



December 24, 2010

Delivered Electronically

The Honorable Michael F. Mundaca
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 3120
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel, Internal Revenue Service
1111 Constitution Avenue, NW
Room 3026
Washington, DC 20224

Re: Comments on Notice 2010-46.

Dear Assistant Secretary Mundaca and Chief Counsel Wilkins:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ welcomes the opportunity to submit the following comments regarding Notice 2010-46 on the prevention of over-withholding and US tax avoidance with respect to certain substitute dividends (the “Notice”). The members of SIFMA support the efforts of Treasury and the IRS to develop a workable system that will eliminate over-withholding on cascading dividend equivalent payments while still advancing the goal of Congress to prevent impermissible tax avoidance.

¹ SIFMA brings together the shared interests of securities firms, banks and asset managers. SIFMA’s mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public’s trust and confidence in the markets and the industry. SIFMA works to represent its members’ interests locally and globally. It has offices in New York, Washington, DC, and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

Background

The Notice relates to new Code Section 871(m) (formerly 871(l)) enacted as part of the Hiring Incentives to Restore Employment Act, in March of this year.² Code Section 871(m) both codifies the existing rule, set forth in regulations, that substitute dividend payments made pursuant to a securities lending or a sale repurchase transaction have the same character and source as the underlying dividend and sets forth a new rule that dividend equivalent payments made pursuant to certain notional principal contracts are to be treated as US source.³ Section 871(m)(6) grants the Secretary authority to adjust the withholding tax to prevent over-withholding where a taxpayer can show that the appropriate level of tax has already been paid or to reflect the use of financial intermediaries in a chain of payments.

The Notice first withdraws the prior rules designed to address over-withholding on a chain of payments, set forth in Notice 97-66 (such repeal effective from September 14, 2010 onwards), and sets forth a new framework that future regulations will follow to address the problem of cascading withholding tax on dividend equivalent payments. Under this framework, the primary approach is a qualified securities lender (“QSL”) program (somewhat similar to the qualified intermediary (“QI”) program that currently exists) that will allow qualifying foreign financial institutions to receive substitute dividend payments free of withholding tax, provided that they agree to withhold and report on the payments they make to people who have lent securities to them and to report and pay tax on those payments they receive for their own account.

² Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

³ Dividend equivalent payments are defined as:

(A) any substitute dividend payments made pursuant to a securities lending or a sale-repurchase agreement that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States,

(B) any payments made pursuant to a specified notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and

(C) any other payment determined by the Secretary to be substantially similar to a payment described in subparagraph (A) or (B).

The Notice proposed a secondary approach for all other payments (i.e., payments to entities that are not QSLs). This secondary approach is a credit-forward system that allows a withholding agent to reduce or eliminate the amount of tax it must withhold if it has reliable documentary evidence that a withholding tax has been paid by a prior withholding agent in the chain of payments. The Notice also provides for temporary rules that adopt this framework in slightly modified form.

Summary

The Notice invites comments on the guidance it proposes. The members of SIFMA are eager to help develop a workable system that addresses the problem of cascading withholding under the new Section 871(m) rules. We realize that the Notice is only preliminary guidance and that the regulations to follow will likely clarify some unanswered questions. We have tried to tailor our comments to those areas where we can provide helpful input on the implementation of the framework set forth in the Notice as well as mentioning areas where we think additional guidance is needed.

Our comments and recommendations may be summarized as follows⁴:

- The QI and QSL Rules
 - Future guidance should confirm the interplay of the QI and QSL rules, and in particular, future guidance should (i) confirm that where a QI is acting as an intermediary pursuant to its QI agreement and has assumed primary withholding responsibility, either (a) the QI need not be a QSL to avoid withholding on the substitute dividend payments it receives on behalf of its customers or (b) the QI can be a QSL with minimal further changes, and (ii) clarify that a QSL has met its obligation to “withhold and remit” in instances where it does not withhold because withholding is not required.

⁴ We would like to note that although the Notice only applies to substitute dividend payments, substitute interest payments raise many of the same issues. We suggest that the scope of rules set forth in the Notice be expanded to cover substitute interest payments.

- Future guidance should confirm that the current practice of providing a withholding agent with both a Form W-8IMY and a QSL certification effectively allows the withholding agent to pass the responsibility for all withholding and reporting on substitute dividend payments to the QSL;
 - Future guidance should allow a QI to become a QSL pursuant to a simple process where they may elect to withhold and report on all substitute dividend payments they make; and
 - IRS Form W-8IMY should be amended to provide a box that a QI could check to agree to take on primary withholding and reporting responsibility with respect to all substitute dividend payments it makes or retains.
- Qualification as a Qualified Securities Lender
 - Future guidance should:
 - clarify how a foreign entity that is not a QI may become a QSL;
 - permit a foreign entity that borrows from (or lends to) related customers to become a QSL;
 - permit a foreign financial institution that has agreed to be a participating foreign financial institution under FATCA to become a QSL; and
 - permit a foreign securities lender with an affiliate that is a QSL to “piggy-back” off the QSL agreement and rely on the related QSL to meet its withholding and reporting obligations.
- Payments to a QSL
 - The QSL rules should also cover actual dividends and dividend equivalent payments, not just substitute dividends; and

- The IRS should create a standard form on which a foreign entity can certify as to its status as a QSL.
- Payments by a QSL
 - All QSLs should be permitted to do pooled reporting; and
 - Payments of substitute dividends by a QSL to a US custodian of a foreign person should be exempt from nonresident alien withholding tax by the QSL.
- Credit Forward System
 - Future guidance should clarify that a borrower making substitute dividend or dividend equivalent payments to a Non-Qualified Securities Lender should apply the applicable treaty withholding rate;
 - Under the credit forward system, a securities lender should be allowed to use any reasonable method to match dividend and dividend equivalent payments received with dividend equivalent payments it makes on identical securities; and
 - The credit forward system should cover all dividend equivalent amounts, not just actual and substitute dividends.
- Reporting and Withholding Issues
 - Reporting and withholding by the Depositary Trust Company (“DTC”) should relieve a securities borrower from the obligation to withhold and report.
- Transition Rules
 - QSL certification should only be needed once during any transition period; and
 - The instructions to Form 1042-S and Form 1042 (specifically line 66) should be clarified to allow a credit forward for withheld tax under the transition rule.

Discussion

A. The QI and QSL Rules

1. *Future guidance should confirm the interplay of the QI and QSL rules and confirm what is required for a QI to become a QSL.*

(i) *QI Rules.*

As an initial matter we think it is important to clarify the reporting and withholding rules that previously applied and we believe continue to apply (without regard to the Notice) with respect to dividend and substitute dividend payments made to a foreign person, including a QI that is acting in its capacity as an intermediary (as that term is used in the regulations under Section 1441).⁵ An entity that is a QI that is acting in its capacity as an intermediary may receive payments of US source dividends or substitute dividends free of withholding, provided it agrees to take on the primary responsibility of complying with the US withholding and information reporting rules that would normally apply to a US payor making payments of US source income to a foreign payee. In effect, the QI is permitted to step into the shoes of such a US payor.

For example, a QI that receives an actual US source dividend payment from an issuer through its custodian can provide the custodian with an IRS Form W-8IMY on which it informs the custodian that it has agreed to take on primary withholding and reporting responsibility (such a QI a “Withholding QI”). In that situation the custodian would pay the full amount of the dividend to the QI (without withholding). The QI would apply the proper amount of withholding applicable to the beneficial owners of the payment, and remit such amount to the IRS.⁶ With respect to amounts paid to non-US persons, the QI would comply with the Chapter 3 information reporting rules by reporting such income (and the amounts withheld) to the IRS on Forms 1042 and 1042-S and the payments and any withholding amounts would also be reported separately to the beneficial owners on Form 1042-S. If any one of the beneficial owners of the payment were a US person, the QI would also comply with the information reporting and backup withholding rules applicable to payments to a US

⁵ An intermediary is a person that is acting as a custodian, broker, nominee, or otherwise as an agent for another person. Treas. Reg. §1.1441-1(C)(13).

⁶ As discussed below, where the beneficial owner of the payment is a direct account holder the reporting can be done on a pooled basis.

nonexempt recipient under Chapter 61 (which generally requires reporting on IRS Form 1099) and Code Section 3406.⁷

A QI may comply with its information reporting obligations with respect to payments made to direct account holders that are nonresident aliens on a pooled basis such that the QI may pool together recipients subject to the same rate of withholding without specifically indentifying each recipient to the IRS. A Withholding QI must provide information (i.e., Form W-9) on the beneficial owners of the payments that are US nonexempt recipients.

Under the standard QI agreement,⁸ however, a QI need not agree to be a Withholding QI. For example, a QI may, and often does, choose not to assume withholding responsibility, but only to comply with any required nonresident alien information reporting obligations. Instead, the QI may request that the withholding agent do any actual nonresident alien withholding, based on the information that the QI provides to the withholding agent. The QI likewise has the option to provide this information on a pooled basis by providing the withholding agent with the amount of the payment allocable to each pool and the tax rate to be applied.

A QI treats a substitute dividend payment as a dividend for the purposes of meeting its withholding and/or information reporting obligations. For example, if the UK customer of the QI loans its US issuer shares to a US broker-dealer, the substitute dividends the QI receives on behalf of its UK customer are subject to the same Chapter 3 withholding and reporting rules as regular dividends.⁹ Therefore, a QI receiving such a substitute dividend payment may receive the payment free of withholding by providing the US broker-dealer with a Form W-8IMY on which it notifies the US broker-dealer that it intends to assume primary nonresident alien withholding responsibility with respect to the substitute dividend payment.

As we understand it, the rules set forth in the Notice do not change the basic framework described above applicable to a QI that receives actual or substitute dividend payments as

⁷ For information reporting see IRC §§6042; 6045 and the regulations thereunder and for backup withholding see IRC §3406 and the regulations thereunder.

⁸ See Rev. Proc. 2000-12.

⁹ Treas. Reg. §1.1441-2(b)(4).

an intermediary from a US withholding agent. A Withholding QI should receive dividend and substitute dividend payments free of withholding tax. In instances where the QI does not choose to assume primary nonresident alien withholding responsibility, that obligation will remain with the US withholding agent and payments to the QI will be net of tax. A QI will continue to be permitted to report payments to the IRS on a pooled basis.

As a result, a Withholding QI that is receiving a payment of dividends or substitute dividends as a custodian, nominee or agent should not be required to establish its status as a QSL to receive dividends or substitute dividend payments free of withholding.

(ii) *The QSL Rules.*

Similar to the QI rules, the QSL rules set forth in the Notice permit a foreign entity to voluntarily assume certain withholding and reporting obligations normally imposed on a US person. While the QI rules apply solely to payments received by a foreign institution acting as an *intermediary*, however, the proposed QSL rules would extend them to substitute dividend payments received by a foreign entity as a *principal* (whether or not the QSL is under an obligation to make offsetting substitute dividend payments to another securities lender). Specifically, under the QSL rules set forth in the Notice, a QSL is entitled to receive a substitute dividend payment free of any dividend withholding. The QSL is required to report and pay US tax on that substitute dividend income unless it has made an offsetting payment with respect to identical securities.¹⁰ For example, a UK QSL that lends its own US securities to a US broker-dealer should receive substitute dividend payments from the US broker-dealer free from withholding. Instead, the UK QSL is required to report and pay US tax on the substitute dividend at the applicable US/UK treaty rate.

Where the QSL is obligated to make a corresponding substitute dividend payment (i.e., where the QSL is running a “matched book” with respect to the lent equity securities), the QSL must withhold and report in the same manner as a US payor. Specifically, with respect to payments to non-US persons, the QSL must impose the proper withholding and comply with the reporting rules under Chapter 3 (reporting on IRS Form 1042-S) and with respect to payments to US persons it must comply with the backup withholding and reporting rules under Code Section 3406 and Chapter

¹⁰ Such reporting is to be done on IRS Forms 1042 and 1042-S.

61 (Reporting on IRS Form 1099). For example, a UK QSL that borrows US securities from a non-treaty country investment fund and then lends those securities to a US broker-dealer will receive substitute dividends from the US broker-dealer free from withholding. The UK broker dealer will be required to withhold 30% on the substitute dividend payment it makes to the non-treaty country investment fund, and must report such payment and withholding on IRS Form 1042-S.¹¹

While we believe the description above is an accurate characterization of how the framework set forth in the Notice works, we request that future guidance confirm our understanding. In particular, we note that our understanding of the rules is somewhat inconsistent with the 2010 Instructions for Form 1042-S. Those instructions say that with respect to payments to a QSL, a withholding agent “is not required to withhold on a substitute dividend payment that is part of a series of dividend equivalent payments.” This implies that a payment of a substitute dividend to a QSL that does not have an obligation to make a corresponding payment would not be free from withholding. We believe this is inconsistent with the Notice.

Similarly, the Notice requires a QSL to certify that it will “withhold and remit or pay the proper amount of US gross-basis tax with respect to substitute dividend payments that it receives or makes.” In some instances, however, a QSL will be making a substitute dividend payment to a US lender. Under the US withholding rules, there is no obligation for a withholding agent to withhold on a payment of dividends or substitute dividends to a US payee (provided the withholding agent has received the proper tax forms and certifications). Future guidance should clarify that a QSL has met its obligation to “withhold and remit” in instances where it does not withhold because withholding is not required.

(iii) The Interplay of the QI and QSL Rules.

While we believe our description above is the proper technical analysis of the interplay of the QI rules with the new QSL rules we note that for certain foreign QIs that are, for example, broker-dealers in the business of lending securities, it is not always possible for them to

¹¹ Another example would be where a QSL borrows a US security from a US person and lends the same security to a foreign borrower. Substitute dividend payments by the foreign borrower to the QSL should be free of withholding (because the payment is to a QSL) and the QSL should comply with any applicable backup withholding and Form 1099 reporting on the substitute dividend payment to the US person.

distinguish, vis-à-vis a particular paying agent, what portion of a substitute dividend payment they are receiving (i) as an intermediary QI, (ii) as principal (i.e., as the initial owner of the US security with respect to which the substitute dividend is paid) or (iii) as part of their matched book. As a result, many QIs have begun the practice of providing the US payor with both a Form W-8IMY and the QSL certification statement to cover each substitute dividend payment it receives from that US payor.¹² We believe that where the QI is a Withholding QI, this current practice of providing both the Form W-8IMY and the QSL statement to a US payor should be sufficient to eliminate the need for withholding by the US payor because all reporting and withholding will be done by the QI/QSL. In particular, provided that the QI/QSL reasonably determines how much of the payment it receives is allocable to either counterparties or clients and, by process of elimination, how much of the payment is for its own account, this practice should serve to ensure that the appropriate amounts are being withheld, remitted and reported to the Treasury.¹³

(iv) *Future guidance should clarify what is required for a QI to become a QSL.*

In essence, as proposed in the Notice, a QSL must agree to assume primary withholding and reporting responsibility with respect to substitute dividend payments it receives as a principal, regardless of whether it has an obligation to make corresponding payments to another securities lender. It seems to us, therefore, that if a QI were to agree to assume primary withholding and reporting responsibility with respect to *all* substitute dividend payments it makes to payees or retains as beneficial owner (regardless of whether it receives dividend equivalent payments as an *intermediary* or as a *principal*) the requirements of both the QI rules and the QSL rules would be satisfied.¹⁴ We therefore propose that the QI Agreement be amended to allow the QI to elect to take on primary withholding *and* reporting obligations with respect to any substitute dividend payments

¹² We note that recently developed withholding tax forms from DTC require a QSL to provide Form W-8IMY and to certify as to its QSL status.

¹³ Because the privacy laws of certain foreign jurisdictions currently permit QI reporting pursuant to a QI Agreement, it would be helpful if future guidance made clear that the reporting obligation of a QSL that is also a QI is pursuant to its QI Agreement.

¹⁴ The ability to elect to withhold and report on *all* substitute dividend payments a QSL makes will go a long way toward alleviating the problem, discussed above, that a securities lender is often unable to determine what portion of a particular substitute dividend payment it is receiving as an intermediary and what portion of that payment it is receiving as a principal.

or other dividend equivalent payments it receives. We believe that this could be done in a very straightforward way, perhaps by the QI signing a simple, one page rider to its QI agreement.¹⁵ We also, recommend that the IRS Form W-8IMY be amended to provide a box that a QI could check to agree to take on primary withholding and reporting responsibility with respect to all substitute dividend payments it receives (whether it retains these or makes corresponding payments to others) . A QI that so amended its QI Agreement could then either be deemed a QSL or deemed a QI to which dividend equivalent payments could be made free of withholding.¹⁶

2. *Qualification as a Qualified Securities Lender.*

Under the Notice, in order for a foreign entity to be a QSL it must:

- be a bank, custodian, broker-dealer or clearing organization that is subject to regulatory supervision by a government authority in the jurisdiction in which it was created and be regularly engaged in a trade or business that includes borrowing and lending US securities to unrelated customers,
- be subject to the summons and audit power of the IRS or be a qualified intermediary (“QI”) that is subject to an audit by an external auditor and appropriately amend its QI agreement, and
- comply with annual IRS certification requirements.

We believe that this provision requires a number of clarifications as described below. Additionally, we believe that there are additional circumstances in which a foreign entity should be

¹⁵ We assume that this rider would also provide that the QI’s compliance with its obligations as a QSL (e.g., withholding and reporting) is subject to audit in a manner similar to the audit of its compliance with its QI agreement.

¹⁶ You may also want to consider making an amendment to the QI Agreement that gives a QI the *option* to assume primary withholding and reporting obligations only with respect to a particular stream of substitute dividend payments, similar to the option that is already available under the QI rules. More specifically, there are some cases in which a QI that does not take on primary withholding responsibility may wish to take it on with respect to a specific transaction. In such a case, rather than report withholding information to a US payor and allow the US payor to effect withholding, the QI would assert limited QSL status and assume primary withholding responsibility with respect to a stream of substitute dividend payments to persons that it can readily associate with the dividend equivalent payments it receives from the relevant US payee.

allowed to become a QSL. We believe our suggested additions are sensitive to the needs of the IRS to ensure oversight of the QSL regime, but also ease the compliance burdens of foreign entities attempting to maneuver within the increasingly complex tax regulatory environment.

(i) *Future guidance should clarify how a foreign entity that is not a QI may become a QSL and, in particular, how an entity can meet the audit requirement under the Notice.*

In our experience not all foreign securities lenders are QIs. This is often because a particular securities lender's business may not warrant the effort and expense of entering into a QI agreement. Therefore, we believe a workable system that meets the goal of eliminating most over-withholding should provide an easy method for a foreign non-QI to become a QSL. Pursuant to the Notice, a non-QI must be subject to the audit powers of the US in order to become a QSL. We are unclear on how a foreign entity would do this and are concerned that the requirements may be too onerous.

A. One possible solution would be for the foreign securities lender to file an annual statement describing its activities as a QSL and agree to be subject to external audit by an approved auditor, similar to what is permitted under a QI agreement.

B. It would also be helpful to allow those entities that have entered into an agreement with the IRS to be a "participating foreign financial institution" for purposes of the new Chapter 4 reporting and withholding rules to be QSLs. Under the recently enacted FATCA regime, foreign financial institutions that elect to be participating foreign financial institutions are required to comply with such verification procedures as the Secretary may require with respect to the identification of US accounts.¹⁷ While the audit/verification guidelines used for purposes of Chapter 4 may need to be modified to also cover QSL compliance, we think that permitting entities that are subject to audit for purposes of Chapter 4 reporting purposes to become QSLs is a reasonable way to allow many non-QIs to become QSLs.

C. In many cases a securities lender is not a QI but is in the same affiliated group as a QI. Assuming that the QI properly becomes a QSL, we believe such a securities lender should be able to "piggy-back" off the QSL agreement of its affiliate where the QSL agrees to take on the

¹⁷ IRC §1471(b)(1)(B).

applicable withholding and reporting responsibilities of its securities lender affiliate. Such an arrangement would be similar to that between a QI and a Private Arrangement Intermediary (“PAI”) described in Section 4 of the model QI agreement.¹⁸ The QI’s compliance of those assumed obligations could be subject to the audit procedures already applicable to the QI and, unlike a PAI, the QI could assume liability for the obligations of its affiliate.

(ii) *An entity that borrows from (or lends to) related customers should be allowed to be a QSL.*

The definition of a QSL contained in the Notice requires an entity to be “regularly engaged in a trade or business that includes borrowing and lending US securities to unrelated customers.” We believe this definition unnecessarily excludes a subset of securities lenders that only borrow (or lend) securities to or from their affiliates. For example, as part of a group’s hedging activity, a UK broker-dealer may typically borrow US stocks from its US affiliate and on-lend them to local customers. This UK broker-dealer would not technically fall within the currently proposed definition of a QSL because it does not borrow securities from *and* lend securities to unrelated customers. Instead, it borrows from related customers and lends to unrelated customers. There does not seem to be a good policy reason for excluding it from QSL status. We note that the rules under other areas of the Code recognize that one member of an affiliated group may act in a business capacity for the other members of the affiliated group. For example, the regulations under Code Section 1221 provide that the determination of whether a hedging transaction manages a taxpayer’s risk may be done on a consolidated group basis in recognition of the fact that one member of the group may hedge the risk of other members of the group by entering into a hedging transaction with a group member and then entering into an offsetting position with an unrelated third party.¹⁹ Accordingly, the definition of QSL in the Notice should be amended to require that an entity be “regularly engaged in a trade or business that includes borrowing and lending US securities to related or unrelated customers.”

¹⁸ See Rev Proc 2001-12.

¹⁹ Treas. Reg. §1.1221-2(e)(1).

3. ***Payments to a QSL.***

- (i) *The QSL rules should cover actual dividends and dividend equivalent payments, and not just substitute dividends.*

Under the Notice, a payment of a substitute dividend by a withholding agent to a QSL is exempt from withholding, provided that the QSL assumes responsibility and liability for properly withholding, reporting, depositing and paying US tax with respect to substitute dividend payments. The same exemption does not apply to payments of actual dividends to a QSL even where the QSL is required to make an offsetting substitute dividend payment with respect to identical securities. For example, when a QSL borrows shares from a local customer and simply holds on to the shares, the dividend paid to the QSL will be subject to withholding. We see no reason why there should be withholding on actual dividends to the QSL where the QSL is required to either remit the taxes it owes or withhold on the corresponding substitute dividend payments it makes. The resulting duplicative withholding -- once on the dividend paid to the QSL, and once again on substitute dividends paid by the QSL to the securities lender -- is precisely what the regulations should be designed to avoid.²⁰

The problem also exists with respect to dividend equivalent payments other than substitute dividends (e.g., dividend equivalent payments with respect to certain equity swaps constituting specified notional principal contracts). For example if a QSL borrows US shares from a local foreign customer, sells them to a US person and enters into a long equity swap with such US person over the same US shares (a so-called “cross-in” specified notional principal contract), the QSL will receive dividend equivalent payments from the US person net of withholding, yet will still be required to withhold on the offsetting substitute dividend payments it makes to the local securities lender. The QSL regime should therefore likewise be extended to dividend equivalent payments on

²⁰ While it might be possible in such a case for the QSL to claim mere intermediary status (i.e., that the QSL should treat the securities lender as the real owner of the stock), this conclusion is questionable, particularly in light of recent authority such as *Anschutz v. Commissioner*, 135 TC, No. 5, July 22, 2010, and *Calloway v. Commissioner*, 135 TC, No. 3, July 8, 2010.

specified notional principal contracts and other equity derivative contracts- - i.e., the US person should not be required to withhold on the QSL, because the QSL has undertaken to withhold on payments to the foreign stock lender.²¹

We note that withholding on actual dividends or dividend equivalent payments (other than substitute dividends) can result in over-withholding even when the QSL applies the credit-forward rules. For example, a non-treaty country QSL that borrows US shares from a treaty country lender (subject to 15% withholding) and holds onto those shares will be subject to 30% withholding on the dividends it receives. The non-treaty country QSL will be entitled to apply the credit forward system. Here, however, the total tax paid will be 30% of the dividend amount when it seems more consistent with the QSL system for the QSL to have received the dividend payment free of withholding, and to impose a 15% withholding on the substitute dividend payment the QSL makes to the treaty country lender. (We note that under the credit forward system, withholding on actual dividends does count towards the total amount withheld in a series of payments, but there is no ability to claim a refund for a higher rate of withholding in the chain of payments.)

(ii) *The IRS should create a standard form for a QSL to certify as to its status.*

Under the rules set forth in the Notice, a withholding agent must receive a written certification from the QSL of its QSL status in order to be relieved of its obligation to withhold on payments of substitute dividends. The Notice contemplates that this certification may be on a form prescribed by the Service. As discussed above, we recommend revising the existing Form W-8IMY to allow the QSL to elect to assume withholding and reporting obligations with respect to dividend equivalent payments (and actual dividends). We believe this will simplify what a withholding agent

²¹ Problems could also arise where a QSL enters into back to back swaps with US counterparties. For example, a QSL could enter into a swap constituting a specified notional principal contract with a US person pursuant to which the QSL receives dividend equivalent payments and may also enter into an offsetting swap with a US broker-dealer pursuant to which the QSL must make dividend equivalent payments on the same underlying security. As noted above, under the current rules withholding would be required on the payment to the QSL. We believe it would be appropriate for there to be no withholding on either dividend equivalent payment where the QSL makes a corresponding and offsetting payment to a US broker-dealer.

may rely on.²² Regardless of the format adopted, we request that any new form be issued first in draft form, and that the public be given the opportunity to review it and provide comments before it is issued in final form.

4. *Payments by a QSL.*

In circumstances where a QSL receives a substitute dividend payment and is obligated to make an offsetting substitute dividend payment with respect to identical securities, the Notice states that future regulations will provide that a QSL must properly withhold and report under Sections 1441 and 1442 with respect to the offsetting substitute dividend payment and must also comply with any reporting under Chapter 61, and with the backup withholding requirements under Code Section 3406.

(i) Pooled Reporting should be permitted by QSLs.

We understand that it is the intent of the IRS and Treasury to allow a QSL that is also a QI to apply the pooled reporting principles to the reporting of substitute dividend payments it makes to non-US payees. We applaud the decision of the IRS and Treasury to allow pooled reporting. We would like to expand on this and recommend that pooled reporting be permitted by all QSLs and not just QSLs that are also QIs.

Pooled reporting was implemented as part of the QI withholding regime in recognition of the fact that foreign financial institutions did not wish to disclose the identity of their non-US clients to their US counterparties, and would be at a competitive disadvantage if they were required to do so. Furthermore, non-US customers of these foreign financial institutions, while willing to pay any applicable withholding tax, did not necessarily want to provide identifying information to the US taxing authorities. Requiring them to do so could have a negative impact on investments in US assets. The QI regime, combined with the ability to do pooled reporting, addressed these concerns while still protecting US tax collection efforts. Furthermore, pooled reporting reduced the amount of paperwork required by the QI in connection with its reporting obligations.

²² For purposes of this form, a QI/QSL should provide its QI EIN. A QSL that is not also a QI should be issued an EIN.

Similar concerns apply in the case of a QSL required to report on payments of substitute dividends. As discussed above, the QSL qualification rules can ensure that all QSLs have the ability to implement proper reporting, including pooled Form 1042-S reporting. Therefore, we can think of no good policy reason for not permitting a QSL to do pooled reporting. Pooled reporting will reduce the paper work required by a QSL while still ensuring that withholding and reporting is properly accomplished. Furthermore, assuming our proposal to extend the QSL program to all dividend equivalent payments is adopted, we think pooled reporting should be permitted for all dividend equivalent payments.

We also recommend that when doing pooled reporting, a QSL be permitted to combine the reporting of actual dividends and substitute dividends. Because the withholding rate is the same for actual and substitute dividends, there does not seem to be a good policy reason for requiring that the reporting on the two types of payments be done separately. Furthermore, in situations where a QSL has borrowed and sold short shares of stock that are part of a pool of shares maintained for customers, a QSL will have difficulty determining whether it is paying an actual dividend or a substitute dividend in any given case. The ability to do combined reporting will eliminate the need to make that determination.

(ii) *Payments to a US custodian of a foreign person should be free from nonresident alien withholding tax.*

Foreign stock lenders frequently hold their rights to substitute dividend payments through a US custodian. Future guidance should clarify that a payment of substitute dividends by a QSL to a US custodian acting for a foreign person is, consistent with the rules under Sections 1441 and 1442, free of nonresident alien withholding if the QSL has no reason to believe that the US custodian will not comply with its US withholding and reporting obligations.²³

B. Credit Forward System

A foreign entity that is unable to become a QSL, or chooses not to, may take advantage of the credit forward system to avoid cascading withholding. Under the credit forward system, a withholding agent may limit the aggregate withholding tax paid to an amount equal to the

²³ Treas. Reg. §1.1441-1(b)(2)(ii).

highest withholding tax applicable on the payment of the dividend or substitute dividend to a party in the chain of payments. Withholding agents may relieve excess withholding by reducing the amount it withholds on a substitute dividend payment it makes by the amount previously withheld, but only if there is sufficient evidence that the tax was actually withheld on a prior payment.

1. *Future guidance should clarify that a borrower making payments to a non-qualified securities lender should apply the applicable treaty withholding rate.*

Under the Notice, regulations are expected to provide that,

“withholding agents may limit the aggregate US gross-base tax within a series of securities lending transactions to the amount of US gross-basis tax, if any, applicable to the foreign taxpayer . . . bearing the highest rate of US gross-basis tax on either a substitute or actual dividend with respect to the underlying security transferred in the series.”

It is our understanding that certain withholding agents have read this to mean that they must withhold at the maximum 30% rate on any payment it makes to a non-qualified securities lender, regardless of whether the recipient of the payment is entitled to a lower rate of withholding under a treaty. We do not believe this is the proper reading of the credit forward provisions in the Notice. As we understand it, the credit forward provisions in the Notice are intended to ensure that each subsequent withholding agent in a chain of payments is required to withhold on the payments it makes *at the treaty or non-treaty rate applicable to the payee* unless it can sufficiently establish that all or a portion of that tax has been previously withheld. Therefore, a borrower making a payment of substitute dividends to a UK lender that is not a QSL should generally withhold at the 15% rate provided for under the treaty between the United States and the UK (assuming the UK lender is eligible for the benefits of that treaty).

2. *The credit forward rules should provide a reasonable method to track payments received and payments made.*

To implement the credit forward system, a withholding agent will need to track pools of identical securities to determine whose securities were lent out and what rate of withholding was previously applied to each security in that pool and compare that to the withholding rate that must be imposed on a corresponding substitute dividend payment. For example, a UK broker-dealer with a pool of securities in an account with a custodian that includes securities it holds for its own account

and securities that it holds for customers (which it is permitted to lend) must determine for both withholding and reporting purposes who is receiving substitute dividend payments and who is receiving regular dividends.

Furthermore, if the UK broker dealer is receiving and paying substitute dividends, it must track the amount withheld on the substitute dividends it receives and determine how to properly allocate these among the substitute dividends it pays. For example, a UK broker-dealer may have lent identical US securities to both a US and foreign borrower. Assuming that the borrowers held onto those securities and the issuer paid a \$100 dividend, the foreign borrower should have received \$70 (\$100 minus a 30% withholding tax), while the US borrower should have received \$100. The UK lender must determine which of its customers received a substitute dividend on which \$30 of tax has been paid and which of its customers received a substitute dividend on which no withholding tax had been paid. Ideally, the UK lender should be allowed to allocate the substitute dividend on which \$30 of US tax has already been paid solely to offsetting substituted dividend payments to foreign stock lenders (and the substitute dividend payment in respect of which no US withholding tax has been paid solely to offsetting substitute dividend payments to US stock lenders). This allocation will eliminate duplicative withholding without jeopardizing the collection of the proper amount of tax, for there is no need to collect a second withholding tax from a foreign securities lender where a full withholding tax has already been collected in respect of the dividends actually paid to foreign beneficial owners. We therefore think the regulations should implement a presumption designed to minimize duplicative withholding along the lines of the presumption set out in Treasury Regulation Section 1.6045-2(f)(2).

Because each securities lender has its own method for recording and tracking payments, however, we believe that future regulations should not require securities lenders to specifically identify the record owner or be limited to using any prescribed tracking method. Instead, similar to the approach used in Treasury Regulation Section 1.6045-2(f)(2), a securities lender should, with the approval of the Commissioner, be permitted to adopt any reasonable system to track the withholding on securities. A reasonable method is one that produces, overall, the correct amount of withholding. Such method should permit allocations that reduce the likelihood of cascading withholding.

3. *The credit forward system should cover all dividend equivalent amounts, and not just actual and substitute dividends.*

Under the Notice a withholding agent may take into account prior withholding on actual dividends and substitute dividends. The Notice does not address other dividend equivalent amounts, such as amounts paid pursuant to certain equity swaps constituting specified notional principal contracts. For example, a UK broker-dealer may borrow US shares from a local customer and sell them to a US broker-dealer. If, at the same time, the UK broker-dealer enters into an equity swap with the US broker-dealer pursuant to which it receives payments that are contingent on the dividends paid on the sold shares such payments are dividend equivalent amounts and will be subject to 15% withholding under the US-UK treaty. Absent the ability to credit forward the amount withheld, the UK broker-dealer will be required to withhold another 15% on the substitute dividend payments it owes its local customer. This defeats the purpose of the credit forward system. We believe that the credit forward system should reflect the withholding tax paid on dividend equivalent amounts. This is consistent with the language of Section 871(m)(6), which addresses over-withholding on chains of dividend equivalent payments.

C. *Other Reporting and Withholding Issues*

Most US stock loan transactions are processed through the DTC Stock Loan Income Track System (SLITS). With respect to substitute dividend payments, DTC acts as an accommodating party for its participants that utilize SLITS. On a dividend payment date, DTC debits the borrower participant's account by the gross amount of the dividend paid and credits the lender participant's account.

1. *Payments of substitute dividends to non-US participants.*

With respect to payments made to a foreign participant's account, it is our understanding that DTC obtains an IRS Form W-8 and withholds on payments of dividends and substitute dividends unless the payee is a Withholding QI or a QSL. DTC reports these payments on Form 1042-S. Future guidance should make clear that, to the extent DTC (or other clearing agent) has withheld and reported, the borrower participant whose account was debited should have no obligation to withhold or report.

D. *Transition Rules.*

The Notice provides for transition rules that are in effect from September 14, 2010, until December 31, 2011.

1. *QSL certification should only be needed once during the transition period.*

Under those transition rules, a withholding agent may adopt a system that reasonably implements the principals of the QSL system. During this transition period, a withholding agent need not withhold on payments to a counterparty if it receives, at least annually, a statement from that counterparty that it substantially complies with the certification requirements for QSL status set forth in Part II.A.ii of the Notice. We recommend that Treasury and the IRS promptly issue a notice providing a standard form statement that a QSL may use for this purpose. In addition, given the relatively short transition period (15.5 months) and the low likelihood of a counterparty's status changing within that period, we think the need to provide such a statement "annually" is unnecessary and would only serve to create a risk of inadvertent non-compliance. If Treasury and IRS were to insist on an annual statement, they should clarify how the annual period should be measured. For example, should the withholding agent receive a statement for each calendar year, for the period ending one year after the previous statement has been issued, or for each of its tax years (if different than the calendar year).

2. *The instructions to Form 1042-S should be clarified to allow a credit forward for withheld tax under the transition rule.*

During the transitional period, a withholding agent is not required to withhold on a substitute dividend payment to the extent (a) it receives a dividend or substitute dividend that reflects a reduction due to the withholding for US tax, (b) the withholding agent does not know or have reason to know that the tax was not withheld and deposited or paid, and (c) the withholding agent is a person subject to audit. Under this transition rule, a withholding agent does not need to have received an IRS Form 1042-S to substantiate the prior withholding. Instead, there is a presumption that the proper withholding has occurred with respect to an earlier payment if the above three conditions are satisfied. As part of its reporting requirement, the withholding agent should record this prior withholding on line 66 of Form 1042. In the experience of the SIFMA members, however, IRS employees at processing centers do not accept the line 66 amounts as proper credits for taxes withheld by other agents unless a supporting Form 1042-S from an upstream agent is included with

the form, even when a written explanation is included with the filing. This is inconsistent with what is permitted by the Notice during the transition period. If the transition rules are to work properly, Treasury and the IRS should address this disconnect, by both updating the instructions to Form 1042 and by providing updated training to employees at the processing centers and IRS examiners.

Conclusion

SIFMA appreciates your consideration of its collective views and suggestions on Notice 2010-46. We believe our suggestions and comments will contribute to a more comprehensive and workable withholding system that reduces the problem of cascading withholding. Please do not hesitate to contact me at (202) 962-7333 or emccarthy@sifma.org if you have any questions or if we can be of further assistance.

Sincerely,



Ellen McCarthy
Managing Director, Government Affairs
Securities Industry and Financial Markets
Association

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