INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

IIAC Comments on Proposed Regulations (REG-140206-06)
Notice of Proposed Rulemaking on Withholding Procedures under Section 1441 for Certain Distributions to Which Section 302 Applies

1. Introductions

- I am Barbara Amsden, Director, Capital Markets, Investment Industry Association of Canada or IIAC.
- As someone from one former British colony to people from another, I can say that one of my favourite events in American history learned when I was at Middlebury College in Vermont is the Boston Tea Party – no taxation without representation. To make representations with me today are people knowledgeable on the operations and tax sides of the Canadian brokerage industry:
  - Catherine Patterson is part of the Executive of the Investment Dealers Association of Canada – the IDA – Financial Administrators Section and she chairs the FAS Operations Subcommittee
  - Ann Noges is vice-chair of the IIAC Qualified Intermediary Committee
  - Nevio Rafaelic is a member of the IDA FAS Operations Subcommittee
- To unravel the interconnections here, the IDA is Canada's investment dealer self-regulatory organization, similar to NASD or now FINRA. FAS is an IDA umbrella committee structure that addresses operational issues and advocates on regulatory issues for its members.

2. The IIAC and their members

- The vast majority of IDA members are also members of the IIAC. We are the Canadian equivalent to the Securities Industry and Financial Markets Association or SIFMA.
- Our 200 member firms range in size from small regional brokers to large investment dealers that employ thousands of individuals across the country

3. Qualified Intermediaries (QIs) in Canada

- Many brokers in Canada, as in other parts of the world, have chosen to assume the responsibilities of QIs and entered into QI Agreements with the IRS. Where Canada seems to differ from QIs of other countries is that the majority of Canadian QIs, in terms of number and value of payments processed, are withholding QIs – QIs that have assumed U.S. non-resident alien withholding, and backup withholding, and Form 1099 reporting obligations. Of the total U.S. source payments processed by the Canadian Depositary for Securities or CDS – the Depository Trust and Clearing Corporation's or DTCC's equivalent – over 99% of the total amount is paid to QIs and over 75% is paid to withholding QIs.
- The recently published GAO report on the QI program notes that QIs must verify account owners' identities through rigorous know-your-client identification requirements – these also apply for Canada's anti-money-laundering and anti-terrorist financing purposes, which are among the most stringent in the world. QIs also must engage external auditors to test and report to the IRS on QI compliance with the terms of the QI Agreement.

- I won't say that people in Canada are more honest than people in other parts of the world, but we may be somewhat more oriented to regulatory compliance. Canada's slogan is "law, order and good government." Perhaps not as catchy as the American mantra of 'life, liberty and the pursuit of happiness,' but it is consistent with how very seriously the Canadian QI community takes its obligations with the IRS. Ann and her counterparts at other Canadian organizations has worked closely with the IRS on QI matters since before the effective date of the first QI Agreements. The comments submitted by the IIAC and other Canadian QIs on the proposed regulations, and our presence before you, are confirmation of our continued commitment.
- Some of our comments today relate specifically to withholding QIs. While the comments we see on the IRS website seem to suggest this is a Canadian issue, we know that our other concerns are equally relevant to withholding agents in the U.S. and around the world.

4. REG-140206-06

As indicated in our submission, the proposed regulations present three major areas of concern.

The first and by far the most significant are the certification requirements. As echoed in other submissions, we believe that the certification process is unreasonably onerous and complex, and contrary to the intention of the *Paperwork Reduction Act*, particularly given that it appears that the majority of the distributions under section 302 will satisfy one of the conditions under section 302 and qualify for treatment as payments in exchange for stock.

Although the background to the proposed regulations refers to transactions where a publicly traded corporation offers to buy stock from its shareholders ("self tenders") – Estimated at 50 to 70 for 2007 – the proposed regulations require certificates to be obtained for *any* public section 302 distribution. By including all distributions by public corporations in the redemption of stock and not only self tenders, DTC estimated 600 to 800 possible section 302 distributions in 2007.

The regulations require certificates even in those situations where a shareholder disposes of all shares held, either through a voluntary tender or a mandatory redemption. ***We believe that, in the case of a mandatory redemption leading to a complete termination of the interests of the shareholder in the corporation, the withholding agent should be permitted to process the distribution as a payment in exchange for shares without the need to obtain a certification from the shareholder.***

In the case of a voluntary tender, particularly where most shareholders do *not* tender their shares – the case for the majority of 2007 self tenders that we examined – it is unclear how a shareholder that tenders a portion of his or her shares will *not* realize a decrease in their interest in the distributing corporation. It seems close to mathematically certain, if some shareholders have not disposed of shares, while others have, those that have disposed of shares will have decreased their percentage holdings. ***We believe that the withholding agent should be permitted to process distributions related to self tenders as payments in exchange for stock where the terms of the tender offer support this result for shareholders tendering their shares.***

In Canada, there are also a large number of entities and arrangements that are exempt from withholding tax on dividends under the provisions of Article XXI of the Canada-U.S. Income Tax Treaty, including accounts for charities and that provide pension, retirement and other employment benefits – the national pension plan itself holds __ per cent of its holdings in the U.S. Even if payments to these accounts were treated as dividends, there would be no U.S. withholding tax, provided the accounts are properly documented. ***Again, withholding agents should be permitted to process section 302 distributions to such accounts as payments in exchange for stock without the need to obtain certifications.***

Two of Canada's largest brokers have done some analysis of 20 2007 self-tender events in one case and 50 in another. Their preliminary findings are consistent with comments submitted by the Association of Global Custodians. In the case of one broker:

- Of the 33 events for which the broker held shares –
  - There was only one corporation in which the broker held in excess of one per cent of the outstanding shares subject to the tender offer (approximately 2.85 per cent)
  - Shares were tendered for only 17 of those events
- Of the 17 events for which shares were tendered –
  - 20 to 40 per cent of the shares were tendered for four events
  - One to 10 per cent were tendered for eight events
  - Less than one per cent were tendered for the remaining five events
  - In almost all cases, the tender resulted in complete disposition of investor holdings in the distributing corporation for the accountholder
  - With the exception of one offer that had only a single accountholder holding shares, the majority of shares held in the distributing corporation where *not* tendered, which should have increased the likelihood that those shareholders that tendered, but still held some shares after the event, experienced a reduction in the percentage of their holdings.

The second main area of concern are the proposed escrow procedures. The proposed procedures generally require that any amounts that are to be withheld on payments determined to be dividends should be withheld by the U.S. withholding agent. We discussed why the procedures have not been made available to QIs with members of the IRS QI Team and U.S. advisors, and neither could provide any explanation. Operationally, this severely complicates processing of payments for both the U.S. withholding agent and the QI. The U.S. withholding agent that generally makes payments to a withholding QI gross on the basis of the W-8IMY that the QI has provided must therefore introduce non-standard (and likely manual) procedures to withhold on section 302 distributions. ***The processing of transactions will be much more streamlined and efficient when a withholding QI maintains responsibility for withholding and remitting.***

The third area of concern relates to timing. There has been insufficient notice and time to comment on and implement the procedural changes. The largest U.S. withholding agent – DTC – advised only mid-last November that it would implement the escrow and certification procedures effective January 1 of this year, which was and is unworkable for intermediaries. ***We ask that the IRS support a 100-per-cent pass-through of payments to withholding QIs for withholding and reporting until the proposed regulations are final and there is a reasonable time for implementation.***

5. The process then and as proposed

To put the work effort associated with the proposed regulations into perspective visually, we have prepared a table showing the "before" and "after" steps involved in processing the new withholding requirements. Based on the new procedures DTC and CDS intend to use, what was a 10-step process has become a potentially 55-step process… and that is at a high level. For many steps, there will be other additional sub-processes required, including incremental translation, printing, stuffing, mailing, tracking, reporting, auditing, filing and so on.

And beyond the back-office procedural changes – we do not think at this time that there will be an easy systems solution – think of the confusion there will be as investors receive notices. Picture your grandmother or grandfather getting a bulletin saying 'if you take up the tender you will received an amount of $56 net of withholding tax on an $80 payment – and then later, you may receive $24 more or something less.' What would she or he do – put the tender notice aside to do something with later? Throw it out? Call you? Call their advisor who could tell them that as the tender due date comes close, markets will adjust and they can sell their stock for pretty much the tender price *and* get 100% of the value *and* not have to read, understand, complete and return a form?

Given that initial research indicates that the number of foreign shareholders that are eligible to participate in tender offers and that actually tender their stock are generally low, *and* the certification process required may either further discourage participation in the tenders or drive sales of the shares instead of taking up the tender, what revenue will the IRS obtain? If additional tax revenue is generated, it is more likely to result from the failure of shareholders that otherwise satisfy the conditions of section 302 to elect and get non-dividend treatment. And any additional tax revenue that could properly be collected will likely be exceeded by the cost associated with obtaining certifications.

6. Costs

All additional steps 11 to 55 will have incremental costs. The supplementary information released with the proposed regulations provided an estimated annual frequency of response of five, which we interpret to be the estimated number of distribution events to which section 302 applies, an estimated number of respondents of 700 and two hours per transaction or $36.68 for a small firm. We believe that these numbers significantly underestimate the annual reporting burden.

Specific costs of the proposed changes will vary depending on whether some of the changes we recommend will be undertaken. If full or mandatory redemptions are included, costs are escalated 120 times – that is, DTC identified 600 events last year compared to the five set out in the proposed regulations. This alone would take the cost estimate of $36.68 per event for five events – $183.40 – to $22,000 – and that would be for a small broker.

If full redemptions are excluded and we assume annual self-tenders of about 70, annual costs would still range considerably – we estimate from several thousand for small firms to hundreds of thousands for the largest 20 Canadian brokers, with an average of $18,000 per firm.

What is certain is regardless of which interpretation or scenario comes to pass, there will be significant costs involved if the amendments we have proposed are not allowed. Those costs will be borne by the withholding agents/custodians, the financial intermediaries, and the end beneficial shareholders participating in these offers.

7. Recommended solutions

There are many issues we haven't fully touched on such as the technical complexity for investors and advisors, concerns about investor delays in obtaining or inability to obtain refunds, and the potential for further impacts on the perceptions of U.S. capital markets at a time they are already facing increasing competition.

Consistent with what others have said, our recommendations are to:

1. Allow withholding agents (including QIs) to process all distributions subject to section 302 as payments in exchange for stock without the need to obtain certifications from shareholders.

2. At a minimum, allow withholding agents (including QIs) to process distributions subject to section 302 as payments in exchange for stock *without* the need to obtain certifications –
   - For mandatory events under which all outstanding shares are being acquired
   - For those accountholders that dispose of their entire position (ignoring constructive ownership and shares held elsewhere)
   - For accountholders that would be entitled to claim benefits under a tax treaty with the U.S. and receive the distribution exempt from withholding tax even if the distribution were treated as a dividend.

3. If an initial presumption of dividend treatment is required under any circumstances, it should be limited to ownership thresholds of more than five per cent. In such cases, withholding agents (including QIs) should be allowed to use whatever methods they deem appropriate to make a determination that the distribution qualifies as a payment in exchange for stock, including determinations and validations made and information obtained per standard business practices acceptable to their regulators.

4. Allow withholding QIs to use the same escrow procedures as U.S. withholding agents.

5. Support a 100-per-cent pass-through of payments to withholding QIs for withholding and reporting until the proposed regulations are final and changes can be implemented.

In light of the background provided today and our earlier letters and other submissions, we hope the proposed regulations will be amended and re-published for comment in the near future to bring closure and clarity to this issue for all participants.

Thank you for the opportunity to present our collective views today and offer some potential solutions. We would be pleased to answer questions you may have.