sifma®

Invested in America

December 8, 2017

David Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dana Trier
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Gentlemen:

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to submit comments on the regulatory project to reduce burdens under section 871(m) of the Internal Revenue Code that is identified on the Department of Treasury's 2017-2018 Priority Guidance Plan, released October 20, 2017. As we discussed in our October 10th meeting, we believe the final section 871(m) regulations impose significant administrative and operational challenges and that the policy objectives underlying Section 871(m) can be achieved through a simpler regime.

Consistent with our discussion, Section I of this letter focuses primarily on issues that SIFMA members face in implementing the regulations as they are in force today. We are currently working under the delta-one framework established by Internal Revenue Service ("IRS") Notices 2016-76 and 2017-42, which provide that "good faith" efforts by taxpayers to implement that framework will be respected as well as other simplifying measures, particularly with respect to the combination rule and Qualified Derivatives Dealers ("QDDs").[2] Section II discusses the most important issues that need clarification in order for the delta-one standard to be administered by SIFMA members after 2018 without the benefit of the "good faith" standard. Finally,

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org..

[2] Notice 2016-76, 2016-51 IRB 834; Notice 2017-42, 2017-34 IRB 212. Notice 2017-42 provides the IRS will take into account the extent to which a withholding agent makes a good faith effort to comply with the Regulations with respect to any delta-one transaction in 2017 and 2018, and any non-delta-one section 871(m) transaction in 2019. The notice provides that a withholding agent is required to combine transactions entered into in 2017 only when the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other, extends withholding relief for QDDs acting in their capacity as equity derivatives dealers through 2018 and delayed the requirement for QDDs to compute their net delta exposures until 2019. Finally, the notice provides the IRS will take into account the extent to which a QDD makes a good faith effort to comply with the Regulations during 2018.

Section III addresses other important issues with respect to section 871(m) that require additional guidance.

SIFMA continues to believe that the delta 0.8 standard presents overwhelming administrative challenges and would urge the government to provide clear assurance in the form of a notice that this standard is being reconsidered and that additional time will be given for withholding agents to comply with any forthcoming guidance. If the delta 0.8 standard is retained, a host of additional issues will need to be addressed in guidance for there to be any chance of practicable implementation. SIFMA members would need significant lead time from the finalization of the rules to build and place into operation the necessary new withholding and recordkeeping systems. Even if broker-dealers had answers today to all of the interpretive questions raised by the delta 0.8 standard, the looming January 1, 2019 effective date may not afford sufficient lead time.

I. Current Delta-One Issues under a Good Faith Standard

a. Master Limited Partnerships – Resolve Over-Breadth of Current Rule and Lack of Transparency of Necessary Information

As discussed in a letter SIFMA submitted in March 2016 (the "March 2016 SIFMA Letter"), and even under the delta-one/good faith standard in effect today, there are many issues with applying the Regulations to partnerships. These issues are particularly stark in respect of the class of publicly traded partnerships focusing on the natural resources sector commonly referred to as master limited partnerships ("MLPs"), which do not in general have substantial exposure to U.S. equities.[3] As such, SIFMA requests that an outright exclusion from withholding be granted for MLPs.[4]

The requested exclusion is a practical solution. SIFMA members have estimated that the anticipated section 871(m) withholding tax revenue for MLPs is minimal in comparison to the costs of implementing a withholding system: estimates for a benchmark MLP index provide for dividend equivalent payments that are a

[3] Letter from Payson Peabody, Managing Director and Tax Counsel, SIFMA, to Hon. Mark Mazur, Assistant Secretary for Tax Policy, Department of the Treasury et al (Mar. 31, 2016). (https://www.sifma.org/resources/submissions/sifma-submits-comments-to-the-treasury-and-irs-on-section-871m-regulations).

[4] SIFMA members believe it would be inconceivable that an investor would attempt to avoid section 871(m) by entering into a derivative over *any* partnership interest – and in particular a publicly traded partnership interest - because the economic exposure provided by such a derivative would be dramatically different from a direct investment and the costs of investing through a partnership derivative would far outweigh any withholding benefit of the transaction. As noted in the March 2016 SIFMA Letter, while we understand the government may have a concern that the holder of a long position in a partnership derivative could be subject to more advantageous tax consequences than if it had directly invested in the partnership, we believe that it is inappropriate to effectively achieve this policy objective by causing partnerships that have a relatively small percentage of their assets invested in US equities to be subject to Section 871(m). These are matters that should be addressed in future guidance.

fraction of the overall distribution yield, around 15-20 basis points compared to a yield of 5-10%. Publicly available information necessary to facilitate section 871(m) withholding and reporting does not exist in the MLP market today. In general, withholding agents lack visibility into the precise holdings of covered partnerships of which they are not partners, and even where a withholding agent is entitled to receive a covered partnership's tax returns and financial statements, it does not receive this information until it is too late to allow for timely withholding and reporting.[5]

If the government is not prepared to exempt MLPs, we would request that the government at a minimum issue a notice specifying that withholding agents that are not timely provided with publicly available information necessary to perform withholding (i) be allowed, but not required, to rely on estimates of dividend equivalents based on dividends paid to the MLPs (and reported by the MLPs to their partners) in the preceding year in calculating withholding and reporting of dividend equivalents (unless they have reason to know this amount is not indicative of current year dividends) and (ii) have until September 15th following the year in which the relevant payment is made to perform withholding and reporting and be permitted to reimburse clients for over-withholding up until that date without risk of interest or penalties being imposed in respect of withholding payments made by the same date.

b. Structured Notes – Resolve Withholding Issues

Under the delta-one/good faith standard in effect today, SIFMA members have identified several issues with equity-linked instruments (for purposes of this letter, "Structured Notes"). For the reasons discussed below, we request a notice that addresses three of these issues immediately or as soon as possible. With respect to Structured Notes that are cleared outside the United States, our members would like immediate guidance to help avoid (i) multiple levels of withholding on the same dividend equivalent and (ii) withholding on dividend equivalents of notes held in inventory; in addition (iii) we believe there is a general need for coordination of withholding imposed under section 871(a)(1)(A) and section 871(m).[6]

---

[5] The March 2016 SIFMA Letter includes a detailed discussion of the Regulations concerning derivatives over partnerships. The regulations define a "covered partnership" as any partnership if more than 25% or more than $25 million of its assets consist of underlying U.S. equity securities. We believe this definition has the unintended result of causing most MLPs to be covered partnerships even though their corporate dividend income is a small proportion of total income. MLPs generally do not make significant investments in third party corporate stock, but they commonly have wholly-owned subsidiaries that are U.S. "blocker" corporations that generally do not, if at all, pay significant amounts of dividends to the MLP shareholder. While it is difficult to know the exact holdings of MLPs, our members understand that blocker corporations are typically worth a small fraction of the total assets of the MLP, though given the size of MLPs it is not uncommon for the value of a blocker corporation to exceed $25 million. As such, SIFMA requested in the March 2016 letter that Treasury and the IRS eliminate the $25 million prong of the "covered partnership" definition for MLPs. While such an amendment would not solve the more pressing issue of obtaining useable information from MLPs, it would substantially reduce the scope of the problem.

[6] There are other issues with respect to Structured Notes that are included in sections II and III of this letter.

As is discussed in depth in the March 2016 SIFMA Letter, Structured Notes typically clear and settle through a centralized securities depository (a "CSD") and most of the Structured Notes issued outside the United States settle through Euroclear or Clearstream. Due to operational constraints that prevent them from withholding under section 871(m), Euroclear and Clearstream, two major international CSDs, published a "common approach" outlining requirements that issuers of Structured Notes subject to section 871(m) must meet before these CSDs will clear such notes.[7] The common approach requires that issuers withhold 30% of any dividend equivalent payment at source regardless of the jurisdiction of the beneficial owner of the Structured Note (the "Issuer Solution"). Euroclear and Clearstream will not agree to clear any Structured Notes subject to section 871(m) unless the Issuer Solution is complied with, which leaves issuers with no choice but to comply if they are to continue issuing such notes.[8]

The first issue that arises is whether downstream withholding agents are relieved of their withholding obligations under the Issuer Solution. If the issuer has withheld, then from a policy perspective there is no need for downstream withholding agents to withhold a second time. However, it is unclear what evidence of previous withholding the downstream withholding agents must obtain to relieve them of withholding responsibility. Also, if evidence is required, it is unclear what evidence of previous withholding issuers would be able and willing to pass downstream. Forms 1042-S are not generally due until after the downstream agent is required to withhold, so downstream withholding agents cannot expect issuers to provide Forms 1042-S in time. SIFMA therefore requests a notice stating that, if an issuer of Structured Notes withholds on all dividend equivalents at the maximum rate (or at the applicable rate, in the event the issuer has confirmation of the holders' tax rates), and the issuer indicates in any relevant offering document or other public statement that withholding will occur, and that appropriate evidence will be provided upon request, then no additional withholding will be required by any downstream agent.[9]

The second issue that requires immediate guidance is the treatment of dividend equivalents on structured notes held in inventory by an issuer or an affiliate of the issuer. Issuers often hold notes in inventory to be able to sell such notes to customers in the future. Under current rules, dividend equivalent payments made with respect to such notes may be subject to withholding if the issuer or affiliate is a non-US person and not a QDD. However, downstream withholding agents are insisting that the withholding under the Issuer Solution must be applied on 100% of any issuance,

---

[7] *See* http://www.clearstream.com/blob/85916/28224f4b3bf140d8005d0887189df30d/a16192-871m-data.pdf. We understand that the CSDs have a range of concerns, including cashless withholding and tracking secondary market purchases, among others.

[8] The CSD approach also permits issuers to pay actual cash dividends on structured notes in lieu of the Issuer Solution, but our members' experience is that this alternative approach has not been taken up by issuers because of complexity. For example, (i) where the underlyer is an index there are almost daily dividends, and (ii) in some cases holders do not desire interim payments on their notes.

[9] Alternatively, the government could provide guidance stating that downstream withholding agents are permitted to rely on other government-approved documentation evidencing withholding by another withholding agent as sufficient proof to provide credit for prior withholding.

including on inventory, irrespective of whether the notes are held by a U.S. or non-U.S. person. We request a notice that provides that no withholding is required for any dividend equivalent payment with respect to positions clearly identified as inventory in an issuer's or affiliate's books and records as inventory.

The third issue arises with respect to Structured Notes that are subject to withholding under both sections 871(a)(1)(A) and 871(m). For example, a common type of Structured Note is a non-principal protected, coupon bearing instrument. As discussed in the March 2016 SIFMA Letter, issuers of coupon-bearing structured notes that are not treated as debt for tax purposes may treat the coupons on such notes as FDAP income that is subject to withholding tax. If such a note is also subject to Section 871(m) withholding, it is not clear whether and how the other FDAP withholding and Section 871(m) withholding regimes interrelate to prevent two levels of withholding on the same income. We understand from prior statements made by government officials that duplicative withholding was not the government's intent. We therefore request a notice confirming the government's agreement and intent that such duplicative withholding should not occur, and ask that the government allow the industry to use any reasonable method until the government can give guidance on the necessary coordination rules to eliminate duplicative withholding. We would welcome the opportunity to work with the government on some of the key technical and operational issues of any specific coordination rules.

c. Structured Notes – Administrative Issues

To the extent withholding on a Structured Note is required by an issuer or a withholding agent, we request that the quarterly deposit rule provided in Notice 2016-76 should be made permanent prior to January 1, 2018 in order to reduce administrative complexity.

II. Delta-One Issues in the Absence of a Good Faith Standard

We have also considered the issues SIFMA members would face if the current delta-one rules applied after 2018 without the benefit of a good faith standard, as well as other simplifying measures, particularly with respect to the combination rule and QDDs. There are two primary areas in which guidance from the government is critical if such a regime is to be implemented: the QDD regime and the combination rule. As you have requested specific recommendations only on issues faced under the current delta-one/good faith standard, we have not devoted significant space in this letter to this potential future scenario, but we will be happy to provide a more detailed discussion at your convenience.

a. Qualified Derivative Dealer Regime – Eliminate Tax on Ordinary Course of QDD's Business / Related Issues

In SIFMA's June 28, 2017 letter (the "June 2017 SIFMA Letter") SIFMA described in detail many problems with the QDD regime.[10] We appreciate the relief provided to QDDs for compliance during 2017 and 2018 and we believe these rules would be appropriate as permanent guidance.

First, SIFMA believes the temporary rule that allows QDDs to receive dividend equivalents that are part of their dealer business free of withholding tax and free of a tax on their net delta exposure to the relevant U.S. equity should be made permanent. Under current regulations, QDDs must be regulated banks, broker dealers or bank subsidiaries and must be acting in their dealer capacity in order not to be withheld upon. Dealers should not be subject to tax under section 871(m) for commonplace dealer activity undertaken in their ordinary business.[11] The calculation of net delta is a needless complexity that should be eliminated from the rules. However, if the net delta concept is retained, SIFMA requests that the requirement to complete a reconciliation schedule be removed.

Second, SIFMA believes there should be a permanent exemption from withholding on payments of U.S. source dividends on physical stocks.[12] Although many trades are currently backed into the US for risk management purposes, we believe that a QDD should not be forced to hedge trades into the US to get a better withholding tax result, particularly where regulators are encouraging brokers to limit back-to-back affiliate trades. Once again we appreciate the temporary relief on this point and believe this provision should be made permanent. We believe that how a derivative is hedged should be driven by the market and market regulators and not tax considerations. If the government has concerns, we would like to work with the government make sure they are addressed.

---

[10] Letter from Payson Peabody, Managing Director and Tax Counsel, SIFMA, to Karl Walli, Senior Counsel – Financial Products, Department of the Treasury, et al (Jun. 28, 2017). (https://www.sifma.org/resources/submissions/revenue-procedure-2017-15-qualified-intermediary-agreement).

[11] Many securities dealers do not do any significant proprietary trading due to Dodd Frank and other regulatory restrictions.

[12] See page 4 et seq. of the June 2017 SIFMA Letter. That letter also suggested an alternative solution, requesting that a QDD determine its section 881(a)(1) tax liability on dividends and deemed dividends received in its capacity as an equity derivatives dealer by reducing its potential tax liability for dividends and deemed dividends received by its withholding tax liability for dividend equivalents paid to account holders. That letter also requested a coordination rule between the section 881(a) tax liability and section 871(m) amount tax liability by providing that the QDD tax liability is the greater of its section 871(m) amount tax liability or the section 881(a) tax liability (as determined by the calculation described in the preceding sentence).

b. Combination Rule

SIFMA members strongly believe that the "priced, marketed or sold" standard for over-the-counter derivatives that was adopted by the Notices should be the permanent standard for determining whether a withholding agent must withhold on a dividend equivalent payment. As discussed in the March 2016 SIFMA letter, the current combination rule is unworkable. Moreover, despite extensive discussions with their business and operations colleagues, SIFMA members have not been able to create a viable and administrable alternative to priced, marketed or sold. Finally, from a policy perspective, a withholding agent should only be responsible for trades it actually knows were meant to be in connection with one another.[13] Accordingly, we request that the current rule that withholding agents only be required to combine over-the-counter trades that are "priced, marketed or sold" together be made permanent and that express guidance be issued stating that withholding agents are not required to combine non-over-the-counter trades, including listed options. The responsibility to combine transactions and pay section 871(m) tax with respect to transactions outside of the priced, marketed or sold rubric should remain with the taxpayer.[14]

III. Other Issues

The following is a non-exhaustive list of issues that SIFMA members believe need to be addressed prior to implementation of the Regulations.

a. Qualified Indices

There are numerous issues with the definition of Qualified Index in the Regulations, described in the March 2016 SIFMA Letter.[15] It would be helpful if the government were to publish a non-exhaustive list of certain, key indices that can be treated as Qualified Indices to ensure market consistency. We also call particular attention to the issues raised by the rules on short positions with respect to an index and suggest that such short positions be subject to the same simplified "priced, marketed or sold" standard currently in place for the combination rule. Absent actual knowledge that the long party has taken short positions with respect to a Qualified

---

[13] Withholding agents must be able to rely on objective information to assess whether transactions should be combined, which is achieved by the "priced, marketed or sold" standard: where a transaction is priced, marketed or sold with another, the withholding agent arguably has actual knowledge that the trades are connected. A looser definition of "priced, marketed or sold" may be appropriate for taxpayers with subjective knowledge of their trading intentions: transactions entered into at the same time or in anticipation of a plan to combine the trades.

[14] To facilitate administrability, we recommend that the government provide taxpayers specific guidance on when to combine listed options. For these instruments, taxpayers (and not withholding agents) should be required to combine listed options only if they are entered into on the same day, with the same term and the same strike price.

[15] See pp. 43 et seq. of the March 2016 SIFMA Letter. The letter focuses on questions about the definition of the minimum level of trading necessary to satisfy the definition of "traded" under the requirement that an index may only constitute a qualified index if options or futures on the index are "traded" on certain specified markets; discusses issues with capped indices; and also focuses on contracts that indirectly reference a Qualified Index.

Index, a withholding agent should be permitted to treat the transaction as referencing a Qualified Index. The responsibilities to pay section 871(m) tax with respect to transactions where a taxpayer has taken short positions with respect to a Qualified Index should remain with the applicable taxpayer.

b. QSL – Extend Qualified Stock Lender ("QSL") Regime for Entities in Stock Lending Businesses

Given the onerous requirements for becoming a QDD, many entities that currently engage only in U.S. stock lending businesses and are currently QSLs are unable to become QDDs and would therefore become subject to withholding on trades where they are effectively acting as an intermediary (even if the transactions are documented as principal trades). We request that the government make permanent the QSL regime to avoid withholding tax on entities engaged in stock loan activity as dealers. Notwithstanding the request above, we acknowledge the government's desire to import the more robust governance mechanisms of the Qualified Intermediary ("QI") and QDD regimes into the QSL regime, and if keeping the current QSL regime is not an option, we request an extension of the QSL regime until the regulations can be amended to include a system that will accommodate traditional commercial securities lending transactions without unnecessary administrative burdens (e.g., a simplified QI/QDD regime for entities solely engaged in the stock lending business and, where practical, allowing entities that are currently QSLs to use IRS forms W-8IMY to pass through documentation of their counterparties even where they are not acting as an agent).

Thank you for your consideration of the foregoing comments on the Section 871(m) regulations. We would be happy to answer any questions you may have at your convenience. You can reach me via e-mail at ppeabody@sifma.org or by phone at (202) 962-7300.

Sincerely,

Payson Peabody
Managing Director & Tax Counsel
SIFMA