. Recommendations Relating to Employee Compensation Arrangements

The Proposed Regulations should clarify that employment arrangements, such as restricted stock units and employee stock options, are not "financial transactions" within the meaning of the regulations and are therefore not "equity-linked financial instruments" subject to withholding tax.

Many employment arrangements, such as restricted stock units, provide for cash payments determined by reference to the dividends paid on a U.S. employer's stock. These payments have never been treated as dividends subject to withholding tax when received by foreign resident employees. Rather such payments are treated as employment compensation that may be subject to U.S. income tax or social security tax to the extent that the payments are deemed received for services performed in the United States (and to the extent a U.S. tax treaty does not exempt such compensation from U.S. income and withholding tax).

We assume that the Proposed Regulations do not seek to reverse this longstanding treatment, either for dividend equivalent payments that are actually received by foreign employees in respect of such arrangements, or for dividend equivalent payments that might otherwise be deemed received by foreign employees under the Proposed Regulations in respect of their holding restricted stock units, employee stock options or other rights determined by reference to the value of a U.S. employer's stock. Subjecting such employment-related compensation to outbound withholding tax would disrupt the complex and settled rules that are already in place to govern the taxation of such arrangements. Moreover, doing so would arguably violate treaties designed to govern rights of taxation in such cases.[29]

[29] For example, most U.S. tax treaties provide that compensation for services performed by foreign employees in the United States is not taxable in the United States if the employee is present in the United States for less than 183 days in any trailing 12-month period, the local foreign subsidiary that actually employs the foreign employee is not a resident of the United

A plain reading of the Proposed Regulations as currently drafted suggests that the Proposed Regulations do not intend to impact such employment arrangements. Although withholding applies to an "equity-linked instrument", an equity-linked instrument is in turn defined as a "financial transaction". Common understanding suggests that employment arrangements are not "financial transactions". However, a subsequent sentence that cites as examples "a future contract, forward contract, option, debt instrument," continues with "or other contractual arrangement that references the value of one or more underlying securities is an equity-linked instrument". This has led to some concern, because an employment arrangement is arguably a contractual arrangement.

In light of the above, we believe that the Proposed Regulations should expressly clarify that an employment arrangement is not a "financial transaction" (and therefore not an equity-linked financial instrument) for purposes of the Proposed Regulations.[30]

## XI. Relief for Information Sharing for Exchange Traded and Cleared Products

Delta for listed derivatives should be based on the prior trading day's market close.

Listed and cleared derivatives pose unique issues in that there are often multiple marketplace participants that are involved in the trading, settlement and payment flows with respect to a single listed derivative transaction. A listed derivative contract is listed on an exchange on a particular date with a fixed expiration date and is continuously offered so that investors can enter into what is effectively a new contract with identical terms as the original issuance at any time between issuance and expiration. All listed contracts of a particular issuance are intended to be fungible with each other.

While the executing broker may know the price and execution time of a particular position in a listed derivative contract, it may not be able to compute the delta of a particular position. It is practically impossible for an executing broker, or a clearing broker that may be a different financial institution and is acting in a custodial capacity, to calculate or systematically track or maintain the delta at the time of execution for each holder. As a practical matter in some cases, the only viable method to obtain delta is to rely on third party published sources based on approximate trade information, and this delta may differ from internal models or actual pricing. Given the high volume of listed derivative contracts, it would be a significant departure and a substantial build for financial institutions to keep track of the unique delta associated with respect to each listed derivative contract for each price execution. Testing the delta of a contract based on the prior trading day's market close (i.e., the day before the contract is acquired) would

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States, and the compensation is not borne by a permanent establishment that such foreign subsidiary has in the United States.

30 In the case of restricted awards of actual shares of stock, such stock is treated as actually owned by the employee once it vests or once a Section 83(b) election is made with respect to the stock. In this limited context, we presume withholding could still apply under Section 871(m) with respect to dividends subsequently paid on the stock.

reduce some of the operational build and would provide parties with certainty of whether their contracts are in scope of Section 871(m) withholding. Nevertheless, we continue to have serious concerns about how to implement Section 871(m) withholding in the context of exchange traded and listed products.

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We hope these suggestions are sufficiently clear, and sufficiently detailed, to help in each case to advance the ball. We realize, however, that further explanation or detail may be required. Please do not hesitate to call our tax counsel, Payson Peabody, at (202) 962-7300, or our outside counsel, David Hariton, at (212) 558-4248, if you would like any such further explanation or detail, and they will coordinate our efforts in this regard.

Sincerely,

Payson R Peabody

Payson R. Peabody
Managing Director & Tax Counsel
Securities Industry and Financial Markets Association

cc: Mark Erwin, Branch Chief, International Branch 5, IRS Chief Counsel
Peter Merkel, Senior Technical Reviewer, International Branch 5, IRS Chief Counsel
Karen Walny, Attorney-Advisor, International Branch 5, IRS Chief Counsel

APPENDIX

Examples of Application of the Delta Test and the Proposed Additional Test

Example 1. *Delta test denominator includes only maximum number of shares to which ELI exposes the offshore investor/counterparty.* (i) F buys a call on 100 shares of XYZ stock and, in connection with that call, it sells a put on the same number of XYZ shares. The strike price on the put is equal to or lower than the strike price on the call. Although F holds two positions each referencing 100 shares, they together give it exposure to only 100 shares – that is, for every $1 increase in the value of XYZ, it will receive an additional dollar on the ELI, and vice-versa. Thus, the denominator references 100 shares for purposes of applying the delta test.
(ii) The facts are the same as in (i) except that the strike price on the put is higher than that of the strike price on the call. Thus, to the extent that the stock price at maturity of the options is above the strike price on the call (but below the strike price on the put), F's return will be determined by the increase in value of 200 shares – that is, for every $1 increase in the value of XYZ, it will benefit by two dollars, and vice-versa. Thus, the denominator references 200 shares for purposes of applying the delta test.

Example 2. *Delta test denominator references maximum number of shares whether or not the ELI provides unlimited exposure to that number; numerator takes all "connected" positions into account.* An ELI gives F (a) the downside on 100 XYZ shares and (b) the upside on 300 XYZ shares, but not to the extent that the value of XYZ at maturity exceeds $110. The upside is measured using a strike price of $100. The ELI gives F exposure to 300 shares of XYZ as F will receive $3 for every $1 increase in the value of XYZ between $100 and $110. The denominator therefore references 300 shares for purposes of applying the delta test. This is true notwithstanding the fact that (a) the ELI does not give F exposure to any extent above $110 or (b) the ELI only gives F exposure to 100 (not 300) shares to the extent XYZ falls below $100. The numerator will take into account all the positions embedded in the ELI, specifically the (i) short put position on 100 shares, (ii) long call position on 300 shares, and (iii) short call position on 300 shares.

Example 3. *Application of delta test to strip of calls.* F acquires an ELI consisting of four calls, each exercisable for 100 shares of XYZ. The calls are one year calls exercisable sequentially, that is, the first call is exercisable only in year 1, the second one is exercisable only in year 2, etc. The exercise or non-exercise of a given call does not impact the right to exercise the call in any of the following years. As the ELI gives F exposure to 400 shares of XYZ, the denominator references 400 shares for purposes of applying the delta test.

Example 4. *Digital option; application of the anti-abuse rule to determine if it is substantially equivalent to a delta one position.* An ELI provides that if the spot price of XYZ on the ELI's maturity is above $90, F (the holder of the ELI) will receive $1,000, without regard to the amount by which XYZ exceeds $90 on that date. The ELI has a maturity of thirty days or more and the spot price at the time of its acquisition of $90 or less. Because, other than the "knock-in" price, there is no correlation between the value of XYZ stock and the payoff on the ELI, it is not possible to determine how many XYZ shares should be deemed referenced in the denominator of the delta test. The ELI can therefore not be tested under the delta test. However, the ELI must also be tested under the anti-abuse rule to determine if it is substantially equivalent to a delta one position. One approach to such a rule might be application of a "proportionality test", as noted in Section 2A above. The initial hedge is [10] XYZ shares. Under the proportionality test, the expected difference between the change in value of the ELI and that of the initial hedge over its life is significant. Thus, the ELI would not be within the scope of section 871(m).

Example 5. *Further illustrations of application of anti-abuse rule to determine if a derivative is substantially equivalent to a delta one position.* (i) The facts are the same as in Example 2 with the additional fact that the spot price at the time of the ELI's acquisition by F is $100 (the same as the strike price on the embedded short puts and long calls). With a denominator of 300 shares, assume that the ELI has a delta of less than 0.7. However, the ELI must also be tested under the anti-abuse rule to determine if it is substantially equivalent to a delta one position. One approach to such a rule might be application of the "proportionality test" noted above. The Initial Hedge is [102] XYZ shares. Taking into account the different degrees of exposure to XYZ shares that occur depending on whether the price of XYZ is above or below $100 or above $110, and the likelihood of those prices being realized, the expected difference between the change in value of the ELI and that of the Initial Hedge over its life is significant. Thus, the ELI will not be within the scope of section 871(m).

(ii) The facts are the same as in Example 2 with the additional fact that the spot price at the time of the ELI's acquisition by F is $70 (that is, $30 below the $100 strike price on the embedded short puts and long calls). With a denominator of 300 shares, assume that the ELI has a delta of less than 0.7. However, the ELI must also be tested under the anti-abuse rule to determine if it is substantially equivalent to a delta one position. One approach to such a rule might be the application of the "proportionality test" noted above. The Initial Hedge is [100] XYZ shares (each with a value of $70). Taking into account the different degrees of exposure to XYZ shares that occur depending on whether the price of XYZ is above or below $100 or above $110, and the likelihood of those prices being realized, the expected difference between the change in value of the ELI and that of the Initial Hedge over its life is not significant. Thus, the ELI will be within the scope of section 871(m).

(iii) An ELI provides that F will receive the upside on (i) 100 XYZ shares to the extent that the spot price at maturity of the referenced shares is above $80 and (ii) a further 100 shares to the extent that the spot prices at maturity of the ELI is above $150. The spot price at the inception of the ELI is $100. The denominator for purposes of applying the delta test would reference 200 shares – the 100 shares referenced by the $80 call and the 100 shares referenced by the $150 call. With a denominator of 200 shares, assume that the ELI has a delta of less than 0.7. However, because the ELI must also be tested under the anti-abuse rule to determine if it is substantially equivalent to a delta one position. One approach to such a rule might be application of the "proportionality test" noted above. The Initial Hedge is [95] XYZ shares. Looking at the range of expected change in value of XYZ over the life of the ELI, there is not a meaningful likelihood that the stock price will be below $80 or above $150 at the time the ELI matures. As a consequence, the expected difference between the change in value of the ELI and that of the Initial Hedge over its life is not significant. Thus, notwithstanding the fact that the ELI has a delta of less than 0.7 under the basic delta test, it will be within the scope of section 871(m).

(iv) The facts are the same as in the previous paragraph except that the strike price on the second option is $120, rather than $150. The denominator for purposes of applying the delta test is 200 XYZ shares – the 100 shares referenced by the $80 call and the 100 shares referenced by the $120 call. With a denominator of 200 shares, assume that the ELI has a delta of less than 0.7. However, the ELI must also be tested under the anti-abuse rule to determine if it is substantially equivalent to a delta one position. One approach to such a rule might be application of the "proportionality test" noted above. The Initial Hedge is [110] XYZ shares. Taking into account the expected change in value of XYZ over the life of the ELI, the expected difference between the change in value of the ELI and that of the Initial Hedge over its life is significant. Thus, the ELI will not be within the scope of section 871(m).

(v) An ELI gives F (a) the downside and the upside on 100 XYZ shares plus an "additional amount" equal to (b) the upside on a further 75 XYZ shares, but not to the extent that the value of XYZ at maturity exceeds $100.25. At the time the ELI is acquired by F each XYZ share is trading at $100. Therefore, the maximum additional amount is $18.75 (equal to 75 shares x 0.25). The denominator for purposes of applying the Delta test is 175 shares. With a denominator of 175 shares, assume that the ELI has a delta of less than 0.7. However, the ELI must also be tested under the anti-abuse rule to determine if it is substantially equivalent to a delta one position. One approach to such a rule might be application of the "proportionality test" noted above. The Initial Hedge is [100.1] XYZ shares. Looking at the expected change in value of XYZ over the life of the ELI, and taking into account the relatively minimal additional amount that F can receive on part "(b)" of the ELI, the expected difference between the change in value of the ELI and that of the Initial Hedge over its life is not significant. Thus, the ELI will be within the scope of section 871(m).

(vi) The facts are the same as in the previous paragraph except that the "additional amount" is equal to $1000 if the value of XYZ at maturity exceeds $500, otherwise the additional amount is zero. By reason of the digital option it is not possible to determine how many XYZ shares should be deemed referenced in the denominator of the delta test and thus it is not possible to apply the delta test. However, because the ELI is a complex derivative, the ELI must be tested under the anti-abuse rule to determine if it is substantially equivalent to a delta one position. One approach to such a rule might be application of the "proportionality test" noted above. The Initial Hedge is [100] XYZ shares. Applying the additional test, the expected difference between the change in value of the ELI and that of the Initial Hedge over its life is not significant. Thus, the ELI will be within the scope of section 871(m).