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

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CC:PA:LPD:PR (REG-127895-14)
Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington DC 20044

Delivered electronically via Federal eRulemaking Portal and email

Re: Comments of the Investment Industry Association of Canada (IIAC) on Final and Temporary Regulations and Proposed Rulemaking on Dividend Equivalents from Sources Within the United States (REG-127895-14) (the "Regulations")

The Investment Industry Association of Canada (IIAC)[1] is writing to follow up on our previous submission dated November 6, 2015, and in response to the Regulations published by Treasury and the IRS relating to Internal Revenue Code section 871(m). Our previous letter focused only on the issues raised by the early applicability provisions, and we greatly appreciate the correcting amendments published by the IRS, removing the language relating to the early applicability date and confirming that the Regulations are generally applicable to payments made on or after January 1, 2017 with respect to transactions issued on or after January 1, 2017. This comment letter focuses on other aspects of the Regulations that have been discussed by our members to date; however, given the extremely complex nature of the concepts described in the Regulations, and because we still await additional information about proposed concepts such as the "Qualified Derivatives Dealer" (QDD) regime, we anticipate having additional comments to provide at a later date.

[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 144 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.

General Comments

As stated in our previous submissions, the technical complexities of correctly identifying, reporting and withholding on transactions under the Regulations will make full implementation of the section 871(m) requirements extremely difficult from an operational perspective for brokers. There are significant operational challenges to calculating, tracking and storing delta (or substantial equivalence, if adopted) 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 need to be built and tested, and both traders and back office personnel require extensive training to understand the complex requirements. Given that many non-U.S. individuals have little or no experience with U.S. tax rules, providing them with sufficient training within a very short timeframe to be able to explain the Regulations to clients and counterparties is expected to be particularly difficult. Additionally, where the number of transactions involved is not on a large enough scale, system development is likely not a feasible option for a broker. As a result, calculation and transmission of information may require manual implementation, which comes with its own set of resourcing burdens – this is why implementing the substantial equivalence test may be particularly onerous even if it applies only to a smaller subset of transactions.

Complex Contracts/Substantial Equivalence Test

We understand that the Regulations also present complex challenges for Treasury and the IRS, and the significant amount of consultation and effort that has been put into the rulemaking process to date. Given the complexity around the proposed substantial equivalence test, and the fact that there may be a significant number of comments received on the use of that test, we would urge Treasury and the IRS to consider a further delay on the applicability dates for complex contracts, so that both the authorities and the industry have an ample time period to amend Regulations (if required), digest and understand the concepts, and have adequate time to develop internal procedures and systems. It is our concern that if the substantial equivalence test is developed and implemented too quickly, it could create a great deal of uncertainty in the market for complex products, with unknown impact on the capital markets generally. As such, we would prefer to see a phased in approach, with applicability to complex contracts occurring no sooner than **January 1, 2018**, provided that adequate guidance with respect to identifying complex contracts subject to section 871(m) is finalized by no later than January 1, 2017.

Our members continue to work toward understanding how the substantial equivalence test would be applied to a variety of complex products, and as such, we may have more specific comments relating to particular products at a later date.

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Exchange-Traded Options

We were disappointed that Treasury and the IRS have not amended the definition of “equity-linked instrument” (ELI) to eliminate from its scope certain types of low-risk products, such as convertible debt instruments and exchange-traded options. In particular, 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. source dividend amount free from withholding tax. Treasury Department officials have stated publicly that it is anticipated that few of these traded options would generate a delta of 0.80 or higher, and as such, would likely end up being out of scope for section 871(m) withholding. However, it is precisely the implementation difficulty of calculating, transmitting and storing the delta calculation which is causing the greatest concern for industry participants, and would generate considerable cost, likely with no substantial benefit to the U.S. Treasury as there would be little or no withholding on these products.

In our previous submissions to IRS and Treasury, we have referred specifically to challenges faced by Canadian securities dealers that are clearing members of the Options Clearing Corporation (the OCC). We have continued our dialogue with the OCC to discuss the implementation challenges with respect to the Regulations for exchange traded products. The Canadian investment industry’s outstanding primary concerns are as follows:

1. ***If exchange traded options and futures are not removed from the scope of section 871(m) altogether (which is still the preferred approach), we ask that the IRS and Treasury consider a more reasonable alternative to the timing of the delta calculation that would allow the use of an “end of day” calculation of delta which could then be applied to the next day’s trades.*** Calculating on an end of day basis is a more reasonable alternative to calculating delta at the time of trade, and, as we understand it, could leverage existing systems to calculate and transmit the delta. If this flexibility is not allowed by Treasury and the IRS, calculating delta for exchange traded options at the time of trade may be administratively impossible, or at the least, would require new systems that would be so costly to build and maintain, that it could make it uneconomical for Canadian dealers to offer U.S. listed options on U.S. underlying securities to institutional and retail clients in Canada. 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. Once again, 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. Furthermore, if Treasury and the IRS are not amenable to allowing the end-of-day delta to be used, industry would appreciate an extended applicability date to apply for these products to allow additional time for systems to be built.

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2. We agree with the OCC's position in its previous submissions that it is not in the position to know the tax status of a clearing member's customer, or to know if transactions are related, and as such it does not make sense for them to be put in the position of withholding agent for payments made to that customer (please also see our comments on QDD, below) or to make the determination of whether a transaction is a "section 871(m) transaction" as they lack the requisite knowledge; however, dealers and other custodians clearing trades through these facilities lack the information to calculate delta for these products, even if allowed on an end of day basis. We note that the Regulations have broadened the definition of a "party to the transaction" to include "any agents acting on behalf of the long party or short party, or any person acting as an intermediary with respect to the potential 871(m) transaction". We view this definition as including the OCC or other clearing agencies acting as intermediaries, but we would appreciate clear confirmation from Treasury and the IRS that this is a correct interpretation, such as an example which could be added to the Regulations. If this is the case, we presume that the information provision requirements outlined in §1.871-15(p)(3), including the safe harbor allowing reliance on that information in §1.871-15(p)(3)(iii), would apply to the provision of the delta of the potential section 871(m) transaction from the party calculating the delta to the party using the delta to determine if the transaction is a section 871(m) transaction. We urge Treasury and the IRS to continue dialogue with the various industry parties to further clarify the definitions and reporting provisions in the Regulations to ensure that they make sense from a practical perspective and provide enough comfort to various parties that they (a) will receive necessary information from other parties in a timely fashion, and (b) can place reliance on this information and will not be liable for errors if they have no reason to know that the information is incorrect.

Qualified Derivatives Dealer (QDD) Regime

We very much appreciate that Treasury and the IRS have listened to the recommendations of industry to address concerns about cascading and multiple withholding arising in the context of section 871(m) transactions. In general, we agree with the approach taken to broaden the existing Qualified Securities Lender (QSL) regime described in IRS Notice 2010-46 to include transactions under section 871(m). However, there are questions about the expanded scope of responsibilities of Qualified Intermediaries (QI) as proposed in the preamble to the Regulations, and there are concerns about the more restrictive scope of QDD eligibility requirements, the inability of QDDs to "self-withhold" on payments received by the QDD acting as a proprietary trader, the liability for tax incurred by the QDD when making an offsetting dividend equivalent payment to a U.S. counterparty, and the potential discontinuance of the credit forward regime.

Expanded Scope of Responsibility of QIs

It is our understanding from public statements made by both Treasury and the IRS that a revised QI Agreement will be published either by the end of 2015 or early 2016, which will contain new

provisions outlining the scope of the compliance responsibilities for QIs that elect to be QDDs. It is also our understanding that these requirements and responsibilities will be bifurcated, in the sense that a QDD will only be required to comply with the compliance and audit provisions for QDDs with respect to QDD payments, and that QDD transactions will not be designated as QI accounts. While our preliminary assessment is that this seems to be a reasonable approach, we would like to reserve any further comment until we are able to review the actual provisions of the revised QI Agreement. As such, we would appreciate that ample consultation time is provided for comment on the QI Agreement, and urge the IRS to release it for review as soon as possible, given that current QI Agreements expire on December 31, 2016.

QDD Eligible Entities

Regarding the QDD program, the Regulations limit an "eligible entity" to QIs that are (a) securities dealers subject to regulatory supervision by a governmental authority in the jurisdiction in which it was organized or operates; or (b) banks subject to regulatory supervision by a governmental authority in the jurisdiction in which it was organized or an entity that is wholly owned by a bank which is subject to regulatory supervision. Furthermore, an entity under (b) must (i) issue potential section 871(m) transactions to customers; and (ii) receive dividends with respect to stock or dividend equivalent payments pursuant to potential 871(m) transactions that hedge potential section 871(m) transactions that it issued.

Our first concern is that a QI which is not a securities dealer, a bank or a wholly-owned foreign affiliate of a bank will not be able to act as a QDD based on this limited definition, even if it is currently operating as a QSL. There are currently withholding QIs in Canada (for example, custodians that are not securities dealers or wholly owned bank affiliates) that would likely not qualify as a QDDs, and therefore would not be able to receive gross dividend equivalent payments.

We strongly urge Treasury and the IRS to reconsider the strict eligibility requirements for QDD, and to revert back to the eligibility requirements for QSL as described in Notice 2010-46, by extending QDD eligibility to custodian QIs (including custodians that are not wholly owned bank affiliates) that are subject to regulatory supervision by a government authority in the jurisdiction in which the entity was created, as long as they agree to assume primary withholding and reporting responsibilities with respect to the dividend equivalent payments and comply with all QDD certification requirements. As long as the custodian QI agrees to withhold and report on the payment and complies with procedures, it does not seem to make sense to arbitrarily exclude it from eligibility.

Second, the Regulations limit the scope of the QDD regime to dividends or payments that may be dividend equivalents made with respect to potential section 871(m) transactions that the QDD receives while acting in its capacity "as a dealer". Proposed §1.1871-15(q)(1) states "for purposes of this paragraph (q), a dividend or dividend equivalent is not treated as received by a qualified derivatives dealer acting in its dealer capacity if the dividend or dividend equivalent is received by

the qualified derivatives dealer acting as a proprietary trader". We believe that it is impractical for the QDD regime to be limited only to payments received as a dealer, and that this exclusion should be eliminated. In particular, we are concerned that if Canadian QDDs are not allowed to "self-withhold" with respect to proprietary trades (or trades of affiliated entities of the QDD) that these Canadian QDDs could be potentially shut out of certain U.S. clearing organizations and marketplaces (such as the OCC), who for these types of transactions would be forced into the role of U.S. withholding agent. We do not believe that this is the intended result of the Regulations, and is not an outcome that is desirable to Canadian FIs nor, we hope, the U.S. clearing organizations. It is certainly not a result that would benefit either the U.S. or Canadian capital markets.

We understand that Treasury and the IRS have concerns about the manner in which QDDs would "self-withhold" with respect to payments received by the QDD acting as a proprietary trader, specifically whether there is a risk that amounts subject to withholding for these proprietary trades would be "netted" with the payments received with respect to the QDD's dealer trades, prior to the withholding taking place. It is our understanding, based on discussion with our members that this is not the standard practice among Canadian QIs that engage in proprietary trading; that payments received with respect to dealer and proprietary trades are not netted for U.S. tax withholding purposes. Payments received with respect to proprietary trades are treated as paid to a separate corporate entity, with that "corporate client" fully documented for U.S. tax purposes and if required, the appropriate withholding is made on the gross amount of the §871(m) payment made with respect to the proprietary trade.

QDD Liability for Withholding Where Offsetting Payment Made to U.S. Person

Finally, we also note that according to proposed §1.871-15(q)(1), if a QDD receives a dividend or a dividend equivalent and makes an offsetting dividend equivalent payment that is less than the amount the QDD receives, the QDD is liable for withholding tax for the difference. According to §1.871-15(c)(2), a payment that references a distribution with respect to an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to §871(m). Therefore, our understanding is that if a QDD makes an offsetting dividend equivalent payment to a U.S. person (not subject to §871(m)), the QDD would be liable for withholding tax for the entire dividend or dividend equivalent payment it receives, even if it does not receive any of the economic benefit from the payment. We believe that this is not an appropriate result, and that the IRS should reconsider its position, if it is in fact the intended result. Again, this would likely result in QDDs choosing not to enter into transactions where offsetting payments are made to U.S. financial institutions, an outcome that could cause substantial harm to the capital markets, particularly given the volume of transactions entered into between Canadian and U.S. financial institutions and their clients.

Credit Forward

We believe that the credit forward system outlined in IRS Notice 2010-46 should be retained as part of the section 871(m) and QDD regime, as it is another mechanism that can be used to address the problem of duplicative withholding. We understand the concerns of the IRS around the difficulty in verifying prior withholding in a chain of security loans, however, it seems that by tightening the eligibility requirements for QDD to QIs who are subject to reporting and audit requirements, that this would improve the ability to verify that prior withholding has taken place. We would rather see more stringency around the verification process rather than a wholesale elimination of the credit forward system.

Withholding on Zero Payments

We would like to reiterate our concerns around withholding on payments that have never been received (zero payment). A prime example is where the investor is “long” on a call option, the option is “out of the money”, and a quarterly dividend payment is made. In order to receive the dividend payment, the option must be exercised before ex-dividend date, but it is not exercised because it is out of the money. Eventually, the option expires worthless, but withholding must still be applied because under the Regulations, it is implied that the investor that was long the call option received the quarterly dividend payment. Not only does this result not make sense economically to the underlying investor, existing withholding systems are simply not designed to withhold on “phantom payments”, and as such, we do not agree that unexercised, expired options – that are at a low risk of use for tax evasion purposes – should be included in the scope of section 871(m) transactions. We note that this is a significant change to the current QI withholding requirements, and would require changes to withholding systems that require additional time to develop beyond the January 1, 2017 applicability date.

We greatly appreciate the ongoing work and dialogue with the industry on the 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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Cc:

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