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April 4, 2012

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Re: <u>Comments on Proposed Regulations Issued Under Section 871(m)</u>

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("SIFMA")[1] welcomes and appreciates the opportunity to submit comments on the regulations that you have proposed to help implement Section 871(m) of the Internal Revenue Code. The members of SIFMA support the efforts of Treasury and the IRS to prevent foreign investors from inappropriately avoiding the U.S. withholding tax on dividends paid on U.S. equities, and we offer these comments in connection with our desire and intention to help Treasury and the IRS accomplish that result. The members of SIFMA also appreciate the substantial time and effort you have committed, and the substantial progress you have made, in developing these rules. We hope these comments will assist you in further building upon your efforts so that the finalized rules serve maximally to achieve the objectives of Congress and minimally to adversely impact capital markets. Please feel free to call our tax counsel, Payson Peabody, at (202) 962-7333 or our outside counsel, David Hariton, at (212) 558-4248 if we can answer any questions or assist you further in any way.

1 The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

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1. <u>Background and General Approach</u>.

Section 871(m) of the Code was enacted in response to the perception that foreign investors were avoiding U.S. withholding tax on dividends they earned in respect of their ownership of U.S. equities by taking the position, as a matter of form, that they had disposed of their U.S. equities and were instead taking long positions in equity swaps. Both the Senate and the IRS concluded that in many cases, the foreign investors had transferred nominal title to the relevant U.S. equities for a period of time but still owned the U.S. equities as a matter of substance.

More broadly, the concern expressed by Senator Levin, among others, was that the financial transactions in question were not primarily business transactions by which foreign investors sought to obtain economic exposure to U.S. equities in the most tax advantageous manner. Rather, they were entered into by foreign investors who already owned U.S. equities, did not change the foreign investors' economic position, and were entered into solely to allow these foreign investors to avoid U.S. withholding tax. Senator Levin specifically focused, in this regard, on transactions whereby foreign investors temporarily converted actual ownership of U.S. equities into long equity swap positions and then back into actual ownership of U.S. equities by means that substantially eliminated any risk of economic loss as compared with simply continuing to own the relevant U.S. equities over the relevant period of time.[2]

Largely unconsidered in the dialogue that led to the enactment of Section 871(m) was the following significant fact: Foreign investors holding U.S. equities did not enter into these sorts of transactions *primarily* to avoid U.S. withholding tax. In most cases, foreign investors entered into these transactions primarily to obtain financing for their equity positions.[3] A long position in an equity swap is economically equivalent to leveraged ownership of the underlying U.S. equities, and "crossing into" an equity swap was therefore a convenient means of obtaining financing for long equity positions under standardized terms, with fewer regulatory constraints (such as the margin rules that generally apply to actual leveraged ownership of U.S. equities) and with better pricing (because the counterparty was less exposed to risk of loss from the foreign investors' default than was a party that lent money to the foreign investor). Indeed, foreign investors still obtain financing in this manner in respect of U.S. equities that do not pay any dividends, as well as in respect of foreign equities not subject to U.S. withholding tax; and U.S. investors do the same in the strictly domestic market. It is true that a long position

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2 *See* 156 Cong. Rec. S1745-01 (March 18, 2010 Statement of Senator Levin on the Enactment of the HIRE Act) at S1746 (Referring to parties that use "more subtle methods of ensuring a riskless transfer between holding U.S. securities and engaging in notional principal contracts."); *see also* 155 Cong. Rec. S2624-01 (March 2, 2009 Statement of Senator Levin on the Introduction of the Stop Tax Haven Abuse Act) at S2632 ("Let me be clear. I do not oppose structured finance transactions used for legitimate purposes, including swaps and stock loans that facilitate capital flows, reduce capital needs, or spread risk. . . . What this section is intended to stop are dividend-based transactions whose economic purpose is nothing more than tax dodging.").

3 The most prominent exceptions to this were so-called "extraordinary dividend" cases, such as transactions entered into in respect of Microsoft's $3 per share special dividend paid in 2004. *See, e.g.,* Staff of Senate Permanent Subcommittee on Investigations, Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends (September 11, 2008), at 27-28 (describing extensive marketing of "dividend enhancement" products to non-U.S. investors seeking to avoid withholding tax on Microsoft's 2004 special dividend).

in an equity swap was not subject to U.S. withholding tax under law antedating the enactment of Section 871(m), and so avoidance of U.S. withholding tax as compared with borrowing against physical shares was often an ancillary benefit of obtaining financing in this manner. But for the reasons set out in the subsequent paragraphs, it was not clear that the resulting avoidance of U.S. withholding tax was a manifestation of tax abuse. Indeed, in most cases imposition of U.S. withholding tax appeared to be the "wrong" answer.

More specifically, a foreign holder of a leveraged long position in U.S. equities does not normally earn any current net income in respect of that position. Rather, in a normal interest rate environment, the interest rate on the relevant borrowing exceeds the dividend rate on the relevant U.S. equities, so that if foreign investors were granted a deduction for the interest expense associated with their investments (as U.S. investors are), they generally would not pay any U.S. tax in respect of their investments. It is true that unlike a U.S. investor, a foreign investor does not pay U.S. tax on capital gains (such gains being sourced to, and presumably taxed by, the investor's home jurisdiction), but this has nothing to do with what led Congress to impose a gross basis withholding tax on outbound payments of interest and dividends. The gross basis withholding tax on U.S. dividends paid to foreign investors was initially devised to deliver "rough justice" (approximating the result of taxing net income) to foreign investors who presumably did not wish to file U.S. tax returns,[4] and it was imposed on the assumption that such foreign investors generally did not borrow to acquire or hold their positions.

The Securities Industry and Financial Markets Association made this point to members of the staffs that were drafting the legislation that became Section 871(m), and it appears to have had an impact: Congress was not prepared to do anything "radical" in response, such as granting foreign investors a deduction for associated interest expense. But it *was* prepared to concede that a foreign investor who did not yet own any U.S. equities and who chose a long position in an equity

4 *Cf.* Section 903 (granting U.S. taxpayers a foreign tax credit for similar gross withholding taxes imposed by *other* foreign countries on the dividends derived by U.S. taxpayers from their investments in the stock of foreign corporations; the credit is allowed because the tax is characterized as a tax "in lieu of" a tax on net income); *see also* Hugh J. Ault & David Bradford, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises, in* Taxation in the Global Economy 11, 22 (Assaf Razin & Joel Slemrod eds., 1992) ("The theory of this form of taxation is that it is impossible administratively to calculate deductions . . . Accordingly a lower gross rate of tax is applied as a surrogate for net-basis taxation.").

swap as the most advantageous means of obtaining economic exposure to U.S. equities should not be taxed as if he had first purchased U.S. equities and then borrowed against them—*i.e.*, that such an investor should be allowed to retain the comparative tax advantage associated with derivative exposure to U.S. equities. For where imposition of gross basis tax does not make sense as a matter of policy, there is no reason to seek to impose it by analogy, or by reference to economic equivalence. Moreover, regardless of whether the financing transactions that had been targeted by the Senate could properly be described as "primarily" tax-motivated, it was clear that a foreign investor's initial decision to expose itself to risk relating to U.S. equities was a business decision possessing both business purpose and economic substance, where tax consequences were but incidental. It was certainly not the sort of "tax dodge" that troubled Senator Levin.

For this reason, Congress made a conscious decision *not* to impose U.S. withholding tax on all dividend equivalent payments made on equity swaps, in direct contrast to an earlier version of the legislation that imposed withholding in all such cases.[5] Rather, Section 871(m) effectively set out a paradigm of the case in which a foreign investor who already owns U.S. equities temporarily converts the position into a derivative by "crossing into" and "crossing out of" an equity swap without incurring significant incremental economic risk. It also set out a paradigm of the case where a purported swap counterparty arguably acts in a manner resembling a foreign investor's *agent* in acquiring U.S. equities to begin with: more specifically, (a) where the swap counterparty could not independently acquire such stock as a hedge in an active trading market, because the stock is not actively traded, and (b) where the swap counterparty actually posts the stock it acquires as a hedge as collateral for its obligations under the swap, with the result that the foreign investor does not have credit exposure to the swap counterparty as an economic matter. Only a few months prior to enactment, the IRS (in an IDD) identified a similar case in which the foreign investor effectively required the swap

5 The initial version of Section 871(m) that Senator Levin introduced in March 2009 as part of the Stop Tax Haven Abuse Act did not provide exemptions. *See* S. 506, 111th Cong. (March 2, 2009). However, the statement of Senator Levin upon the introduction of the bill made clear that it targeted tax avoidance schemes. *See* 155 Cong. Rec. S2624-01 (March 2, 2009 Statement of Senator Levin on the Introduction of the Stop Tax Haven Abuse Act) at S2632 ("What this section is intended to stop are dividend-based transactions whose economic purpose is nothing more than tax dodging"). Later versions of the statute proposed prior to its enactment as part of the HIRE Act made plain that it was aimed at abusive transactions. *See* H.R. 3933, 111th Cong. (October 27, 2009); H.R. 4213, 111th Cong. (December 7, 2009).

counterparty to hedge its position and then controlled when and how the hedge was acquired.[6]

Section 871(m) effectively identified these circumstances (including most particularly the first one—crossing in or out) as cases of U.S. withholding tax avoidance, and it directed the Secretary to devise regulations that would prevent other manifestations of them. For example, Senator Levin pointed out in his statement on the passage of the HIRE Act that there were doubtless "more subtle methods of ensuring a riskless transfer between holding U.S. securities and engaging in notional principal contracts."[7] The Senator did not want the legislation to be little more than an exercise in developing such subtler methods. The intent was that foreign investors who were merely financing or otherwise converting U.S. equity positions on a risk-free basis would continue to be subject to U.S. withholding tax. It is for this reason that Congress directed the Secretary to impose withholding tax after 2 years on any equity swap unless it determined that it was of a type which does not have a potential for tax avoidance and to also impose withholding tax on any payment that it determined to be substantially similar to a substitute dividend payment or a dividend equivalent payment. It was not to support a broad expansion of the circumstances under which the U.S. imposes outbound withholding tax on equity derivative transactions that are not economically equivalent to the ownership of U.S. equities.

We think it important for Treasury and the IRS to take this history into account in drafting regulations implementing Section 871(m) of the Code. It was not the intent of Congress to impose U.S. withholding tax on equity derivative positions generally, or on dividend equivalent payments generally, or even on viable substitutes for the ownership of U.S. equities. Rather, it was to prevent foreign investors who actually bought (or were actually buying) U.S. equities from avoiding the U.S. withholding tax that was imposed in respect of such ownership by entering into transactions that lacked business purposes and economic substance or by mischaracterizing the substance of their ownership based on formalism. We believe that there will be adverse and disruptive consequences to the U.S. equity markets and to market participants if you do not tailor Section 871(m) rulemaking to the types of tax motivated transactions contemplated by Congress. Overbroad

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6 *See* Internal Revenue Service, Industry Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax, LMSB-4-1209-044 (January 14, 2010).

7 *See* 156 Cong. Rec. S1745-01 (March 18, 2010 Statement of Senator Levin on Enactment of the HIRE Act).

Section 871(m) rulemaking would in effect force all market participants to treat every U.S. equity derivative as a tax motivated transaction even where the incidence of a "tax dodge" with respect to a U.S. dividend equivalent is essentially remote.

In other words, Congress has directed the Secretary and the Commissioner to effectively police the line between taking a long position in an equity swap (or other equity derivative) and actually acquiring U.S. stocks and borrowing against them. In this regard, we believe the Secretary should keep squarely in mind the pattern that the Senate initially focused upon and that has since been the greatest cause for concern, including in the IRS directive on the issue:[8] For whatever business reasons, Foreign Investor A has already purchased U.S. equities on the open market, rather than having entered into an equity swap. Foreign Investor A now proposes to finance the U.S. equities it owns by selling them to Broker Dealer B while simultaneously entering into an equity swap with B over the same U.S. equities at pricing that directly reflects the price for which it sells the equities to B (so that it does not incur any market risk on account of this "cross in"). When Foreign Investor A wishes to effectively repay its borrowing, it will terminate the equity swap on the understanding that Broker Dealer B will simultaneously sell the underlying equities back to A at pricing that reflects the price for which the swap is terminated (so that it again does not incur any market risk on account of this "cross out"). Congress has directed the Secretary and the Commissioner to impose withholding tax on dividend equivalent payments received by Foreign Investor A in this case because it believes that as a matter of substance, Foreign Investor A continues to own the underlying U.S. equities.

We recognize that this is a difficult area of the law to police and enforce, and indeed in some respects, to even fully conceptualize. Nevertheless, we do not think it would be reasonable for Treasury and the IRS to respond by going well beyond the apparent intent of Congress and imposing U.S. withholding tax in respect of a broad array of equity derivative transactions as a prophylactic measure. It is important—not only for the financial markets but also for the broader U.S. economy—that foreign investors be permitted to invest in U.S. equities on whatever basis Congress intended to allow. Moreover, we believe that notwithstanding the complexity of financial markets, the line between an equity derivative position and actual leveraged ownership of U.S. equities *can* be policed

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8 *See* Internal Revenue Service, Industry Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax, LMSB-4-1209-044 (January 14, 2010).

and enforced on a consistent and effective basis that will satisfy Congress, provided that there are clear and coherent procedures in place, as discussed below.

2. Procedures for Withholding.

The regulations under Section 1441 of the Code set out procedures whereby U.S. securities dealers and other U.S. or foreign withholding agents (including "qualified intermediaries") determine whether and how much to withhold on dividends and interest paid to foreign persons on the basis of presumptions and certifications made on standardized forms provided by the IRS.[9] These procedures are not discretionary; if a foreign investor fails to meet the requirements for receiving a payment free of withholding, the relevant U.S. withholding agent is required to withhold and is liable for penalties and interest for any failure to do so.[10] Indeed, the framework of withholding requirements and obligations developed under Section 1441 operates independently of the statutory framework of Sections 871 and 881, and while it is obviously generally designed to produce results consistent with the relevant taxpayer's substantive gross income tax obligations, it has also been designed to be more workable and pragmatic than the underlying substantive rules. Foreign investors who (owing to the fact that Section 1441 withholding does not always correspond to substantive liability) are withheld upon in the absence of substantive withholding tax liability may seek a claim for refund under Treasury Regulations Section 1.1464-1.[11]

More specifically, a withholding agent *must* withhold 30 percent of any payment made to a presumptive foreign payee unless it can connect the payment with IRS-authorized documentation that would allow it to treat the payment as not subject to withholding (by reason of the character of the payment or the nature of the recipient) or as eligible for a reduced rate of withholding.[12] Conversely, where a withholding agent receives such documentation, the paying agent may rely upon

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9 *See* Treasury Regulations Section 1.1441-1 *et seq*.

10 Section 1461.

11 *See* Treasury Regulations Section 1.1441-1(b)(8).

12 These exceptions arise most commonly in situations in which the recipient is a U.S. person or is a "qualified intermediary", or where the income is (i) effectively connected with the conduct of a U.S. trade or business, (ii) eligible for the "portfolio interest exemption", (iii) eligible for a reduced rate of withholding under an income tax treaty, or falls within several other classes of income that are not subject to withholding under Section 1441 *et seq*.

it (and will therefore not be subject to liability for the tax in the event the resulting presumption proves incorrect), provided that it does not have actual knowledge or reason to know otherwise.[13] In most cases, the relevant foreign investor signs the relevant form under penalties of perjury,[14] and the likelihood of falsification is accordingly diminished. It is our understanding, at least in the case of large-scale transactions with major financial institutions, that it has generally been the experience of the IRS that certifications made using these forms are accurate, and that paying agents in any case do not rely on inaccurate presumptions in circumstances where they have reason to know otherwise.

The procedures referenced above were developed and implemented during the late 1990s in response to perceived shortcomings in the existing system for determining proper withholding. Under presumption rules then in effect, paying agents were entitled to presume that a payee was a foreign resident of a specific jurisdiction if a dividend payment was made to a foreign address (the "address rule").[15] It was readily apparent, however, that U.S. securities dealers and other paying agents had no real means of knowing whether their payees were really foreign persons resident in the specific jurisdiction, and thus Treasury eliminated the address rule based in part on perceived abuses.[16] The IRS proceeded to implement the W-8 certification system that is in force today, not because it was perfect, but because it was better than the alternative of doing nothing.

If, for example, the IRS had allowed U.S. securities dealers and other withholding agents to rely solely on an "address rule", there would have been no practical limits to the ability of taxpayers to evade income tax by claiming treaty

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13 *See* Treasury Regulations Section 1.1441-7(b).

14 *See, e.g.*, IRS Form W-8BEN (Rev. Feb. 2006); IRS Form W-8ECI (Rev. Feb. 2006).

15 *See* Former Treasury Regulations Section 1.1441-3(b)(3).

16 *See* T.D. 8734 (Oct. 21, 1997); *see also* Andersen, Income Tax Treaties of the United States ¶ 1.03 (2011) ("[T]he IRS believed the address rule for dividends has facilitated abuses because it relies entirely on a particular address without any certification on the part of the beneficial owner that the address is a valid address."); *id.* at ¶ 9.02 (2011) ("The address rule provides little or no assurance that the recipient of a dividend is a resident of the treaty country, and allows for a much more porous withholding tax system than what is required by other countries."); Wolf and Collins, *U.S. Withholding Tax – IRS Issues Final QI Audit Guidelines* (Jan. 28, 2003) ("The IRS believed the address rule for dividend income was being abused to allow treaty shopping by foreigners[.]"), *available at* http://www.mondaq.com/article.asp?articleid=18833 (visited March 6, 2012).

benefits to which they were not entitled. It is true that the IRS might have cautioned withholding agents that they would be *liable* for unpaid substantive tax liability of their customers, and withholding agents would surely have done their best to avoid such liability. But given that absent certification these withholding agents had no means of knowing who their payees were, it would hardly have been prudent to leave them to swim and then sink in this manner. They would likely have been advised that absent any reason to know otherwise, they could reasonably presume that a payment made to a foreign addressee was being made to a foreign person residing at that address. Some more conservative withholding agents might at first have responded by withholding on *all* foreign addressees, unless the payee voluntarily made some sort of representation. These withholding agents would soon have discovered, however, that they had no foreign customers, and they would have quickly been forced to take a different view (or at least, their failure to do so would have been irrelevant, since they would not have been doing any withholding).

In other words, the IRS requires withholding agents to withhold in the absence of certification not primarily as a concession to the securities industry to help limit their withholding agent liability. Rather, it does so to protect the U.S. fisc; and securities dealers then cooperate with the IRS to help enforce existing law, effectively obtaining these certifications on the government's behalf and withholding in the absence of them. The certification system, in turn, standardizes the process of information gathering and withholding in a manner that clearly defines the duties and obligations of the relevant participants. This serves to prevent the market from pushing the standards lower over time under arguably valid but competing interpretations of law, and it avoids incenting participants to compete with each other through their demand for, or adoption of, lower diligence standards.

We note in this regard that the securities industry has always worked with and for the government—reporting to both the IRS and to taxpayers receipts of interest, dividends received by both domestic and foreign taxpayers and gross sales proceeds received by domestic taxpayers; obtaining certifications of status where appropriate; and now even computing and reporting the tax basis of securities in the hands of certain investors pursuant to newly effective basis reporting regulations. Although the securities industry does all of this at substantial cost (involving the implementation of complex computer systems and the hiring of a substantial amount of compliance personnel), it views these tasks as part of its franchise. In exchange, members of the securities industry are able to transact with customers without the imposition of gross basis withholding in respect of amounts for which no substantive tax is due, and they are generally able to rely on the certifications they receive, unless they have reason to know otherwise. In our view, an effective harnessing of the securities industry in this manner is the most feasible means the government has of preventing foreign investors from avoiding the outbound withholding tax. And effective, in our view, means practical, which is what Section 1441 and the withholding regime is all about. With this in mind, we wish to make the following points:

First, in the vast majority of scenarios, securities dealers will have no independent means of knowing whether a foreign swap counterparty or investor has bought stock, sold stock, or taken a larger position (or an offsetting position) in a particular stock.

Second, absent a government directive to the contrary, foreign trading clients will not make representations about their trading activities, partly because one individual trader is generally not in a position to know what scores of other traders in an organization are doing.

Third, absent a government directive to the contrary, certain withholding agents who lack any knowledge of any violation of any of the seven proscriptions set out in the proposed regulations will assume that there has been no such violation and will therefore *not* withhold on payments.

Fourth, withholding agents who employ the opposite presumption (*i.e.*, who withhold on all payments unless they receive representations of their own devise that satisfy them that the seven proscriptions have not been violated) will soon feel market pressure (*i.e.*, long parties will quickly abandon that withholding agent) to adopt a similar position and not withhold, in order to remain competitive.

Fifth, any *post hoc* IRS effort to correct this situation will likely be too little and too late and will create friction between the withholding agents and the IRS as to what level of diligence was required of the withholding agents with respect to information that is only known to the payee.

Sixth, whether or not the securities industry is blamed for it, the inevitable outcome described above will accomplish nothing constructive for Congress, Treasury or the IRS as compared with implementing a pragmatic system of enforcement to begin with.

Seventh, the government directive that is called for in this situation (and that is consistent with over a decade of withholding in accordance with the certification procedures set forth in the Section 1441 regulations) is a regulatory directive to all withholding agents that they must withhold on all dividend equivalent payments made to foreign counterparties in the absence of certifications or representations prescribed by the government that are more fully discussed in Section 3 below.

For all of these reasons, we believe a coordinated certification system is necessary and appropriate, and we therefore urge you to adopt one. As we have discussed privately, the securities industry lacks the systems required to determine whether a given swap counterparty has purchased or sold underlying stock from or to another desk or another affiliate of the same securities dealer, let alone to an unrelated securities dealer. It will therefore be essential to require foreign investors to make some sort of certification in this regard. We recognize that equity swap counterparties are generally large and sophisticated institutions, and they may differ in this regard from the small foreign portfolio investors that are sometimes envisioned as signing Form W-8s in order to receive U.S. source interest free of withholding. We note, however, that the avoidance concern that lies behind the W-8 certification requirement does not relate to small investors but rather to wealthy foreign investors who might be treaty shopping (or wealthy U.S. investors who might otherwise seek to evade income tax on interest income derived from U.S. sources by hiding it offshore). Moreover the institutional character of most of the relevant foreign investors in this case is if anything an advantage, as these institutions are normally investing on behalf of other parties, are therefore advised by competent outside counsel, and therefore take all of their regulatory and tax obligations very seriously.

As for securities dealers, the certification system will allow them to enforce the will of Treasury without the confusion, lack of cohesion and lack of coordination in inter-dealer policy that can lead over time to more aggressive transactions. As noted above, once the outlines of the system are in place, securities dealers will gladly incur the costs required to implement it, based on their understanding that helping the government collect tax on financial income is part of their franchise.

3. <u>Certification and Standards for Withholding</u>.

Assuming that you adopt our recommendation to require that withholding agents receive government prescribed certifications to make dividend equivalent payments free of withholding, the next question to consider is what these certifications should say. In this regard, we think you should have two objectives: The first objective (as more fully discussed above) is to enforce the will of

Congress by effectively drawing a line between (a) actually acquiring, and effectively continuing to own, U.S. equities whilst avoiding the U.S. withholding tax associated with such ownership by characterizing such continued ownership as an equity derivative as a matter of form, and (b) obtaining exposure to U.S. equities to begin with by entering into derivative transactions. As discussed more fully above, Congress is particularly concerned with variations of the former involving so-called "crossing in" and "crossing out" of already held U.S. equities (generally, but not necessarily, in connection with a financing). The second objective is to succeed in the above as a matter of *practice* by ensuring that foreign investors can, and will, comply with the new regulatory regime rather than reverting to a pattern of avoidance similar to the one that led to the enactment of Section 871(m).

As regards the latter, we note on the one hand that many foreign investors are large institutions with scores or hundreds of traders and investors pursuing various idiosyncratic and complex strategies relating to equities and equity indexes, and these large institutions are now responsible for the lion's share of trading in equity derivatives. One trader at one of these institutions is simply not in a position to forbid other traders from buying or selling shares of the underlying equities on a particular day (or even to know whether or not this is happening). Nor would doing so serve any substantive purpose. In point of fact, as we understand it, it is quite possible that one or more other traders are both buying *and* selling shares of the underlying equities on that day and that in the aggregate the institution is *buying* shares, yet under the proposed regulations as currently drafted, this would not prevent the relevant equity swap from becoming a specified notional principal contract.[17] We have asked a number of large foreign investing and trading institutions whether they would be prepared to devise systems that allowed them to track gross transactions across jurisdictions and across desks of related entities in a manner sufficient to make certifications based on the rules as currently drafted. These institutions basically replied that they did not think they could conduct their business on a competitive basis if they were to forbid all traders to trade a particular equity merely because someone was entering into an equity swap with respect to it.

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[17] Indeed, the gross threshold under the proposed regulations as currently drafted is fairly draconian—any sale of an amount of underlying shares other than a sale of less than 10 percent of the notional amount of the relevant swap. *See* Proposed Treasury Regulations Section 1.871-16(c)(1)(ii).

We note, on the other hand, that these foreign investors have numerous means at their disposal for taking economic positions in U.S. equities in ways that do not give rise to outbound U.S. withholding tax. More specifically, they may enter into equity derivative positions that do not provide for any dividend equivalent payments or dividend-related adjustments, such as forward and futures contracts, or equity swaps that provide for fixed dividend equivalent payments based on estimated dividends, and accept exposure to the risk that dividends may change. Alternatively and additionally, foreign investors could enter into equity derivative positions primarily with foreign counterparties that may not be fully aware of the intricacies of the tax law and withholding requirements of third-party countries like the United States. These foreign counterparties might in turn hedge their positions with equity derivative contracts with related or unrelated parties that do not provide for dividend equivalent payments.

We point these facts out to be sure you have fully considered what the practical consequences would be of imposing a certification regime that was perceived as too onerous for most large foreign investors to follow. We do not think the consequence would be that foreign investors would start paying large amounts of U.S. withholding tax in respect of positions in U.S. equities. Most foreign investing funds are highly levered, and they could not reasonably afford to take economic positions in U.S. equities if they were going to be subject to a gross basis withholding tax without any offsetting interest deductions. The resulting large gross basis tax, bearing no relation to their much smaller amount of net income, if any, could overwhelm their bottom line results. We are therefore concerned that such a regime would discourage foreign investors from obtaining leveraged exposure to U.S. equities by entering into equity swaps with U.S. securities dealers and instead encourage them to avoid the U.S. withholding tax in ways that Congress has directed Treasury and the IRS to prevent. Such an outcome would render these carefully designed regulations a failure insofar as they served to carry out the will of Congress. They would at best accomplish little more than requiring securities dealers to develop systems for withholding and certification that were little used in practice.

If, on the other hand, the required certifications contain representations that (a) can reasonably be made by most large foreign investors, (b) encourage, rather than discourage, most foreign investors to use equity swaps to initiate their exposure to U.S. equities, and (c) nevertheless serve reasonably well to ensure that foreign investors are not buying U.S. equities first and then crossing-in (or otherwise taking positions that constitute actual ownership of U.S. equities as a matter of substance), then we think it likely that the securities industry and associated U.S. and foreign withholding agents—acting on behalf of, and at the direction of, Treasury and the IRS—will succeed in enabling you to successfully enforce the will of Congress in the manner that Congress intended.

For these reasons, we recommend first that the substantive rule for determining whether dividend equivalent payments on an equity swap or other U.S. equity derivative are subject to withholding tax be whether a foreign investor has sold the underlying U.S. equities (or bought the underlying U.S. equities) *in connection with* entering into (or terminating) the relevant equity swap or derivative. We recommend that the same qualification apply to any other relevant test for the application of withholding that is in the foreign investor's control. For example, the aggregate test for trading volume should be whether, in connection with entering into a relevant equity swap, the foreign investor entered into other equity swaps on the same day which, when aggregated with the relevant equity swap, referenced underlying U.S. equities of an amount in excess of the agreed upon percentage of the average adjusted trading volume of those U.S. equities.

We make this recommendation first and foremost because we think the "in connection with" standard is adequate to protect the fisc and accomplish what Congress sought to accomplish in enacting Section 871(m) of the Code. If one of the foreign investor's other traders happened to sell or buy shares of the underlying, but *not* in connection with the foreign investor's entering into the relevant equity swap, then there is no reason to think that the foreign investor was seeking to, or in fact did, avoid U.S. withholding tax in the manner that has been proscribed by Congress. To the contrary, Senator Levin made it clear that what he was seeking to prevent was "transactions whose economic purpose is nothing more than tax dodging."[18]

We make this recommendation second because, based on our preliminary investigations, we think that most foreign funds and investors would be in a position to certify that they were not entering into equity swaps in connection with purchases and sales of the underlying and would be willing to take whatever reasonable precautions were necessary to ensure that this was the case. More important, based on our preliminary investigations, we think that if making such certifications, and taking such precautions, would suffice to allow them to earn dividend equivalent income free of U.S. withholding tax, then they would generally expose themselves to U.S. equities not by purchasing the equities and

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18 *See* 155 Cong. Rec. S2624-01 (March 2, 2009 Statement of Senator Levin on the Introduction of the Stop Tax Haven Abuse Act) at S2632.

then borrowing against them, but rather by entering into equity swaps to begin with (without seeking to control whether and how the swap counterparty hedged its position).

Finally, we recognize that "in connection with" is not a "bright line standard" and that this approach therefore diverges to some extent from the approach otherwise taken by the proposed regulations. Moreover, for the reasons set out above in our discussion of certification procedures, we support and appreciate your efforts to introduce objective rules, and limit discretionary judgments, to the greatest extent possible. Nevertheless, sometimes a wholly objective bright-line rule is really not possible to implement without throwing out the baby with the bathwater.

More specifically, the obvious bright-line rule available to the Treasury is to impose U.S. withholding tax on all dividend equivalent payments received by foreign persons, regardless of the circumstances. For the reasons set out above, we do not think imposition of such a rule was intended by Congress. What we are asserting here is that the bright line rule that you have therefore proposed in the alternative—impose U.S. withholding tax in any case where the foreign investor or a related party buys or sells the underlying equities on the same day —is not much better as a practical matter, because there is no practical means of enforcing it. It can only be enforced in conjunction with a directive from Treasury and the IRS to withholding agents to withhold on all dividend equivalent payments to foreign persons in the absence of certifications that foreign investors are not in a position to make, which simplifies into a directive to withhold on all dividend equivalent payments made to foreign persons.

In other words, we recognize that "in connection with" is a *standard* that will need to be understood and applied in the context of particular transactions. There is, however, substantive meaning to the words "in connection with" and good reason to believe that these words will be taken seriously by most foreign investors when they represent that they are not violating that standard. Large foreign investors can be audited by the IRS, and if they are in fact selling the underlying stock into the market in connection with entering into the relevant equity swap, this should become readily apparent in the course of the audit. If, for example, a foreign investor consistently buys U.S. equities and then sells them while simultaneously entering into an equity swap over them, the requirement that the former be "in connection with" the latter is not likely to prevent the Commissioner from imposing withholding tax, plus interest and penalties. Moreover, most foreign investors are properly advised by conservative counsel and financial statement auditors that will not allow them to make representations that do not accord with their procedures and are not consistent with the underlying facts.

Treasury and the IRS could go further, moreover, and require certifying foreign investors to have reasonable procedures in place to ensure that their representations were correct, such as specified means of routinely informing their traders of IRS requirements. Analogous authority supports providing limited exemptions in cases in which information is disseminated regarding important tax rules applicable to specific instruments. For example, under the "TEFRA D" exception applicable to notes issued prior to March 19th of this year, distributors were deemed to satisfy the requirement that the bearer bond not be offered or sold to U.S. persons if, among other things, the distributor had in effect, in connection with the offer and sale of the obligation during a specified period, "procedures reasonably designed to ensure that its employees or agents who are directly engaged in selling the obligation are aware that the obligation cannot be offered or sold" to a U.S. person during that specified period.[19]

We also note that an "in connection with" standard may be better from the perspective of the IRS than a bright-line rule, for the latter could conceivably be abused. For example, it is possible that a foreign investor could "cross into" an equity swap that is subject to withholding under the proposed regulations. If the foreign investor then terminated that equity swap and entered into a similar equity swap on a subsequent date (*e.g.*, within a few days), the new swap would arguably *not* be tainted within the literal language of the regulations, because it would not be accompanied by any sale of shares on the same day. It would be clear, under an "in connection with" standard, however, that the original sale of shares tainted all of the subsequent equity swaps that were associated with it.

In any case, while one of the principal advantages of a standard here is that it will be flexible enough to accomplish its objective when applied to varying fact patterns, you might consider (as you have done in other regulations) providing some examples that help delineate how the standard is intended to work. Thus, one example might involve a case where an e-mail between traders of a foreign investor directs one to enter into an equity swap while the other sells the underlying shares, so that the economic position in the shares can be financed. Such an e-mail would of course be *prima facie* (or perhaps conclusive) evidence that the two transactions occurred in connection with each other. Another example

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19 *See* Treasury Regulations Section 1.163-5(c)(2)(i)(D)(ii).

might involve a routine pattern in which an affiliate of a foreign investor sells a similar amount of underlying shares on the same day that the foreign investor enters into an equity swap. Another example might involve a case where an equity swap had "market on close" pricing, and the foreign investor had sold underlying stock on the same day in an amount equal to the notional amount of the swap for a price based on the market on close price of the stock.

It is of course important to consider what sort of documentation would serve to ensure that foreign investors were fully focused on the consequences of their representations. The detail of the legal obligations associated with an equity swap is normally documented on an ISDA Master Agreement that is entered into at the start of any relationship between a foreign investor and its swap counterparty. At the time of signing this initial agreement, the parties normally sign any withholding forms or other necessary tax-related certifications, such as a Form W-9 (in the case of a U.S. taxpayer), a Form W-8BEN (in the case of a nonresident), or a Form W-8ECI (in the case of a nonresident deriving swap income that is effectively connected to a U.S. trade or business). In addition, the ISDA Master Agreement will also reflect tax representations from each party intended to provide comfort to both parties that payments under swaps entered into between the parties can be made free of withholding. Thereafter, each equity swap is manifested by a written confirmation that reflects the specific terms of the equity swap but references the master agreement for most of the legal rights and obligations. These confirmations tend to be short and very limited. We therefore think it might be onerous and counterproductive to require that certifications be produced, under penalties of perjury, at the time that each swap confirmation was entered into. Rather, the certification procedures for equity swaps should be contemporaneous with, or be incorporated into, other W-8-type initial certification procedures.

As a matter of administrative convenience, however, we think the necessary representations might best be incorporated into the ISDA Master Agreement entered into by the parties. There exists precedent for such an approach within the Section 1441 regulations. For example, the regulations provide that if a payee provides a representation in a "master agreement" (such as an ISDA Agreement or a relevant Schedule thereto) or in a trade confirmation that the payee is a U.S. person or a non-U.S. branch of a foreign person, payments in respect of a swap under that agreement or confirmation may be treated as not being effectively connected with the conduct of a U.S. trade or business for purposes of Section 1441. As a result, the withholding agent in respect of such payments is not required to report such amounts on Forms 1042 or 1042-S.[20] Similarly, we suggest that the proposed regulations be amended to provide that withholding agents may rely on representations and covenants provided in an ISDA Master Agreement relating to specified notional principal contract status.

Under either approach, foreign investors would need a means of "opting out" of their prior certifications (and into a withholding regime) if they discovered that they were not in a position to comply with the requirements of the proposed regulations in respect of a specific equity swap or equity derivative. Similarly, they would need a means of informing their counterparties or withholding agents if they discovered *post facto* that one or more of the requirements of the proposed regulations had not been met with respect to a specific transaction. (In the latter case, the counterparty would presumably initiate withholding out of any of the foreign investor's collateral on hand, or out of any subsequent payments made to the foreign investor, but it would not be liable for any tax that was not ultimately collected by the IRS, since it would have relied upon the foreign investor's initial certifications.) In general, we might envision your requiring the foreign investor to represent that it (a) *anticipated* meeting the requirements of the proposed regulations with respect to any transactions entered into under the relevant ISDA documentation, (b) had reasonable procedures in place to ensure that this would likely be the case, and (c) would inform the relevant counterparty or withholding agent (and/or the IRS) as soon as possible of any circumstances where this did not turn out to be the case. The current W-8BEN, for example, already contains an agreement of the signatory to "provide a statement that identifies those notional principal contracts from which the income is **not** effectively connected with the conduct of a trade or business in the United States" and to update the statement as required.[21]

4. <u>Breadth of Application</u>.

As currently drafted, the proposed regulations could potentially apply to a broad range of financial instruments that have little potential for withholding tax avoidance. As discussed below, this could needlessly impede financial markets,

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20 *See* Treasury Regulations Sections 1.1441-4(a)(3)(ii); 1.1461-1(c)(2)(ii)(F). A parallel exemption from Form 1099 reporting is available where the payee provides a representation that the counterparty is a foreign person. *See* Treasury Regulations Section 1.6041-4(a)(4).

21 *See* IRS Form W-8BEN, Line 11 (Rev. Feb. 2006).

and it could require you to provide substantial additional guidance. Moreover, the costs and difficulties associated with obtaining certifications in respect of such transactions would be substantial, as would be the costs and difficulties associated with developing systems to implement potential withholding. We recognize that Treasury and the IRS have a duty to ensure that avoidance potential be limited to the maximum reasonable extent. We also note, however, that good administration should involve consideration of what is reasonable in this context and should endeavor to balance the costs of systems implementation against the risks of potential tax avoidance. We therefore respectfully request, for the reasons set out below, that the proposed regulations not be extended to the following kinds of financial instruments:

A. <u>Instruments Providing for Dividend-Related Adjustments Only in the Case of Extraordinary Dividends</u>.

Most options, warrants or other rights to acquire common stock (including options embedded in convertible debt or preferred stock) provide for strike-price adjustments in the event of certain "extraordinary dividends", which are generally (in the case of listed options) defined under OCC standards as nonrecurring or "special" dividends that are (i) not "ordinary" or (ii) exceed $12.50 with respect to each option contract.[22] Similarly, the strike prices of such options are generally adjusted for stock splits, stock consolidations, mergers and similar corporate events. The logic of these adjustments is that the price of the underlying corporate stock is not expected to move significantly in respect of changes in routine distributions of earnings and profits, but its value will be significantly decreased if the underlying corporation issues a large special dividend or spins off one of its subsidiaries or otherwise makes an unanticipatedly large distribution of its assets.

Similarly, while many, if not most, financial indexes are so-called "price return indexes" which do not reflect the amount of dividends declared and paid on underlying stock, we understand that such indexes generally *do* reflect distributions of unanticipatedly large "special dividends"—*i.e.*, dividends that are "outside of the normal payment pattern established historically by the corporation".[23] A large

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22 *See, e.g.*, The Options Clearing Corporation By Laws, Section 11A (Adjustment for Stock Option Contracts), *available at* http://www.theocc.com/about/publications/bylaws.jsp (visited February 29, 2012). Even in the event of such a dividend, however, adjustment is subject to determination on a case-by-case basis. *See id*.

23 *See* S&P Indices, Corporate Actions Policies & Practices, Index Methodology (June 2011); *see also* Dow Jones Global Titans 50 Index Rulebook (May 2011)

number of structured notes and other financial instruments currently reference such financial indexes.

The Proposed Regulations (reasonably, in our view) would impose withholding tax on a dividend equivalent paid in respect of an extraordinary dividend if a foreign investor entered into an equity swap or other equity derivative after the extraordinary dividend had already been announced. In such a case, a foreign investor who already held the relevant stock might seek to avoid withholding tax on the extraordinary dividend by selling the stock and simultaneously entering into a derivative that allowed the foreign investor to maintain the same financial position. By contrast, however, there is no tax avoidance potential where a foreign investor enters into an equity derivative position that does not provide for any adjustments in respect of dividends (except for extraordinary dividends) and where no extraordinary dividend has been announced. A foreign investor entering into such a position cannot be seeking to avoid dividend withholding tax on either a regular dividend (because the contract does not provide for any dividend equivalent payments in respect of regular dividends) or an extraordinary dividend (because none is expected). In the unlikely event that an extraordinary dividend is ultimately declared in respect of the underlying stock, such an investor cannot be entering into the position to avoid withholding tax, because the investor already *is* in a derivative position that was not entered into with tax considerations in mind.

On the other hand, applying Section 871(m) to equity derivative investments and transactions merely because they make adjustments for extraordinary dividends would be exceedingly onerous for everyone concerned. Securities dealers would be forced to maintain systems for potential withholding on a broad array of equity-flavored contracts having no potential for tax avoidance. Similarly, investors in such instruments (including in many cases unsophisticated retail investors) would be required to make detailed certifications in respect of activities that could not possibly be designed to avoid withholding tax and suffer actual withholding in the event that an unanticipated extraordinary dividend actually materialized.

("[E]xtraordinary and special cash dividends are included in the price return index."), *available at* http://www.djindexes.com/mdsidx/downloads/rulebooks/Dow_Jones_Global_Titans_50_Index_Rulebook.pdf (visited February 27, 2012).

As the proposed regulations are currently drafted, a dividend equivalent payment includes any payment that is determined by reference to the payment of a dividend. Although this generally doesn't include a fixed payment that equals an anticipated future dividend, it does include such a payment if the future dividend has already been announced at the time the derivative is entered into. The proposed regulations further provide that if the already announced dividend is a "special dividend", the relevant derivative contract is automatically a "specified notional principal contract" subject to withholding tax. A "special dividend" is defined as "a nonrecurring payment to shareholders of corporate assets that are in addition to a recurring dividend payment".

For the reasons set out above, we recommend that the proposed regulations provide that where a derivative contract provides for dividend-related adjustments *solely* in the event of a "special dividend" that had not been announced at the time the derivative contract was entered into, then Section 871(m) will not apply to the contract.

B. Instruments Referencing Broad-Based Indexes.

Many financial instruments or transactions that are currently issued or entered into reference an array of readily available, broad-based equity indexes, ranging from those (such as the S&P 500 Index) that are designed to measure the performance of the largest U.S. companies as a whole to those (such as the NASDAQ 100, which primarily reflects the performance of large technology firms, or the MSCI US Investable Market Energy 25/50 Index, which reflects the domestic energy sector) that are designed to measure the performance of a specific industry sector. There are two reasons why it is unlikely that foreign investors entering into equity swaps or other derivatives relating to these indexes are merely crossing in and out to obtain financing of already-acquired equity positions or otherwise avoiding the dividend withholding tax: First, because of the size and diversification of these indexes, it is unlikely that foreign investors already own all of the underlying equities in pro-rata proportions. Second, because these indexes reflect the overall performance of a particular industry sector, rather than a particular investor's view regarding which companies within the sector are likely to do well, they could not effectively serve as vehicles for financing positions that foreign investors already own. Put differently, a foreign investor looking to take a long position in a U.S. industry sector (or in U.S. companies as a whole) is not likely to purchase a balanced portfolio of all of the stocks in the sector and then cross in; but such an investor *is* likely to acquire or enter into a derivative on the index with someone that already maintains long positions in the index. Similarly, a foreign investor interested in taking a position in one of these indexes is not likely to want to control a U.S. counterparty's initial acquisition of underlying stocks as a hedge or otherwise put the swap counterparty in the position of an agent.

We understand that for these reasons, it is already your intention to carve such indexes out of the application of the proposed regulations—*i.e.*, that dividend equivalent payments on financial instruments referencing these indexes will not be subject to U.S. withholding tax even if they adjust for changes in routine dividends. We wholeheartedly agree with this decision, and we note that you will have to make technical changes to the language of the proposed regulations to implement it, for the current draft of the proposed regulations defines such terms as "customized index" and "narrow based index" solely for purposes of determining whether an equity derivative is automatically a "specified notional principal contract" because the underlying equities are not regularly traded.

We do recognize, however, that not all purported indexes are broad-based indexes reflecting general industry performance. For example, broker dealers sometimes enter into swaps over so-called "customized indexes" that do reflect a series of specific directional views of a particular foreign investor, or that reflect the operation of models or formulas provided by such a foreign investor. We further recognize that such customized indexes could have potential for avoiding U.S. withholding tax if they were accompanied by crossing in, crossing out or other factors that Congress has identified as presenting a risk of tax avoidance. For this reason, a reasonably bright and coherent line needs to be drawn between broad-based industry sector indexes and customized indexes.

In its March 2011 letter to the Treasury Department, the International Swaps and Derivatives Association ("ISDA") made the following proposal:

> "For the foregoing reasons, we recommend that regulations create a concept of a "qualified index" and exempt transactions or instruments providing for dividend equivalent payments in respect of any such qualified index from the application of Section 871(m). The definition of qualified index would have two components. First is the definition of "index." We recommend defining an index as (i) a measure of a portfolio of stocks that are chosen to reflect the changing value of a certain market, industry, market sector, geographical sector, combination thereof, or similar

> segment of the market, (ii) the value of which is determined by reference to the prices of its constituent shares (calculated by reference only to the share value or also taking into account actual dividends paid on those shares), and (iii) that is modified or rebalanced at set intervals according to predefined objective rules (except, in limited circumstances, where the methodology provides ambiguous answers) in order most accurately to reflect the changing landscape of the particular market, industry, market sector, geographical sector, combination thereof, or similar segment of the market. The [North American Tax Committee of ISDA] believes an index should include not only the well known public indices, but also proprietary indices established by market participants that are intended to achieve the same goals as the public indices, and the recommended definition would include both types."
>
> "The second part of the definition is what makes an index "qualified." We recommend defining a qualified index as any index (i) the value of which is published and publicly available and widely available for use, whether freely or by any license or similar arrangement, or which is made available for use by multiple unrelated parties, and (ii) satisfies appropriate size and concentration tests. We note, in this regard, that the proposed regulations already contain relevant size and concentration limits that can be applied for this purpose. Alternatively, if 9 components is not deemed to be a large enough minimum, it might be appropriate to look to the "portfolio" test of Regulation section 1.246-5(c)(ii), which requires a portfolio to have at least 20 securities before it will be treated as a portfolio for purposes of that section."

For the reasons set out above, we wholeheartedly endorse this proposal and think it should be adopted in the proposed regulations. If it is adopted, we hope it will be clarified that it extends to financial instruments and contracts reflecting the returns on one or *more* such indexes, or reflecting various combinations of such indexes, as that has become a pattern in the marketplace.

If it is not adopted, however, we note that the definition of "customized index" set out in the current draft of the proposed regulations cannot serve as an alternative, because it effectively defines "customized index" to include any index that is not traded through futures or options contracts on a qualified board or exchange. In fact, however, many of the well-known broad-based equity indexes that are referenced by derivative financial instruments are *not* traded as options or futures contracts. For example, the S&P 500 total return index is not traded as an option or futures contract (although the S&P 500 price return index is). We do understand that most such indexes are effectively traded in the sense that one or more Exchange Traded Funds reference the index and nothing else. If therefore you do not adopt a definition of customized index along the lines of ISDA's proposed definition, then it might suffice as a second choice to effectively define customized index to include any index that is not in effect publicly traded through either futures, options or ETFs.

We further note that many broad-based worldwide indexes include U.S. equities as a relatively small fraction of the value of the index. It would be exceedingly onerous to implement and impose U.S. withholding tax in respect of the small portion of payments on derivative instruments reflecting such indexes, and for obvious reasons, there would be little potential for avoidance of U.S. withholding tax in respect of derivatives on these indexes. If, therefore, our recommendation is not fully adopted, we recommend that Treasury also exclude from the definitions of specified notional principal contract and equity-linked financial instruments any instruments linked to an index where more than 80 percent of the index weighting is in respect of stocks of foreign corporations.

C. Principal-Protected Debt Instruments.

The proposed regulations would in effect impose U.S. withholding tax on any dividend equivalent received by a foreign person in respect of an "equity-linked instrument" as defined in the regulations. An "equity-linked instrument" is at present broadly defined to include any financial instrument that references one or more underlying securities to determine its value. As further discussed below with respect to non-delta-one instruments, we believe that this definition is too broad and would impose U.S. withholding tax in some cases that were clearly not intended by Congress. In particular, it would appear to apply to any contingent debt instrument, convertible debt instrument or other investment that promises holders a full return of principal plus interest determined by reference to the total returns on a U.S. equity-related index.

Equity-linked debt instruments are relatively common, and many (such as those that reference a total return equity index) include routine dividends in the potential upside returns, along with price appreciation. Most of these instruments, moreover, adjust for extraordinary dividends above a certain threshold. These financial instruments do not present any meaningful risk of U.S. withholding tax avoidance. It is inconceivable, for example, that a foreign investor who owned IBM stock would temporarily "cross in" to ownership of a debt instrument exchangeable for IBM stock merely to avoid U.S. withholding tax. Such an instrument would presumably cost much more than the underlying stock, in light of the associated principal protection. More important, the foreign investor would be exposed to the credit of the issuer, a very substantial risk in today's financial environment.

Moreover, we believe Congress specifically intended to exempt income derived from such financial instruments from outbound withholding tax when it enacted Section 871(h) of the Code granting the "portfolio interest exemption." In subsequently enacting Section 871(h)(4), dealing with contingent interest payments, Congress expressly retained the portfolio interest exemption for debt instruments with interest or principal payments referenced to publicly traded stocks. [24] There is no indication that Congress intended or even anticipated that Section 871(m) could apply to a principal-protected debt instrument and effectively override Section 871(h)(4) in part.

Moreover, if withholding were imposed in respect of such instruments, holders might be subject to U.S. withholding tax in respect of deemed receipts of dividend equivalent payments even though (on account of a subsequent decline in the value of the underlying index) they ultimately received no more than the principal amount of their notes. Put differently, such investors would be subject to withholding tax even though the equity options that were embedded in their instruments as an economic matter ultimately expired worthless. There is no sense in which the resulting tax could properly be viewed as imposed on the receipt of "income", and there is nothing to suggest that Congress ever intended such a result.

In any case, the imposition of U.S. withholding tax in respect of payments made on these instruments would be exceedingly onerous for all parties involved, and the burdens would significantly outweigh the benefits. Securities dealers would have to devise complex systems to implement withholding on dividend-related portions of interest or principal payments (or even mere adjustments to

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24 *See* Section 871(h)(4).

future potential payments) made to large numbers of retail and institutional holders of these instruments. Moreover, retail and institutional holders of these instruments would have to make certifications, and learn complex rules, to mitigate this withholding, and/or possibly file claims for refund of the taxes withheld. We think it clear that such requirements would dampen an active financial market in these instruments that is solely business related and is beneficial to the economy. Moreover, we think they would do little, if anything, to lessen the perceived risk of withholding tax avoidance that Congress directed the Secretary to focus on.

For these reasons, we propose that the regulations be clarified to confirm that a financial instrument is not an "equity linked instrument" for purposes of these rules if it constitutes a debt instrument for federal income tax purposes.

D. Options and Other Non-Delta-One Instruments that Reference U.S. Equities.

Section 871(m) of the Code effectively imposes U.S. withholding tax on U.S. source substitute dividend payments received by foreign persons on stock loans and dividend equivalent payments received by foreign persons on equity swaps. In both cases, the foreign person is long a derivative position that is economically equivalent to actual ownership of the underlying U.S. equities. Section 871(m) of the Code also imposes U.S. withholding tax on any other payment that is "substantially similar" to a dividend equivalent payment received in respect of a stock loan or an equity swap. This might encompass, for example, a case where a foreign person repo's out its U.S. stocks and for some reason is not treated as continuing to own the U.S. stocks; or any case where a stock loan or equity swap has another name for formalistic reasons. It might also encompass dividend equivalent payments received in respect of forward contracts or other equity derivatives that are economically similar to ownership of the underlying U.S. equities.[25]

[25] The Joint Committee Explanation of Section 871(m) notes the following with respect to the "substantially similar" to a dividend rule: "Under this rule, for example, the Secretary may conclude that payments under certain forward contracts or other financial contracts that reference stock of U.S. corporations are dividend equivalents." *See* General Explanation of Tax Legislation Enacted in the 111th Congress, JCS-2-11 at 163 (March 23, 2011). *Cf*. Rev. Rul. 82-150, 1982-2 C.B. 110, treating certain options that are 60% deep in the money as equivalent to current ownership of the underlying. *See also* Rev. Rul. 83-98, 1983-2 C.B. 40, dealing with certain adjustable rate convertible notes.

It is difficult to see, however, why this can or should be stretched to include options or other financial positions that are in no sense economically equivalent to the actual ownership of U.S. equities and that do not provide their holders with payments or other economic benefits equivalent to dividends paid in respect of the underlying. The holder of an option is protected from any risk of loss from ownership of the underlying equities in excess of the premium paid. Moreover, while the option may be priced to reflect an anticipated dividend payment, the decline in value of the option arising from such a payment is normally a mere fraction of the decline in value of the underlying.

Almost all options, convertible or exchangeable instruments provide for strike price adjustments in the event of unanticipated extraordinary dividends over a certain threshold. As discussed above, we are hopeful that a financial instrument will not be treated as subject to Section 871(m) merely on account of such an adjustment, as there is no potential for tax abuse. The proposed regulations appear to raise an additional concern, however, with respect to options that are entered into after routine dividends are declared on the underlying equities. More specifically, as currently drafted, the proposed regulations would define a dividend equivalent payment to include (on the theory that it is "substantially similar" to a dividend equivalent payment on an equity swap) any payment of purchase price made pursuant to an equity-linked instrument (including futures, forwards, options and "other contractual arrangements") that is determined by reference to a dividend,[26] and the proposed regulations provide elsewhere that an express carve out from dividend equivalent treatment for payments determined by reference to a fixed estimate of future dividends is not available where the future dividend has already been announced.[27] While this carve out is presumably directed at an already announced extraordinary dividend (which for obvious reasons has a heightened tax avoidance potential, as discussed in Senate Hearings),[28] and while

26 *See* Treasury Regulations Section 1.871-15(d).

27 *See* Treasury Regulations Section 1.871-15(b)(2)(ii).

28 *See* Staff of Senate Permanent Subcommittee on Investigations, Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends (September 11, 2008) (statements of Reuven Avi-Yonah: "An abuse occurs, for example, as was mentioned, when a foreign taxpayer actually holds the stock, sells it just before the record dividend date, receives the dividend equivalent and then it reacquires the stock back."); (statements of Senator Levin: "Now, take a look at Exhibit 6, if you would, which is an e-mail between two employees of Maverick Capital, which runs a number of offshore hedge funds. And the e-mails from 2004 describes a Microsoft special dividend announced that year to pay $3 on every Microsoft share for a total of $32 billion.")

the carve out is itself from a provision primarily dealing with equity swaps purporting to make periodic fixed dividend equivalent payments (rather than with the mere fact that the pricing of options takes account of anticipated dividend payments), some practitioners and taxpayers have been concerned that the aggregate implication of these various provisions is that an option or other equity-linked instrument that does not provide for any dividend equivalent payments or adjustments at all might nevertheless be subject to outbound U.S. withholding tax if entered into by a foreign investor between the time that a routine dividend is announced and when it is paid (because the pricing of the instrument will presumably take account of the fact that the impending dividend payment will reduce the value of the underlying).

With regard to the above, we note the following points:

First the withholding tax avoidance potential of an option or similar instrument is *de minimis*, because the economic profile does not resemble the economic profile of long ownership of U.S. equities. In other words, it is not reasonable to suppose that a foreign holder of U.S. equities will temporarily exchange those U.S. equities for a mere option over substantially similar U.S. equities merely to avoid U.S. withholding tax on an impending regular dividend.

Second, whatever avoidance potential might conceivably exist in such a case, it does not differ meaningfully from the avoidance potential that exists in respect of such an instrument when it is entered into or acquired immediately before the announcement of the next routine dividend. Thus, if a foreign investor *was* willing to temporarily own an option to avoid U.S. withholding tax on routine dividends, it would just as effectively accomplish the avoidance if it entered into the option immediately before the announcement of the next routine dividend, for the pricing of the option would similarly reflect the expected amount of the dividend about to be declared, and it is unlikely that the actual dividend would prove to be different than what it was expected to be the day before. In other words, the presence of tax avoidance potential cannot reasonably turn here on certainty *vel non* with regard to a possible change in an impending dividend payment, as such a change would likely be insignificant in relation to the value of the option and remote in any case in terms of likelihood of occurrence.

Third, nothing in the statutory language of Section 871(m), or in the associated legislative history, suggests an intention on the part of Congress to impose outbound withholding tax on options or similar instruments. To the contrary, Section 871(m) only directs the Secretary to impose withholding tax in respect of contracts that are "substantially similar" to stock loans and long positions in equity swaps, both of which provide full "delta one exposure" to U.S. equities—*i.e.*, are economically equivalent to ownership, or leveraged ownership, of the underlying U.S. equities.

Fourth, the withholding tax imposed would not bear a reasonable relation to any profit derived by the holder of the instrument, because the value of an option does not decrease on a one-to-one basis with the decrease in option strike price (and in the value of the underlying) that is associated with a dividend distribution (unless the option is so deep in the money that its "delta" is one or extremely close to one). In the case of a typical 20-percent-out-of-the-money option, the anticipated increase in option value associated with a strike price adjustment for a dividend paid on the underlying is a mere fraction of the change in strike price. Moreover, securities dealers and withholding agents have no means of imposing and collecting a tax based on this increase in value. Nothing in their systems measures or records such an increase in value. Moreover, such withholding tax might be imposed even where the option expired worthless and the holder derived no income of any kind. We do not think imposition of tax in such a case would reflect a tax on "amounts received" by foreign persons as authorized by Congress under Sections 871 and 881 of the Code.

Fifth, options are traded in large volumes both over-the-counter and on various exchanges, and they are acquired by retail investors on public exchanges. It would be surprising and confusing to discover that they were subject to accruals of outbound withholding tax during certain "blackout periods" between routine dividend announcement and payment dates. Foreign investors in such options could in no case avoid withholding tax if the option provided for physical settlement, or was terminated in less than 90 days, or was not with respect to stock that was actively traded stock, or was collateralized with underlying stock (as are most variable prepaid forward contracts, such as those described in Rev. Rul. 2003-7). Moreover, physical settlement is the routine means by which options on property are normally settled. The physical settlement of an option is not a telltale indication that the option holder is "crossing out," having temporarily converted long stock ownership into a derivative position.

Sixth, the certifications that would be required from purchasers of such options to ensure that they were not violating any of the seven factors in connection with their purchases would be difficult, costly and confusing to obtain, and presumably would *not* be obtained by many foreign issuers of options. Retail purchasers of options in particular would not be in a position to make the sorts of certifications that counterparties to equity swaps might be expected to make.

Seventh, the systems that U.S. securities dealers and other withholding agents would have to devise in order to determine when such options were acquired during routine "blackout periods", obtain appropriate certifications and withhold on option payments in the absence of such payments (with potentially complex associated collateralization requirements to ensure that the withholding could in fact be collected) would be wholly out of proportion to any potential for withholding tax avoidance. In many, if not most, cases, withholding agents would not be making any payments from which they could reasonably withhold and remit a tax. Neither have they developed any systems or arrangements for imposing withholding in the absence of any cash payments. And the circumstances under which withholding was due would not be uniform, but rather would be complex and idiosyncratic.

Finally, imposition of withholding on options in the absence of any cash payments would constitute a novel approach to enforcing withholding tax that has never been sanctioned by Congress. To the contrary, in the analogous case where withholding is due in respect of accruals of original issue discount on debt held by foreign persons, Congress imposes withholding obligations only in respect of payments ultimately made on the instrument.[29] As a result, in the case of such notes, withholding obligations generally do not arise in the absence of cash that would be available to satisfy such obligation.[30] Unlike counterparties to equity swaps, moreover, investors in options do not post any collateral to support their obligation, because they do not have any. There would therefore be no practical

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29 There is an exception for limited cases in which there is a sale between two holders that is part of a plan to avoid tax and the withholding agent knew or had reason to know of such plan. *See* Section 1441(c)(8) (the Secretary may prescribe regulations that "include[e] rules for the deduction and withholding of the tax on original issue discount from payments of interest."); *see also* Treasury Regulations Section 1.1441-2(b)(3)(i); Treasury Regulations Section 1.1441-2(a)(6).

30 We understand from descriptions of public panels that partly for this reason, you have considered a system that might impose withholding on options only where payments were actually made (*e.g.,* where an option was exercised). There is of course no theoretical basis for distinguishing here between options that do and don't ultimately pay off in respect of an appreciation in the value of the underlying. But more important, the fact that foreign investors might not receive any payments on which withholding could be imposed underlines how little potential there would be in this case for avoidance of withholding tax.

means of collecting a withholding tax from an option holder, and the option itself might ultimately expire worthless, with no further payment made to the holder.

For all of these reasons, we do not think the proposed regulations should apply to options and other non-delta one instruments. We are divided as a group on the question of whether the proposed regulations should apply to forwards, futures and other delta-one contracts that likewise do not provide for any dividend adjustments but are entered into after the announcement of a routine dividend. All of the administrative and procedural difficulties described above apply with equal force to such contracts. It would be exceedingly difficult, for example, to seek certifications in respect of an exchange traded contract (or even an over-the-counter contract) merely because it was entered into during the gap between a routine dividend announcement and payment date, and then impose withholding tax if the certifications were not timely received or if the contract was terminated, settled or offset too quickly. Moreover, equity derivative sales forces and investors would have to make continual case-specific determinations about the interaction of complex contractual terms with the detailed specifics of the 871(m) withholding regime. Nor would the resulting considerable imposition on markets, systems and withholding procedures for the entire forward and futures market accomplish much in terms of mitigating tax avoidance, inasmuch as actual foreign holders of U.S. equities who really were seeking to avoid the U.S. withholding tax by crossing into a forward contract could always do so *prior* to a routine dividend announcement date.

Some of us do understand, however, that you might want to at least ensure that such actual foreign holders would have to cross into a forward contact for a period of time that was at least as long as a dividend announcement period. If to accomplish this result you therefore do decide to generally require certifications in the forward and futures markets, then you will presumably have to draw a line between delta-one and non-delta-one instruments. Whatever line is chosen, we think it should be based on a bright line test, to discourage competition on the basis of legal interpretation. One example might be that an option will not be treated as a delta one contract for this purpose if the holder does not have the burdens and benefits of ownership in respect of changes in the value of the underlying over a range equal to some specified percentage of the value of the underlying. Another example might be that the option will not be treated as a delta-one contract if delta at the time the contract is entered into is less than some specified amount (*i.e.*, if the change in the value of the contract is meaningfully less than the change in the value of the underlying). We do not think the test needs to be unduly conservative, however, as we do not think foreign investors who already owned U.S. equities would be willing to expose themselves to meaningful changes in their economic positions merely to avoid U.S. withholding tax. As noted above, if avoiding U.S. withholding tax was their paramount priority, such holders could simply "cross into" a long term forward contract prior to a routine dividend announcement date. We note, moreover, that some members of our group believe that a test based on delta would be a better approach, as that approach takes term and volatility into account and is the principal means by which traders currently measure correlation with the underlying. Members of our group would be glad to meet with you to explain at greater length how delta operates and could work as a bright-line test.

We further note in this context that a foreign investor could aggregate positions (*e.g.*, acquire an at-the-money call option and also issue an at-the-money put option) to achieve a position that was economically equivalent to a forward position in the underlying stock. We therefore think it would be appropriate to subject foreign investors to an anti-abuse rule that aggregates positions for this purpose if they are entered into in connection with each other, and that likewise subjects securities dealers to potential withholding tax liability if they knowingly accommodate such aggregation. We do not think it would be reasonable, however, to go on for this reason to require that all foreign investors who acquire options on exchanges or in the over-the-counter markets make certifications to prevent withholding. For the reasons set out above, the burdens placed on the investor community and on withholding agents would be very large in relation to any benefit. The incremental transaction costs and risks associated with aggregating options to achieve the economic equivalent of such a forward contract are substantial, and it is unlikely that a foreign investor would incur them merely to avoid U.S. withholding tax. As noted above, a foreign investor determined to avoid U.S. withholding tax can always enter into a forward contract, futures contract or other equity derivative instrument that is economically equivalent to the ownership of the underlying equities but does not provide for dividend equivalent payments or adjustments.

E. Exchanged Traded and Structured Notes.

A broad range of complex equity derivative forward contracts are currently sold as structured notes to foreign investors in the retail or quasi-retail market. Foreign investors in these notes expose themselves to long-range credit risk of the issuer. Moreover, these notes generally have terms of anywhere between one year and 30 years. We think it unlikely that a foreign investor would expose itself to such credit risk, or to other uncertainties associated with ownership of these notes, merely to avoid withholding tax, given that such an investor could instead enter into a typical forward contract prior to the dividend announcement date. By contrast, the complexities associated with implementing withholding on these instruments, and requiring associated certifications, would be very substantial, given their broad retail distribution. We therefore think consideration should be given to extending a general exemption to these instruments.

F. Instruments With Payments That Vary But Don't Correlate With Underlying Dividends.

As currently drafted, the proposed regulations would effectively impose withholding on any "dividend equivalent payment" received by a foreign person in respect of an equity-linked financial instrument. A "dividend equivalent payment", in turn, would be defined to include any payment that is "contingent upon or determined by reference to the payment of a [U.S. source] dividend". Presumably this is meant to encompass the case where payments under a derivative equal, or vary directly with, dividends paid on underlying U.S. equities. Numerous financial instruments, however, link their payouts to the payment of a dividend without offering one-to-one, or even positive, correlation with the dividend.

As discussed above, Section 871(m) of the Code is directed at situations in which (a) a foreign holder of U.S. equities crosses into derivative ownership for a period of time, partly to avoid the U.S. withholding tax on dividends, or (b) a swap counterparty effectively plays the role of a foreign investor's agent for the actual purchase of U.S. equities. An equity derivative transaction does not have this potential if its variations in payments do not correlate with variations in the payment of the underlying dividends. We therefore presume that such a transaction would not be providing for payments that were "contingent upon or determined by reference to" U.S. source dividends. Absent clarification, however, it would be difficult to reach this conclusion under the literal language of the proposed definition.

For this reason, we propose that the regulations clarify that a payment is not "contingent upon or determined by reference to the payment of a [U.S. source] dividend" unless the amount of the payment varies directly with the dividends paid on underlying U.S. source equities.

G. Unfunded Stock Grants.

The expansion of Section 871(m) also has the seemingly unintended consequence of potentially affecting existing employee compensation arrangements under which foreign employees of certain domestic corporations receive restricted stock grants that are adjusted to account for dividends paid on equity of the issuer. Under the existing source rules, any income attributable to these arrangements is generally sourced as compensation by reference to the location where the employee's services are performed.[31] Under the proposed regulations as currently drafted, an "equity linked instrument" is broadly defined to include any "financial instrument" that references one or more underlying securities to determine its value, including a "contractual arrangement". While we do not think compensatory stock grants should be treated as "financial instruments" for this purpose, it is not clear what a financial instrument is under the proposed regulations, and an agent could therefore seek to treat contractual rights under an employment agreement as such an instrument. If then the arrangement had one of the seven factors (such as providing for physical settlement by reason of the employee receiving actual shares, as is common in the case of restricted stock compensation), it could be treated as a specific notional principal contract, thus potentially causing dividend adjustments to be treated as dividend equivalent payments that would be re-sourced and subject to U.S. withholding tax under Section 871(m).

Obviously imposition of U.S. withholding tax in respect of such arrangements would not further the purposes of Section 871(m) of the Code by mitigating the risk of avoidance of dividend withholding tax by foreign investors. For this reason, we recommend that the proposed regulations clarify that employee compensation arrangements are not treated as financial instruments for purposes of the regulations.

5. <u>Minimum Term and Offsetting Positions</u>.

As more fully explained in the introduction above, nothing in the statute, legislative history, or hearings preceding and surrounding the enactment of Section 871(m) suggests that Congress thought there was a problem *per se* with an equity swap that has a short term. Although a minimum term requirement found its way into the President's initial proposal for legislation in respect of dividend equivalent payments on equity swaps,[32] this was apparently because the drafters of that provision looked partly to guidelines employed by securities dealers in devising

[31] *See* Sections 861(a)(3), 862(a)(3).

[32] *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (2009) (exception for swaps that, among other conditions, have a term of at least 90 days).

substantive terms. These securities dealers, in turn, sometimes included minimum terms as part of their guidelines to help ensure that their trading desks were not involved in crossing in and out type transactions or other arrangements (such as those involving inter-dealer intermediaries) that might conceivably be challenged by the IRS as reflecting continued ownership in substance by a foreign counterparty. They were also concerned that where the term of an equity swap was short but included a dividend payment date, there was a heightened risk that the characterization of the swap might be challenged by the IRS as primarily tax-motivated.

In this regard, the minimum term included in some securities dealer guidelines played a role that was analogous to the role played by Section 901(k) of the Code, which imposes a 15-day minimum term of unhedged ownership on U.S. persons seeking to credit foreign withholding taxes imposed in respect of dividends received on foreign stocks. Section 901(k) was enacted by Congress in response to perceived "trafficking" in foreign tax credits—*i.e.*, taxpayers were acquiring foreign stocks immediately before a dividend payment date and selling them immediately after in order to "capture" the foreign withholding tax credit associated with the relevant dividend.[33] The enactment of Section 901(k) did not suggest that Congress was reversing the so-called "technical taxpayer rule" (*i.e.*, the rule that a taxpayer is entitled to credit the foreign taxes that are actually imposed upon him), a rule that has since been reaffirmed by Treasury on numerous occasions. Rather, it was asserting that it did not want taxpayers acquiring U.S. stocks solely for tax-motivated reasons, and a minimum unhedged term ensured that there would be sufficient economic risk associated with stock ownership to make such strictly tax-motivated acquisitions unpalatable.

Having noted this, however, we think it important to point out that the guidelines set out by securities dealers always allowed customers to terminate a swap at any time for good business reasons. We presume, therefore, that the 90 day minimum term proposed by the President was intended only to reference the

[33] *See* General Explanation of Tax Legislation Enacted in 1997, 1999-3 C.B. 89, 246 ("[S]ome U.S. persons engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that were unable to benefit from such credits (such as a tax-exempt entity or a taxpayer whose use of foreign tax credits was prevented by the limitation) to persons that could use such credits. These transactions sometimes involved a short-term transfer of ownership of dividend-paying shares."); s*ee also Compaq* v. *Commissioner*, 277 F.3d 778 (5th Cir. 2001) (addressing such a transaction that occurred prior to the enactment of Section 901(k)).

legal term initially provided for in the relevant documentation. If the requirement is here intended (as the "offset rule" discussed below suggests) to serve in effect as a "lock-in" requirement, then we wish to observe first that the proposed minimum term is much too long to serve usefully as a measure of tax-avoidance motivation. It is reasonable to suppose that a foreign investor who would otherwise enter into a tax-motivated swap for a term of one day surrounding a dividend payment date might be discouraged from doing so if the minimum term was 15 days. But it does not follow that a foreign investor who would otherwise enter into a tax-motivated swap for a term of 50 days would be discouraged from doing so if the minimum term was 90 days. Foreign investors likely *would* stop entering into equity swaps on account of a minimum term requirement of 90 days, but they would stop doing so for business reasons—*i.e.*, because 90 days is just too long a period of time to commit to a long position in U.S. equities—not for tax reasons. For the reasons set out in the introduction above, moreover, there is no reason to impose *any* minimum term requirement where Treasury and the IRS are already comfortable that the foreign investor does not own the relevant stock as a matter of substance. Thus if, in light of the certification and other requirements included in the proposed regulations, it is clear that foreign investors are not "crossing in", "crossing out" or otherwise converting actual ownership of U.S. equities into temporary derivative positions, then the derivative position does not have any tax avoidance potential, and the term of the derivative position is irrelevant. Significantly, Congress did not include the President's term limit proposal in its list of factors that cause an equity swap to be treated as a "specified notional principal contract". This is presumably because the list already included crossing in and crossing out.

Meanwhile, we note that a "lock-in" minimum term requirement would be an onerous one that would adversely impact the securities dealer business and significantly curtail the volume of equity swaps and other derivatives. Most hedge funds and other foreign investors seeking short-term exposure to U.S. equities through equity swaps and other derivative transactions are interested in relatively short terms as an economic matter, or at least they need the ability to exit their positions quickly if necessary. A 90-day minimum term requirement would prevent these investors from meeting their economic needs by entering into swaps. Assuming quarterly dividend payments, 90 days is nearly as long as an entire dividend period, so any swap that did not last for a term at least equal to the entire period between quarterly dividends would flunk the test. We think this is far greater than necessary and would impose a business cost out of proportion to any potential benefit in terms of limiting the risk of tax avoidance.

Moreover, securities dealers and other withholding agents would be forced to implement retroactive withholding in any case where the swap was actually terminated in less than 90 days. As discussed elsewhere in this paper, it is exceedingly difficult to design systems and collateral arrangements to deal with a broad range of cases where withholding is not required but might in a few cases be required after all.

For the reasons set out above, we recommend eliminating the term limit as unnecessary given the more fundamental requirement that the foreign investor not be selling the underlying stock or buying the underlying stock in connection with entering into the relevant equity swap. Alternatively, we recommend providing that while the initial documentation must provide for a term of at least 90 days, a foreign counterparty may still terminate the contract sooner without incurring withholding tax. If neither of these recommendations is adopted, however, then we think the minimum term should be no more than 15 days, a term which has already been deemed sufficient by Congress to minimize the risk of dividend-related tax avoidance in the cross-border context in the case of Section 901(k).

We in any case do not understand what role the offsetting position rule plays in connection with term limits. More specifically, the proposed regulations currently provide that for purposes of determining whether an NPC is a short-term NPC, the NPC is treated as terminated, in whole or in part, on the date that a long party has entered into an offsetting position with respect to an underlying security in the NPC.[34] Unlike the case of Section 246(c)(4) of the Code and Section 901(k) insofar as it references Section 246(c)(4), however, the concern here is not that an investor's position may lack economic substance because the investor has *offset* the relevant economics. To the contrary, the concern is that the investor's position may lack economic substance because it *continues* already-existing ownership of the relevant U.S. equities. Similarly, the concern here is that a foreign investor that terminates a long position in a swap over U.S. equities will *continue* to be exposed to those equities as an economic matter by purchasing the underlying equities from the swap counterparty (*i.e.*, by "crossing out") at the same time as it terminates the swap.

A foreign investor might indeed enter into a long position in an equity swap and then, shortly thereafter, offset that long position with a short position in the same underlying equities, rather than terminate the first position itself. This is after all the principal means by which contracts are terminated on futures markets—so-

34 Proposed Treasury Regulations Section 1.871-16(c)(4)(ii).

called termination by offset. But this behavior would be consistent with a desire to terminate the swap for business reasons, not a confirmation of tax avoidance motivation. If a foreign investor was planning to sell his U.S. stock anyway, he could have done so immediately before the dividend payment date. He garners no relative tax advantage by crossing into an equity swap, receiving the dividend derivatively, and then offsetting the position to eliminate the economic exposure.

Put differently, the only concern to which a minimum term requirement could coherently speak to is that a strictly tax-motivated foreign investor might not be prepared to cross in and stay on swap for a term of more than 90 days before crossing out. Thus, foreign investors that prefer to hold the physical equity over holding a swap for business reasons would likely *quickly* enter and exit the swap for withholding purposes so that they could get back to their preferred form of investment as soon as possible. Assuming, however, that a strictly tax-motivated foreign investor *is* prepared to cross in and stay on swap for a term of more than 90 days, what is accomplished by a rule that demands that the foreign investor not hedge out of the economic position in the stock that it is continuing to own as a matter of substance? If anything, the foreign investor's decision to hedge in less than 90 days serves to establish that the foreign investor's position was *not* tax-motivated.

Meanwhile, this offset rule is needlessly onerous. Foreign hedge funds and other large foreign investors are continually putting on and taking off positions in equities, commodities and various derivatives. They are not in a position to periodically restrict their entire trading organizations (consisting of scores, and even hundreds, of traders) from taking positions in particular U.S. stocks for 90 day periods (as opposed to just on the day the swap is entered into) merely to satisfy an offset rule. Nor, as noted above, would satisfaction of such a rule serve to accomplish any coherent objective in terms of mitigating the risk of tax avoidance.

For the reasons set out above, we recommend that any offset or other hedging-related rule be eliminated. If this recommendation is not adopted, however, we recommend that the meaning of offsetting position be clarified to cross-reference Section 246(c)(4) of the Code and Treasury Regulations Section 1.246-5(b)(2). More specifically, as currently drafted, the term of a notional principal contract (for purposes of determining whether the notional principal contract has a term of fewer than 90 days) is reduced by any period during which the long party has entered into an "offsetting position".[35] While the proposed regulations define a "position" by reference to Treasury Regulations Section 1.246-5(b)(3), they do not define what it means to "offset" an existing position.[36] We have considered two provisions that govern situations in which a taxpayer has offsetting positions. Section 1092 of the Code defines "offsetting positions" for purposes of the straddle rules as existing if there is a "substantial diminution" of the taxpayer's risk of loss from holding one position by reason of his holding the other position. By contrast, Section 246(c)(4) of the Code treats the holding period of stock as reduced for purposes of the dividends received deduction only where the taxpayer holds "substantially similar or related property", and Treasury Regulations Section 1.246-5(b)(2) treats a taxpayer as having diminished its risk of loss for this purpose if the position in substantially similar or related property is expected to vary inversely with the stock.

While neither standard offers certainty as to what constitutes an offsetting position, we believe adoption of the standard in Treasury Regulations Section 1.246-5(b)(2) would be appropriate for two reasons. First, the Section 246 standard specifically applies in the context of determining the taxpayer's holding period in a position in dividend-paying stocks and corresponds to the proposed regulation's existing cross-reference to the definition of a "position", which is highly analogous to the issue of determining the term of an instrument that may give rise to dividend equivalent payments. Second, existing regulations under Section 246 provide examples that provide meaningful guidance as to when a position offsets another. By contrast, significantly less guidance exists under Section 1092 with respect to diminution of a taxpayer's risk and, to the extent regulatory guidance has ever been enacted, generally cross-references to the rules under Section 246.[37] As such, we propose that, if an offset rule is retained, it be clarified to directly import the "diminished risk of loss" standard of Treasury Regulations Section 1.246-5(b)(2).

6. <u>"Significant Portion of Trading Volume" Standard</u>.

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35 *Id.*

36 We note that at least one commentator believes that the cross-reference was intended to reference the definition of a diminution of risk of loss under Treasury Regulations Section 1.246-5(b)(2). *See* Mark Leeds, *New Tax Regulations Change the Rules for Dividend Equivalents*, 2012 TNT 24-13, n.49 (February 6, 2012). We recommend that such a reference be added to the proposed regulations in the following discussion.

37 *See* Treasury Regulations Section 1.1092(d)-2.

Under Proposed Regulations Section 1.871-16(c)(6), a notional principal contract is a specified notional principal contract (and thus dividend equivalents in respect of such notional principal contract are subject to withholding under Proposed Regulations Section 1.871-15(a)) if its notional principal amount exceeds either of (i) 5% of the public float of the class of the underlying security or (ii) 20% of the 30-day average daily trading volume of the underlying, subject to an aggregation rule for all notional principal contracts with the same long party that reference the same underlying. This aggregation rule would not appear to be limited to positions that are entered into on the same day as the equity swap in question. In other words, a notional principal contract can become a specified notional principal contract because, for example, the foreign investor (or a related party) entered into a notional principal contract in respect of the same equities the week or the month before.

The notion of a maximum notional amount in relation to public float first appeared in the President's proposal with respect to dividend equivalent payments on equity swaps in the 2010 Treasury Green Book, which exempted swaps that met certain requirements, including swaps having a notional amount of less than 20% of the average daily trading volume of the underlying. Like the minimum term requirement, it was drawn from the drafters' understandings of what some securities dealers were already incorporating into guidelines for their trading desks. Like the minimum term requirement, the thought here was that if the notional amount of a swap substantially exceeded the average trading volume of the relevant securities, then it was reasonable to suppose that the trading desk was in effect acquiring some of its hedge from the relevant foreign investor—*i.e.*, that there was likely an indirect cross in, whether or not the trading desk was aware of it.[38]

We note first that, in light of this objective, there is no reason to aggregate swaps or equity contracts entered into on days preceding the day in question. The purpose of the rule is presumably not to prevent foreign investors from taking too large a position in the underlying publicly-traded equities. Rather, it is to prevent

[38] The Joint Committee on Taxation's explanation of this proposal suggested that this criterion, taken together with the other specified NPC criteria, reflected ownership of the underlying security pursuant to an agency relationship with the short party. *See* Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal – Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment, JCS-4-09 at 140 (September 2009).

foreign investors from converting outright ownership into a derivative position by crossing in on a relatively risk-free basis.

We note second that while a volume limit equal to the average daily trading volume might be justified on this basis, a volume limit of only 20% of the average daily trading volume is in our view too low to strike a reasonable balance. First, we understand that the components of the Dow Jones Industrial Average, the S&P 500, and the Russell 2000 trade on average less than 1% of their float on a trading day. Therefore, on average, a notional principal contract would become a specified notional principal contract simply by referencing an amount in excess of 0.2% of the float of a publicly traded security in one of these three major indices. However, the notional amount of a significant portion of the equity swaps that are routinely entered into exceeds this amount and swap counterparties routinely hedge their positions in the swaps by acquiring the relevant equities on the open trading market. Moreover, as discussed further below, the notional amounts underlying options and other non-delta-one equity-derivative instruments are often significantly larger. The hedging counterparty's correspondingly large acquisition of underlying equities may affect the trading price of the underlying equities on that day, but given the certifications that will be made by foreign investors in connection with entering into these swaps, there is no reason to think that this size position will imply a crossing in. If the proposed regulations were adopted as currently drafted, these equity derivatives could not be entered into by foreign persons without the imposition of U.S. withholding tax.

In light of the fact that foreign investors will already be required to represent that they are not buying or selling the underlying equities in connection with entering into the equity swap, we think the 20 percent of adjusted daily trading volume rule should be eliminated. Like the minimum term rule, its only rationale is to minimize the risk that there will be crossing in and out.

If the volume limit is retained, however, we think the limit should simply be the average daily trading volume of the relevant shares, rather than some percentage of it.

Moreover, long term options and similar instruments are often over larger equity positions. As discussed above, these positions do not present tax avoidance potential because they do not resemble ownership of the underlying as an economic matter. Moreover, the amount of shares that a dealer must acquire to hedge the option is but a fraction of the notional amount of the options, because the change in the value of the option is but a fraction in the change of the value of the underlying. A high volume option is therefore less likely to raise concerns about potential "crossing in". In any case, the volume limitations introduced by some securities dealers in guidelines were applied solely to equity swaps and were never intended to extend to options and other equity derivative financial instruments. Nor has Congress ever envisioned a limit on the size of a position that can be taken through an equity derivative transaction. If the volume limit is retained, therefore, we think you should apply it solely to equity swaps.

Also, regardless of what percentage the limit turns out to be, the proposed regulations should clarify that the limit applies only on the day the swap is entered into. Some practitioners have expressed the concern that because the proposed regulations do not speak directly to the point, the limit might have to be met continuously over the life of the relevant swap. This would be inconsistent, however, with the tax law in general, where the characterization of a financial instrument (*e.g.*, as equity or debt) is determined on the date of issuance and does not change over time owing to changes in the marketplace or in the financial condition of an issuer or counterparty. Moreover, for the reasons set out above, a "continuous" volume limitation would bear no relation to the purpose of the limitation, which could only be to further ensure that a foreign investor was not indirectly "crossing in."

7. <u>Extension of Notice 2010-46 to Dividend Equivalent Payments</u>.

Section 871(m)(6) of the Code grants the Secretary authority to reduce or eliminate withholding tax to avoid duplication of tax on dividend equivalents paid through chains of financial intermediaries and to otherwise address the roles of financial intermediaries in the payment of outbound dividends. As drafted, the section applies both to actual dividends and all dividend equivalent payments.

To date, Treasury and the IRS have issued Notice 2010-46, which sets out a proposed regulatory framework (that can be immediately relied upon on an interim basis) for dealing with chains of payments on stock loans, but which does not yet extend to actual dividends or dividend equivalent payments on equity swaps and other equity derivatives. The proposed regulatory framework relies primarily on the concept of a foreign broker dealer or other financial intermediary becoming a "qualified securities lender" that (a) actively withholds and reports on substitute dividends paid to foreign lenders of U.S. stocks, and is subject to audit by the IRS, and (b) can therefore receive substitute dividend payments from other payors free of withholding tax. Such a qualified securities lender would play a role similar to the one currently played by a "qualified intermediary" in respect of outbound withholding tax on actual U.S. source dividends, assuming that such qualified intermediary takes on primary withholding responsibility.

In our comments to you dated December 24, 2010, we urged you to merge the concepts of a "qualified intermediary" and a "qualified securities lender" and to also extend the proposed regulatory regime to dividend equivalent payments on equity swaps. We would now further recommend that a "qualified securities lender" be renamed a "qualified financial intermediary" (a "QFI"), that such a QFI be required to properly report and withhold on any dividend equivalent payments it makes, and that such a QFI likewise be entitled to receive all dividend or dividend equivalent payments free of withholding. Pooling and other concepts that are discussed in the Notice, and that we discussed in our prior submission, would apply equally to all dividend equivalent payments received and paid by a QFI.[39]

The extension of certification and withholding procedures to equity swaps and other equity derivatives, as discussed in Sections 2 and 3 above, will increase the urgency of the need for extending Notice 2010-46 (or some other form of relief from cascading withholding) to all forms of dividend equivalent payments, including particularly dividend equivalent payments made on equity swaps. The current draft of the proposed regulations contains a limited rule dealing with related parties, but it is not broad enough to encompass most of these transactions.

For example, as noted in our prior submission, a foreign financial intermediary that borrows shares of U.S. stock may hold onto the stock, thereafter receiving actual dividends from a U.S. paying agent and paying substitute dividends to its customer. Alternatively, it may sell the stock short to a related or unrelated party and enter into the long position in an equity swap with the buyer or another party. Thereafter, it may receive dividend equivalent payments on an equity swap from a U.S. swap counterparty and pass them on as substitute dividend payments to its customer. These and other transfers of securities among related and unrelated securities dealers in the ordinary course of business have nothing to do with tax avoidance but rather are motivated or required by business and regulatory constraints, including the new constraints imposed by Dodd-Frank. They occur in sufficient volume, moreover, that it would be impracticable to require foreign securities dealers to present certifications to each other in respect of all their transactions in the inter-dealer market and, as noted above and in the next paragraph, as a practical matter such foreign dealers would be unable to provide

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39 Likewise, as discussed in our prior submission, one QSL should take on the obligations of numerous affiliates.

certification because they generally will be in the market or otherwise have offsetting positions. Likewise, U.S. paying agents should not be required to withhold on dividends and dividend equivalents paid to foreign broker dealers on positions that serve for those foreign broker dealers as hedges of positions with their own customers and that are in effect being passed on to those customers through equity swaps or other derivative transactions.

As another example, because foreign securities dealers routinely serve as intermediaries in the inter-dealer swap market, they routinely enter into long positions in equity swaps with local customers or other dealers and hedge out by entering into offsetting short positions in equity swaps with other dealers or customers, or by shorting the relevant underlying stock. The local customers of these securities dealers will not be in a position to request and receive certifications that allow them to conclude that they need not withhold on their payments to their local foreign securities dealers. Rather, the foreign securities dealers should be able to obtain qualified status if they meet the relevant requirements.

Analogous changes should be made to the back-up "credit forward system" methodology for chains of payments made through foreign financial intermediaries. For example, suppose as noted above that a foreign customer lends U.S. stock to a foreign financial intermediary that is not qualified, and the foreign intermediary holds on to the stock. Or suppose the foreign intermediary later sells the stock to a U.S. person and enters into a long position in an equity swap over that stock with that U.S. person or with another U.S. person. If the foreign financial intermediary is properly withholding on the substitute dividends it pays to its foreign customer, it should not be subject to a second outbound U.S. withholding tax on what is essentially the same dividend or dividend equivalent payment received from a U.S. payor. Withholding on equity swap payments made by a foreign financial intermediary should be credited against withholding tax on actual dividends or dividend equivalent payments it receives and where appropriate serve to establish that the latter are free from additional withholding.

In summary, assuming that foreign securities dealers meet the requirements set out in Notice 2010-46 for being a qualified intermediary and are, in the spirit of that Notice, fully meeting all of their obligations to withhold on payments made to their customers and counterparties, (a) they should (within the spirit and intent of that Notice) be generally exempted from U.S. withholding tax to the extent that they are passing on dividend or dividend equivalent income, rather than earning it for their own accounts, (b) their payors and counterparties should likewise be exempted from any requirements to withhold on them, on the assumption that they are already meeting their withholding and tax obligations, and (c) a backup credit-forward system should be available to such intermediaries to the extent set out in Notice 2010-46 as applied to all dividend and dividend-equivalent payments.

8. Effective Dates.

The proposed regulations would institute both an exceedingly novel approach to withholding and exceedingly novel circumstances for withholding. Thus, under the proposed regulations as currently drafted, securities dealers and other withholding agents would for the first time be required to withhold on payments not on the basis of who the payments were made to, but rather on the basis of when the underlying contract was entered into, or when it was terminated, or what the counterparty did in respect of other transactions, or what was the specific nature of the relevant contract and what it provided for, or what was the nature of the underlying U.S. equities and whether and how they were traded. At present, securities dealers and other withholding agents have no systems capable of focusing on these questions in respect of large volumes of derivative transactions with numerous counterparties, nor do they even have a potential approach for developing such systems.

Moreover, under the proposed regulations, securities dealers and other withholding agents would for the first time be obligated to withhold in the absence of any payments made to foreign investors and to develop collateralization and other arrangements to support such withholding. In a normal interest rate environment, for example, the amount of the notional interest payments received by a U.S. securities dealer from a foreign equity swap counterparty will generally exceed the amount of the notional dividend payments received from the swap counterparty, so that the U.S. securities dealer does not make any payments from which it might withhold, nor will it ever make any payments unless the value of the underlying equities increases over the life of the swap. By contrast, Congress has heretofore required withholding only out of payments actually made, even in respect of currently accruing original issue discount.

We note in this regard that securities dealers and other withholding agents will need a substantial amount of technical guidance to implement the new procedures. For example, as noted above, in a normal interest rate environment a U.S. securities dealer will be withholding tax in respect of net payments it *receives* from a foreign counterparty, because interest payments it receives will generally be greater than embedded dividend payments it makes. Clarification is needed as to whether this withholding should be remitted to the IRS periodically at the time the dividend on the underlying reference security is paid, or aggregated and paid out of any ultimate payment that the securities dealer makes *to* the foreign counterparty (upon termination of the swap or otherwise). Assuming that the answer is the former, there is likewise a need for clarification as to whether the payment should be treated as a partial termination of the relevant equity swap, with the proceeds of termination remitted to the IRS to meet the foreign counterparty's withholding tax obligations, and assuming the answer is yes, how the remaining cash flows under the swap should be recomputed to determine the amount of withholding obligations arising in respect of subsequent withholding determination dates. There is likewise a need for clarification with respect to what *are* the proper determination dates for imposing withholding tax in respect of, for example, so called "bullet swaps" that provide for payments only at maturity and any other derivative contracts that do not simply provide for dividend equivalent payments at the time of payment of the underlying dividends. And there is a need for clarification with respect to what would become of withholding obligations deferred until the date of actual payments if there was an intervening sale of the relevant equity derivative position to a U.S. person or to a certifying foreign person. Resolution of some of these questions is awaiting further guidance under Section 446 of the Code dealing with contingent notional principal contracts. Others will require independent guidance under Section 1441 of the Code.

Only after guidance with respect to these questions has been received can securities dealers and other withholding agents begin to develop systems, and implement new collateralization arrangements, that will allow them to properly and timely collect these new withholding taxes from foreign counterparties. In this regard, we think it important for you to consider the scale of the systems build out that will then have to be undertaken to implement the proposed Section 871(m) regulations. The proposed regulations will require significant modification of (i) trade capture systems, (ii) common data depositories and (iii) tax information and reporting systems. Trade capture systems are used to input necessary transaction data, such as trade terms, including price, maturity, payment dates and the specifics of payment formulas that determine payment amounts. Some data is manually inputted and, where possible, other data is sourced electronically from a database or data provider. The proposed Section 871(m) regulations require that trade capture systems be created for a variety of new inputs and data fields on account of the new doctrines that are introduced by the proposed regulations, including term of the derivative, active trading of the underlying, announcements of prior dividends and entrance into offsetting positions. While most trade capture systems are expandable and have an open architecture to accommodate new products and new data fields, many financial institutions tailor trade capture systems by product type (*e.g.*, a system for swaps, a system for debt issuances, a system for structured notes) and, thus, each system requires separate review and updating. Of note, the proposed regulations will require the development of new kinds of data fields to be added to trade capture systems. For example, in respect of the requirement that each dividend announcement date be memorialized, it is not clear what is the best method for observing and recording the dividend announcement date on an on-going basis. Also, since the proposed regulations apply to all payments after the effective date, it is not clear how best to capture relevant trade information for existing transactions.

Once all relevant trade data has been captured, most financial institutions endeavor to store this information in a central database. Local storage of data is disfavored because it results in more system maintenance overall and a central database promotes data integrity and validity (*i.e.*, so that everyone uses the same source data in processing). As with any large computer system, central databases undergo scheduled upgrades, and several modifications are often bundled together for scheduled rollout after system testing has been completed. As a result, the system upgrades that are needed for the proposed Section 871(m) regulations must be scheduled and coordinated with other changes now in process, including cost basis reporting and FATCA implementation. Often, many of the same personnel are involved in several system upgrades and effective project management requires that upgrades be implemented in stages. Thus, making Section 871(m) implementation a number one priority in the remaining months of 2012 would adversely affect the timing and roll out of other projects currently mandated. To implement Section 871(m) information reporting and withholding, the internal "pipes and plumbing" that lead from the trade capture system to the central database will need to be revisited and, sometimes, rebuilt; and resources, funding and time will be required to accomplish these tasks in coordination with all other upgrades.[40]

Lastly, once the proposed regulations are final, the logic of the rules will need to be written into code, and data feeds will need to be established to bridge the sharing of information from the source database to tax information reporting

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[40] In a recent letter, we discussed some of the difficulties inherent in implementing and updating systems to accommodate new tax compliance requirements in a short period of time. *See* Letter from Mr. Payson Peabody, Managing Director and Tax Counsel, SIFMA, to Ms. Pamela Lew, Office of Associate Chief Counsel (Financial Institutions and Products), dated February 14, 2012, regarding the implementation of basis reporting rules on debt instruments and options, at 3-4.

and withholding systems. For products such as options and structured notes, where U.S. dividend equivalent payments may not be readily apparent from the payment terms of the underlying instrument as reflected in the books and records, code will be needed to create synthetic cash flows. Without very substantial wastage of resources and duplicative work, it will not be possible to commit resources and funding to an upgrade project until the substantive tax rules are final. Also, it is important to note that once systems are built and tested, middle and back office employees will have to be trained to properly employ the new systems.

Currently, for over-the-counter swap transactions, most financial institutions employ "manual withholding" to effect withholding and information reporting under Section 871(m) as in effect through January 1, 2013.   For this purpose, "manual withholding" means that there are significant breaks in the flow of information from trade capture systems to data depositories to tax information reporting and withholding systems. These "breaks" require manual (or human) intervention and, for example, the use of Excel spreadsheets to port data from one system to another or to collect factual data locally. While manual withholding can be implemented for a relatively small number of over-the-counter swaps, it is not a scalable system and it is exceptionally burdensome on in-house personnel (front, middle and back office functions).

The members of SIFMA are hopeful that Treasury will take into account the amount of systems work that must be done and the time required to complete this work to create a robust, reliable and scalable tax information and reporting system as contemplated by the proposed Section 871(m) regulations for the wide variety of products proposed to be subject to the Section 871(m) regulations. The members are also hopeful that Treasury understands that manual withholding is not a long term substitute for scalable, automated systems and that manual withholding is often only practicable where the withholding agent has a direct relationship with the beneficial owner of the income (as is the case in an over-the-counter swap). Manual withholding is often not an option for brokers, custodians and clearinghouses (*e.g.*, for listed products and structured notes) because the relevant tax information is simply not available to these withholding agents.

In light of the above, we think the effective date of these regulations needs at the very least to be extended to January 1, 2014, which would be in coordination with the implementation of withholding on outbound payments under the FATCA regulations. We note, however, that with regard to implementation of the more complex proposals for withholding on so-called "foreign pass-through payments" under the FATCA regulations, the currently proposed effective date is January 1,

2017. Given the presumed complexity of the new withholding regime for embedded payments under Section 871(m), we think the effective date should be the later of January 1, 2014 (or the ultimate actual effective date of withholding under the FATCA regulations) and a date that is 18 to 24 months after finalization of the regulations under Section 871(m) and associated regulations under Section 1441 providing guidance with respect to the questions noted above.

9. Grandfathering.

While securities dealers and other withholding agents may ultimately be able to develop the systems required to implement withholding on equity swaps and other derivatives issued after the effective date, they will never be in a position to implement withholding on swaps that have already been entered into and financial instruments (such as indexed notes) that have already been issued in the public and private markets. For one thing, it will be impossible for securities dealers to obtain certifications or information with respect to events—such as sales of underlying equities, or entrance into offsetting positions—that may or may not have taken place in the past and might therefore theoretically taint the status of an equity derivative transaction. For another, securities dealers have already entered into the relevant transactions, or issued the relevant financial instruments, under documentation that would require them to gross the foreign counterparty or holder up for any U.S. withholding imposed upon the relevant payments. Securities dealers may therefore in some cases bear the financial brunt of imposition of U.S. withholding tax under broad rules that could not reasonably have been foreseen. Indeed, it is still not possible for securities dealers and other withholding agents to envision the ultimate framework of these regulations, as many of the relevant issues are still in flux.

In light of the above, we think the proposed regulations should apply only to transactions entered into at least 90 days after the date on which the proposed regulations are finalized, reducing the possibility of the problems discussed above with respect to existing transactions, and allowing additional time for dealers and other withholding agents to implement systems to properly apply the finalized rules.

10. Technical Clarification of the Definition of "Payment".

The preamble to the proposed regulations states that the expanded specified notional principal contract definition is "applicable to payments made on or after

January 1, 2013". Similarly, the temporary regulations provide that the existing definition of specified NPC applies to payments made before January 1, 2013.[41]

Some uncertainty has arisen in respect of swaps and other equity-linked instruments that provide for payments after the effective date in respect of underlying dividends paid prior to the effective date. More specifically, it is somewhat unclear whether the term "payment" in the regulations refers to a payment made pursuant to the relevant equity swap or to the payment of a dividend on the underlying security. We believe the latter was clearly intended, as otherwise two substantially similar instruments could be subject to entirely different regimes under Section 871(m) simply by providing for a final payment on different dates. Moreover, the proposed regulations would otherwise be effective immediately for certain kinds of equity derivatives, such as previously issued bullet swaps, and we presume that this was not intended. Nevertheless, the existing wording is unclear. We therefore request that the proposed regulations be clarified to confirm that they do not apply to payments made after the effective date in respect of underlying dividends paid prior to the effective date.

11. Conclusion.

SIFMA appreciates the opportunity to comment on the proposed regulations, and we hope our comments have been helpful. Given our unique position not only as counterparties to equity swaps and other equity derivatives, but also as the agents primarily vested with the obligation to implement any regime for withholding on financial income derived by foreign persons, we think we are uniquely qualified to offer both meaningful insights and practical advice in connection with the proposed regulations. Please let us know if we can further assist in your efforts in any way.

41 Temporary Treasury Regulations Section 1.871-16T(b).