September 10, 2024

U.S. Department of the Treasury
1500 Pennsylvania Ave NW
Washington, D.C. 20220

Re: 2024 Proposed Regulations for the Identification of Basket Contract Transactions as Listed Transactions

Ladies and Gentlemen,

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to submit comments on the 2024 proposed listed transaction regulations[2] identifying certain basket transactions as listed transactions (the "proposed regulations").

I. Executive Summary

As discussed in more detail below, SIFMA has serious concerns about the breadth of the proposed regulations and the severe implications of reclassifying basket transactions from transactions of interest to listed transactions. SIFMA makes the following recommendations in Sections III-V for narrowing the proposed regulations to exclude non-abusive benign transactions that should not be labeled as tax shelters:

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] REG-102161-23, July 12, 2024.

- Section III.A: Restore the limiting language on the meaning of "substantially similar" from Notice 2015-74 so that taxpayers can know precisely what transactions are listed transactions and do not refrain from entering into non-abusive commercially-driven transactions out of a concern that they may be "substantially similar" under the broader standard.

- Section III.B: Narrow the definition of "designee" by replacing the "selected by" prong with an "acting in concert" standard. This change would ensure that the regime appropriately targets abusive transactions without unduly requiring disclosure of transactions that pose no risk of abuse and are not susceptible to challenge. Further, revisions should clarify that the mere payment of a commercially reasonable index licensing fee should not cause the index provider to be a designee.

- Section III.C: Clarify the meaning of "objective instructions, operations, or calculations" and/or "routine judgment in the administration of the rules" in the context of rules that may require index providers or committees to be involved in interpreting or making determinations under those rules.

- Section III.D: Exclude any contracts that reset at least annually. If the government is unwilling to exclude contracts with an annual reset, then the government should consider excluding those with a quarterly reset and should absolutely exclude contracts with a monthly reset. Likewise, all contracts that have terms of one year or less should be excluded, but if the government is unwilling to exclude all short-term contracts, the government should consider excluding those with a term of three months or less or at the very least, one month or less.

- Section III.E: Limit the definition of "tax benefit" to make clear that the deferral or conversion resulting from the transaction must arise specifically from the form of the transaction as a derivative over multiple positions.

- Section IV.A: Exclude from a counterparty's reporting obligations any Non-U.S. Targeted Instruments (as defined below) distributed under a securities law program that is restricted to distribution outside of the United States, such as Regulation S issuances.

- Section IV.B: Allow a counterparty more flexibility in relying on withholding tax forms and representations regarding a taxpayer's U.S. tax status to take a transaction out of scope.

- Section IV.C. Allow issuers to rely on their treatment of an instrument as a contingent payment debt instrument ("CPDI") or variable rate debt instrument ("VRDI"), as indicated by the issuer's disclosure in an offering document and/or by its filing of a Form 8281.

- Section V: Any transaction that is entered into prior to finalization should be analyzed under the preexisting rules of Notices 2015-73 and -74 and should be reported only as required thereunder, and no new disclosure should be required for transactions previously disclosed as transactions of interest under Notice 2015-74.

II. The Purpose of the Proposed Regulations

The proposed regulations would identify transactions that are the same as, or substantially similar to, certain basket contract transactions as listed transactions, a type of reportable transaction. Material advisors and certain participants in these listed transactions would be required to file disclosures with the IRS and would be subject to penalties for failure to disclose. The proposed regulations would affect participants in these transactions as well as material advisors.[3]

In this part, we set forth our recommended overall approach to determining which transactions should be covered by the proposed regulations. As detailed in the following paragraphs, the listed transaction regime is intended to apply only to abusive transactions. The proposed regulations, however, would apply much more broadly. Accordingly, they would tend to discourage many transactions that not only are not entered into with a principal purpose of obtaining a tax benefit, but that could not even be successfully challenged under current law. This could impair the functioning of the capital markets. Such an impact would have adverse consequences on investors, counterparties, advisors, and the Internal Revenue Service (the "IRS").

A. The Listed Transaction Regime is Intended to be Narrowly Drawn

It has long been clear that the listing regime was intended to be narrowly tailored to its fundamental role of assisting the government in combatting abusive tax shelter transactions. Thus, in testimony before Congress in 2000, the then-Acting Assistant Secretary of the Treasury stated that the listed transaction regime is intended "not only to identify improper tax shelters, but also to protect taxpayers that engage in legitimate business transactions" and that "[t]he IRS wants to ensure that transactions are not labeled as improper tax shelters merely because they are novel or complex."[4]

The government has followed this approach. Thus, the current listed transaction regime properly reflects

a narrow focus on transactions that lack any substantial business purpose, and that are entered into primarily for tax purposes. For example, the regime applies to abusive micro-captive structures, in which promoters, accountants or wealth planners persuade owners of closely held entities to participate in schemes that lack many of the attributes of genuine insurance. It also applied to syndicated conservation easements, in which investors typically acquire an interest in a partnership that owns land and then claim an inflated charitable contribution deduction based on a grossly overvalued appraisal when the partnership donates a conservation easement on the land.[5] The government should similarly maintain a focus on abusive transactions in the area of

[3] See *Identification of Basket Contract Transactions as Listed Transactions*. Available at [Federal Register :: Identification of Basket Contract Transactions as Listed Transactions]
[4] See Treasury Acting Assistant Secretary for Tax Policy, Jonathan Talisman, Testimony Before Senate Finance Committee (Mar. 8, 2000).
[5] See https://www.irs.gov/businesses/corporations/abusive-tax-shelters-and-transactions.

basket transactions.

B. <u>Overbreadth of the Proposed Regulations</u>

As we discuss below, the listed transaction regime envisioned by the proposed regulations is overly broad in several respects. The overbreadth of the proposed regulations could create significant disruption in the market for non-tax motivated derivative transactions.

Unlike transactions of interest, which are transactions the IRS designates in order to evaluate the potential for abuse, listed transactions are viewed as abusive tax shelters by investors. Most taxpayers would not knowingly enter into a listed transaction, and many taxpayers would not enter into a transaction if there is *any* meaningful risk that the transaction could potentially be a listed transaction, even if they believe it is likely not. Given the severe consequences of entering into a listed transaction, this creates an *in terrorem* effect that disrupts markets and prevents taxpayers from entering into many non-tax motivated investment transactions, even if taxpayers believe there are good arguments for why the listed transaction regime should not apply. Additionally, many advisors are prohibited by internal policies from advising their clients regarding a listed transaction, including even preparing or signing a tax return that includes a listed transaction disclosure. An overly-broad disclosure regime may also result in overdisclosure of innocuous transactions, which could increase the workload, and reduce the efficacy, of the IRS. Finally, the obligation to report potential tax shelters is something that the financial services industry takes very seriously, not merely on account of the penalties that accompany a failure to report, but also on account of the reputational and other considerations that accompany this obligation. Thus, the proposed regulations will, if finalized in their current form, disrupt the markets and drive inefficient behavior by preventing taxpayers from entering into non-abusive transactions out of fear that the reporting regime *might* apply.

C. <u>Supplement the Reportable Transaction Guidance with Substantive Guidance</u>

We believe that the transactions at which the proposed regulations are aimed are transactions principally entered into to facilitate tax avoidance by U.S. taxpayers. Thus, these are transactions that generally would be entered into in physical form, not derivative form, but for the taxpayer's desire to convert ordinary income and short-term capital into long-term capital gain. SIFMA suggests that the proposed regulations should be substantially narrowed (as described in more detail below) to ensure that they capture only transactions that are abusive. If the government believes that some of the transactions that fall outside of the scope of the proposed regulations should nevertheless be subject to section 1001 when changes are made to the basket of reference securities, the government should promulgate substantive guidance regarding when the modification of a non-debt derivative gives rise to the recognition of gain or loss. SIFMA would welcome the opportunity to work with the government to develop any such guidance.

III. Recommended Changes to the Proposed Regulations that Affect Both Taxpayers and Counterparties

A. Restore Notice 2015-73 Approach to "Substantially Similar"

As currently drafted, the proposed regulations significantly broaden the scope of reportable transactions beyond that of Notice 2015-74. In Notice 2015-74, the government stated that a transaction would be "substantially similar to the transaction of interest identified in this notice" only if the transaction met four specified criteria. This limitation on what could be considered a substantially similar transaction was added by the government in response to taxpayer concerns about the breadth of the general standard. The proposed regulations, however, contain no corresponding limiting language on the meaning of "substantially similar," unlike in Notice 2015-74. Rather, the proposed regulations describe five factors in Prop. Reg. §1.6011-16(c) that, if satisfied, will result in a listed transaction, and then go on to provide in Prop. Reg. §1.6011-16(a) that any transactions that are the same as, *or substantially similar to*, transactions that meet this five-factor test will also be listed transactions. Treas. Reg. §1.6011-4(c)(4) provides that the term "substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy." Moreover, that regulation states that "the term substantially similar must be broadly construed in favor of disclosure." The current language thus vastly increases the ambiguity around which transactions are within the scope of the listed transaction definition.

The proposed regulations' broader standard will be much more difficult to interpret and will thereby, as described above, produce considerable uncertainty regarding whether a transaction is a listed transaction. This problem is particularly acute, because, as described in this letter, the listed transaction regime envisioned by the proposed regulations is overly broad. For example, consider a transaction that meets all of the factors in Prop. Reg. §1.6011-16(c) except that the taxpayer is a section 475 dealer and therefore its tax return will not reflect a tax benefit, as defined in Prop. Reg. §1.6011-16(b)(5). Would such a transaction be substantially similar and therefore be a listed transaction? It is not generating a tax benefit, but it does meet four out of five of the factors listed in the proposed regulations. A taxpayer might, out of an abundance of caution, need to treat such transaction as a listed transaction even where the taxpayer is clearly not receiving any tax benefit. Further, the taxpayer's tax return preparer may no longer be able to sign its tax return, and the taxpayer's counterparty may refuse to execute the transaction. This outcome is clearly inappropriate and, we think, unintended.

Similarly, consider a situation in which a taxpayer pays an entity for the right to use the entity's index. The entity is not an agent of the taxpayer. The index tracks a broad market, and is widely used and publicly quoted. The index-based contract has a term of two years. The taxpayer's tax return shows that it has been able to defer income recognition on the entity's changes to the reference basket. Would such a contract need to be reported? It is true that the entity would fall within an exception to the term "designee" because the index tracks a broad market and is widely used and publicly traded, but it otherwise meets the proposed regulations' criteria for reporting a basket transaction and the taxpayer does have a tax benefit. Further, consider a transaction that meets all of the factors in Prop. Reg. § 1.6011-16(c) except that changes to the basket are made only pursuant to rules that meet the exception in Prop. Reg. §

1.6011-16(b)(4)(ii). Thus, neither the taxpayer nor its designee has exercised discretion to change the assets in the reference basket or the trading algorithm. Would such a transaction be substantially similar and therefore be a listed transaction? Such a taxpayer may still be treating its gains on the transaction as long term capital gains realized at maturity of the transaction, even though if it had owned the reference assets in physical form rather than as a derivative and rebalanced its portfolio according to the same algorithm or formulaic rules that were specified in the derivative, it may have had ordinary income or short term capital gains. Without clarity, and taking into account "the term substantially similar must be broadly construed in favor of disclosure," tax advisors, taxpayers, and counterparties might, out of an abundance of caution, struggle with whether they need to treat such transaction as a listed transaction.

Taxpayers, counterparties, and tax advisors need to know precisely what transactions are listed transactions. The government was responsive to market participant concerns in 2015. SIFMA's members are even more concerned about the breadth of the proposed regulations now that these transactions are to be considered listed transactions instead of merely transactions of interest, and the government should be similarly responsive and restore the limiting language of Notice 2015-74.

B. Tailor Appropriately the "Designee" Definition

As currently drafted, the person that modifies the reference basket can be treated as the taxpayer's ("T's") designee if one of three things is true: the person is T's agent, the person is compensated by T for the changes, or the person is selected by T to make the changes. This third prong, "selected by," should be replaced by a more appropriately-tailored "acting in concert" requirement. As currently drafted, this "selected by" prong can potentially turn any person into a designee of T even where there is no relationship between T and the "selected" person. For example, suppose an entity ("E") makes publicly available a list of securities that is rebalanced periodically pursuant to some criteria, but E is not engaged in active asset management. The criteria that E uses in compiling its list might, for example, focus on companies across different industry segments that are effectively using artificial intelligence in their businesses. T has no relationship with E and enters into a derivative with a counterparty ("C") over the publicly-available index. E clearly has discretion to change the basket, and because E arguably would have been "selected" by T to do so, a derivative over this information entered into between T and C would potentially possess the "designee" factor necessary to be a listed transaction under the proposed regulations. (While there is an exception to the "selected by" prong, qualifying for it would require either that the updated list track a "broad market" or a "market segment," each of which is not defined, or that the index be widely used and publicly quoted and based on "objective financial information," which is also undefined and which may be difficult to establish in many circumstances. The undefined terms in these two exceptions for indices create immense concern for taxpayers, who will need a significant level of certainty to conclude that a transaction is not a listed transaction. This concern would be greatly exacerbated by rendering basket contract transactions listed transactions instead of transactions of interest.)

We do not believe that it would be appropriate to treat such a derivative as a listed transaction. T's motivation in entering into the derivative is to conveniently gain exposure to the stocks recommended by E, and not to enter into a transaction in derivative rather than physical form merely to gain a tax advantage. Not only is this transaction clearly not abusive, but many practitioners believe that changes to the basket underlying such derivative would not give rise to the recognition of gain or loss under section 1001 because such changes would occur pursuant to the terms of the derivative and because the investor would have no control over such changes.[6]

Instead of a "selected by" test, the government should replace the third prong of the designee definition with a requirement that T and another person (who is not T's agent and is not compensated by T within the meaning of Prop. Reg. § 1.6011-16(b)(3)(i)(A) and (B), respectively) be "acting in concert." This concept is well understood by advisors and taxpayers, and appropriately addresses the government's concerns about taxpayers entering into derivative transactions principally for tax avoidance purposes. Under an "acting in concert" standard, in order to be a "designee," the third party (who by assumption is not an agent of T and is not compensated for his role) and T must have a relationship and the third party must be aware that T intends or may intend to use the basket/index to as the basis for a derivative contract.

We believe it would also be helpful if the regulations gave examples of the "acting in concert" standard. For example, consider an investment advisor ("IA"), who is willing to determine a varying basket of stocks that he believes will outperform the market. T, a long-time customer of IA, wants exposure to the basket, but does not want to invest directly in a separately managed account. T persuades IA to provide the basket composition information to a counterparty C, and C and T then enter into a derivative contract over the basket. IA is not compensated by T or C for its information provision and IA is not T's agent under principles of agency law. Here, T and IA would be acting in concert and IA would thus be a designee of T.

In contrast, consider an index offered by entity E. E is not an affiliate or agent of C or T, and neither C nor T nor any of its affiliates or agents were involved in E's creation of the index. C pays E a licensing fee and then offers total return swaps over the index. T enters into one of these swaps with C. C does not have any exclusivity provisions in its license with E, and E is willing to license the index to other market participants that pay the licensing fee and does not have a relationship with C. Here, T and E are not acting in concert, and E should be not considered a designee of T.

The second prong of the "designee" definition should also be clarified to confirm that commercially reasonable licensing fees paid by C to a person in exchange for the right to use an otherwise publicly available indices do not constitute "compensation" by T. Payment of an index license fee to an index provider in the ordinary course by C should not cause the index provider to be treated as "compensated by T for suggesting, requesting, or determining changes in the assets in the reference basket or the trading algorithm."

C. Clarify the Definition of "Discretion" including Specific Examples of "Objective Instructions, Operations, or Calculations"

As currently drafted, T will not be treated as having discretion to change (either directly or through a request to C the assets in the reference basket or the trading algorithm if (A)

[6] *See e.g.,* Michael Shulman & Nathan Tasso, *Changes to Derivatives "Pursuant to their Terms" Part II*, TAX NOTES, May 8, 2017.

changes in the assets in the reference basket or the trading algorithm are made according to objective instructions, operations, or calculations that are disclosed at the inception of the transaction (rules) and (B) T does not have the right to alter or amend the rules during the term of the transaction or to deviate from the assets in the reference basket or the trading algorithm selected in accordance with the rules. This definition, however, does not sufficiently clearly exclude a class of transactions in which the requisite objectivity may arguably be lacking. For example, some derivatives are based upon an assessment of environmental, social, and governance ("ESG") considerations pursuant to a pre-determined standard that is disclosed at the inception of the transaction. Other derivatives are based on pre-determined market themes such as "robotics" or "large cap growth stocks with below average PE ratios." In addition, some indices are constituted to comply with Shariah law, and exclude certain potential component stocks based on determinations made by a Shariah committee.

Taxpayers would greatly appreciate clarification that such considerations are sufficiently objective to avoid creating discretion and that the changes to the basket to administer the index criteria would fall within the "routine judgment in the administration of the rules" exception. Under this approach, any reasonably objective changes to ensure that the index/basket continues to satisfy the pre-determined criteria (as opposed to active management of the assets to improve financial performance) should constitute non-discretionary changes.[7] We understand that the government may believe there are circumstances in which T might reasonably be required to recognize gain when changes are made to the underlying exposures in this situation, and we would welcome substantive guidance under section 1001 or other relevant provisions on this issue. In the context of a regime that designates transactions as listed transactions, given the stigma that results from such transactions for taxpayers, financial institutions, and advisors, we believe that the more targeted definition of discretion we recommend here is appropriate. To address this issue, we recommend that "discretion" should not be found to exist where an index has a theme that is based on rules determined at the inception of the contract and changes consistent with such rules are made to the basket in order to maintain exposure consistent with that theme.[8]

The proposed regulations should at least be modified to include examples of ESG or thematic indices that would be treated as sufficiently objective within the meaning of Prop. Reg. § 1.6011-16(b)(4)(ii)(A). For example, the government could explicitly give as an example the following transaction: A financial entity creates an ESG index by taking the list of the S&P 500 companies and excluding the companies that engage in certain businesses or do not meet certain ESG criteria. In addition, the index committee assigns "ESG scores" to potential component stocks based on its evaluation of those issuers' business practices, excluding any potential components that do not meet a certain score threshold. The ESG index is rebalanced on a

[7] Such a change would be consistent with the proposed expansion of the definition of notional principal contracts to encompass derivatives that are based on specified nonfinancial indexes. *See* Prop. Reg. §1.446-3(c)(2)(ii) (2011).

[8] Alternatively, the government could incorporate these concepts into an exception (either a new or existing exception) to the definition of "designee" in the Proposed Regulations. Currently, the "designee" definition is defined to exclude an entity making changes in the assets included in a widely used and publicly quoted index that is based on objective financial information or an index that tracks a broad market or a market segment. This exception could be broadened to include indices that are based on reasonably objective financial or non-financial information, and by examples showing that a broad market or market segment can include ESG, Shariah, and thematic indices.

quarterly basis to reflect both changes in the S&P 500 and changes to the relevant companies' business practices. T wants to invest in more ESG-friendly companies and enters into a swap with a bank, C, over the ESG index. C pays the index provider a regular licensing fee. At quarterly intervals, C updates the reference basket of the swap to reflect any changes made by the index provider. This transaction is non-abusive and completely distinguishable from the types of transactions targeted by the basket contract rules. Accordingly, revisions should clarify that these types of indices are not reportable transactions.

D. Exclude Contracts with Shorter Terms or Taxable Resets

The proposed regulations should exclude contracts that reset at least annually. A reset should be defined as a payment event pursuant to which all gains and losses on the referenced underlying property for the relevant period are taken into account in determining the amount of such payment. The proposed regulations, and the Notices before them, are concerned with taxpayers deriving significant tax benefit from deferring taxable income. In particular, Notice 2015-73, which defined the transactions that are listed under current law, did not apply if the contract in question was fully settled at intervals of one year or less. See Notice 2015-73, §2.01. This limitation is reasonable and should apply here. If the taxpayer in question has a contract that resets at least annually, the taxpayer would not be using the basket contract to materially defer income or to convert such income into long-term capital gain.[9] Thus, removing such contracts from the scope of the proposed regulations would reduce the burden on the counterparty to report non-abusive transactions without incurring the administrative burden of securing a representation from the taxpayer that it has not obtained a tax benefit.

If the government is unwilling to exclude contracts with an at least annual reset, then the government should consider excluding those with an at least quarterly reset and should absolutely exclude contracts with a monthly reset (in each case with the term "reset" defined as described above). Such contracts would clearly not be vehicles for material tax deferral or conversion, and the counterparty should be under no obligation to procure a representation regarding a taxpayer's lack of tax benefit.

Likewise, the proposed regulations should exclude all contracts that have terms of one year or less. Such contracts present no opportunity for conversion and the possibility of obtaining a single year of deferral does not rise to the level of tax abuse that the listed transaction regime is intended to target. As currently drafted, contracts fall within the scope of the proposed regulations if they have terms longer than one year or if the contract overlaps more two of the taxpayer's taxable years. It is unreasonable for the government to require reporting of contracts that have a term of one year or less. If, however, the government does decide to require reporting of contracts that have a term of one year or less, counterparties should not be required to report a contract that begins and ends within a single calendar year. It would be unreasonable to require a counterparty to report a transaction merely because the transacting taxpayer may have a fiscal year that differs from the calendar year, or a short tax year, which is rare and hard for

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[9] Note that under Treas. Reg. § 1.446-3(e)(2)(ii), a taxpayer that holds a notional principal contract with periodic resets will recognize the ratable daily portion of a periodic payment as it accrues. If such a contract has a period that crosses into a new taxable year, the taxpayer would recognize the allocable portion of a payment to be made or received at the end of the prior taxable year.

counterparties to determine. If the government is unwilling to exclude all short-term contracts, the government should consider excluding those with a term of three months or less, or at least a term of one month or less. Taxpayers entering into contracts with these short durations are generally not doing so for tax avoidance reasons, and the length of time of any deferral is not significant. It would not be sensible, for example, if taxpayers that regularly entered into one month contracts and rolled them every month could not enter into such contracts during the month of December.

E. Limit the Definition of Tax Benefit

The government should limit the definition of the tax benefit language to make clear that the deferral or conversion permitted by the taxpayer's chosen form of the transaction must arise from the use of a derivative over multiple positions. That is, if the U.S. federal income tax consequences of the basket contracts are identical to those that would result from a single name derivative, the transaction should be excluded.

For example, consider a single name short swap over equity. If a taxpayer enters into a physical short sale and closed that short sale after 13 months, the taxpayer would have short term capital gain when it closes the short sale transaction by delivering the underlying stock. However, if the taxpayer enters into a 13-month single name bullet swap over that equity, the taxpayer would have long-term capital gain when it settles the swap. The taxpayer will have achieved conversion of the capital gain from short term to long term by using a bullet swap instead of engaging in a physical short sale.

Now, consider a three-year short bullet swap over a 20-equity basket. At the 13-month mark, the taxpayer exercises its discretion to change one of the reference basket assets. The taxpayer recognizes gain in the taxable year in which this change to the basket occurs and treats such gain as a long-term capital gain. While the taxpayer still has the benefit of long-term capital gain, its benefit has arisen from choosing to use a bullet swap rather than a physical short sale. By contrast, the benefit does not derive from fact that it has entered in a bullet swap over a basket as opposed to a bullet swap over a single equity. in a basket transaction. Therefore, such tax benefit should not be considered of a type that the government is concerned with in the proposed regulations.

Likewise, consider a swap that is a hedge, such as a hedge of stock-based employee compensation obligations. Under Treas. Reg. sec. 1.446-4, any gains or losses on the swap would need to be reasonably matched with gains and losses on the hedged exposure. Such matching could result in deferral of gain on the swap to match the corresponding item of loss on the employee compensation obligation (which generally would be realized only at the time payment is made to the executive). However, as in the short bullet swap described above, this deferral arises because of the hedge timing rules and not because of the fact that the taxpayer has a basket transaction. That is, the taxpayer could have obtained exactly the same deferral benefit if it had entered into multiple single name swaps over the relevant equities. Thus, this tax benefit should likewise be excluded from the definition of the term "tax benefit" in the proposed regulations.

To accomplish this clarification, we suggest adding a second sentence to the definition of "tax benefit." This second sentence could say, "For purposes of determining whether a tax benefit exists, deferral or conversion is not deemed to exist if the taxpayer could have derived such deferral or conversion if it had entered into a derivative over a reference basket consisting only of a single asset, and had terminated that derivative at the same time it (or its designee) exercised discretion to modify the reference basket."

IV. Recommended Changes to the Proposed Regulations that Affect Only Counterparties

In additional to the specific changes to the substance of the proposed regulations, the government should specifically exclude the following transactions from the scope of the proposed regulations.

A. Exclude Structured Notes and Similar Products Distributed outside of the United States

The size of the non-U.S. market for structured products (such as structured notes, certificates, warrants, and similar instruments) ("Non-U.S. Targeted Instruments") over actively managed underliers is in the billions of dollars. That market represents a large amount of investment activity by non-U.S. investors that has nothing to do with U.S. tax, and it would be significantly disrupted if the rules are finalized as written. Given the reluctance of taxpayers and financial institutions to enter into listed transactions, without substantial changes along the lines we suggest below, a multi-billion dollar market could entirely cease to function.

Non-U.S. Targeted Instruments that are distributed under a securities law program that is restricted to distribution outside of the United States, such as Regulation S,[10] should not be subject to reporting by the issuer. Regulation S generally provides that offers and sales of securities that occur outside of the United States are exempt from the registration requirements of Section 5 of the Securities Act of 1933; it is generally designed to facilitate companies issuing securities only to non-U.S. persons. Among other things, an issuance must satisfy two general conditions: (i) the offer or sale must be made in an "offshore transaction," which generally means that the transaction takes place when the offer is not made to a person in the United States and either the buyer is outside of the United States (or the offeror reasonably believes that the buyer is outside of the United States) or the transaction is executed on an established foreign securities exchange, and (ii) no "directed selling efforts" may be made in the United States. A Regulation S issuance of structured notes, for example, takes place in the following manner. A bank prepares the notes under the Regulation S exemption for registration. It then issues the notes to a non-U.S. distributor.[11] The notes are typically deposited with a clearing organization that is the registered holder of the obligation and operates an electronic book entry system that identifies the clearing organization's members (such as the distributor or its custodian) holding interests in the notes. The members (often, banks or broker-dealers) record their clients' ownership of the notes in their book entry systems. The clearing organization facilitates and records transfers of the notes among the clearing organization's members. Crucially, the issuer of

[10] Offshore Offers and Sales, Securities Act Release No. 33-6863, 17 C.F.R. 230.901-230.904 (1990) ("Release 6863").

[11] A Regulation S issuance can also be structured through a U.S. distributor that then further distributes to non-U.S. persons where the notes are deposited at central clearing system.

the structured note is generally unable to identify the beneficial owners of the note, because these are known only to the clearing organization's members. The distributor in turn is the party that has acquired the notes and sells them on to non-U.S. persons.

These Non-U.S. Targeted Instruments are subject to all of the restrictions provided by Regulation S to keep them from being purchased by U.S. holders. Upon its transfer to the distributor, the issuer obtains any needed relevant withholding forms on the transaction from the entity to whom the issuer makes payments (e.g., the paying agent or clearing organization), but the issuer has no further knowledge of or access to the U.S. tax withholding status of the beneficial owner(s).

The government has been concerned with tax benefits obtained by U.S. taxpayers, as evident from the exclusion of transactions where the taxpayer provides a W-8BEN, and from the definition of a "tax benefit." However, issuers of Non-U.S. Targeted Instruments may be unable to collect IRS forms from holders because they may have no direct contact with the holders after the note is in the clearing system or sold to a distributor and may not even know who the beneficial owners of the contracts are, as the contracts are further distributed to downstream holders. Thus, we recommend that the proposed regulations be modified to exempt a counterparty from reporting requirements if the transaction is issued under Regulation S and if the counterparty does not have actual knowledge or reason to know that the transactions are being sold to a U.S. person within the meaning of section 7701(a)(30). Note that we do not recommend that the government require such an issuance to be "widely distributed" because an issuer will not have knowledge about how successful a distributor's activities may be, or whether the distributor sold all of the issuance to related foreign funds. The proposed regulations should clarify, potentially with an illustrative example, that an issuer qualifying for this exception does not have "reason to know" that notes are sold to a "United States person" (as defined for U.S. tax purposes) when (i) it has sold the notes to a beneficial owner that is a non-"United States person" (as defined for U.S. tax purposes) and there is no indication that such person intends to transfer the note to a "United States person" (as defined for U.S. tax purposes), or (ii) it has sold the notes to a distributor that has indicated that it intends to distribute the notes outside the United States, or (iii) the offering documents for the notes contain a legend providing that they may not be transferred to "United States persons" (as defined for U.S. tax purposes).[12]

We recommend that this exception apply only to the issuer. If a U.S. person within the meaning of section 7701(a)(30) actually acquired a basket contract that was issued under Reg S, the holder would continue to be subject to the listed transaction requirements. But unless the issuer has actual knowledge or reason to know that it is transacting with a U.S. holder, such issuer, as the counterparty, should not be treated as a participant in a listed transaction.

B. Greater Counterparty Reliance on Provided Forms and Representations

As discussed above, when the individual or entity holding the potential basket transaction is not a U.S. taxpayer, it will not receive the U.S. tax benefits of tax deferral or conversion of

[12] The language in Treas. Reg. § 1.1275-3(d) may be helpful here. That language states that "[a] foreign or domestic issuer is subject to the rules of this section with respect to an issue of debt instruments unless the issue is not offered for sale or resale in the United States in connection with its original issuance."

ordinary income and/or short-term capital gains into long-term capital gains, and the U.S. government has no interest in prohibiting or acquiring information about the transaction. Thus, the prior notices and the proposed regulations permit the parties to avoid disclosure when they have obtained certain specific tax forms or representations documenting such facts. However, the exceptions provided by the proposed regulations ignore market realities and are unnecessarily strict.

Issuers should be able to rely on representations from distributors

As described above, in many markets for financial products, distributors provide the products to the ultimate buyers and the issuers of the products have no direct contractual relationship with the buyers. In fact, the distributors may view the issuers as competitors and may refuse to provide issuers with documents, including tax forms and contractual representations, which reveal the identities of specific buyers. In addition, even when distributors are willing to share such information with the issuers, it constitutes "customer identifying information" ("CID") that is subject to each individual financial institution's internal policies, which are often crafted to comply with the laws and regulations of the various jurisdictions in which such financial institutions operate. Laws and policies governing CID may prohibit its dissemination, require encryption, and impose complex record-keeping and other requirements.

We are concerned with derivative issuances that are targeted at investors that are not U.S. taxpayers, but that may not qualify as Regulation S issuances. Given the lack of governmental interest where the buyer of the derivative is not receiving a U.S. federal income tax benefit, to comport with these market realities, the proposed regulations should be amended to provide an exception from disclosure if the issuer of the derivative (the "counterparty") either receives the appropriate tax form or representation from the buyer of the derivative (the "taxpayer") or receives a representation in a legally binding contract from another party, e.g., a distributor, to the effect that it has received such tax forms or representations. As drafted, the proposed regulations (like the prior notices) require the issuer (i.e., the "counterparty") to receive such tax forms or representations directly, even though this is impossible, impractical or overly complex for the reasons described above.

Representations provided to C under the exception provided in Prop. Reg. § 1.6011-16(d)(1)(3)(i) should not be required to be made under penalties of perjury

Counterparties should be able to rely on a taxpayer's representation pursuant to the exception provided in Prop. Reg. § 1.6011-16(d)(1)(3)(i) that its tax returns will not reflect a tax benefit, without requiring that that the taxpayer make such representation under penalties of perjury. Firstly, it is unclear, as a legal matter, how a counterparty could ensure that penalties of perjury would apply to a private bilateral negotiation. If the government is concerned about a taxpayer's inaccurate reporting, the taxpayer's own tax returns are already subject to penalties of perjury. Second, the "penalties of perjury" language can cause reluctance to provide the representation due to its nature (not because the representation is untrue) and could lead parties to abandon ordinary commercial transactions that have no potential for tax abuse. Instead, the representation should be able to be provided in a similar manner to other counterparty representations that are not made under penalties of perjury. For example, tax-related representations could be provided in the same manner as the withholding representations provided on International Swaps and Derivatives Association, Inc. ("ISDA"); over-the-counter derivative agreements are not typically made under penalties of perjury.[13]

Additional withholding certification forms should be included for purposes of the exception provided in Prop. Reg. § 1.6011-16(d)(1)(3)(ii)

Likewise, a counterparty should be able to accept more withholding forms than just Form W-8BEN or W-8BEN-E. Counterparties should be able to rely on any combination of withholding forms that establish that its transacting counterparty is not subject to U.S. tax on the transactions. For example, a Form W-8EXP and Form W-8IMY confirming qualified derivative dealer status or a Form W-8IMY with only Forms W-8BEN, BEN-E, and EXP attached, or with an allocation statement with no allocation to an underlying Form W-9 or W-8ECI should all be sufficient.

C. Allow Parties to Rely on Their Treatment of a Contract as a CPDI or VRDI

Currently, a contract that is treated as a CPDI under Treas. Reg. 1.1275-4 or a VRDI under Treas. Reg. 1.1275-5 is excepted from listed transaction treatment under the proposed regulations. It is unclear from the language of the regulations who needs to treat the contract as such in order for the exception to apply – is it the IRS, the counterparty, or the taxpayer? There are also cases where the treatment as a CPDI or VRDI is subject to some uncertainty. Without limiting the scope of the current exception in Prop. Reg. §1.6011-16(d)(2), it would be helpful if final regulations clarify that, in circumstances where the issuer states that it is treating the instrument as a CPDI or a VRDI, as indicated by the issuer's disclosure in an offering document, by its filing of a Form 8281, or by the inclusion of a legend reflecting CPDI status (as required under Treas. Reg. 1.1275-3(b)), the issuer should not be required to treat the instrument as a listed transaction. We recommend that this exception apply only to the issuer. The taxpayer would still be required to report the instrument as a listed transaction if the taxpayer adopted a treatment that differed from the disclosed treatment and in fact obtained a tax benefit.

V. Recommended Changes to the Proposed Regulations' Transition Rules

As currently drafted, the proposed regulations appear to require transactions that are entered into prior to finalization to be disclosed as listed transactions once the regulations are finalized. We are concerned that if the requirements are not changed, the potential for listed transaction treatment will have a market-dampening effect even though the final regulations might end up differing from the proposed regulations. Instead, any transaction that is entered into

[13] Although Forms W-8 and W-9 must be signed under penalties of perjury, and these forms are also provided to counterparties in private transactions, the representations in such forms are distinguishable from the representation required by the proposed regulations. IRS "withholding certificates," as defined in Treas. Reg. § 1.1441-1(c)(16), serve multiple purposes (among them, a central and critical role in the U.S. information reporting and withholding system) and are governed by a complex and comprehensive set of requirements in the regulations promulgated under Section 1441, including record retention rules. See Treas. Reg. § 1.1441-1(e)(4)(iii). It is reasonable that these forms would be signed under penalties of perjury. Counterparties generally have no concerns about making representations under penalties of perjury where those representations appear in an official U.S. government form, but do have concerns when they appear in a document negotiated between private parties.

before regulations are finalized should be analyzed under the preexisting rules of Notices 2015-73 and -74 and only be reported as required thereunder. The retroactive effect of making historic transactions into listed transactions unfairly penalizes taxpayers who had no notice at the time of entry into such transactions that they would be treated as engaging in abusive tax shelter transactions years later.

Further, if the above change is not accepted, the proposed regulations would require new disclosure of all transactions that fall within their scope for all open tax years as of the date of finalization. There is no exclusion for transactions previously disclosed as transactions of interest under Notice 2015-74. We believe that this requirement provides no benefit to government and is an unnecessary administrative burden on compliant taxpayers. There should be no requirement to redisclose transactions previously disclosed as transactions of interest, as the IRS will already possess the disclosed information regarding these transactions. Form 8886 does not request additional information on listed transactions as opposed to transactions of interest.

VI. Conclusion

SIFMA much appreciates your consideration of all our comments. We believe that our comments will assist the IRS and Treasury in targeting only transactions that present elements that achieve an abusive tax result, have a tax avoidance motive, and create a strong likelihood that the IRS can successfully challenge the intended treatment of the transaction. We look forward to working with the government on the targeting of such transactions and the reduction of abusive transaction in a manner that is most appropriate for the domestic and international securities and derivatives markets. Please contact PJ Austin (pjaustin@sifma.org) or Matthew Stevens (matthew.stevens@ey.com) if you have any questions regarding this submission.

Respectfully submitted,

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