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CC:PA:LPD:PR (REG-120282-10)
Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington DC 20044

Delivered via email

Re: REG-120282-10: "Dividend Equivalents from Sources within the United States" (the "Proposed Regulations")

The Investment Industry Association of Canada (IIAC)[1] welcomes the opportunity to provide further comment on the Proposed Regulations with respect to dividend payments contingent upon or determined by reference to U.S. source dividend payments under section 871(m) of the Internal Revenue Code, hereinafter referred to as "dividend equivalents". This letter provides additional comments to supplement and support the IIAC's previous letter dated February 21, 2014 (the "Preliminary Letter").

General Comments

The IIAC appreciates the work of Treasury and the IRS that has gone into the development of the Proposed Regulations, and that significant consideration has been given to comments previously provided by industry in 2012. While we understand the general policy concerns underlying the provisions of section 871(m), in particular, the need to identify capital markets transactions that have

[1] The Investment Industry Association of Canada (IIAC) is the national association representing the investment industry's position on securities regulation, public policy and industry issues on behalf of our 160 IIROC-regulated investment dealer Member firms in the Canadian securities industry. These dealer firms are the key intermediaries in Canadian capital markets, accounting for the vast majority of financial advisory services, securities trading and underwriting in public and private markets for governments and corporations. The IIAC provides leadership for the Canadian securities industry with a commitment to a vibrant, prosperous investment industry driven by strong and efficient capital markets.

the potential for tax avoidance, our members continue to harbour serious concerns about the Proposed Regulations and the provisions of section 871(m) generally. These general concerns can be categorized into two main areas: complexity of implementation and unintended consequences for global capital markets.

First, the technical complexities of correctly identifying, and reporting and withholding on transactions under the Proposed Regulations will make implementation of the section 871(m) requirements extremely costly purely from an operational perspective for financial institutions, even with the simplified definitions and tests contained in the Proposed Regulations. Currently, the infrastructure does not exist in the marketplace to support delta test determination and the corresponding taxation for derivative products of this nature for institutional clients, let alone for the vastly more numerous and disparate retail clients.

Second, the risk of market disruption or distortion remains a significant concern under the Proposed Regulations (as described more fully herein) as market participants may modify behaviour, including changing longstanding industry practices not based on tax planning, to avoid uncertainty. Investors and counterparties enter into many types of transactions that could be flagged under section 871(m) as having the potential for tax avoidance for business and economic reasons purely unrelated to tax planning. Clients would likely be completely unaware of such a theoretical and unforeseen tax for exchange traded products, for example. In addition, these clients may not be transacting in the underlying security itself, which may cause further confusion. Retail and institutional clients generally trade listed options for hedging or speculative investment purposes only, and such instruments would not be used for the purpose of retaining a U.S. sourced dividend amount free from withholding tax.. Additionally, the transaction costs and financial risks make it prohibitive for retail clients to trade such products for the implied dividend amounts alone. The cost of exercising such contracts to receive the underlying securities (which may pay a dividend amount) would be subject to clearing and transaction fees, which in many cases would be greater than or at least a large percentage of the dividend amount earned in theory.

We are concerned that overly broad rulemaking could shift behaviour of market participants even where the likelihood of tax-avoidance motive is remote, causing unpredictable distortions in the marketplace. For example, this proposed withholding calculation process creates a large enough implementation burden, that it could make it uneconomical for Canadian broker dealers to offer U.S. listed options on U.S. underlying securities to institutional and retail clients in Canada. Once communicated fully to the investing public in Canada, it may deter such potential investors from trading products caught by these Proposed Regulations, as the tax reporting burden on them alone would be inefficient, cumbersome and uneconomical. By extension, if Canadian investors no longer choose to trade equity linked instruments such as exchange traded futures and options, principal protected notes, and other products caught by the Proposed Regulations, they will likely also reduce, their trading in the U.S. listed securities and debt that underlie those products.

As such, while we do appreciate the attempts of Treasury and the IRS to simplify the Proposed Regulations in response to industry comments provided on the previously proposed section 871(m) regulations, we believe the current approach is problematic and requires further revision in order to

achieve the intent of Congress to curb transactions primarily designed for tax avoidance in a way that will not be disruptive to the global capital markets. We make specific comments herein with respect to particularly challenging aspects of the Proposed Regulations, however, we tend to agree generally with comments made previously to Treasury and the IRS, that an approach that incorporates representations by counterparties that derivatives transactions are not entered into “in connection with” transactions in underlying securities, is more appropriate, pragmatic, and better aligned with the true intent of Congress. The presumption under such a scenario would be that a withholding agent (or withholding QI) would be required to withhold on all dividend equivalent payments made to counterparties in the absence of such a representation. This would reduce the confusion and complexity of the regime for securities dealers and withholding agents who are not in a position to determine whether transactions are intentionally entered into “in connection” with one another, and to reduce the possibility that transactions without intent of tax avoidance are unintentionally swept into the overly-broad definitions of NPC and ELI.

Finally, we reiterate previous comments made by the IIAC and other organizations about the scale of the systems development that will need to be undertaken by securities dealers and withholding agents to implement section 871(m) requirements under the Proposed Regulations. There are significant operational challenges to calculating “delta” (not once, but twice) and linking the capital markets areas of financial institutions to tax information reporting and withholding systems. These systems and linkages do not currently exist and would need to be built and tested, and both traders and back office personnel would require extensive training to understand the complex requirements. Where the number of transactions involved is not on a scale that makes system development a feasible option for an FI, calculation and transmission of information may require manual implementation, which comes with its own set of resourcing burdens. Section 871(m) implementation for securities dealers is particularly burdensome as it is happening concurrently with interconnected implementation requirements for FATCA (including areas where it impacts current requirements under Chapters 3, 61 and Section 3406), cost basis reporting, and the expected OECD Common Reporting Standard (CRS).

As FIs and withholding agents work towards all of these timelines concurrently, and because we believe that these Proposed Regulations require further amendment, we believe that Treasury and the IRS should reconsider the timelines for section 871(m) implementation, perhaps on a later, more phased-in basis that would allow FIs and withholding agents to focus first on the implementation of already finalized regulations for FATCA and cost basis reporting, and to understand the impact on the capital markets before layering the section 871(m) requirements on top of existing regimes.

Scope of “Specified Equity-Linked Instruments” (ELIs)

Proposed section 1.871-15(a)(4) defines an “equity-linked instrument” (ELI) as “a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, that references the value of one or more underlying securities. For example, a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one or more underlying securities is an ELI.” We reiterate the comments made by many organizations in response to the previous version of the regulations, and which are referenced in the preamble to the Proposed

Regulations – that the definition of ELI remains overly broad, and in particular should not include certain instruments, such as convertible debt instruments and exchange-traded options and futures.

With respect to options, we will not enumerate here again the many valid reasons for exclusion as set out by SIFMA in 2012[2] (with which we continue to agree), but would like to refer specifically to challenges faced by Canadian securities dealers that are clearing members of OCC. We support the approaches recommended previously by OCC in 2012 and 2013[3] to address issues of importance to both OCC and its Canadian clearing members: (1) that exchange traded options and futures should be excluded from the scope of section 871(m); (2) alternatively, to receive clarification that OCC is not a withholding agent for the purposes of 871(m). IIAC members are deeply concerned that if these issues are not addressed by Treasury and the IRS – preferably by removing exchange traded options and futures from the scope of section 871(m) altogether – that Canadian clearing members will not be able to continue participating in the U.S. listed options and futures market, as the OCC will not be willing to take on the risks and reporting obligations of a withholding agent (even where OCC's non-U.S. clearing members are both FATCA compliant and qualified intermediaries (QIs) assuming primary withholding responsibility). This is a prime example of the overly broad approach to the scope of transactions potentially caught under section 871(m) having a disruptive effect on the functioning of the capital markets.

Definition of "Specified NPC" and "Specified ELI" – Delta Test

Under proposed sections 1.1871-15(d)(2) and §1.871-15(e) it is provided that, with respect to payments made on or after January 1, 2016, any notional principal contracts (NPCs) or ELIs that have a delta of 0.70 or greater with respect to an underlying security at the time that the long party acquires the NPC or ELI will be a "specified NPC" or a "specified ELI". We appreciate that Treasury and the IRS are proposing this single "bright line" test in response to comments received by organizations that the seven-factor test proposed in the previous set of regulations would be both difficult to administer, and would not be the best framework for evaluating whether a transaction has the potential for tax avoidance. However, as we have stated above in our general comments, we believe that the use of the delta test will also pose its own administrative challenges for dealers.

While the determination of delta could provide an indicator of economic comparability between the derivative transaction and the ownership of an underlying security, it does not necessarily follow that even a "near delta-one" exposure means that a transaction was entered into for tax avoidance. As outlined above, we believe that an approach incorporating representations from counterparties on which dealers and withholding agents could rely would be more effective in identifying and curbing avoidance transactions, rather than creating a regime that could incorrectly target transactions that are at low risk of tax avoidance, and could create disruption in the markets. We would urge Treasury and the IRS to reconsider the intent of section 871(m) and the use of the delta test generally. In this

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[2] Letter from SIFMA to IRS and Treasury dated April 4, 2012, pp. 29-34.

[3] Letter from OCC to IRS Commissioner Douglas Shulman dated May 2, 2012, pp. 4-5; Letter from Covington & Burling LLP to IRS and Treasury dated November 22, 2013.

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instance, a bright line test may not be the best approach, from either an administrative or effectiveness standpoint.

However, if it is determined that a delta test must be used to better target transactions which are in scope for section 871(m) as specified NPCs and specified ELIs, we do not think that the Proposed Regulations should apply to listed options (as outlined above) and other non-delta one instruments. If Treasury and the IRS feel strongly that "near delta-one" instruments must be included as an anti-abuse measure to reduce the likelihood of transactions being structured to narrowly avoid being caught, we recommend that the test be set much closer to one – our members have suggested a delta test of 0.9 as being more appropriate.

Grandfathering of ELIs

We greatly appreciate the communication from Treasury and the IRS in the recently released Notice 2014-14, clarifying the intention to limit "specified ELIs to ELIs issued on or after 90 days after the date of publication of the final regulations", which temporarily alleviates industry concerns about the original application date of the proposed delta test (to ELIs acquired on or after March 5, 2014). As articulated in our Preliminary Letter, in our experience, it is highly unusual for a proposed regulation to take effect before it is finalized, and in particular because of the complex nature of the Proposed Regulations, we believe it would have been extremely unreasonable for securities dealers and withholding agents to have been prepared to implement this test to identify Specified ELIs before comments on the Proposed Regulations closed and were considered by IRS and Treasury for possible amendments to the final regulations.

Combined Transactions

Proposed section 1.871-15(l) states that for the purposes of determining whether a transaction is within scope of section 871(m), two or more transactions will be treated as a single transaction where (i) a person is the long party for each transaction; (ii) the transactions reference the same underlying security; and (iii) the potential transactions are "entered into in connection with each other (regardless of whether the transactions are entered into simultaneously or with the same counterparty)". Again, we believe that the determination of whether multiple transactions are entered into "in connection with" each other is generally not something that could be known by a withholding agent. However, this may also be difficult to determine at a large investment fund or dealer, where a trader is not in the position to necessarily know if other traders are engaging in activities that would require combination. While the Proposed Regulations provide some relief for withholding agents where they lack the knowledge that a long party entered into transactions "in connection with" each other, and there are now specific examples provided, we believe the administration of these tests, including the combining of the deltas for the connected transactions, will be extremely difficult, if not impossible, to operationalize. We would recommend that these provisions should be limited to instances when the client counterparty informs the broker/dealer of the transactions that are connected for tax purposes. At a minimum, these rules require further simplification and clarity, and if the delta tests are retained, additional examples would be required showing how a combined delta is to be calculated where there are two or more connected transactions.

Substantially Similar Payments – "Due Bills"

In the preamble to the Proposed Regulations, Treasury and the IRS have specifically requested comments whether other payments (for example, a "due bill") should be treated as a "substantially similar payment" under section 1.1871-15(f). In general, a "due bill" evidences a payment of dividends to be made after the record date, for example, where securities are undergoing a corporate action. Due bill arrangements are not made with the intent of tax avoidance, but as part of the overall structure of the corporate action taking place, and in our opinion, do not represent the kinds of "substantially similar" payments that were contemplated by Congress under section 871(m). Additionally, tracking and including these types of payments as part of the section 871(m) regime would be extremely administratively complex and could have unknown consequences for capital markets firms engaging in these types of transactions and the markets generally. For these reasons, we strongly recommend that any payments made as part of a due bill arrangement should not be considered a "substantially similar payment" under section 871(m) and the Proposed Regulations.

Qualified Index Exemption

Section 1.1871-15(k)(2) of the Proposed Regulations provides the definition of a "qualified index" that could be treated as a single security that is not an underlying security for the purposes of section 871(m). We recommend that this definition be amended to allow the qualified index exemption to apply to indices listed outside of the United States. Clarification is also required with respect to the requirements of paragraph (iv) that qualified indices must be rebalanced "only according to pre-defined objective rules at set dates or intervals" as it is our understanding that even the S&P 500 has some discretionary provisions for instances where the index could be re-balanced outside of the prescribed systematic approach, on an as-needed basis.[4] Treasury and the IRS should also consider that some common indices have a dividend yield that would exceed the dividend test and therefore would not be a "qualified index".

Chain of Transactions – Multiple/Cascading Taxation

In the preamble to the Proposed Regulations, it is noted that IRS and Treasury received several comments regarding the possibility that a chain of derivatives could result in multiple or "cascading" taxation where there is a "chain" of dividend equivalent payments made with reference to the same underlying securities. Previous comments made to Treasury and the IRS have already fully explained how multiple or cascading transactions occur with respect to potential section 871(m) instruments, and we will not duplicate those explanations in this letter.[5] However, we would like to reiterate that under section 871(m)(6) ("Prevention of Overwithholding") it is contemplated that where there is a chain of dividend equivalent payments, there should not be double withholding or multiple layers of withholding

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[4] S&P U.S. Indices Methodology. http://www.spindices.com/documents/methodologies/methodology-sp-us-indices.pdf

[5] Letter from New York State Bar Association to IRS and Treasury dated April 25, 2012, pp. 80-82; SIFMA, April 4, 2012, pp. 45-48.

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if the taxpayer can establish that withholding tax has been paid with respect to another dividend or dividend equivalent payment in the chain. We agree with the comments in the Preamble to the Proposed Regulations that this is a serious concern, and we believe that it should be addressed more fully prior to any further implementation under the Proposed Regulations.

As such, we recommend Treasury and the IRS issue regulations or guidance setting out procedures consistent with those in IRS Notice 2010-46, which addressed cascading and multiple withholding issues arising in the context of securities lending transactions. As a matter of fairness, there is no reason why section 871(m) instruments should be treated differently than securities lending transactions when it comes to the matter of cascading withholding taxes. This guidance should be available well in advance of the applicability dates for the Proposed Regulations.

If you have any questions with respect to the foregoing, we kindly ask that you contact the undersigned at **ataylor@iiac.ca** or 416-364-2754.

Yours sincerely,

"Andrea Taylor"

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