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Re: Section 871(m) Regulations

Dear Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to submit comments on the final, temporary and proposed regulations (collectively, the "Regulations") under Section 871(m) of the Internal Revenue Code (the "Code"). We appreciate and acknowledge the significant effort that went into the drafting of the Regulations and the consideration that the government devoted to the issues that were raised by the securities industry, and we are committed to working with the government to implement the Regulations.

SIFMA believes that it is in a unique position to make practical suggestions relating to the implementation of the Regulations because it represents most of the U.S. broker-dealers that

[1] SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving retail clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

execute, and are the withholding agents with respect to, the transactions that are subject to the Regulations. As discussed below, our comments are focused on constructive and practical recommendations that are designed to ensure that the Regulations are operationally administrable and achieve their objectives.

We understand and acknowledge that most of the Regulations were issued in final form and that the government is accordingly not inclined to make significant changes to the Regulations. We urge the government to nonetheless consider whether certain changes to the Regulations are necessary in light of the complexity of the Regulations, the novel and ground breaking withholding regime that is set forth in the Regulations, and the impact that the Regulations will have on the equity derivatives markets. In addition, many of the recommendations set forth in this letter could be implemented through the issuance of administrative guidance and do not necessarily require a change to the Regulations.

Furthermore, while we appreciate that the government wants to expeditiously complete its mandate to finalize and implement the Section 871(m) withholding regime, we wish to underscore that if such rules are finalized before all of the relevant issues have been fully considered and addressed, they could - - however inadvertently - - cause a significant market disruption in the U.S. equity derivatives market. This could particularly be the case if market participants do not fully comprehend the Regulations and do not have the necessary time or guidance to implement the far reaching and complex rules under the Regulations. While we cannot predict the scope and severity of such a market disruption, we offer the comments and recommendations below with a view to ensuring that market participants can implement the Regulations without causing a market disruption or otherwise adversely affecting market participants in a manner that is not contemplated by the Regulations.

Moreover, we want to stress that market participants will be required to develop extremely sophisticated and complex systems in order to implement the Regulations and it will not be possible to do so in the absence of some of the additional guidance with respect to the Regulations that is discussed in this letter. Many of these systems cannot be implemented on an independent basis but must be coordinated with other market participants on an industry wide basis, particularly in the case of structured notes and listed options that, as discussed below, are held through intermediary financial institutions. We note that the securities industry is being asked to implement this novel and complex withholding regime at the same time that it is devoting extraordinary effort and resources towards implementing the FATCA rules, the Section 305(c) rules, and the "common reporting standards" ("CRS") rules.

This letter does not address the portion of the Regulations that applies to qualified derivatives dealers because we understand that the government intends to issue a Revenue

Procedure that will address these rules in more detail. We intend to address these rules in a letter that we will submit to the government subsequent to the issuance of the Revenue Procedure.

In addition, this letter does not address the application of the Regulations to derivatives and securities loans with respect to convertible debt, options and other instruments that could be subject to Section 305(c) of the Code (collectively, "convertible instruments"). While guidance is needed with respect to the application of the Regulations to such transactions, we understand that the government intends to shortly issue guidance regarding the application of Section 305(c) to convertible instruments. We therefore intend to address any issues with respect to the application of the Regulations to derivatives and securities loans with respect to convertible instruments after the issuance of the forthcoming Section 305(c) guidance.

I. Overview of Recommendations

The following is a brief outline of our primary recommendations for guidance with respect to the Regulations that are set forth in this letter. Each of these recommendations, as well as other issues and recommendations with respect to the Regulations, are discussed in more detail in Part II of this letter.

A. Combination Rules

1. A withholding agent should only be required to combine a contract with another contract for Section 871(m) purposes if it has actual knowledge that the two contracts were "priced, marketed or sold" in connection with each other.

2. The Regulations can be read not to apply the combination rule to contracts that, when combined, would be complex contracts. If the government disagrees with this position, the government should clarify that and provide that taxpayers and withholding agents should be entitled to use any reasonable approach to determine whether the combined complex contract should be subject to Section 871(m) as long as such approach (a) is reasonably consistent with the policy of the delta and substantial equivalence tests that are set forth in the Regulations, (b) is applied consistently for similar instruments, and (c) is not designed to cause such combined instruments to be outside of the scope of Section 871(m).

B. Timing of Withholding

1. Current withholding systems are built to enable withholding from cash payments. Although the Regulations generally provide that dividends equivalents are not treated as paid until a payment date, the Regulations define a payment date to include the termination of a contract where no cash payment is made. Given the chance of cashless withholding, some withholding agents believe it would be easier to build systems based on the payment of

underlying dividends. Accordingly, we propose that withholding agents be allowed to elect to treat a dividend equivalent amount as paid, and as thus subject to Section 871(m) withholding, on the dividend payment date for the underlying security that is referenced by the Section 871(m) contract. The current rule in the regulations should remain the default rule as many withholding agents believe that building systems based on payments, as defined in the regulations, remains the most time and cost efficient build.

C. Timing of Investor's Tax Liability

1. A foreign investor should not be subject to Section 871(m) tax with respect to a Section 871(m) contract prior to the date upon which the Section 871(m) withholding tax is due with respect to such contract.

D. Delta Determination

1. Except as described below in respect of listed options and structured notes, the delta of a contract (or the application of the substantial equivalence test with respect to a contract) should be computed on the date that the parties to the contract have (a) entered into a binding agreement to enter into the contract and (b) agreed upon the final pricing terms for the contract.

E. Structured Notes

1. The issuer of a structured note should be the only party that is required to compute the Section 871(m) information (as defined below) for the note even if (a) the issuer is not a broker or dealer or (b) the note is held through financial institutions that are also treated as "parties to the transaction" under the Regulations.

2. If a withholding agent makes a payment on a structured note that is subject to Section 871(m) withholding and it does not have actual knowledge of the beneficial investor's holding period in the notes, it should assume that the investor has held the notes during the entire term of the notes, unless the investor (or a financial institution that holds the note on behalf of the investor) provides a certification that sets forth its holding period in the notes.

3. Upon a sale of a structured note, the seller's broker should be the sole withholding agent with respect to any Section 871(m) withholding tax that is due upon the sale.

4. An investor should be entitled to credit any FDAP withholding that it is subject to with respect to a structured note against any Section 871(m) withholding that is subsequently imposed on the investor with respect to the note.

5. The rules in the Section 108 regulations with respect to the purchase of debt by an issuer or an affiliate that is acting in its dealer capacity should similarly apply for Section 871(m) purposes to an issuer or an affiliate that acquires structured notes in its dealer capacity.

6. In the case of structured notes that have a single issue date and multiple pricing dates, the delta (or substantial equivalence test) for all of the notes should be determined on the first pricing date for a substantial amount of notes so long as there are no more than thirteen days between the first pricing date and the final pricing date for the notes.

F. Listed Options

1. The delta of a listed option should equal the delta of the option as of the close of the business day immediately prior to the acquisition of the option.

2. The clearing house that is the counterparty under a listed option should be the only party that is required to compute the delta for the option.

3. A clearing house should not be required to record the inputs for the delta computation for each specific listed option in the manner that would normally be required under the Regulations, as long as it retains information to demonstrate that its delta computation methodology is consistent with the manner required by the Regulations.

G. Withholding Responsibility for "Cashless" Withholding

1. The withholding agent that has primary withholding responsibility for any actual payments of a dividend equivalent should also have primary withholding responsibility for any "cashless" dividend equivalent payments. The withholding agent should be granted additional time to deposit any "cashless" Section 871(m) withholding tax.

H. Partnership Derivatives

1. The definition of the term "covered partnership" should be revised so that it eliminates the $25 million test in the Regulations and only includes a partnership that is either a dealer or trader in securities or that satisfies the 25% test set forth in the Regulations.

2. The delta of a derivative with respect to underlying securities that are held by a partnership that is subject to Section 871(m) should equal the delta of the derivative with respect to the partnership interest as a whole and should not be determined based on a look-through to the underlying securities that are held by the partnership.

3. Market participants should be entitled to rely on any information that is provided by a partnership, its agent, or a reasonably reliable third party provider, in order to determine the Section 871(m) withholding tax, if any, with respect to a derivative on a partnership interest.

4. If a partnership does not provide the aforementioned information to a withholding agent, then a withholding agent should be entitled to satisfy its Section 871(m) withholding obligation by assuming that the dividends on the underlying securities that are held by the partnership are equal to the distributions that are made by the partnership.

I. Qualified Indices

1. An index should be treated as satisfying the "traded" requirement under the qualified index rules as long as options or futures or the index are listed on an exchange that is described in the Regulations.

2. Withholding agents should only be required to apply the "short position rule" (as defined below) in the case of two positions that are "priced, marketed or sold" as part of a single investment transaction.

3. A "capped index" (as described below) that does not independently satisfy the "traded" requirement necessary to constitute a qualified index should nevertheless satisfy such requirement as long as it mirrors (subject to the cap limitation) an index that satisfies the "traded" requirement.

J. Non-Qualified Indices

1. A non-qualified index (whether denominated as an index or a basket of securities) should be treated as a single underlying security for Section 871(m) purposes, and therefore the delta for a derivative with respect to a non-qualified index should be based on the index as a whole rather than on each component of the index. Accordingly, the delta for the derivative should not be recomputed each time there is a change to the index unless the changes to the index trigger a deemed reissuance of the derivative under Section 1001 of the Code.

K. Dividend Determination Date

1. If an investor in a Section 871(m) contract is economically entitled to a payment or contract adjustment based on the payment of a dividend on the underlying security, then the corresponding dividend equivalent payment under Section 871(m) should be determined on the date on which the long party becomes economically entitled to the payment or adjustment under the terms of the contract, and should not be based on the record date or ex-dividend date for the dividend.

L. Definition of Complex Contract

1. The single fixed number of shares requirement under the simple contract definition should be satisfied even if a contract provides for adjustments to the number of securities that are referenced by the contract to take into account a distribution with respect to the securities, if the delta for the contract can be computed in the manner that is contemplated by the Regulations.

2. A contract should not be treated as a complex contract solely because the contract can be redeemed by the issuer, as long as the delta for the contract can be computed in the manner that is contemplated by the Regulations.

M. Substantial Equivalence Test

1. An issuer of a complex contract should be entitled to use a test that differs from the substantial equivalence test for purposes of determining the Section 871(m) withholding tax with respect to the contract as long as the Section 871(m) withholding tax, if any, with respect to the contract under the alternative test will be the same as if the issuer had employed the substantial equivalence test.

II. Detailed Discussion of Recommendations

A. Combination Rules

The Regulations provide that two or more contracts that reference the same underlying security will generally be combined if they are entered into "in connection with" each other and if the combined contracts replicate the economics of a Section 871(m) transaction (the "combination rule").[2] The Regulations do not define the "in connection with" standard, but they state that two transactions will generally be presumed to not be "in connection with each other" if they are entered into more than two days apart or are not recorded in the same account (the "presumption rules").[3]

The combination rule is an anti-abuse rule that is intended to prevent an investor from avoiding the application of the Regulations by entering into two related transactions that would each have an independent delta that is below .8 but that would have a delta that is equal to .8 or above on a combined basis. We agree that the combination rule is needed to prevent this result, and our members intend to devote a considerable amount of resources and effort in order to

[2] Treas. Reg. Sec. 1.871-15(n)(1).

[3] Treas. Reg. Sec. 1.871-15(n)(3).

identify, and impose withholding taxes on, transactions that are subject to the combination rule. However, as described in more detail below, we believe that further guidance is needed in order to ensure that the combination rule is applied in a manner that is limited to abusive transactions and that can be reasonably implemented and applied by withholding agents.

1. Withholding Standard

The Regulations generally require that withholding agents apply "reasonable diligence" in order to determine whether a transaction is subject to Section 871(m).[4] We understand, however, based on informal comments made by government personnel that the reasonable diligence standard is not intended to supplant the general "know or reason to know" standard that is otherwise set forth in the Section 1441 regulations, and that accordingly withholding agents will not be required to combine contracts unless they "know or have reason to know" that such contracts were entered into "in connection with each other". For the reasons set forth below, we urge the government to issue guidance that provides that a withholding agent will only be treated as satisfying the "know or reason to know" standard with respect to the combination rule if it has actual knowledge that two or more contracts were "priced, marketed or sold" in connection with each other, and that accordingly a withholding agent will not be required to apply the combination rule to contracts for which it does not have such actual knowledge.[5] (For purposes of simplicity, the remainder of this discussion uses the term "independent contracts" when referring to a contract for which the withholding agent does not have actual knowledge that such contract was "priced, marketed or sold" in connection with another contract). Under this approach, the presumption rules can be eliminated because contracts that satisfy the "priced, marketed or sold" standard would be subject to the combination rule even if they are entered into more than two days apart or in separate accounts. As discussed in more detail below, we believe that the "priced, marketed or sold" standard is appropriate from both a policy and practical perspective, and we are very concerned that the failure to adopt such a rule could severely impair the market for foreign investment in US equity derivatives.

The practical and policy issues that would arise if withholding agents are required to apply the combination rule to independent contracts can be illustrated by considering the nearly

[4] Treas. Reg. Sec. 1.871-15(p)(1).

[5] For purposes of clarity, we note that this standard would only apply to withholding agents, but foreign investors would continue to be subject to the combination rule if two or more contracts satisfy the "in connection with" standard.

impossible tasks that a withholding agent would be required to undertake in order to apply the combination rule to such contracts. More specifically, if a foreign investor enters into a contract with respect to an underlying security, the withholding agent would first need to identify every single contract that the investor holds with respect to the underlying security that is not subject to the presumption rules (i.e., contracts that are entered into in the same account within two days of each other). This would include contracts with respect to baskets or non-qualified indices that include the underlying security. In addition, while the separate account presumption can be employed for contracts that are held in custodial and brokerage accounts, many financial institutions do not maintain separate accounts, or may not maintain accounts at all, for counterparties in OTC derivative transactions. In such a case, the withholding agent would presumably be obligated to identify all the OTC positions it entered into with the investor (and any related parties) within a two day period that relate to the same underlying security, notwithstanding that such positions may have been entered into by different business units across the globe that do not otherwise share information with each other.

Once the withholding agent identifies such positions, it would need to determine whether any of the positions were entered into in connection with each other. This would require the withholding agent to make a subjective determination regarding the investor's subjective intent for entering into a transaction. Aside from the fact that a withholding agent will often have no basis for making such a determination, there is significant legal uncertainty regarding the application of the "in connection with" standard, particularly with respect to investors and financial institutions that regularly enter into OTC transactions (which, as noted above, often do not use separate accounts) in different business units that operate independently of each other. The lack of an objective legal standard and the fact that the "in connection with" standard is based on facts that will often be unknown (and cannot be known) to the withholding agent will inevitably result in withholding agents employing inconsistent standards in making this determination. Furthermore, we expect that some withholding agents will simply assume that any positions with respect to the same underlying security that are not subject to the presumption rules are entered into connection with each other and thus subject to the combination rule because (a) they will have no information regarding the investor's subjective intent that would allow them to conclude otherwise and (b) they will not want to take the risk that a contrary position would be challenged by the IRS. In addition, depending on how broadly one interprets the "in connection with" standard, it is arguable that two positions that a taxpayer enters into with respect to the same underlying security within a two day period should be treated as connected with each other because the taxpayer will presumably consider each of its recent positions with respect to an underlying security when entering into another position with respect to the same underlying security.

Once the withholding agent identifies the positions of the taxpayer that are subject to the combination rule, it would need to determine which positions should be combined with each other. This could be illustrated by an example, which is not uncommon, in which an active foreign investor acquires or sells hundreds of listed options within a two day period with respect to the same underlying security. If the withholding agent treats all such positions as entered into in connection with each other, the Regulations would require the withholding agent to combine the positions in a manner that would create the maximum number of position that have a delta of .8 or above.[6] In the case of the investor in the example, that would require the withholding agent to compute tens of thousands of possible combinations that could be constructed from the hundreds of listed options in order to apply this test. Furthermore, there are many uncertainties regarding the application of the combination rules which would further complicate this analysis and may make it impossible to develop an automated system that could make these determinations. In addition, the withholding agent would need to monitor each time that a component of a combined instrument is sold or terminated so that it can apply the rules described below that apply in the case of a "leg-out" of a combined instrument. Finally, if, as discussed in more detail below, the government takes the position that contracts can be combined into a complex contract, the withholding agent would apparently be required to apply the substantial equivalence test to the notional complex contract that is created pursuant to the combination rule. The withholding agent would then be required to compute all of the inputs that are required under the substantial equivalence test, including information regarding the initial hedge for the instrument. This would be the case even though the initial hedge and other inputs would be hypothetical computations for a hypothetical instrument that the withholding agent would not otherwise be computing for any other purpose.

The discussion above illustrates why it is practically impossible for withholding agents to apply the combination rule to independent instruments, and particularly to expect them to do so by January 1, 2017. We note that withholding agents are being asked to implement this unprecedented withholding regime for combined transactions at the same time that they are devoting extraordinary effort and resources towards implementing the core requirements of the Section 871(m) rules, the FATCA rules, the Section 305(c) rules and the CRS rules. In addition, withholding agents are not subject to the substantive Section 871(m) tax, but like other withholding taxes, are being asked to collect the tax on behalf of the government. We understand that the withholding tax regime is a fundamental part of the tax system and the members of SIFMA devote a considerable amount of time and resources in order to comply with their withholding obligations. However, the withholding regime is intended to enable withholding agents to collect withholding tax based on facts that it knows or that it can

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

reasonably obtain from market participants. The combination rule is essentially an anti-abuse rule that is designed to prevent an investor from inappropriately avoiding the Section 871(m) rules through the use of separate instruments that would otherwise not be subject to Section 871(m). It is unprecedented and unreasonable to require withholding agents to implement an anti-abuse rule that is dependent on (a) information regarding the investor's subjective intent that the withholding agent is not aware of and cannot determine, (b) a legal determination regarding the application of the "in connection with" standard to a taxpayer's specific facts and (c) complex financial calculations that are not being computed for any other purpose. Moreover, the withholding rules in the Regulations in any case do not prevent a foreign investor from engaging in an abusive transaction that avoids the Section 871(m) withholding tax because an investor could simply avoid withholding under the Regulations by entering into two related positions with two brokers that do not know that the two positions are related to each other.

Furthermore, the withholding rules are designed to enable the US to collect taxes with respect to amounts paid to foreign investors because otherwise the government would generally be unable to collect the tax from the foreign investors. However, a very significant percentage of the foreign investors in US equity derivatives, and particularly those that are engaged in sophisticated trading strategies that implicate the combination rule, are foreign hedge funds that have significant activities in the US and are within the IRS's audit ambit. Moreover, many of these hedge funds are subject to US GAAP financial reporting which would require their auditors to identify instruments that should be subject to the combination rule in order to ensure that they are properly accounting for their tax liabilities on their financial statements. The IRS will accordingly in many cases have other mechanisms to ensure that foreign investors are applying the combination rule, which is more effective and appropriate than requiring withholding agents to apply the combination rule based on facts that they do not, and often cannot, know.

We also believe that the application of the "priced, marketed or sold" standard to withholding on combined instruments is the correct standard as a policy matter. More specifically, we believe that, aside from the collection of taxes with respect to abusive transactions, the government's objectives under the combined instrument withholding rules should be (a) to create a global withholding system that all withholding agents can reasonably implement and comply with and (b) to ensure that the withholding rules do not apply to transactions that should not be subject to the combination rule and that could result in numerous refund claims from foreign investors. The "priced, marketed or sold" standard will enable withholding agents to identify transactions that are clearly related to each other and that should be of the most concern to the government. By contrast, if the combination rule applies to independent contracts, withholding agents will not be able to reasonably implement the withholding tax rules for the many reasons described above. This could significantly disrupt the

global US equity derivatives market because withholding agents may refuse to hold US equity derivatives that are owned by foreign investors that could be subject to Section 871(m) withholding under the combination rule. Other withholding agents may attempt to comply with the combination rule but will do so in an incomplete and inconsistent manner, thereby undermining compliance with, and market confidence in, the combination rule. Finally, as discussed above, if the combination rule applies to independent contracts, some withholding agents may treat all contracts that are not subject to the presumption rules as subject to Section 871(m) withholding. This could cause the IRS to be inundated with refund claims, which would frustrate the purpose of the combination rule and would impose an undue burden on the IRS's resources.

Accordingly, based on the discussion above, we recommend that guidance be issued that a withholding agent will only be required to apply the combination rule to a contract if it has actual knowledge that the contract was "priced, marketed or sold" in connection with another contract. If the government disagrees with this approach, we recommend that at a minimum the January 1, 2017 effective date should be deferred for purposes of applying the combination rule to independent contracts. This would allow market participants and the government more time to address the many issues described above and to effectively implement systems and policies that would enable withholding agents to apply the combination rule to such contracts.

2. Complex Contracts

The following subsection addresses the application of the combination rule to contracts that are complex contracts or that would be complex contracts after the application of the combination rule. We first note that the Regulations arguably do not apply the combination rule in such a case because the Regulations provide that instruments should be combined in a manner that results in the maximum number of combined instruments with a delta of .8 or above.[7] The reference to delta, which only applies to simple contracts, implies that the Regulations only contemplated the combination of instruments that would be simple contracts, and not complex contracts. This position is further supported by an example in the Regulations in which an investor entered into two call options and one put option with respect to an underlying security. The Regulations state that one of the call options and the put option should be combined for Section 871(m) purposes, while the second call option should not be subject to the combination rule, even though all three options were apparently entered into in connection with each other.[8] This is the case notwithstanding that the three options could have been combined

[7] Treas. Reg. Sec. 1.871-15(n)(6).

[8] Treas. Reg. Sec. 1.871-15(n)(6).

into a single complex contract that provides for a leveraged delta one position with respect to the underlying security. The fact that the Regulations did not combine the three options in this manner supports the position that contracts should not be combined into a complex contract under the combination rule, or at a minimum that a contract should not be combined with a simple contract that is already subject to Section 871(m) if doing so would create a complex contract. If that was the government's intent, it should clarify that position.

If, however, the government believes that the combination rule does apply to contracts that, when combined, would be complex contracts, it should issue guidance as to how Section 871(m) should be applied to the combined complex contract. More specifically, the Regulations provide that a complex contract will only be subject to Section 871(m) if it satisfies the substantial equivalence test.[9] The substantial equivalence test seemingly assumes that the issuer of the instrument will price and hedge the complex contract and therefore will have the pricing and hedging information necessary (e.g., the "initial hedge", "standard deviation" and probability information) to apply the test. This will generally not be the case with respect to a complex contract that is created pursuant to the combination rule because the combined instrument is a notional instrument that is not issued by the withholding agent or any other party. If the withholding agent is nonetheless required to apply the substantial equivalence test in such a case, it would be required to compute extremely complex information regarding the hypothetical hedge that it would enter into if it were to hypothetically issue the combined instrument. It is not realistic or feasible to require withholding agents to make such computations for ordinary course client investments, and we do not think that Congress intended to impose such an obligation on withholding agents. This is particularly the case for assets held in a custodial account where complex financial calculations such as the substantial equivalence test are not done and for which the inputs to apply the test would not exist.

In order to address the issues described above (and assuming that the government's position is that the combination rule can apply to create combined complex contracts), we recommend that guidance be issued that provides for the following two rules relating to the application of the combination rule to complex contracts. First, when combining multiple contracts, such contracts should, if possible, always be first combined into simple contracts, rather than into complex contracts, which will reduce the number of combined contracts that are subject to the complex contract rules.

Second, if a combined contract is treated as a complex contract, withholding agents should be entitled to apply any reasonable approach to determine whether and to what extent the

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

contract is subject to Section 871(m) as long as such approach (a) is reasonably consistent with the policy of the delta and substantial equivalence tests that are set forth in the Regulations, (b) is applied consistently for similar contracts, and (c) is not designed to cause such combined contracts to be outside of the scope of Section 871(m).[10] Reasonable approaches would include, but not be limited to, (a) the addition of the independent deltas of each contract and (b) the application of the substantial equivalence test based on the hypothetical initial hedge and inputs that would apply if the withholding agent were to hypothetically issue the combined contract.

We note that the need for the guidance set forth in this subsection would be significantly reduced if the government accepts our recommendation above that the combination rule should only apply to contracts that are "priced, marketed or sold" as part of a single investment transaction, because the overwhelming majority of contracts that are “priced, marketed or sold” together are of a type that, when combined, would constitute a simple contract.

3. Sale or Termination of a Component of a Combined Contract

The Regulations provide that a taxpayer that sells or terminates a component of a combined instrument (a “leg out event”) will still be subject to Section 871(m) with respect to the remaining component of the combined instrument even if the remaining component would not be subject to Section 871(m) on an independent basis.[11] The Regulations do not address whether the delta of the remaining component (or the initial hedge of the remaining component if it is a complex contract) for purposes of determining the ongoing Section 871(m) withholding amount should be based on (a) the original delta (or the original initial hedge) of the combined instrument, notwithstanding that the taxpayer no longer holds a portion of the combined instrument, (b) the delta (or initial hedge) that was attributable to the remaining component when it was originally issued, or (c) the delta (or initial hedge) of the remaining component on the date of the leg out event. The Regulations also do not address whether the remaining component can thereafter be combined with other contracts for Section 871(m) purposes. In addition, the Regulations do not address whether the remaining component’s status as a simple or complex contract should be based on the status of the original combined contract or the status of the remaining component (either upon original issuance or upon the leg out event). Finally, the Regulations do not address whether the leg out event should be treated as a “payment” that would trigger withholding for all of the accrued but unpaid dividend equivalents on the combined instrument, even though there has been no payment on the remaining component that will continue to be subject to Section 871(m).

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[11] Treas. Reg. Sec. 1.871-15(n)(2).

As a policy matter, if one puts aside the very important administrative issues described below, we believe that the Regulations should provide that the remaining component of the combined instrument should not be automatically subject to Section 871(m), but rather that its Section 871(m) status should be based on its delta (or its initial hedge) at the time of the leg out event. That is because there is no policy reason for the remaining component to be subject to Section 871(m) if such component would not be subject to Section 871(m) if it were hypothetically issued upon the leg out event and if it would not have been subject to Section 871(m) on an independent basis when it was originally issued. Under this approach, the taxpayer would be treated as having disposed of the entire combined instrument for Section 871(m) purposes upon the leg out event with any Section 871(m) taxes due at such time, and as then having entered into a new contract that is represented by the remaining component that would or would not be subject to Section 871(m) in the same manner as if it were newly issued upon the leg out event. This would be consistent with the rules that govern integrated debt instruments under which a taxpayer that "legs out" of one component of the integrated instrument is treated as disposing of the entire synthetic debt instrument, notwithstanding that it continues to hold one component of the synthetic debt instrument.[12] Some of our members believe that for the reasons set forth above the Regulations should adopt this approach, rather than the approach that is currently set forth in the Regulations.

Some of our members, however, believe that while the approach set forth in the preceding paragraph makes more sense as a policy matter, the Regulations should continue to adopt the approach that is currently in the Regulations because of the administrative burden that withholding agents would be subject to if they were required to retest the delta (or the initial hedge) of a remaining component each time there is a leg out event with respect to a combined instrument. This would be particularly problematic if the remaining component is a complex contract because the withholding agent would then have to compute the hypothetical initial hedge information and other inputs that would apply if the remaining component were hypothetically issued upon the leg out event.[13] Furthermore, as discussed above, withholding agents are already overly burdened with the task of implementing the very complex Section 871(m) withholding regime (even if our recommendations above regarding the combination rule

[12] Treas. Reg. Sec. 1.1275-6(d)(2).

[13] Alternatively, if our recommendation above regarding the application of Section 871(m) to complex contracts is accepted, the withholding agent would apply a "reasonable approach" in applying Section 871(m) to the remaining component.

are accepted), and it is unreasonable and unwarranted to additionally require withholding agents to reapply the delta and substantial equivalence tests each time there is a leg out event with respect to a combined instrument. The SIFMA members who would like to adopt this approach believe that in the interest of administrative convenience (a) the delta (or initial hedge) of the remaining component after a leg out event should continue to be the same as the delta (or initial hedge) of the combined contract, (b) the remaining component after the leg out event should not be available to be combined with another contract for Section 871(m) purposes, and (c) any accrued but unpaid dividend equivalents with respect to the combined instrument should be due upon the leg out event but only to the extent of any proceeds that are received in connection with the leg out transaction.

In any case, although our members do not have a unanimous view regarding these issues, SIFMA believes guidance should be issued that addresses how Section 871(m) applies after a leg out event so that withholding agents can apply Section 871(m) to the remaining component of a combined instrument.

4. Reasonable Approaches for Applying the Combination Rule

The mechanics for applying the combination rules to specific situations will sometimes be unclear under the Regulations because the Regulations do not specifically address the application of such rules to every particular case. Some of these uncertainties have been identified and some will inevitably be identified once market participants start implementing and applying the combination rule to specific transactions. One uncertainty can be illustrated by an example in which a foreign investor acquires two listed options that are "priced, marketed, or sold" as part of a single investment transaction on successive days. In such a case, it is unclear whether the delta for the combined instrument should be determined based on the delta of the combined instrument on the date on which it is combined (i.e., day two in the example) or based on the delta of each component on the date that it was issued. In addition, it is unclear whether the day one option in the example would still be combined with the day two option if the day one option has an independent delta of .8 or above and would thus independently be subject to Section 871(m) in the absence of the combination rule.

While we recommend that guidance be issued with respect to these issues, there will inevitably be other combination rule issues that are not addressed by the Regulations that will come to light once market participants begin implementing the combination rule. We therefore recommend that guidance be issued that would allow taxpayers and withholding agents to use any reasonable approach in applying the combinations rules in cases in which the Regulations do not specifically address the mechanics for applying the rules as long as (a) the taxpayer or

withholding agent applies such approach consistently among similar financial instruments, and (b) such approach is reasonably consistent with the intent of the combination rules.[14]

B. Timing of Withholding

1. Withholding Election

We recommended in our May 2014 letter to the government regarding the proposed Section 871(m) regulations that Section 871(m) withholding should not be imposed prior to the payment of a withholdable amount because otherwise withholding agents could be subject to cashless withholding, in which case they would have to implement collateral and/or indemnity arrangements with investors in order to enable them to collect the withholding tax. This could be particularly problematic in the case of structured notes and listed options in which the withholding agent often has no contractual relationship with the investor, and thus may be unable to obtain collateral from which to collect the withholding. In addition, withholding agents in some cases may be subject to legal or regulatory restrictions that could impair their ability to claim other assets of an investor in order to fund the withholding tax.

The Regulations partially incorporated this recommendation insofar as they generally defer the imposition of withholding tax until a payment under a Section 871(m) contract.[15] The Regulations, however, still provide for the possibility of cashless withholding because they provide for withholding upon (a) the sale or termination of a Section 871(m) contract, irrespective of whether the Section 871(m) tax exceeds the gross proceeds received by the long party, (b) the payment of amounts by the short party to the long party, irrespective of whether the Section 871(m) tax exceeds such payment, and (c) the payment of amounts by the long party to the short party, even though there is no payment to the long party upon which to withhold.[16] Market participants will therefore often need to implement the collateral and indemnity arrangements described above even under the approach set forth in the Regulations.

While we continue to believe that Section 871(m) withholding should generally only be due upon, and limited to, the actual payment made to the long party, after considering the application of the Regulations to specific cases, the systems that need to be developed to

[14] We note that the number of uncertainties regarding the application of the combination rule, and thus the need for the guidance set forth in this subsection, would be significantly reduced if the government accepts our recommendation above that the combination rule should only apply to contracts that are "priced, marketed or sold" as part of a single investment transaction.

[15] Treas. Reg. Section 1.1441-2(e).

[16] Treas. Reg. Section 1.1441-2(e)(8).

implement withholding on the payment date under the Regulations (the "Payment Date"), and the fact that some withholding agents will in any case have to implement the collateral arrangements described above, we believe that the Regulations should provide for an election (a "Withholding Election") under which a dividend equivalent would be treated as paid, and as thus subject to Section 871(m) withholding, on the dividend payment date for the underlying security that is referenced by the Section 871(m) contract (the "Underlying Dividend Date").[17] More specifically, we believe that the Regulations should provide for such an election because some withholding agents believe that it would be easier for them to implement systems that would impose withholding on the Underlying Dividend Date, rather than on the Payment Date, because withholding agents generally have existing systems that impose withholding on the Underlying Dividend Date for dividends that are paid on physical stock positions. By contrast, these withholding agents believe that it would be more difficult for them to implement systems that would impose withholding on the Payment Date because that would require them to develop systems that would track and retain dividend payment information over the entire term of a Section 871(m) transaction and then impose withholding based on such information on the Payment Date for the transaction. In addition, a withholding agent may only be willing to incur the risk that it will be unable to collect the withholding tax for one dividend on the underlying security, which would generally be the case if it makes the Withholding Election, but it may be unwilling to incur the risk that it could be subject to cashless withholding for multiple dividends, which could be the case if withholding can only be imposed on the Payment Date.

The government would not be disadvantaged by providing such an election, because it would generally enable the government to collect the Section 871(m) tax earlier than the Payment Date. We stress, however, that as a general matter the Section 871(m) tax should be imposed on the Payment Date, and that the Withholding Election, while important for limited cases, should not be the default rule but rather should be the exception to the general Payment Date rule. If Section 871(m) withholding is imposed on the Underlying Dividend Date in all cases, there would be an exponential increase in the amount of cashless withholding for Section 871(m) contracts, which would (a) generally subject withholding agents to increased complexity and economic exposure with respect to such contracts and (b) potentially cause many foreign investors to withdraw from the market for such contracts. Moreover, many withholding agents believe that it would be easier for them to implement systems that would impose withholding on the Payment Date, rather than the Underlying Dividend Date, because current withholding systems generally impose withholding on the payment date for a financial instrument. By contrast, these withholding agents believe that it would be more difficult for them to develop

[17] For purposes of clarity, the end of quarter election that is set forth in Treas. Reg. Section 1.871-15(i)(3(i) with respect to a derivative that references more than 25 underlying securities should also be available if a withholding agent makes a Withholding Election.

systems that would impose withholding on the Underlying Dividend Date, because that would require them to develop entirely new systems that would constantly monitor, and impose withholding on, dividend payments on the applicable underlying security in the absence of a payment on the applicable financial instrument. In addition, many financial institutions have already devoted considerable time and resources to implement systems that can impose Section 871(m) withholding on the Payment Date, and it would therefore be unfair to change the existing rule under which withholding agents can impose Section 871(m) withholding on the Payment Date. Accordingly, our recommendation that the Regulations should provide for a Withholding Election is premised on the understanding that taxpayers and withholding agents will not be subject to any interest or penalty charges if they opt for the default Payment Date rule rather than making an affirmative Withholding Election.

We recommend that the Regulations provide for the following rules in order to implement the Withholding Election. First, the Withholding Election should be made by the withholding agent that has primary withholding responsibility for any Section 871(m) withholding tax that is due with respect to a contract (the "primary withholding agent"). Second, the primary withholding agent should make the Withholding Election by withholding any Section 871(m) taxes on the first Underlying Dividend Date for the applicable Section 871(m) contract. Third, once a primary withholding agent makes a Withholding Election with respect to a Section 871(m) contract that is held by an investor, the election should be binding and irrevocable (in the absence of approval from the Commissioner) as long as it (or any related party or successor) is the primary withholding agent for the contract and the contract is held by such investor (or any related party or successor).

Fourth, the Regulations should address the application of a Withholding Election if there is a change in the primary withholding agent for a Section 871(m) contract from an "old" withholding agent to a "new" withholding agent that is not related to, or a successor of, the old withholding agent. This could happen, for example, if an investor transfers a contract to a new custodian that holds the contract on its behalf.[18] In such a case, the new withholding agent would need to know whether the old withholding agent made a Withholding Election in order to properly apply Section 871(m) for the period after the transfer. We recommend that the Regulations provide that, subject to the exception described below, if the old withholding agent did not make a Withholding Election with respect to a Section 871(m) contract, the old withholding agent should be required to impose Section 871(m) withholding upon the transfer

[18] For purposes of simplicity, the discussion below assumes that the change in withholding agent will occur as a result of a transfer of a Section 871(m) contract to a new custodian. A change in withholding agent, however, could occur for other reasons, and the discussion below would equally apply in such a case.

with respect to any accrued but unpaid dividend equivalents under the contract at such time.[19] The new withholding agent would then independently determine whether or not to make the Withholding Election after the transfer, and it would not have to obtain any information from the old withholding agent as to whether it made the Withholding Election prior to the transfer and the dividend equivalent amounts that accrued during the investor's holding period in the contract (the "prior Section 871(m) information").[20] The Regulations, however, should provide for an exception to this rule (in which case the Section 871(m) tax for the contract would not be accelerated upon the transfer) if (a) the old withholding agent and the new withholding agent agree in writing that the new withholding agent will not make the Withholding Election and (b) the old withholding agent provides the new withholding agent with the prior Section 871(m) information for the contract prior to the transfer.

2. Timing for Withholding

The Regulations state that a dividend equivalent is treated as paid with respect to a Section 871(m) contract on the later of (a) the earlier of (i) the record date of the dividend on the underlying security and (ii) the day prior to the ex-dividend date with respect to the dividend on the underlying security (the "Dividend Determination Date") and (b) the Payment Date with respect to the contract.[21] This rule is generally intended to defer the Section 871(m) tax with respect to the dividend on an underlying security until a payment is made on the contract that references the security. However, a technical reading of this rule could result in cashless withholding by requiring immediate withholding on a Dividend Determination Date for a Section 871(m) contract if there was a prior periodic payment under the contract. The Section 871(m) withholding tax in such a case would apparently be due on the Dividend Determination Date

[19] For purposes of clarity, we note that, as discussed above, this rule would only apply if the new withholding agent is not related to, or a successor of, the old withholding agent. In such a case, the new withholding agent would have all of the information necessary to apply Section 871(m) after the transfer, and as noted above, it would continue to be bound by the old withholding agent's Withholding Election (or lack thereof).

[20] The only alternative to this approach would be to (a) require the old withholding agent to provide the prior Section 871(m) information to the new withholding agent and (b) only permit the new withholding agent to make a Withholding Election if the old withholding agent made a Withholding Election, because otherwise no withholding taxes would be collected with respect to the dividend equivalents that accrued prior to the transfer. We do not think that the Regulations should adopt this approach because the old withholding agent would then mandatorily be subject to the administrative burden of providing the prior Section 871(m) information to the new withholding agent. Moreover, the new withholding agent may not have the systems to impose withholding on the Payment Date and it may therefore be unable to act as the custodian for a contract unless it can make the Withholding Election.

[21] Treas. Reg. Sec. 1.1441-2(e)(8)(i).

even if no cash is paid on the contract at such time, because at that point there will have been a prior payment on the contract and a dividend on the underlying security, and thus the two requirements set forth above will be satisfied.

We understand from informal comments made by government personnel that the Regulations were not intended to work in this manner, and that it was intended that withholding would only be due upon a payment under a Section 871(m) contract that is concurrent with, or subsequent to, the Dividend Determination Date. However, in light of the wording of the Regulations, we recommend that the Regulations be revised to provide that (subject to the Withholding Election) a dividend equivalent will only be treated as paid with respect to a contract upon the first payment under the contract on or after the Dividend Determination Date. This would mitigate the cashless withholding scenario described above and would be consistent with the apparent intent of the Regulations.

C. Timing of Investor's Tax Liability

As noted above, the Regulations provide that withholding with respect to a Section 871(m) contract is not due until the Payment Date.[22] The Regulations, however, do not provide a similar rule that defers the date of a foreign investor's liability under Sections 871 and 881 of the Code with respect to any dividend equivalents that are paid on the contract. The Regulations could therefore be interpreted as subjecting a foreign investor to Section 871(m) tax on the Dividend Determination Date even though withholding is not due until the Payment Date. Such an approach would be inconsistent with the general approach of the Section 1441 regulations under which a foreign investor's tax liability generally accrues at the same time that the withholding obligation arises. Moreover, among other negative consequences, such an approach could result in the double payment of the Section 871(m) tax -- first, when the foreign investor pays the substantive tax, and second, when the withholding tax is imposed.[23] While we imagine that the drafters of the Regulations intended that an investor's tax liability should accrue at the same time as the corresponding withholding tax liability, we recommend that the Regulations be revised to provide clarification in this regard.[24]

[22] Treas. Reg. Section 1.1441-2(e).

[23] While an investor could always claim a refund in such a case, the investor would unnecessarily be subject to the burden of having to file a tax return to pay the tax and then a refund claim after the withholding is imposed, and the IRS would unnecessarily be subject to the burden of having to process such refund claims.

[24] If our recommendation above regarding a Withholding Election is accepted and a withholding agent makes a Withholding Election with respect to a Section 871(m) contract, the investor would become

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D. Delta Determination

The Regulations do not specifically address whether the delta for a contract should be determined on the pricing date or the settlement date for the instrument. The text of the Regulations states that the delta of a contract is determined on the date on which the contract is "issued",[25] which is in turn defined as the "date of inception or original issuance".[26] While there is no tax definition of the term "inception", the reference to "original issuance" supports the position that delta should be determined on the settlement date because the term "issue date" is defined under the original issue discount ("OID") regulations as referring to the settlement date for the debt instrument.[27]

The preamble to the Regulations, however, provides that a contract is treated as "issued" when it is "entered into, purchased or otherwise acquired at its inception or original issuance".[28] The reference to "entered into" supports the position that the delta of a contract should be determined on the pricing date for the contract, because that is the date upon which the parties enter into a legally binding agreement to enter into the contract.

For the following reasons, we believe that guidance should be issued that confirms that the delta of a contract for Section 871(m) purposes should generally be determined on the pricing date for the contract.[29]

First, the delta of a derivative is based on the economic terms of the instrument. It is therefore most appropriate that the delta for a derivative be computed on the pricing date because that is the date upon which the economic terms for the instrument are determined. The settlement date for a derivative, by contrast, has nothing to do with the economic terms of the instrument and merely represents the date that the instrument is legally issued.

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liable for the Section 871(m) tax upon the Dividend Determination Date (as such date is modified if our recommendations later in this letter are accepted).

[25] Treas. Reg. Sec. 1.871-15(g)(2).

[26] Treas. Reg. Sec. 1.871-15(a)(6).

[27] Treas. Reg. Sec. 1.1273-2(a)(2).

[28] Preamble at p. 3.

[29] Market participants often use the terms "trade date" and "pricing date" interchangeably, and in the majority of cases they will be the same date. There are, however, rare cases in which the parties agree to enter into a transaction before agreeing to the specific pricing for the transaction, in which case there will be a difference between the trade and the pricing date. We therefore have used the term pricing date in the discussion below.

Second, in the case of a complex contract, the substantial equivalence test is based on the initial hedge of the issuer of the contract. An issuer enters into a hedge on the pricing date for the instrument, and not the settlement date, because it would otherwise be exposed to price movements between the pricing date and the settlement date. Once the initial hedge is based on conditions on the pricing date, the delta for the benchmark that is used under the substantial equivalence test should presumably also be determined on such date. If the pricing date is the relevant date for applying the substantial equivalence test to complex contracts, then it should likewise be the relevant date for computing delta for simple contracts.

Third, parties to a contract become bound to the terms of the instrument on the pricing date and not on the settlement date. Investors obviously need to understand the tax consequences of an investment before they irrevocably agree to enter into the investment. If the delta of a contract is determined on the settlement date and not the pricing date, an investor will not know the Section 871(m) consequences of an investment when it agrees to enter into the investment. It is therefore important that the delta of a contract be computed on the pricing date so that market participants will understand and consider the Section 871(m) consequence of an investment before entering into a contract.

Based on the discussion above, we recommend that guidance be issued that clarifies that, subject to the modifications discussed below for listed options and structured notes, the delta of a contract should be computed on the date that the parties to the contract (which can include the underwriter in the case of a structured note) have (a) entered into a binding agreement to enter into the contract and (b) agreed upon the final pricing terms for the contract.[30] In addition, the delta of a contract should be determined at the precise time on such date when such conditions are satisfied.

E. Structured Notes

The following section addresses the guidance that we believe should be issued regarding the application of Section 871(m) to transferable instruments, such as structured notes, warrants and convertible debt. For purposes of simplicity, the discussion below refers to such instruments collectively as structured notes despite the fact that such instruments can be denominated in a

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[30] There is normally a relatively short period between the pricing date and settlement date for an equity derivative. In the rare case in which there is a longer period between the pricing date and settlement date for a financial instrument, we believe that delta should still be determined on the pricing date because all of the arguments set forth above as to why delta should be computed on the pricing date would equally apply in such a case, and we cannot think of a case in which this would lead to an abusive result. However, even if a longer period between the pricing date and settlement date does lead to an abusive result that we cannot contemplate, the IRS could always challenge the delta computation in such a case under the general Section 871(m) anti-abuse rule.

different manner.[31] While some of the same issues also apply in the case of listed options, listed options raise unique issues and are therefore separately addressed below.

1. Computation of Section 871(m) Information

Structured notes are generally held through intermediary financial institutions, and accordingly payments on structured notes are generally made to investors through a chain of financial intermediaries rather than directly by the issuer. The Regulations do not explicitly address who should be responsible for determining whether and to what extent Section 871(m) applies to such instruments. More specifically, the Regulations provide that a broker or dealer that is a party to a potential Section 871(m) transaction is generally required to determine whether the transaction is subject to Section 871(m), and if applicable, the delta, "initial hedge", and dividend equivalents for the transaction (the "Section 871(m) information").[32] In addition, the Regulations provide that the term "party to the transaction" includes an agent of the short party or long party as well as any person that acts as an intermediary to the transaction.[33] Accordingly, in the case of a typical issuance of structured notes, each financial intermediary in the chain of ownership will be a party to the transaction that is arguably responsible to compute the Section 871(m) information. Unlike the issuer of a structured note, intermediaries generally do not have the necessary information to compute and determine this information and there is no policy reason to require any party other than the issuer to do so. Moreover, it is not clear that the Regulations intended to impose this burden on intermediaries because the Regulations that assign the obligation to compute the Section 871(m) information seem to contemplate a case in which the short and long parties are in direct contact with each other, rather than a case in which there are intermediary financial institutions between the short party and the long party.[34]

In addition, the Regulations provide that a short party to a Section 871(m) contract is required to determine the Section 871(m) information for the contract, unless it is not a broker or

[31] We recommend that the Regulations (or any alternative guidance) use the term "negotiable instruments", and that such term should be defined to refer to transferable instruments, such as structured notes, warrants and convertible debt.

[32] Treas. Reg. Sec. 1.871-15(p)(1). The party that is required to determine the Section 871(m) information is also responsible to disseminate that information to market participants in the manner required by the Regulations. In addition, the Section 871(m) information that is determined by such party is binding on withholding agents and investors unless they know or have reason to know that the information is incorrect.

[33] Treas. Reg. Sec. 1.871-15(a)(9)(iii).

[34] Treas. Reg. Sec. 1.871-15(p)(1).

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dealer and the long party is a broker or dealer.[35] Most issuers of structured notes are not brokers or dealers (although they are generally affiliated with brokers or dealers), and some purchasers of structured notes are brokers or dealers. Accordingly, an issuer of a structured note that is not a broker or dealer would not be required to compute the Section 871(m) information for the note to the extent that brokers or dealers acquire the note, despite the fact that the issuer is clearly in a better positon than the holder to compute the Section 871(m) information for the note. Furthermore, the issuer will often not know whether the holder of the note is a broker or dealer, in which case it will not know whether it or the holder is responsible to compute the Section 871(m) information for the note. Moreover, even if the issuer does have this information, brokers or dealers could acquire some, but not all, of the notes in a particular offering, in which case the Regulations would apparently require that the Section 871(m) information be determined by the issuer for a portion of the notes (i.e., those that are not owned by brokers or dealers) and by the note holders for the remainder of the notes (i.e., those that are owned by brokers or dealers), which could lead to different Section 871(m) computations for the same notes.

Finally, a structured note that is issued by a foreign issuer could provide the holder of the note with a short position with respect to the underlying security, in which case the foreign issuer would be the long party that is subject to the Section 871(m) tax. In such a case, the holder of the note would be the short party that is required to compute the Section 871(m) information for the note if the issuer is not a broker or dealer, despite the fact that the issuer is clearly in a better positon than the holder to compute the Section 871(m) information for the note.

In light of the issues set forth above, we recommend that the Regulations be revised to provide that the issuer of a structured note is the only party that is required to compute the Section 871(m) information for the note even if (a) the note is held through financial institutions that are also treated as "parties to the transaction" under the Regulations, (b) the issuer is not a broker or dealer or (c) the issuer holds the long position under the note.[36] The issuer is in the best position to compute and determine such amounts, irrespective of the issuer's status or position under the notes, because it will structure the notes, determine the pricing for the notes, and will generally hedge the notes. This will particularly be the case in respect of the many

[35] Treas. Reg. Sec. 1.871-15(p)(1).

[36] We note that it is critical that this be clarified in the Regulations because a party that is responsible to compute the Section 871(m) information for a contract could be liable for any Section 871(m) withholding taxes with respect to the contract if it fails to compute such information, even though it does not otherwise have withholding responsibility for payments on the contract. Treas. Reg. Section 1.1441-3(h)(2). It is therefore very important that there be no uncertainty regarding the party that is required to compute the Section 871(m) information with respect to a particular Section 871(m) contract.

structured notes that are complex contracts under the Regulations. Furthermore, the only way to ensure that all note holders use the same Section 871(m) information is if the issuer is the sole party that is responsible to determine and disseminate that information. Finally, there is no reason to also require intermediaries to compute the Section 871(m) information for a structured note, particularly when they are less likely than the issuer to have the inputs necessary to determine such information.[37]

2. Secondary Purchasers of Structured Notes

The Regulations do not address the tax treatment of a secondary purchaser of a structured note that is subject to Section 871(m) that does not hold the note when some of the dividends on the underlying securities are paid. This can be illustrated by an example in which an issuer issues a twenty year structured note that is subject to Section 871(m) and that provides for a single payment at maturity based on the performance of an underlying security. Assume that the underlying security pays annual dividends during the entire term of the note, and that a secondary purchaser acquires the note after year ten and holds the note until maturity. The Regulations provide that the seller of the note will be treated as receiving a dividend equivalent payment upon the sale equal to its share of the dividends that were determined on the underlying securities during the period that it held the notes.[38] Although not explicitly stated, this should be the case irrespective of whether the seller of the note is a foreign investor that is subject to Section 871(m) or a US investor that is not subject to the Section 871(m). The Regulations, however, do not explicitly state that the dividend equivalent payment that the secondary purchaser receives upon the maturity of the note is reduced by the dividend equivalent payment that the seller received upon the sale of the note and is accordingly limited to the dividends that were determined on the underlying securities during the period that it held the notes. Because this is the only sensible result, guidance should be issued that provides that the dividend equivalents that are paid to a secondary purchaser of a structured note should be reduced by any dividend equivalents that were previously deemed paid the to the seller of the note (irrespective of whether the seller of the note is a foreign investor or a US investor). Accordingly, the Section 871(m) tax with respect to the investor in the example would only apply to dividends that were determined on the underlying securities during the investor's holding period in the notes.

[37] For purposes of clarity, the recommendation in this paragraph should only obligate the issuer to compute the Section 871(m) information for the note itself but should not obligate it to compute such information for a combined instrument of which the note is a part, unless the issuer priced or marketed the combined instrument.

[38] Treas. Reg. Sec. 1.1441-2(e)(8).

Even if this recommendation is adopted, the Regulations do not address how a withholding agent that does not have a direct relationship with the investor, and thus does not know the investor's holding period in the notes, should determine the Section 871(m) withholding amount with respect to the investor. We therefore recommend that guidance be issued that if a withholding agent makes a payment on a structured note that is subject to Section 871(m) withholding and it does not have actual knowledge of the beneficial investor's holding period in the notes, it should assume that the investor has held the notes during the entire term of the notes, unless the investor (or a financial institution that holds the notes on behalf of the investor) provides a certification that sets forth the period during which it has held the notes. This can be illustrated by an example in which a withholding agent with respect to a structured note transmits a payment on the note to a foreign broker that is not a withholding qualified intermediary and that holds the note on behalf of a foreign investor. In such a case, the withholding agent should assume that the investor has held the notes during the entire term of the notes, unless the investor or the broker submits a certification that sets forth the investor's holding period in the notes. If the withholding agent receives such a certification, or if it otherwise has knowledge of the investor's holding period in the notes, the withholding agent should apply the Section 871(m) tax based on the dividends on the underlying securities that were determined during the investor's holding period in the notes.

3. Withholding Upon Sale of Structured Notes

The Regulations provide that dividend equivalents with respect to a contract are treated as paid when the long party disposes of the contract.[39] Accordingly, as discussed above, a foreign investor that sells a structured note that is subject to Section 871(m) will be treated as receiving any accrued but unpaid dividend equivalents with respect to the note upon the sale. The Regulations do not provide any guidance regarding the party that should be treated as the withholding agent with respect to such dividend equivalent amounts that are received by the seller.

Under the general principles of the Section 1441 regulations it is arguable that the buyer of the structured note or its broker would be required to withhold on the portion of the purchase price that is attributable to dividend equivalents if (a) the buyer or its broker is a US person or a withholding QI and (b) the seller's broker is not a withholding QI.[40] Furthermore, it is possible that the issuer of the structured note and all of the intermediaries in the payment chain could be withholding agents in such a case because the Regulations provide that all parties to a Section

[39] Treas. Reg. Sec. 1.1441-2(e)(8)(ii)(C).

[40] *See generally* Treas. Reg. Section 1.1441-1T(b)(1) relating to payments of withholdable payments to a foreign person that is not a withholding QI.

871(m) transaction are deemed to have custody and control over any dividend equivalents even if they do not actually make any dividend equivalent payments.[41]

The drafters of the Regulations presumably did not intend to impose a withholding obligation on issuers and intermediaries upon a sale of a structured note when they do not have custody of the sales proceeds and they may not have any knowledge of the sale. Furthermore, while the buyer and its broker will have custody of the sales proceeds, imposing a withholding obligation upon them would be inconsistent with the general approach of the withholding regulations under which a buyer of an asset is generally not a withholding agent, notwithstanding that a portion of the purchase price may be attributable to FDAP income.[42] Moreover, the buyer and its broker will generally not be in a position to compute the dividend equivalent amount because it will not know the seller's holding period in the notes. In addition, we are concerned that purchasers of structured notes that are subject to Section 871(m) will be dissuaded from acquiring such notes from a foreign investor if they are required to withhold taxes from the purchase price based on complex calculations of delta and dividend equivalents (and the substantial equivalence test in the case of a complex contract) and information regarding the seller's holding period in the notes. Such a requirement could adversely impact the market and liquidity for such notes which serves as an important source of financing for financial institutions.

In order to address the issues discussed above, we recommend that guidance be issued that the seller's broker is the sole withholding agent with respect to any Section 871(m) withholding that is imposed upon a sale of a structured note. This should be the case even if the seller's broker is not a US person or a withholding qualified intermediary and even if the sales proceeds are less than the withholding amount. We believe that the seller's broker is the most logical withholding agent because it will (a) have custody over the sales proceeds, (b) be in a position to compute the amount of withholding tax based on the seller's holding period in the notes and (c) be the party that is most likely to have custody over assets to withhold from if the withholding amount exceeds the sale proceeds. The buyer and its broker should not have a withholding obligation in this case because they are less likely to satisfy (b) and (c) in the preceding sentence, and they will therefore not be in the best position to compute or apply the withholding tax.

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[41] Treas. Reg. Section 1.1441-7(a)(2).

[42] The only exception is under the Section 1445 FIRPTA rules which in certain cases imposes a withholding obligation on the purchaser of a "U.S. real property interest". However, even that rule only requires the purchaser to withhold at a fixed ten percent rate and does not require the purchaser to withhold based on the actual FIRPTA liability of the seller.

4. Notes that are Subject to Other FDAP and Section 871(m) Withholding

The Regulations do not address how Section 871(m) applies in the case of a structured note that is subject to Section 871(m) withholding as well as withholding under other provisions of Section 871.[43] For example, US issuers of coupon bearing structured notes that are not treated as debt for tax purposes sometimes treat the coupons on such notes as FDAP income that is subject to withholding tax. If such a note is also subject to Section 871(m), it is not clear whether and how the other FDAP withholding and Section 871(m) withholding regimes interrelate to prevent two levels of withholding on the same income.

We recommend that guidance be issued under which any other FDAP withholding that an investor is subject to with respect to a structured note can be credited against any Section 871(m) withholding that is subsequently imposed on such investor with respect to the note. This could be illustrated by an example in which a US issuer issues a coupon bearing structured note that is subject to Section 871(m). If there are no dividend determinations on the underlying securities that are referenced by the note when a coupon is paid, the issuer may impose other FDAP withholding, but not Section 871(m) withholding, with respect to the coupon payment.[44] If there is a subsequent dividend determination with respect to the underlying securities that are referenced by the note so that Section 871(m) tax is due with respect to the note,[45] the Regulations should provide that the amount of Section 871(m) tax should be reduced by the other FDAP tax that was previously imposed on the investor with respect to the coupon payments on the notes.[46] This is the correct result as a policy matter because otherwise an investor could be subject to two levels of withholding tax with respect to the same income, which would not have been the case if there had been a dividend determination with respect to the underlying securities before the coupon payment on the note.

[43] While the issue described in this subsection could theoretically apply to all equity derivatives and not just structured notes, we discuss this issue in the context of structured notes because we are not aware of any case in which an equity derivative other than a structured note is subject to FDAP withholding (other the Section 871(m) withholding).

[44] Alternatively, there could have been prior dividend payments, but there could still be FDAP withholding if the distribution exceeds the dividend payments.

[45] Under our recommendation earlier in this letter, the Section 871(m) tax would only be due upon a subsequent distribution with respect to the note.

[46] Under this approach there could be residual tax if the treaty rate applicable to the other FDAP income is lower than the treaty rate applicable to dividend income.

5. Issuers that are Market Makers for Structured Notes

Structured notes, and particularly exchange traded notes, can generally be sold in the secondary market. In many cases the issuer of a structured note (or an affiliate of the issuer) will act as a market maker for the structured note, and thus may purchase the note in its dealer capacity and then sell the note to the market. If the purchase is treated as a redemption by the issuer of the note for tax purposes, the subsequent sale to the market would be treated as a new issue for Section 871(m) purposes, in which case the delta for the note (or substantial equivalence test) would need to be recomputed at such time. This could cause such notes to be subject to different Section 871(m) consequences than the originally issued notes, in which case such notes may not be fungible with the remainder of the notes for tax purposes.

We recommend that guidance be issued that the rules in the Section 108 regulations with respect to the purchase of debt by an issuer (or an affiliate of the issuer) that is acting in a dealer capacity[47] should similarly apply to structured notes that are subject to Section 871(m) even if the structured notes are not treated as debt for tax purposes.[48] There is no policy reason to require that delta be recomputed for Section 871(m) purposes simply because the issuer (or an affiliate) purchases and sells a structured note in a dealer capacity, and the Section 108 rules for dealers provide an appropriate framework that can apply equally well for Section 871(m) purposes. This is particularly important in this case because otherwise issuers (or their affiliates) may be precluded from making a market in structured notes that are sold to foreign investors, which is often required in order to ensure the liquidity necessary in order to originally sell the notes.

6. Pricing Date

We recommend that the Regulations include two modifications to the pricing date rule described above in the case of structured notes that are sold to multiple investors.

[47] Treas. Reg. Sec. 1.108-2(e).

[48] This rule will generally not be necessary in the case of an affiliate that acquires the notes because an affiliate acquisition of notes (as opposed to an issuer acquisition of notes) will generally not trigger a redemption and deemed reissuance of the notes if the notes are not treated as debt for tax purposes (and if the notes are treated as debt the Section 108 regulations would apply to prevent a deemed reissuance). We nonetheless recommend that this rule also apply to an affiliate acquisition because in some cases a dealer affiliate's acquisition of a note could trigger a redemption and deemed reissuance of the note if the affiliate is treated as acting as an agent of the issuer or if the affiliate hedges its position under the note with the issuer. The dealer exception should similarly apply in such a case because affiliate acquisitions are also included in the Section 108 dealer exception, and there is no policy reason to distinguish for this purpose between an issuer acquisition and an affiliate acquisition as long as the requirements for the dealer exception are otherwise satisfied.

First, many issuers of structured notes issue a series of notes on a single settlement date, but there are multiple pricing dates for the issuance of the notes. If the delta (or substantial equivalence test) for the notes is determined separately on each pricing date, then the notes may be subject to different Section 871(m) consequences and thus may not be fungible with each other for tax purposes even though they are issued on the same issue date.

We therefore recommend that in the case of structured notes that have a single issue date and multiple pricing dates, the Regulations should provide that the delta (or substantial equivalence test) for all of the notes (including notes that are not treated as debt for tax purposes) should be determined on the first pricing date for a substantial amount of notes so long as there are no more than thirteen days between the first pricing date and the final pricing date for the notes. This rule would be consistent with the OID rules under which debt instruments that are issued within thirteen days of the first date on which a substantial amount of notes are sold to the public all have the same issue date and issue price as the notes that are issued on the first date.[49]

Second, many issuers of structured notes issue notes (the "additional notes") that are intended to be fungible with a previously issued series of notes (the "original notes"). This is sometimes done through a new issuance of notes and is sometimes done through a sale of notes that were primarily held as inventory on the books of the issuer. In either case, the notes would be treated as newly issued for tax purposes and thus may be subject to different Section 871(m) consequences than the original notes, in which case the additional notes would not be fungible with the original notes. The ability to sell additional notes in this manner is very important to structured notes issuers because the notes often need to have a sufficient amount of liquidity in order to be sold to the market.

In order to partially address this issue, the Regulations should provide that if the original notes and additional notes are simple contracts that each have a delta that is at least equal to .8 based on their respective pricing dates, the delta of the additional notes should be the same as the delta of the original notes. Similarly, the Regulations should provide that if the original notes and the additional notes are complex contracts that both satisfy the substantial equivalence test, the "initial hedge" for the additional notes that is used to determine the Section 871(m) withholding tax should be the same as the initial hedge for the original notes. In such a case, both the original notes and the additional notes will be subject to Section 871(m) withholding and the maximum loss of tax would be limited to the excess, if any, of the delta (or initial hedge) of the additional notes (determined in the absence of this special rule) over the delta (or initial hedge) of the original notes.[50] We believe that this poses a relatively limited tax cost to the

[49] Treas. Reg. Sec. 1.1275-1(f).

government in light of the important policy objective of enabling financial institutions to raise financing via the issuance of structured notes, which may not be possible if the notes do not have a sufficient amount of liquidity.[51]

F. Listed Options

This subsection addresses the application of Section 871(m) to listed instruments, such as futures and options, that trade on an exchange and for which a clearing house is the counterparty to the contract. For purposes of simplicity, the discussion below collectively refers to such instruments as listed options despite the fact that such instruments can be denominated in a different manner.

Listed options raise unique issues because of the specific manner in which listed options trade, the magnitude of the listed options trading market, and the manner in which the Regulations apply to listed options. More specifically, unlike OTC derivatives and structured notes, listed options are not created by any of the parties to the option, but are rather created by, and traded on, an exchange. Once an investor purchases a position under a listed option, it is novated to a clearing house (which is the Options Clearing Corporation (the "OCC") in the United States) and the clearing house becomes the counterparty under the option. Accordingly, unlike the issuer of a structured note or a dealer under an OTC derivative, the clearing house under a listed option does not compute delta, pricing terms or dividend estimates when it becomes the counterparty to a listed option, because it simply assumes two offsetting positions under two existing contracts with standardized terms. In addition, unlike other traded derivatives, a listed option is newly issued for Section 871(m) purposes each time it is sold because the option is novated to the clearing house. Furthermore, we understand that there are currently approximately 800,000 different series of listed options with respect to US equities that are available for trading.

We first note that we reviewed the letter that was submitted by the U.S. Securities Markets Coalition on February 24, 2016 (the "Coalition Letter") with respect to the application of the Regulations to listed options. We concur with the recommendation in the Coalition Letter

[50] If the delta of the original notes was equal to .8 or above and the delta of the additional notes is below .8, fungiblity could arguably be achieved if the transaction documents require investors to treat the additional notes as having the delta of the original notes and as thus subject to Section 871(m) withholding.

[51] We note that this will not solve the fungibility issue in the more common case in which the original notes have a delta that is below .8 and the additional notes have a delta that is .8 or above. In such a case, the additional notes, and not the original notes, will be subject to Section 871(m) withholding, and therefore the additional notes and original notes will not be fungible with each other.

that the delta for a listed option should equal the delta of the option as of the close of the business day immediately prior to the acquisition of the option, notwithstanding that the delta of other types of Section 871(m) contracts are determined at the time that a contract is entered into.[52] We agree with the arguments that are set forth in the Coalition Letter as to why such a rule is necessary for listed options in light of the unique features of the listed options market, and we are very concerned that foreign investment in listed options would be adversely affected if this rule is not adopted.

As is the case with respect to structured notes discussed above, listed options are held through intermediary financial institutions, and accordingly payments on a listed option are made to the investor through one or more financial intermediaries rather than directly by the clearing house. As discussed above with respect to structured notes, the Regulations would arguably require each financial intermediary in the chain of ownership of the listed option to compute the Section 871(m) information for the option even though they may not be in a position to determine or obtain that information.

Furthermore, as discussed above, the Regulations provide that a short party to a Section 871(m) contract must determine the Section 871(m) information for the contract, unless it is not a broker or dealer and the long party is a broker or dealer.[53] The OCC is not a broker or dealer and it would therefore only be required to determine the Section 871(m) information when it is the short party under a listed option if the long party under the option is not a broker or dealer.[54] The OCC, however, will generally not know the identity of the long party under the option, in which case it will now know whether it or the long party is responsible to compute the Section 871(m) information for the option. Moreover, even if the OCC knows whether the long party is a broker or dealer, identical listed long options that are acquired on the same date will presumably be held by different types of investors, in which case the Regulations would apparently require that the Section 871(m) information be determined by the OCC for some of the options (i.e., those that are not owned by brokers or dealers) and by the long party for other

[52] For purposes of simplicity the discussion in this subsection refers to delta; however the same issues and recommendations equally apply for purposes of applying the substantial equivalence test in the rare case in which a listed option is a complex contract.

We also concur with the recommendation in the Coalition Letter that the delta of an option on its first trading day should equal its delta as of the close of such day.

[53] Treas. Reg. Sec. 1.871-15(p)(1).

[54] For purposes of simplicity, the discussion in this paragraph refers to the OCC; however the same issues would apply to a foreign clearing house that is the short party under a listed option if it is not a broker or dealer.

options (i.e., those that are owned by brokers or dealers). This could lead to different Section 871(m) computations for identical listed options.

In addition, Section 871(m) could also apply to a foreign clearing house that holds the long position under a listed option with respect to a U.S. equity. In such a case, if the foreign clearing house is not a broker or dealer, the holder of the listed option would apparently be required to compute the Section 871(m) information for the option, even if the holder is a retail investor that is in no position to compute the Section 871(m) information for the option.

In order to address these issues, we recommend that the Regulations be revised to provide for the following rules with respect to the application of Section 871(m) to listed options.

First, the clearing house that is the counterparty under the listed option should be the only party that is required to compute the delta for the option (a) even though the option is held through financial institutions that are also treated as "parties to the transaction" under the Regulations and (b) even if the clearing house is not a broker or dealer or is the long party under the option.[55] We understand that the OCC already computes the end of day delta for regulatory purposes for each listed option for which they provide clearing services, so the OCC (and any foreign clearing houses that similarly compute delta) will generally not be subject to any additional burden under this requirement if our recommendation regarding the use of end of day delta for listed options is accepted.[56] In the case of U.S. listed options, this approach would be consistent with the general rule in the Regulations that the short party to a Section 871(m) contract is generally required to compute the delta for the contract.[57] In addition, this approach

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[55] The requirement to compute delta if the clearing house is the long party under an option will only apply in the case of a foreign clearing house, because a listed option will by definition not be subject to Section 871(m) if a domestic clearing house, such as the OCC, holds the long position under the option.

[56]This requirement would impose an additional burden on the OCC (a) in the rare case in which a listed option is a complex contract that is subject to the substantial equivalence test and (b) if the option references a partnership or non-qualified index if, contrary to our recommendation below, the delta for Section 871(m) purposes must be computed on a look-through basis to the underlying securities that are held by the partnership or that are included in the index.

[57] Treas. Reg. Sec. 1.871-15(p)(1). That is because Section 871(m) could only apply to a US listed option if the clearing house is the short party under the option, because the OCC, which is a US entity, would be the long party under any option for which the investor is the short party.

As noted above, there is an exception to this rule if the short party to a contract is not a broker or dealer and the long party to the contract is a broker or dealer. While, as noted above, a clearing house is generally not a broker or dealer, the holder (i.e., the long party) of the listed option will often not be a broker or dealer and the clearing house will generally not know the identity of the holder of the option.

would ensure that market participants use consistent delta information for listed options, which may not be the case if intermediaries and brokers are required to independently compute the delta for listed options.[58]

Second, the delta that is computed by the clearing house with respect to a listed option for regulatory purposes should *prima facie* be accepted as the delta for the option, unless (a) the option is subject to the substantial equivalence test in which case the regulatory delta test would be irrelevant or (b) the Regulations require that the delta be computed for an underlying security that differs from the security for which it computes delta for regulatory purposes.[59] That would be consistent with the rule in the Regulations that provides that if a taxpayer calculates delta for non-tax purposes, that delta ordinarily is the delta that is used for purposes of the Regulations.[60]

Third, in light of the extremely large number of contracts that a clearing house enters into on each day and the unique features of the listed option trading market described above, a clearing house under a listed option should not be required to record the inputs for the delta computation for each specific listed option in the manner that would normally be required under the Regulations, as long as it retains information to demonstrate that its delta computation methodology is consistent with the manner required by the Regulations.[61] This would significantly decrease the administrative burden on the clearing house and would not impair the government's ability to ensure that the delta computations are being done in the manner required by the Regulations.

Furthermore, clearing houses are sophisticated financial institutions and there is no policy reason to distinguish for this purpose between a broker or dealer and a clearing house.

[58] For purposes of clarity, the recommendation in this paragraph should only obligate the clearing house to compute delta for the option itself but should not obligate it to compute the delta for a combined instrument of which the option is a part, unless the clearing house priced or marketed the combined instrument.

[59] As noted above, that would be the case if the option references a partnership or non-qualified index if, contrary to our recommendation below, the delta for Section 871(m) purposes must be computed on a look-through basis to the underlying securities that are held by the partnership or that are included in the index.

[60] Treas. Reg. Sec. 1.871-15(g)(1).

[61] Specifically, in the absence of a special rule, the Regulations would require the clearing house to retain documentation and work papers that support the delta computation and, if applicable, the computation of the substantial equivalence test, for each listed option. Treas. Reg. Sec. 1.871-15(p)(4)(i). However, if our recommendation in the prior paragraph is accepted, the clearing house would in any case not be required to record any inputs for tax purposes if it can use the delta that it computes for regulatory purposes.

Fourth, the Regulations should identify the party that is responsible to determine whether a listed option is subject to Section 871(m). This could be the clearing house, the clearing broker or the withholding agent that is responsible for any Section 871(m) withholding under the option.[62] We note that as a practical matter this determination will generally require little, if any, additional diligence or computations. That is because in the case of a listed option with respect to a single underlying security or a basket or index of underlying securities that is clearly not a qualified index, the Section 871(m) status of the contract will generally directly flow from the delta computation for the option. Furthermore, while the party that has this responsibility would have to determine whether an index option relates to a qualified index in order to determine whether the option is subject to Section 871(m), we anticipate that many financial institutions will in any case have to compile a list of qualified indices in each year and there will likely be third party providers that will provide a list of qualified indices to market participants.[63] While our members do not have a majority view as to which of the three parties listed above should be responsible to determine the Section 871(m) status of a listed option, we recommend that the Regulations identify one of those parties as having this responsibility so that market participants know which party is responsible to compute this information.

Fifth, the Regulations should identify the party that is responsible to determine the dividend equivalent amounts, and if applicable, the dividend estimates, with respect to each listed option that is subject to Section 871(m).[64] This could be the clearing house, the clearing broker or the withholding agent that is responsible for any Section 871(m) withholding under the

[62] While the party that is responsible to determine the delta for a Section 871(m) contract is generally also responsible to determine whether the contract is subject to Section 871(m), a clearing house which serves the function of acting as an intermediary between the short and long party under the option, is arguably not in a position to determine whether a contract satisfies the legal requirements to be subject to Section 871(m).

[63] There can be cases, however, in which there are legal uncertainties as to whether an index is a qualified index, in which case the party that has this responsibility will not be able to simply rely on a third party provider's determination that an index satisfies the objective requirements under the Regulations to constitute a qualified index. Furthermore, the party that has this responsibility may have to conduct additional diligence if the contract relates to a partnership or a nonqualified index (particularly if our recommendations above regarding the application of the Regulations to such contracts are not accepted).

[64] While the short party to a Section 871(m) transaction is generally required to compute the dividend estimates for the transaction, an intermediary (such as the clearing broker) might be the more appropriate party to compute the estimated dividends in the case of a listed option, because the short party for a listed option will generally be the OCC which will not negotiate the pricing of the option and will not otherwise compute the dividend estimates for the option.

option.[65] While our members do not have a majority view as to which of the three parties listed above should be responsible to determine the dividend equivalent amounts for listed options, we recommend that the Regulations identify one of those parties as having this responsibility so that market participants know which party is responsible to compute this information. We further recommend that the Regulations provide that a withholding agent should be entitled to rely on (a) dividend estimates that are provided by the short party to the option and (b) any dividend equivalent information that is provided by the clearing house or clearing broker for the option, even if they are otherwise not tasked with the responsibility to provide that information.

G. Withholding Responsibility for "Cashless" Withholding

As discussed above, structured notes and listed options (and other similar financial instruments) are generally held through one or more intermediary financial institutions. The Regulations provide that each financial institution in the chain of ownership of a Section 871(m) contract is treated as having custody over any dividend equivalents that are actually or deemed paid with respect to the contract, and therefore each financial institution is a withholding agent with respect to the actual or deemed payment of such amounts.[66] Accordingly, the issuer of a structured note, the clearing house under a listed option, as well as every domestic or foreign intermediary in the chain of ownership between the issuer or clearing house and the foreign investor in the note or option, will generally be treated as a withholding agent for any Section 871(m) taxes that are payable with respect to the note or option.

In the case of an actual payment of a dividend equivalent that is subject to Section 871(m) withholding, a withholding agent is not obligated to withhold under the general Section 1441 withholding rules if it pays the dividend equivalent to a United States payee or to a foreign person that is a withholding QI.[67] In addition, a foreign broker that is not a QI (an "NQI") will generally not be obligated to withhold on the payment of a dividend equivalent (even though it is a withholding agent with respect to the payment) as long as it provides the required investor information to the party from whom it receives the payment.[68] This could be illustrated by an

[65] While the party that is responsible to determine the delta for a Section 871(m) contract is generally also responsible to determine the dividend equivalents for the contract, a clearing house which serves the function of acting as an intermediary between the short and long party under the option, is arguably not in the best position to determine these amounts, particularly if it does not know if the investor is a foreign person and/or the investor's holding period in the contract.

[66] Treas. Reg. Sec. 1.1441-7(a)(2).

[67] Treas. Reg. Sec. 1.1441-1T(b)(1).

[68] Treas. Reg. Sec. 1.1441-1T(b)(6)(i).

example in which an issuer of a structured note deposits the note with a withholding QI (such as Euroclear or Clearstream), and a foreign investor holds its interest in the note through an NQI that in turn holds an account with the withholding QI. In such a case, although the issuer, the QI and the NQI are all withholding agents with respect to any dividend equivalent payments on the note, the QI will generally be the sole party that is obligated to impose withholding tax on any such payments because (a) the issuer will not be obligated to withhold on such payments because the recipient is a withholding QI, and (b) the NQI will generally not be obligated to withhold on such payments as long as it provides the required investor information to the QI.

In the case of a structured note or listed option, however, the Section 871(m) withholding tax could exceed the actual dividend equivalent payments that are currently made with respect to the note or option.[69] This could happen (a) upon the expiration of a listed option, (b) upon the maturity of a structured note if the maturity payment is less than the Section 871(m) tax, (c) under the elective regime described above, if the withholding agent elects to withhold upon the dividend payment date of the underlying securities, and (d) in the case of structured notes that provide for periodic coupons, if the periodic coupon is less than the Section 871(m) tax that is due at such time. In such a case, both the issuer and the QI in the example above would arguably be required to collect the withholding tax on the "cashless" dividend equivalent, because the issuer will not make an actual payment of such amount to an NQI and it will thus not be technically entitled to the exemption described above. This would be contrary to the general approach of the withholding regulations under which a single withholding agent has primary responsibility to collect any withholding tax and could lead to double withholding with respect to the same dividend equivalent amount.

In order to address this issue, we recommend that guidance be issued that would provide that the withholding agent that has primary withholding responsibility for any actual payments of a dividend equivalent will also have primary withholding responsibility for any deemed dividend equivalent payments. We believe that this is the most sensible approach because, among other reasons, it will ensure that the same person is the primary withholding agent for actual and deemed payments, which is more likely to result in the proper computation and implementation of the withholding tax.[70] Moreover, this approach will ensure that a withholding agent cannot

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[69] While other instruments can also be subject to Section 871(m) cashless withholding, these are not of concern for purposes of this discussion because there will generally only be one withholding agent in the case of such instruments.

[70] This could be illustrated by an example in which the Section 871(m) withholding is imposed in connection with a cash distribution but the amount of the tax exceeds the amount of the distribution. In such a case, the application of the Section 871(m) tax would be subject to increased complexity and potential for error if one withholding agent has primary withholding responsibility for the portion of the

shift its withholding obligations to another party by making the Withholding Election described above.[71] Under this approach, the QI in the example above would be the withholding agent that is responsible to collect the withholding tax for any "cashless" dividend equivalent payments on the option or note, and the issuer and NQI would not have primary withholding responsibility for such amounts.

As noted in our letter dated June 3, 2015 with respect to the application of Section 305(c) to convertible instruments, withholding agents should be granted additional time to deposit withholding taxes that it has to collect from other assets of an investor. We specifically recommended in the letter that withholding agents should be granted an additional ten days to collect the cashless withholding tax from investors. We similarly recommend that the same ten day extension should be granted in the case of Section 871(m) cashless withholding so that withholding agents will have sufficient time to collect the withholding tax from investors.

H. Partnership Derivatives

The Regulations provide that a derivative with respect to a partnership interest will be subject to Section 871(m) with respect to the underlying securities that are held by the partnership if the partnership is a "covered partnership", or if the partnership holds any interest in a covered partnership.[72] The term "covered partnership" includes a partnership (a) that is a dealer or trader in securities, or (b) if more than 25% or $25 million of the value of its assets consist of underlying securities.[73] While not explicitly stated, this provision will generally only apply to a derivative with respect to a publicly traded partnership ("PTP"), because it is very rare for a derivative to be issued with respect to a partnership that is not publicly traded.

The overwhelming majority of PTPs are in the natural resource business, and they generally do not make significant investments in third party corporate stock. We understand, however, that many PTPs have wholly-owned blocker corporations which hold assets that produce non-qualifying income under Section 7704 of the Code.[74] We further understand that in

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tax that does not exceed the payment and a different withholding agent has primary withholding responsibility for the portion of the tax that is in excess of the payment.

[71] That is because the election will often cause a contract to be subject to cashless withholding when it would not have been subject to cashless withholding in the absence of the election.

[72] Treas. Reg. Sec. 1.871-15(m)(1).

[73] Treas. Reg. Sec. 1.871-15(m)(2).

[74] *See* IRC Section 7704(d).

many cases such blocker corporations have a value in excess of $25 million, but they represent significantly less than 25% of the value of the assets of the applicable PTP.

1. Covered Partnership Definition

We first note that we agree with the government's concern that, in the absence of a Section 871(m) look-through to the assets of a partnership, an investor could inappropriately avoid the application of Section 871(m) by entering into a derivative with respect to a partnership that primarily holds US equities rather than entering into a derivative on the underlying US equities themselves. The Regulations, however, apply to cases in which an investor is clearly not entering into a partnership derivative in order to avoid the application of Section 871(m). As noted above, the Regulations apply to any partnership that (a) holds an interest in another covered partnership or (b) holds $25 million of underlying securities even if such assets represent less than 25% of the assets of the partnership. Accordingly, a partnership that has a $25 million interest in a wholly owned "blocker corporation" will be a covered partnership even if the blocker corporation represents a relatively small percentage of its assets, and a derivative with respect to a partnership that holds *any* interest in a covered partnership will be subject to Section 871(m). It is inconceivable that an investor would enter into a derivative with respect to such a partnership in order to obtain exposure to the equities held by the partnership without being subject to Section 871(m), because the dramatically different economic exposure that such a position would entail would far outweigh any withholding tax benefit of the transaction.

We understand that some believe that rules similar to those in Section 871(m) should apply to derivatives with respect to partnerships that are engaged in a US trade or business so that the holder of a long position in such a derivative is not subject to more advantageous tax consequences than if it had directly invested in the partnership. While a discussion of this assertion is beyond the scope of this submission, we believe that it is inappropriate for the government to effectively achieve this policy objective by causing partnerships that have a relatively small percentage of their assets invested in US equities to be subject to Section 871(m).[75] Section 871(m) and its legislative history do not address partnership derivatives, and Congress clearly did not intend for Section 871(m) to be used for this alternative purpose. Furthermore, if the policy goal is to create a new system of taxation for derivatives with respect to partnerships, the use of Section 871(m) to achieve this policy objective would create an arbitrary distinction among partnerships based on the amount of corporate stock that they hold.

[75] The application of Section 871(m) in this manner could achieve this policy objective because the practical issues described below could cause market participants to withdraw from the market for partnership derivatives.

In light of the issues set forth above, we recommend that the definition of the term covered partnership be revised so that it eliminates the $25 million test described above and it only includes a partnership that is either a dealer or trader in securities or that satisfies the 25% test described above. As discussed above, such a change would be more consistent with the policy of Section 871(m) and would not enable investors to use partnerships to inappropriately avoid the application of Section 871(m). Furthermore, by reducing the number of partnerships that are subject to Section 871(m), this revision would reduce the scope of the practical issues and potential refund claims described below with respect partnership derivatives that are subject to Section 871(m).

2. Application of Section 871(m) to Covered Partnerships

The following subsection addresses the guidance that we believe is necessary to enable withholding agents to determine whether and to what extent a derivative with respect to a partnership interest is subject to the Section 871(m) withholding tax.

More specifically, in the case of a partnership derivative, the Regulations do not provide for any mechanism to enable a withholding agent to determine whether a partnership is a covered partnership. The information necessary to make that determination is generally not available in the tax returns or financial reports of a partnership. For example, in the case of a partnership that holds a US blocker corporation, the tax returns and financial statements of the partnership will generally not include the value of the blocker corporation.

Furthermore, even if a withholding agent knows whether a partnership is a covered partnership, it will generally be unable to compute the delta with respect to non-publicly traded US equities (such as a blocker corporation), which may differ from the delta with respect to the partnership interest.[76] In addition, even if it does have such knowledge, the US equities held by the partnership could change over time, thereby requiring the computation of a new delta with respect to the new U.S. equities, notwithstanding that the withholding agent will generally not know when such changes are made.

Finally, a withholding agent will generally have no knowledge of the dividends that are recognized by a covered partnership with respect to underlying securities. Even if it could obtain that information from the tax returns or financial statements of a partnership, it will often have to make a withholding determination before that information is available. For example, in the case

[76] For purposes of simplicity, the discussion above assumes that the derivative is a simple contract that is subject to the delta test rather than a complex contract that is subject to the substantial equivalence test. If the derivative is a complex contract, the issue described above would be further exacerbated because the substantial equivalence test would be more difficult to apply than the delta test.

of a swap over a partnership and partnership-linked exchange traded notes, the withholding agent will generally be obligated to make current payments to the long party equal to the distributions on the partnership interest. In the absence of any information from the partnership, the withholding agent will not know the portion of the distribution that is attributable to dividends on underlying securities or the timing of the underlying dividend, and will therefore be unable to determine the portion of the derivative payment that is a dividend equivalent subject to withholding. Furthermore, a withholding agent may not be able to obtain the partnership's financial or tax information, because it may not own an interest in the partnership.

In light of the issues set forth above, we recommend that guidance be issued that would provide for the following rules with respect to the application of Section 871(m) to derivatives with respect to partnerships.

First, the delta of a derivative with respect to an underlying security that is held by a partnership that is subject to Section 871(m) should equal the delta with respect to the partnership interest as a whole and should not be determined based on a look-through to the underlying securities that are held by the partnership.[77] Under this approach, the delta of the derivative would not be recomputed each time there is a charge to the underlying securities that are held by the partnership.[78]

Second, in some cases, a partnership that could possibly be a covered partnership may elect to provide information to market participants as to whether it is a covered partnership in a particular tax year and (if it is a covered partnership) the amount and timing of the dividends on underlying securities that it received in such year. It may also be willing to provide such information on a "real time" basis within a taxable year so that withholding agents that make a payment on a derivative with respect to the partnership can determine the portion of such payment that is treated as a dividend equivalent that is subject to withholding tax. Market participants should be entitled to rely on any such information that is provided by a partnership or its agent (or any reasonably reliable third party providers) in order to determine the Section 871(m) withholding tax, if any, with respect to a derivative on a partnership interest. This would be generally consistent with the rule that allows market participants to rely on information that is provided by a broker dealer and/or a short party to a derivative for purposes of determining the

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[77] For purposes of simplicity, the discussion above refers to delta, but we recommend that the same rule should apply for purposes of applying the substantial equivalence test to a complex contract that references a partnership.

[78] This is consistent with our recommendation below regarding the computation of delta with respect to a non-qualified index.

Section 871(m) withholding tax.[79] Moreover, such a rule would make sense from a policy and practical perspective because it would (a) enable taxpayers to properly compute the Section 871(m) withholding tax and (b) prevent investors in such derivatives from having to claim a refund for any excess withholding tax that is imposed on estimated amounts, which would impose a substantial burden on taxpayers and the government.

Third, if a partnership does not provide the aforementioned information to a withholding agent, then a withholding agent should be entitled to satisfy its Section 871(m) withholding obligation by assuming that dividends on the underlying securities that are held by the partnership are equal to and are made at the same time as the distributions that are made by the partnership. A withholding agent should only be entitled to employ this simplifying assumption if it does not have actual knowledge of the dividends that are realized by the partnership from underlying securities. This approach would be beneficial to the government because publicly traded partnerships generally make annual distributions that are significantly in excess of their taxable income and that are certainly in excess of their income from underlying securities. We acknowledge that this approach would generally result in a withholding tax that significantly exceeds the actual Section 871(m) tax with respect to the applicable derivative, but it would enable withholding agents to ensure that they are complying with their withholding obligations, and foreign investors could claim a refund if they can demonstrate that the actual Section 871(m) tax is less than the amount that was withheld.

I. Qualified Index

1. Traded Options and Futures

The Regulations state that an index will only constitute a qualified index if options or futures on the index are "traded" on certain specified markets.[80] The Regulations, however, do not define the minimum level of trading that is necessary to satisfy the "traded" requirement. The preamble to the Regulations, in discussing this requirement, states that futures or options must be listed for trading, thereby implying that the "traded" requirement only requires that futures or options be available for trading without requiring a minimum level of trading activity.[81]

[79] Treas. Reg. Section 1.871-15(p)(3)(D)(iii).

[80] Treas. Reg. Sec. 1.871-15(l)(3)(vii).

[81] Preamble at p. 6.

We recommend that guidance be issued that confirms that listing for trading will be sufficient to satisfy the “traded” requirement. We acknowledge that an index could satisfy the "traded" requirement under this approach even if there is minimal trading of futures or options with respect to the index. However, the Regulations state that an index will not constitute a qualified index unless the index is “widely used” by market participants. The widely used requirement will therefore ensure that the index is widely used in investment transactions (such as options or futures on the index, ETFs that invests in the index, or widely used OTC contracts with respect to the index). The “traded” requirement would thus be duplicative if it required a minimum level of trading activity with respect to the index. Accordingly, we believe that the traded requirement should be interpreted as only requiring that options or futures be listed and thus available for trading, rather than requiring a minimum level of trading activity with respect to a particular index.[82]

If the government does not accept this recommendation, we urge the government to issue specific rules regarding the minimum trading activity that is required to satisfy the “traded” requirement. Otherwise, the market will inevitably apply inconsistent standards in applying this rule, and some market participants will be unable to apply the qualified index test to certain indices due to uncertainty regarding the scope of the “traded” requirement.

2. Short Positions With Respect to an Index

The Regulations provide for an anti-abuse rule under which a contract with respect to an index will not be treated as relating to a qualified index if the investor holds a short position with respect to more than five percent of the components of the index and it holds the short position “in connection with” its position under the contract (the “short position rule”).[83] The Regulations generally require that withholding agents apply “reasonable diligence” in order to determine whether a transaction is subject to Section 871(m),[84] and accordingly that is

[82] The need for guidance in this regard could be illustrated by the MSCI World Index, which is a very widely used index for which there is a significant amount of futures that trade on foreign exchanges. The trading on foreign exchanges, however, will not qualify under the Regulations because more than 50 percent of the index is comprised of US stocks. Futures on the index are also listed on ICE (which is a US exchange) but there is very little trading of the futures. Similarly, the MSCI USA index is a widely used index for which futures are listed on ICE but there is very little trading of such futures. There is no policy reason to exclude such indices from qualified index treatment if they otherwise satisfy the requirements to constitute a qualified index in light of the fact that such indices are diverse, are not customized, and are widely used.

[83] Treas. Reg. Sec. 1.871-15(l)(6).

[84] Treas. Reg. Sec. 1.871-15(p)(1).

presumably the standard of diligence that withholding agents will generally be required to perform in order to determine whether a derivative is subject to the short position rule. The Regulations, however, do not provide any guidance regarding the level of diligence that is "reasonable" in order for a withholding agent to determine (a) whether an investor in an index derivative holds a short position with respect to the components of an index, and (b) if the investor does hold any such short position, whether it was entered into "in connection with" the investor's position under the derivative. In addition, in some cases the withholding agent with respect to an index derivative will be an intermediary that has no relationship with the investor, and it will therefore have no ability to conduct any diligence as to whether the investor holds any short positions with respect to the index. Furthermore, the Regulations do not apply the "same account" and "two day" presumption rules under the combination rule for purposes of applying the short position rule. Accordingly, in the absence of additional guidance, withholding agents will have no way of determining the proper scope of their diligence obligation, and market participants will presumably employ inconsistent standards for satisfying such obligation.

For the reasons discussed below, we recommend that guidance be provided that a withholding agent is only required to treat a derivative with respect to an index as subject to the short position rule if the withholding agent has actual knowledge that the derivative and a short position with respect to some components of the index were "priced, marketed or sold" together as part of a single investment plan. As discussed below, we believe that this is the correct standard from both a policy and practical perspective and is consistent with the anti-abuse nature of the rule. In addition, if our recommendation above regarding the combination rule is adopted, there would be consistency between the standard for applying the combination rule and the standard for applying the short position rule. Moreover, we are concerned that an alternative standard could effectively eliminate a withholding agent's ability to apply the qualified index rule because it may be unable to determine whether any derivative is subject to the short position rule. This in turn could cause many foreign investors to claim refunds from the IRS for withholding taxes that are imposed with respect to such transactions, and could cause withholding agents to refuse to enter into transactions with foreign investors with respect to qualified indices.

As an initial matter, we believe that the scope of a withholding agent's obligation to determine whether the short position rule applies to a particular transaction should be based on the abuse that the short position rule is presumably intended to address. While the preamble to the Regulations and the proposed Section 871(m) regulations do not address the policy behind the short position rule, we assume that this rule is intended to address a case in which a foreign investor seeks to enter into a derivative with respect to a basket of stocks that does not constitute

a qualified index, and instead enters into (a) a derivative with respect to a qualified index that includes those stocks and (b) a short position with respect to the remainder of the stocks in the index. The investor in such a case would be inappropriately employing the qualified index rule in order to avoid the Section 871(m) withholding tax with respect to a derivative transaction that effectively does not reference a qualified index. We note that while this fact pattern is possible, in many cases a taxpayer would not benefit from entering into such a transaction because the hedging costs and administrative inconvenience of the short hedging transaction would outweigh the withholding tax savings of the transaction. Moreover, this is a transaction in which the taxpayer's purpose for entering into the derivative and short position, as opposed to entering into a single derivative with respect to the net long position, is to avoid the Section 871(m) withholding tax that would apply to a single derivative with respect to the net long position. As described in more detail below, however, the "in connection with" standard in the short position rule includes transactions that are economically related to each other that do not have this abusive purpose. The withholding agent's withholding obligation should therefore be limited to transactions that are "priced, marketed or sold" as a part of single investment transaction, because otherwise withholding agents may impose Section 871(m) withholding with respect to transactions that are arguably related to each other but are outside of the scope of the abusive transaction described above.

In addition, in the absence of the "priced, marketed or sold" rule described above, withholding agents would be required to disaggregate every derivative held by a foreign investor with respect to a qualified index and constantly monitor on an ongoing basis whether the taxpayer, or any related party, holds a short position with respect to any components of the index. This can be illustrated by an example in which a foreign investor enters into a total return swap with respect to the S&P 500 index. Under the Regulations a withholding agent would apparently be required to identify every short position that the investor, or a related party, holds with respect to every one of the 500 components of the index. In the case of an investor that is an active trader, the investor could have numerous such short positions in the normal course of its investment activities.

Furthermore, the withholding agent would arguably be required to continue to identify such short positions during the entire term of the swap because an investor may enter into a short position long after it enters into the swap that is related to its long position under the swap. For example, a taxpayer that enters into the swap described above could decide at some point that its global exposure to large capitalization stocks (which could include the swap as well as other long positions) is too great, in which case it may then enter into a short position with respect to a basket of large capitalization stocks (including a non-qualified index) that includes stocks that are in the S&P 500 index. The short position could be treated as entered into "in connection with" the long position under the swap because the investor may have not entered into the short

position (or may have entered into a short position with a smaller notional amount) if it had not entered into the long position under the swap.

Finally, once the withholding agent identifies such short positions it would need to determine whether the taxpayer entered into any of the positions in connection with its long position under the swap. This would require the withholding agent to make a subjective determination regarding the investor's subjective intent for entering into a transaction. Aside from the fact that a withholding agent will often have no basis for making such a determination, there is significant legal uncertainty regarding the application of the "in connection with" standard, particularly with respect to investors and financial institutions that regularly enter into OTC transactions in different business units that operate independently of each other. The lack of an objective legal standard and the fact that the "in connection with" standard is based on facts that will often be unknown (and cannot be known) to the withholding agent will inevitably result in withholding agents employing inconsistent standards in making this determination.

The proposition that withholding agents are required to implement the very complex identification and monitoring regime set forth above, and are then required to make the subjective determinations described above, is not justified or warranted in light of the limited types of transactions that, as described above, should, as a policy matter, be governed by the short position rule. We therefore recommend that, as described above, withholding agents should only be required to apply the short position rule in the case of two or more positions that are "priced, marketed or sold" as part of a single investment transaction. This would enable withholding agents to create a withholding system that they can reasonably implement and that will be most likely to apply to the transactions that are of concern to the government. It would also enable withholding agents to apply the short position rule in a consistent manner, and it would prevent the IRS from being inundated with refund claims from foreign investors who, in the absence of this recommendation, may be subject to withholding on all derivatives with respect to qualified indices because of withholding agents' inability to apply the short position rule to particular transactions.[85]

3. Capped Indices

[85] We considered whether the issues described above could be resolved by entitling withholding agents to rely on an investor certification to the effect that it does not hold any short position "in connection with" its long position under an index derivative. Although foreign investors routinely make certification regarding factual matters, an "in connection with" certification would be a certification regarding an ambiguous legal standard. We don't think that it is appropriate or good tax policy to ask foreign investors to make legal certifications, particularly when there is significant uncertainty regarding the application of the law. Moreover, we expect that investors will often be unwilling to provide a legal certification of this type due to the uncertainty regarding the legal application of the "in connection with" standard.

In some foreign jurisdictions, certain categories of investors are prohibited for non-tax legal reasons from entering into a derivative with respect to an index if a single component of the index could potentially exceed a specified percentage of the index. Many such investors instead invest in a "capped" version of an index that mirrors the index that the investor seeks to invest in, except that the percentage of the index that is invested in any single stock is capped by the applicable legal limit. This could be illustrated by an example in which a foreign investor seeks to acquire a total return swap with respect to the S&P 500 index but it is subject to a cap requirement that precludes it from investing in an index if any component of the index exceeds more than one percent of the weighting of the index. The investor would then enter into a derivative on the capped version of the S&P 500 index that would be exactly the same as the S&P 500 index except that the index would be adjusted if any component of the index exceeds one percent of the weighting of the index. In such a case, the portion of the index that is attributable to the index component that exceeds the one percent threshold would be proportionally reallocated to the remainder of the components of the S&P 500 index (assuming the reallocation does not cause any other component of the index to exceed the one percent limitation). Accordingly, the capped index, while very similar to the index that it is designed to replicate, could slightly differ from the underlying index due to the cap limitation. Capped indices of this type are very popular and widely used in Europe and they often reference an index that constitutes a qualified index under the Regulations. The capped indices, however, do not independently constitute a qualified index because options and futures on capped indices are not listed for trading on qualified exchanges in the manner that is required by the Regulations (the "traded requirement").

We note in this regard that the Regulations provide that a total return index that does not independently satisfy the traded requirement will nonetheless be treated as satisfying such requirement if the price return version of the index satisfies the traded requirement.[86] That makes sense as a policy matter because such an index is not customized and does not incorporate a trading strategy, but rather represents a slightly modified version of an index that constitutes a qualified index. Similarly, in the case of a capped index, the foreign investor seeks to invest in a qualified index but due to legal constraints it must instead invest in a capped version of the index that could slightly differ from the underlying index. There is no policy reason why a total return or price return version of a qualified index should constitute a qualified index while a capped version of a qualified index should not similarly constitute a qualified index. If anything, there is more of a reason to treat a capped version of an index as a qualified index because, unlike a total return or price return version of an index which an investor elects, an investor in a capped index

[86] Treas. Reg. Sec. 1.871-15(l)(3)(vii). The same rule applies if the total return version of the index satisfies the trading requirement and the price return version of the index does not satisfy the trading requirement.

has no legal choice other than to invest in the capped version of the index. We therefore recommend that guidance be issued that a capped index of the type described herein will satisfy the traded requirement as long as the index mirrors (subject to the cap limitation) an index that satisfies the traded requirement.

4. Contracts that Indirectly Reference a Qualified Index

We appreciate that the Regulations added a rule under which a Section 871(m) contract will be treated as referencing a qualified index if it references a security, such as stock in an exchange traded fund (an "ETF"), that itself tracks a qualified index.[87] The Regulations, however, do not define the term "security" for this purpose.[88] In other contexts, the term "security" is sometimes defined as limited to corporate stock[89] and is sometimes defined to include certain interests in partnerships and trusts.[90] We note in this regard that while many ETFs are classified as corporations for tax purposes, some are classified as partnerships or grantor trusts for tax purposes. There is no policy reason to treat a derivative with respect to an ETF that invests in a qualified index any differently for Section 871(m) purposes based on whether the ETF is classified as a corporation, as opposed to a partnership or a grantor trust, for federal income tax purposes. We therefore recommend that guidance be issued that the term "security" for this purpose includes an equity interest in a corporation, partnership or grantor trust.

5. First Year of Index

The Regulations provide that the determination as to whether an index is a qualified index is made on the first day of the calendar year in which the applicable contract is issued.[91] In addition, in order to constitute a qualified index, the annual yield of the underlying securities in the index in the immediately preceding calendar year cannot have been greater than 1.5 times the yield of the S&P 500 index in such year.[92] The Regulations do not provide any guidance as to how these rules should be applied in the first year in which an index is created.

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[87] Treas. Reg. Section 1.871-5(l)(7).

[88] By contrast, Treas. Reg. Section 1.871-15(m)(1) defines the term "security" for purposes of that provision by reference to the Section 475 definition of the term "security".

[89] IRC Section 1236(c).

[90] IRC Section 475(c)(2).

[91] Treas. Reg. Sec. 1.871-15(l)(2).

[92] Treas. Reg. Sec. 1.871-15(l)(3)(vi).

We recommend that guidance be issued that provides that an index will constitute a qualified index in the first year in which it is created if it satisfies the qualified index requirements on the first day on which it is created (rather than on the first business day of the calendar year). The dividend yield test should be determined for this purpose based on the dividend yield that the index would have had in the immediately preceding calendar year if it had existed during all of such year with the same components as the components of the index on the date that the index is created.

J. Non-Qualified Indices

1. Delta Computation

The Regulations provide that the delta of a derivative with respect to a securities basket or index that is not a qualified index must be computed separately with respect to each component of the index, rather than computing the delta amount with respect to the index as a whole. (For purposes of simplicity, the discussion in this subsection refers to indices but it also applies to securities baskets that do not constitute a qualified index). As described below, the look-through approach under the Regulations will create operational complexity upon issuance and uncertainty when the index is adjusted, and will often result in a delta computation that is inconsistent with the economics of the derivative.

The tax treatment of a non-qualified index under the Regulations can be illustrated by an example in which an investor purchases a call option with respect to a non-qualified index that consists of 100 equally weighted US equities. Assume that each stock has a current value of $10 so that the index has a value of $1000, and that the strike price of the call option is $800. Under the look-through approach of the Regulations, the parties to the option would be required to compute 100 separate delta amounts (and, if applicable, 100 estimated dividend amounts) for 100 hypothetical call options with respect to each component of the index. Although it is not entirely clear under the Regulations, the delta for each of the 100 call options would presumably be based on a strike price of $8 per option. Aside from the computational complexity of this approach, the single option in the example could be subject to up to 100 different withholding rates based on 100 different deltas for each hypothetical call option. This could happen if the 100 notional call options that are created under the Regulations all have differing deltas above .8, in which case each of the hypothetical options would be subject to a different withholding rate with respect to the dividend equivalent attributable to the option.

In addition, it is unclear whether the Regulations would require the computation of a new delta (and, if applicable, estimated dividend amount) upon a subsequent rebalancing of the index with respect to any new or increased component of the index, even if the rebalancing does not trigger a deemed disposition of the derivative under Section 1001 of the Code. More specifically,

as discussed above, the Regulations provide that the delta of a contract is equal to the delta upon issuance.[93] In addition, while there is no authority that specifically addresses the issue, it is generally understood that a change to a third party index generally does not trigger a deemed reissuance for tax purposes of a derivative that is linked to the index. Thus, this provision supports the position that the delta of a derivative with respect to a non-qualified index should generally not be recomputed upon a change to an index. On the other hand, the Regulations also state that the delta of a derivative with respect to a non-qualified index must be computed separately for each component of the index. This provision supports the position that a new delta should be computed for the components that were added to the index because there is no delta that was previously computed with respect to such components that can be used under the Regulations. Under the look-through approach of the Regulations, there does not seem to be any way to enable these provisions to operate in a consistent manner. If the latter approach is adopted, the new delta computation for the new components of the index would only further complicate the application of Section 871(m) to the call option in the example above, because it would likely increase the number of different Section 871(m) consequences applicable to the hypothetical call options with respect to the components of the index.

Aside from the practical and business difficulties illustrated above, the computation of delta for non-qualified indices under the Regulations will generally be inconsistent with the economics of the transaction, because a single non-delta-one-derivative with respect to an index is economically different than the aggregate of the same derivative with respect to each component of the index. That is because the single index derivative takes into account the aggregate changes in the value of the index components, whereas a separate derivative with respect to each index component only takes into account the performance of that component. Likewise, the single delta of a non-delta-one derivative with respect to an index will generally differ from the average of the delta amounts with respect to the same derivative on each of the underlying components of the index. Thus, the actual delta that is taken into account in the pricing of a non-delta-one derivative with respect to a non-qualifying index will almost certainly differ from the average of the delta amounts for the derivative that must be computed under the Regulations.

In light of the issues set forth above, we recommend that the Regulations provide that a non-qualified index will be treated as a single underlying security for Section 871(m) purposes. Under this approach, the delta for a derivative with respect to a non-qualified index would be based on the index as a whole rather than on each component of the index. In addition, the delta for the derivative would not be recomputed each time there is a change to the index because the underlying security that is represented by the index would remain the same, unless the changes to

[93] Treas. Reg. Sec. 1.871-15(g)(2).

the index trigger a deemed reissuance of the derivative under Section 1001 of the Code. If the dividend equivalent amount is based on estimated dividends, it would be determined upon the issuance of the derivative based on the projected dividends for the underlying securities in the index (taking into account any projected changes to the index) and would not be readjusted upon a change to the components of the index (again, assuming that the changes do not trigger a deemed reissuance for tax purposes). If the dividend equivalent amount is based on actual dividends, rather than estimated dividends, the actual dividends would be computed based on the actual underlying securities in the index, including any underlying securities that are included after an adjustment to the index.

2. Exchange Traded Security Rule

The Regulations provide for a special rule in the case of a contract with respect to a basket or non-qualified index of at least ten underlying securities if the short party hedges its position under the contract by acquiring an exchange-traded security that references substantially all of the underlying securities in the basket or index (the "exchange-traded security rule"). In such a case, the short party can compute the delta for the contract based on the ratio of the change in the value of the contract to a small change in the value of the exchange-traded security, rather than determining the delta based on a look-through to each of the securities in the basket.[94] We recommend that this rule be extended to a case in which the short party can hedge its position by acquiring the exchange-traded security even if it does not in fact hedge in such a manner. If there is an exchange-traded security that references substantially all of the underlying securities in a basket or index that is referenced by a Section 871(m) contract, there is no policy reason to subject a foreign investor to different Section 871(m) consequences depending on whether the short party actually hedges its position under the contract by acquiring the security, because the exchange-traded security will in either case act as a proxy for the securities in the basket or index. Furthermore, the application of Section 871(m) to contracts in which there would otherwise be a look-through to the components of a basket or index would be greatly simplified if the exchange-traded security rule is extended in this manner.[95] This would be consistent with the rule in the Regulations under which a taxpayer can use a theoretical "initial hedge" under the substantial equivalence test, even if it does not actually acquire the initial hedge to hedge its position under a complex contract.[96]

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[94] Treas. Reg. Sec. 1.871-15(g)(3).

[95] We note that the exchange traded security rule would not be necessary if our recommendation in the prior subsection is adopted, because the look-through rule in the Regulations would then no longer apply to a basket or index.

[96] Treas. Reg. Sec. 1.871-15(a)(5).

The Regulations provide that the per-share dividend amount for a Section 871(m) contract that is subject to the exchange-traded security rule is based on the dividend yield of the applicable exchange-traded security.[97] The term "dividend yield", as opposed to "dividend payment", is generally used to refer to the ratio of the dividends on a security to the market value of the security. We imagine that the drafters of the Regulations intended that the term dividend yield in this case should equal the actual dividends that are paid on the exchange-traded security, because there is no policy reason to determine the per-share dividend amount based on the dividend/value ratio of the security. We recommend, however, that guidance be issued that confirms that the dividend yield for this purpose equals the actual dividends that are paid on the applicable exchange-traded security so that there is no uncertainty in this regard.

K. Dividend Determination Date

As discussed above, the Regulations provide that a dividend equivalent is determined on the earlier of (a) the record date of the dividend on the underlying security and (b) the day prior to the ex-dividend date with respect to the dividend on the underlying security (such date is defined above as the "Dividend Determination Date").[98] The Regulations further provide that a dividend equivalent for which there has been a Dividend Determination Date is treated as paid, and thus subject to withholding, once there is a Payment Date with respect to such amount under a Section 871(m) contract.[99] In most cases, the Dividend Determination Date for a dividend equivalent will be the same as the date (if any) upon which the holder of a Section 871(m) contract becomes economically entitled to the dividend equivalent under the contract.[100] There are some cases, however, in which these two dates will not be the same, particularly in the case of a special dividend for which the ex-dividend date is generally after the record date for the dividend. As discussed below, this could create a disconnect between a foreign investor's tax liability in respect of a dividend equivalent and the investor's economic entitlement to receive a dividend equivalent payment.

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[97] Treas. Reg. Sec. 1.871-15(i)(3)(iii).

[98] Treas. Reg. Sec. 1.871-15(j)(2).

[99] Treas. Reg. Sec. 1.1441-2(e)(8).

[100] That is because the holder of a long position under a derivative generally becomes entitled to any dividend equivalent amounts on or after the day prior to the ex-dividend date for the underlying dividend (although it is not entitled to actually receive the dividend equivalent until the payment date for the underlying dividend). Such date is generally the same as the Dividend Determination Date because the record date for a dividend generally occurs after the ex-dividend date for the dividend.

This could be illustrated by an example in which a foreign investor holds the long position under a total return swap with respect to a security that provides for a special dividend that has an ex-dividend date that is two weeks after the record date for the dividend. Assume that (a) the swap provides that the investor becomes entitled to receive a dividend equivalent for any dividend that is paid on the underlying security on the day prior to the applicable ex-dividend date and (b) the investor terminates the swap after the record date for the special dividend but before the day prior to the ex-dividend date for the special dividend. The investor in such a case would not be entitled to receive a payment in respect of the special dividend upon the termination of the swap. The Dividend Determination Date for the special dividend, however, would be on the record date, because the record date for the dividend is two weeks prior to the ex-dividend date for the dividend. The foreign investor would thus arguably be subject to Section 871(m) withholding in respect of a dividend equivalent with respect to the special dividend because it held the swap on the Dividend Determination Date with respect to the special dividend, notwithstanding that it is not entitled to receive any payment in respect of the special dividend. This result is inconsistent with the definition of the term "dividend equivalent payment" under the Regulations[101], and we believe that as a tax policy matter an investor in a total return swap should not be subject to tax with respect to dividend equivalents that it is not entitled to receive. Moreover, and perhaps most importantly, it would be extremely difficult for withholding agents to implement systems that can impose withholding on the termination of an instrument such as a total return swap based on a dividend amount that the holder of the swap is not entitled to receive.

In order to address the issue described above, we recommend that the Regulations be revised to provide for the following rules regarding the Dividend Determination Date for a

[101] More specifically, the investor should not be subject to withholding in respect of the special dividend in this case, notwithstanding that it terminated the swap after the Dividend Determination Date, because there is arguably no payment of a dividend equivalent when the investor has no economic entitlement to such amount. This position is supported by the fact that definition of a dividend equivalent payment under the Regulations requires that the payment be determined by reference to a dividend, which would seemingly not be the case if an investor in a total return swap is not entitled to a payment in respect of a dividend. See Treas Reg. Section 1.871-15(i)(1). Furthermore, the provision in the Regulations that defines the Dividend Determination Date also includes an example in which the holder of the long position under a contract is entitled to a settlement payment in respect of a dividend on the underlying security. See Treas. Reg. Section 1.871-15(j)(2). This example implies that the investor would not be subject to tax if it was not entitled to the dividend equivalent even if the swap is terminated after the Dividend Determination Date. If that is the government's position, we recommend that this be clarified in future guidance. Furthermore, if that is the government's position, it would not be necessary to otherwise revise the Dividend Determination Date rules in the manner described in this subsection.

dividend equivalent amount. First, if a Section 871(m) contract provides for the actual payment of a dividend equivalent to the long party (e, g,, a total return swap), then the Dividend Determination Date for a dividend equivalent should be the date on which the long party becomes entitled to receive the dividend equivalent under the terms of the contract (irrespective of the record date or ex-dividend date for the dividend payment). If the Section 871(m) contract does not provide for the actual payment of a dividend equivalent but instead provides for the adjustment of the exercise price (or other economic terms) of the contract to reflect a dividend on the underlying security, then the Dividend Determination Date for the dividend equivalent should be the date on which such adjustment is made under the terms of the contract (irrespective of the record date or ex-dividend date for the dividend payment). Thus, under these two rules the Dividend Determination Date for a dividend equivalent would match the date upon which the holder of a Section 871(m) contract becomes economically entitled to the dividend equivalent.

Third, if the long party under a Section 871(m) contract is not economically entitled to any amount based on the payment of a dividend on the underlying security (e.g., a price return swap or an option that does not provide for an adjustment to the exercise price to reflect a dividend payment), then the Dividend Determination Date for a dividend equivalent should be the date that is currently set forth in the Regulations (i.e., earlier of the record date and the day prior to the ex-dividend date for the dividend). That is because in such a case there is no date upon which the long party becomes economically entitled to a dividend equivalent, and thus the Dividend Determination Date can never match the date of the holder's entitlement to such amount.

L. Definition of Complex Contract

1. Dilution Adjustments

The Regulations state that a contract can only be a simple contract if the contract references a single fixed number of shares of underlying securities.[102] As noted in the preamble to the Regulations, this requirement is necessary because delta cannot be computed for a contract that references a variable number of shares as the number of shares that will determine the payout under the contract is not known at inception.[103] It is not clear whether a contract that references a fixed number of shares but that contains ordinary course anti-dilution adjustments would satisfy this requirement because in such a case there could be a change to the fixed number of shares that are referenced by the contract. For example, most convertible notes, and

[102] Treas. Reg. Sec. 1.871-15(a)(14)(i)(A).

[103] Preamble at p. 3.

many structured notes, provide for an adjustment to the number of shares that are referenced by the notes if there are certain cash or stock dividends with respect to such shares.

We recommend that guidance be issued that clarifies that the single fixed number of shares requirement will be satisfied even if a contract provides for adjustments to the number of securities that are referenced by the contract to take into account a distribution with respect to the securities, if the delta for the contract can be computed in the manner that is contemplated by the Regulations. This would be consistent with the intent of the single fixed number of shares requirement because the adjustment to the underlying securities in this case is intended to ensure that the contract economically reflects the fixed number of shares that were originally referenced by the contract. Furthermore, this rule would be consistent with the intent of the Regulations that the substantial equivalence test should only be employed for a financial instrument in cases in which delta cannot be computed for the instrument. This is particularly important in the case of convertible debt because the issuers of convertible debt are usually not financial institutions and they will generally not be in a position to independently apply the substantial equivalence test.

2. Issuer Redemption Rights

The Regulations state that a contract can only be a simple contract if the contract has a single maturity or exercise date, and that a contract will not be a simple contract if it includes a term that accelerates or extends the maturity of the contract.[104] It unclear whether a contract that can be redeemed by the issuer at its current value would be treated as a complex contract under this provision. While the regulatory language seems to state that such a contract would be a complex contract, the preamble to the Regulations arguably contemplates otherwise as it states that “the fact that a contract has more than one expiry, or a continuous expiry, does not preclude the contract from being a simple contract”.[105] It therefore may be possible to interpret the Regulations as only prohibiting a simple contract from including an early redemption if there is an event that accelerates the term, rather than an issuer that exercises a redemption right. This is of particular importance in the case of structured notes, such as exchange traded notes, that often include an issuer option to redeem the notes at their market value but that otherwise would be treated as simple contracts under the Regulations.

In light of this uncertainty, we recommend that guidance be issued that clarifies that a contract will not be treated as a complex contract solely because the contract can be redeemed by the issuer, as long as the delta for the contract can be computed in the manner that is contemplated by the Regulations. This would similarly be consistent with the intent of the

[104] Treas. Reg. Sec. 1.871-15(a)(14)(i)(A).

[105] Preamble at p. 3.

Regulations that the substantial equivalence test should only be employed for a financial instrument in cases in which delta cannot be computed for the instrument.

M. Substantial Equivalence Test

We commend the government for working with the securities industry to develop the substantial equivalence test and for implementing a workable test that accurately measures whether a complex contract substantially replicates the economic performance of the security that is referenced by the contract. However, there are some cases in which requiring an issuer of a complex contract to apply the substantial equivalence test is unnecessary and would impose an undue administrative burden on taxpayers. More specifically, in many, and perhaps in most, cases it will be obvious whether a particular instrument will satisfy the substantial equivalence test. An issuer may be able to make that determination based on (a) the obvious significant disconnect between the economic exposure of the instrument and the underlying asset, (b) the similarity between the instrument and other instruments that clearly failed the substantial equivalence test and/or (c) the delta computation that the taxpayer uses for risk control purposes.[106] In such cases, an issuer should not be required to compute and record all of the information necessary to apply the substantial equivalence test (including determining the simple contract benchmark, the applicable standard deviation, and the percentage likelihood of a specific increase or decrease in the value of the underlying asset) when it will have no effect on the Section 871(m) withholding amount with respect to the instrument. We therefore recommend that guidance be issued that an issuer of a complex contract may use a test that differs from the substantial equivalence test for purposes of determining the Section 871(m) withholding tax with respect to the contract as long as the Section 871(m) withholding tax, if any, with respect to the contract under that test will be the same as if the issuer had used the substantial equivalence test. The government should have no objection to such a rule because it would not reduce the Section 871(m) withholding taxes that it would collect with respect to such contracts. In addition, this rule would enable issuers to reduce the administrative burden of having to compute and record all of the information necessary to apply the substantial equivalence test for a complex contract as long as it is confident that it could demonstrate on audit that the Section 871(m) withholding amount for the contract would have been the same if it had instead applied the substantial equivalence test to such contract.

[106] We understand that most taxpayers use some form of a delta computation for risk control purposes even for complex contracts. We acknowledge, however, that for the reasons described in the preamble to the Regulations such a delta computation will in some cases be insufficient to determine whether a complex contract should be subject to Section 871(m).

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

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