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May 20, 2014

The Honorable Mark Mazur
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
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Re: Proposed Regulations Issued Under Section 871(m)

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit to you this report commenting on the proposed regulations that were issued section 871(m).

Section 871(m) was added to the Code as part of the HIRE Act to address concerns about the avoidance of withholding tax on U.S. source dividends through derivative transactions. Section 871(m)(1) alters the usual rule of recipient-based sourcing on certain notional principal contracts ("NPCs") for "dividend equivalent" payments, and provides that a dividend equivalent payment is treated as if it were a U.S. source dividend for withholding tax purposes. As a result, dividend equivalent payments are subject to U.S. withholding tax when paid to a non-U.S. recipient.

Section 871(m) treats as a dividend equivalent three categories of payments: (a) substitute dividend payments made pursuant to securities lending or sale-repurchase agreements; (b) payments made pursuant to "specified notional principal contracts" that are directly or indirectly contingent upon or determined by reference to the payment of a dividend from sources within the United States; and (c) any other payment determined by the Secretary to be substantially similar to a payment described in (a) or (b).

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Mr. Mazur
Mr. Koskinen
Mr. Wilkins
May 20, 2014

Our principal recommendations relating to the proposed regulations are as follows:

A. *Dividend estimates.* We recommend that section 871(m) apply to dividend “estimates” only for transactions involving preferred shares, and, possibly, short-term transactions or a series of short-term transactions. Transactions that expressly provide for a payment made by reference to a dividend, or for an adjustment to the terms of the instrument if a dividend changes, should be treated as transactions providing for actual dividend equivalent payments.

B. *Delta test.* We are concerned that a delta threshold of 0.70 is too low and we believe that a threshold of at least 0.80 is more appropriate. We also recommend that the delta test not be applied to certain “exotic” instruments, such as digital options; that a disaggregation method be considered for determining whether instruments that provide for exposure to varying amounts of shares are subject to section 871(m); and that, in the case of exchange-traded instruments, a surrogate method be considered for determining whether the instrument is subject to section 871(m).

C. *Convertible debt and other issuer securities.* We recommend that convertible debt obligations and other securities issued by the issuer of the underlying stock be excluded from section 871(m). We also recommend changes to the reporting rules for “deemed” dividends under section 305 to make the regime more effective so that deemed dividends arising under section 305 are consistently reported to taxpayers and are taken into account for net income and withholding tax purposes.

D. *Indices.* We recommend that the determination of whether an index is “qualified” be made by reference to whether modifications or rebalancings of the index are conducted using publicly stated objective criteria and objective goals, even if the index is not created pursuant to a formulaic rule and some discretion is involved in determining whether the criteria are satisfied. Those objective criteria should not take into account any positions or costs (for example, hedging costs) of any party to the transaction or the compiler of the index. We also recommend that the exclusion for certain indices in which U.S. dividend-paying stocks represent less than 10% of the index be narrowed to exclude indices created for the purpose of avoiding dividend withholding tax.

E. *Variable withholding amounts, and withholding on prepayments.* Some members of the Executive Committee believe that consideration should be given to imposing withholding tax on a basis that would simplify the tax calculation on each dividend payment date. Under this approach, tax would be withheld on an instrument subject to section 871(m) as if the delta were 1.0 when the delta on the relevant testing date (that is, the ex-dividend or record date for the relevant dividend) is equal to or greater than the threshold that causes the instrument to be subject to section 871(m), and no tax would not be withheld when it is below that threshold on that date. We recommend that Treasury and the IRS reconsider the requirement that a short party must withhold on dividend equivalents to the extent that it has received a “prepayment,” except in limited circumstances.

F. *M&A transactions.* We recommend that the exclusion for M&A transactions be broadened to apply to transactions involving 20%, rather than 50%, of the stock of a company.

G. *Short-term exception.* We believe that the short-term exception, which requires that the determination of whether withholding is required be made at maturity or other termination of a short-

Mr. Mazur
Mr. Koskinen
Mr. Wilkins
May 20, 2014

term instrument, is useful. We recommend that the short-term rule be limited to instruments that do not actually pay or credit dividend equivalent amounts during their term, and that the determination of whether an instrument is short-term be made based on its term at issuance, rather than when it is acquired.

H. *Testing at issuance versus acquisition.* Some members believe that section 871(m) testing should take place only upon issuance of an instrument, rather than upon any investor's acquisition.

I. *Compensation-related option.* We recommend that compensation-related positions be excluded from the rules.

J. *Cascading withholding tax.* We recommend that a cascading rule, similar to that in Notice 2010-46, be implemented generally to avoid multiple withholdings with respect to a single chain of derivatives. In the alternative, we recommend modifications to the qualified dealer exception.

K. *The "in connection with" rule.* We recommend that changes be made to the rules for determining whether a position is held "in connection with" another position and that examples be added to clarify the application of these rules. We also recommend that taxpayers be permitted to seek a refund if they can demonstrate that their net long position is below the applicable delta threshold.

L. *Partnerships and trusts.* We recommend that, in determining the application of the provisions to partnerships and trusts, taxpayers be allowed to use recent audited financial statements to determine whether the 10% threshold has been met, absent actual knowledge that the threshold is met at the time of an acquisition.

M. *Anti-abuse rule.* We support the inclusion of an anti-abuse rule. We recommend that the anti-abuse rule specify that it applies to transactions that are the substantial economic equivalent of an investment in the stock of a U.S. corporation and that have been structured with a principal purpose of avoiding the application of section 871(m). If this recommendation is not adopted, then we urge that the final regulations clearly state an alternative standard. We also recommend that examples be included to illustrate when the anti-abuse rule would be invoked.

N. *Other issues.* We also address due bills, reporting by issuers, and the Proposed Regulations' effective date. It appears appropriate to subject non-U.S. investors to section 871(m) to extent they receive dividend equivalent amounts as a result of due bill procedures, but we are concerned about the impact that this could have on the orderly functioning of stock exchanges. We recommend that issuers be required to report their determinations of delta contemporaneously with issuances, and on a frequent basis thereafter, and that investors be permitted to rely on the most recent information provided by an issuer. We recommend that specified NPCs that hedge grandfathered specified ELIs should be grandfathered, regardless of when they are issued.

Mr. Mazur
Mr. Koskinen
Mr. Wilkins
May 20, 2014

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We very much appreciate your consideration of our recommendations and would be happy to discuss them with you or provide additional assistance.

Respectfully submitted,



David H. Schnabel
Chair

cc: William E. Blanchard
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May 20, 2014

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