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Re: Remaining Priorities with respect to Section 871(m) Regulations

Dear Sirs and Mesdames:

The Investment Industry Association of Canada ("IIAC")[1] appreciates the various consultations and reviews that the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS")

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[1] The IIAC is the national association representing the investment industry's position on securities regulation, public policy and industry issues on behalf of our 122 IIROC-regulated investment dealer members in the Canadian

have undertaken with respect to the Section 871(m) Regulations. The IIAC would like to expand upon previous comments made in response to several of those consultations[2] to highlight outstanding concerns and to prioritize recommendations that could alleviate the unnecessary burden that the Section 871(m) Final Rules (the "Final Rules")[3] impose on financial institutions.

<u>Overview</u>

IIAC Member Firms understand the Section 871(m) policy objectives of preventing non-U.S. persons from holding derivative instruments that substantially replicate the economic benefit of holding U.S. securities without being subject to U.S. withholding tax. The Final Rules, however, remain overly complex and burdensome, and there is a lack of clear evidence that certain aspects of the regulations meaningfully prevent such tax avoidance as originally intended by Congress.

The costs of complying with the Final Rules exceed the potential benefits and the Final Rules should be withdrawn or substantially modified. As discussed in greater detail in the following paragraphs, we believe that the objectives of the Section 871(m) regulations can be achieved if the current status quo under the Final Rules (the 2017 phase in status) becomes permanent, along with certain additional rule modifications.

<u>Delta-One Framework</u>

Recommendation: Maintain delta-one framework indefinitely and extend application of the general anti-abuse rule under Treas. Reg. §1.871-15(o).

The current delta-one framework established under IRS Notices 2016-76 and 2017-42, in conjunction with the general anti-abuse rule under Treas. Reg. §1.871-15(o) will have the desired impact of preventing tax avoidance without the additional costs and complexities required under a full implementation of the Final Rules. Senior Staff from the Treasury have publicly recognized the administrative issues for the financial industry and taxpayers associated with moving to a non-delta one regime. The delay in Notice 2017-42 was also noted as part of "the administration's broader burden reduction and reconsideration efforts".[4] The IIAC and its Members Firms strongly encourage the IRS and the Treasury to maintain the current scope of delta-one for dividend equivalent regulations.

Even if the delta-one framework is maintained indefinitely, there remain a number of outstanding issues with the Final Rules, which are discussed below.

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securities industry. These dealer firms are the key intermediaries in the Canadian capital markets, accounting for the vast majority of financial advisory services, securities trading and underwriting in the public and private markets for government and corporations. For more information visit, **http://www.iiac.ca**

[2] See **https://iiac.ca/wp-content/uploads/IIAC-Letter-to-Treasury-and-IRS-re-Executive-Order-13777-Enforcing-the-Regulatory-Reform-Agenda-and-Section-871m.pdf**

[3] Final Rules refers to the Internal Revenue Code Section 871(m) Treasury Regulations published September 18, 2015 and further revised in a final rule published in the Federal Register on January 24, 2017.

[4] *See* Stephanie Cumings, Treasury Reconsidering Dividend Equivalent Rules, 2017 TNT 211-3 (November 2, 2017)

Upstream Withholding – Potential for Cascading Taxation
Recommendation: QDDs should not be liable for tax on actual dividends received on physical shares. QIs should be allowed to self-assess their tax liability to prevent cascading taxation.

The Qualified Intermediary (QI) Agreement published in Revenue Procedure 2017-15 allows certain foreign persons to enter into an agreement with the IRS to act as qualified derivatives dealers ("QDDs") and to assume primary withholding and reporting responsibilities on all dividend equivalent payments that they make. IRS Notice 2016-76 revised the methodology for determining the Section 871(m) amount to use a net delta approach and announced that the regulations under §1.871-15(q)(1) would be revised so that a QDD will remain liable for tax under Section 881(a)(1) and subject to withholding under Chapters 3 and 4 on dividends on physical shares and deemed dividends received.

The Final Rules expanded the scope of liability on QDDs by requiring them to be liable for tax on dividends received on physical securities which increases the potential for over withholding. As we highlighted in our May 24, 2017 submission to the IRS[5], this requirement *goes against the very purpose of the QDD regime* which was to reduce the potential for duplicative or cascading taxation where the QDD is not realizing the economic benefit of dividends received. The Final Rules instead favour hedging through derivative transactions as the QDD would be exempt from withholding on the equivalent payments. It is common for foreign FIs to physically hold shares outside of the U.S. to facilitate hedging, as many do not have U.S. subsidiaries. The Final Rules may result in a distortion of market practices if firms restructure in order to avoid punitive rules.

With respect to any concern regarding tax avoidance or under withholding, all QDDs are QIs, and QIs already have self-reporting tax obligations to the IRS. If there is additional tax liability in a transaction where a client has hedged using a physical security, the QI must self-assess and remit. The current regime is sufficient to capture appropriate withholding of tax in these circumstances. Further, operationally, bifurcating payment processes within institutions between QI and QDD functions for this tax liability will result in administrative and operational issues. QIs are currently able to accept payments and properly remit. We strongly encourage revisions to the Final Rules to remove the requirements to have a QDD remain liable for tax under Section 881(a)(1) and subject to withholding under Chapters 3 and 4 on dividends on physical shares and deemed dividends received.

If Treasury and the IRS do not agree with our above recommendation, we believe it is necessary for the IRS to create a "credit forward system" and/or a refund mechanism to ensure that QIs receive offsetting credits for the tax withheld on the dividend equivalents against the amounts withheld on the actual dividends, or refunds where there was over withholding. If the QDD is not net long, they would be overtaxed.

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[5] See **http://iiac.ca/wp-content/uploads/IIAC-Letter-to-IRS-re-QI-QDD-Ch3-Regulations-May-24-2017.pdf [NTD: IIAC Dec. 2016 letter]**

Examples of Potential Cascading Taxation under the Final Rules:

1. Client purchases an over-the-counter option (OTC option), that is not in scope of Section 871(m). The Canadian QDD hedges against this with physical shares that are held outside of the U.S., as they have no U.S. subsidiary. Since the OTC option is not in scope, there is no offsetting payment, however, the FI would still incur tax liability on the dividend under the hedge as a QDD.

2. Structured notes with a delta-one issued by Canadian banks over US equities. There would be withholding when the FI earns income on the hedge and then the FI would also withhold on their client as on the structured note as a within scope section 871 (m) instrument.

<u>Listed Options and Futures</u>
Recommendation: Listed options and listed futures should be explicitly excluded from the scope of Section 871(m) regulations. If the Treasury and the IRS do not agree to exclude listed options and futures entirely, they should be excluded from the combination rules as they are not the type of products that are generally combined for tax avoidance.

We continue to recommend that listed options and futures be explicitly excluded from the scope of the Section 871(m) regulations as these types of transactions do not easily present opportunities for the type of tax abuse that Section 871(m) was designed to prevent[6]. Further, if the Treasury or IRS does not exclude listed products from the scope of Section 871(m), then we purpose that the combination rules should be revised to exclude listed products. Such an exclusion would substantially ease the burden for industry participants as those securities are the transactions that involve the most cumbersome combination determinations. There is high volume of transactions to monitor and track, with very few in-scope transactions captured, resulting in minimal withholding. Excluding listed products from Section 871(m) would enable the Treasury and IRS to achieve its objectives with respect to tax avoidance while also achieving the objectives of Executive Order 13777 of reducing the compliance burden.

Long exchange-traded calls (or short exchange-traded puts) are generally not a viable vehicle for the various tax avoidance schemes that Section 871(m) regulations were implemented to curtail. Many retail investors use options in lieu of purchasing equity for more bona fide reasons, such as leverage, risk management, or to minimize margin interest that would be incurred by buying the underlying equity shares, and the investor accepts to forego the dividends as a trade-off in these strategies. Further, retail investors that purchase these listed options also add to the overall liquidity and efficiency of the listed markets that benefit all involved as maintaining liquidity is a critical component for the marketplace.

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[6] Congress outlined four specific types of transactions that present abuse opportunities, and listed products were not include. Section 871(m)(3)(A)(i)(ii)(iii), and (iv): (i) cross-in transactions, (ii)cross-out transactions, (iii) derivatives for which the underlying security is not readily tradable on an established securities market, and (iv) derivative transactions, if, in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

<u>Combination Rules</u>

Recommendation: The current simplified standard for combination rules available to withholding agents should be extended and expanded to apply to long party agents. If the Treasury and the IRS do not agree to extend and expand the simplified standard for combination rules, then the presumption rules, currently applicable only to withholding agents, should be available to both withholding agents and long party agents.[7]

The combination rules pursuant to the Final Rules are extremely complex for non-U.S. custodians and long party agents. These industry participants have not received guidance from the IRS making it very difficult for firms to determine how to build systems to comply with the requirements. While the simplified standard for combination rules under the phase in period greatly reduce the burden on short party withholding agents, there has been no relief for long party participants. The result has been an inequitable shifting of the combination rule burden to non-U.S. custodians and other long party agents who have, effective January 1, 2017, been operating under the requirement to identify all potential transactions, including listed products, that could be combined to delta one despite a complete lack of specificity with respect to how these rules should be applied. We recommend that the combination rules be amended to ensure equal treatment across the industry and to prevent operational builds that could be unnecessary or unintentionally fail to meet future guidance issued by the IRS.

Notice 2017-42 further extended the application period of the simplified combination rules for withholding agents and correspondingly withholding agents are only required to combine transactions that are over the counter transactions and that are priced, marketed or sold “in connection with” each other. Withholding agents to not have to combine listed securities. This simplified standard should be extended indefinitely and made available to both withholding agents, non-US custodians, and long party agents.

If the Treasury and IRS do not extend the simplified standard beyond December 31, 2018 and to all parties, then the presumption rules should be available to all parties to the transaction and listed products should be excluded from the scope of the combination rules. Without the benefit of the presumption rules, the complexity of this undertaking and the cost of building and implementing systems capable of handling the combination rules are astronomical. Further, there is currently no guidance available to industry to define the “in connection with” standard, despite repeated requests from industry for additional guidance. The ordering rules require parties to combine transactions in the manner that results in the most transactions with a delta of 0.80 or higher (delta one for 2017 and 2018)[8]. The Managed Fund Association noted in their July 31, 2017 submission that :

[7] Refers to the simplified standard for combination rules originally provided in Notice 2016-76.

[8] Treas. Reg §1.87-15(n)(6)

> "a literal application of this provision with respect to an investor that trades 50 option trades on a single name in a single day could lead to both parties having to test the more than *1 quadrillion* unique combinations that could theoretically be formed."[9]

Extending the presumption rules to all parties does not undermine the enforcement goals of Section 871(m), as the IRS has the ability to rebut either of the presumptions with facts and circumstances to show that transactions were entered into in connection with each other and the general anti-abuse rule §1.871-15(o) would continue to be in-effect; each a deterrent that will prevent potential abuses by all parties[10]. The combination rules were designed as primarily anti-abuse rules; however, the complexity in attempting to comply with the Final Rules and the scope of the Final Rule may be obfuscating its original purpose. Further, we believe there should be consistent treatment for all parties in transactions.

Qualified Securities Lending Regime
Recommendation: Securities lending and repo transactions should be removed from the scope of the QDD regime and should be governed by the Qualified Securities Lending ("QSL").

The IIAC and its Members Firms appreciate the extension of the QSL Regime for calendar years 2018 and 2019 provided in Notice 2018-05. However, the Notice did not address the issues faced by FIs that became QDDs in anticipation of the end of the QSL regime. We believe that the QSL rules, including the credit forward allowance originally provided in Notice 2010-46 should be extended indefinitely and applied to all securities lending and repo transactions. The IIAC will be submitting a separate letter outlining our continuing concerns with the application of the QDD regime on securities lending.

QDD Reconciliation Schedule and Reporting
We support the concerns outlined in SIFMA's June 28, 2017[11] letter regarding the need for clarification on the reconciliation schedule requirements and to report QDD tax liability on Form 1042.

Good Faith Standard
Recommendation: Continue to apply the good faith standard during the finalization of the Section 871(m) regulations.

We believe that the good faith standard should continue to apply until at least all aspects of the Section 871(m) regulations are finalized. We further believe it may be appropriate to extend the good faith standard beyond rule finalization, as additional guidance may be required for the combination rules, or around partnerships.

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[9] Letters re Executive Order 13777, July 31, 2017 Managed Funds Association Comments on 871(m) Final Rules, **https://www.managedfunds.org/wp-content/uploads/2017/08/MFA-comment-letter-on-871m-rule-review.pdf**
[10] Treas. Reg §1.871-15(n)(4)
[11] See **https://www.sifma.org/wp-content/uploads/2017/08/SIFMA-Submits-Comments-to-the-Treasury-and-IRS-on-Revenue-Procedure-2017-15-Qualified-Intermediary-Agreement.pdf**

International Implications

The scope of the Final Rules and their application to non-U.S. financial institutions and particularly QIs, is still unclear and this should be taken into consideration as the Treasury and the IRS determine how best to move forward. The United Kingdom, France, Spain, Italy and Germany have raised jurisdictional concerns as to whether or not the U.S. has the authority to impose dividend withholding tax on dividend equivalent payments between foreign counterparties outside of the U.S. The Canada Revenue Agency has not publicly commented on this specific issue at this time. If Canadian QIs withhold on payments of dividend equivalent amounts, but local authorities have determined that these amounts are not subject to U.S. withholding at source because these amounts may not be considered U.S. source income, clients would be penalized as they would be taxed according to U.S. laws and yet not able to receive any tax credits. This will result in contradictory treatment of similar payments across jurisdictions and will create an unlevel playing field within the securities industry depending on how various countries respond to the jurisdictional question.

Conclusion

We appreciate the opportunity to provide comments on the Section 871(m) regulations and how we believe the Final Rules can be improved to achieve both its objectives while reducing the uncertainty and complexity of the rules. We strongly encourage the Treasury and the IRS to review all industry previous submissions, including SIFMA's, as there are some universal concerns regarding fundamental aspects of the Final Rules. We believe that the Final Rules are overly complicated, and the uncertainty in how to operationalize the Final Rules will result in increased costs to both financial institutions and for individual taxpayers.

We greatly appreciate the ongoing work and dialogue with the industry on the Section 871(m) Regulations. If you have any questions with respect to the foregoing, we kindly ask that you contact the undersigned at **awalrath@iiac.ca** or 416-687-5472. Thank you.

Yours sincerely,

"Adrian Walrath"
Assistant Director