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Re: Notice 2016-76: IRS Enforcement and Administration of Section 871(m) and Related Withholding Provisions During the Phase-In Period (the "Notice")

The Investment Industry Association of Canada (IIAC)[1] is writing to urgently convey the concerns of the Canadian investment industry with respect to guidance provided in the Notice, which seems to materially

[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 130 IIROC-regulated investment dealer Member firms in the Canadian securities industry. These dealer firms are the key intermediaries

change fundamental principles of the Qualified Derivatives Dealer (QDD) regime from those originally outlined in the section 871(m) regulations, and in IRS Notice 2016-42, which contained a draft revised version of the Qualified Intermediary (QI) agreement.

Canadian QIs, including financial institutions who act as dealers and custodians, many of which anticipate applying for QDD status, have been anxiously awaiting additional guidance to be able to fully comply with the section 871(m) and QI/QDD requirements. We appreciate the efforts of Treasury and the IRS to review industry comments, and to respond to these concerns. We understand that the intention behind the Notice is to assist taxpayers and withholding agents (presumably, including QIs and QDDs) with additional guidance and comfort as they work towards full compliance on a best efforts basis.

However, certain provisions of the Notice seem to indicate unanticipated and fundamental changes to the implementation of section 871(m) and QI/QDD, and it will be extremely challenging, if not impossible, for withholding agents and QI/QDDs to implement these changes by January 1, 2017, given that this date is now less than one month away. It is also difficult for industry to understand how certain elements in the Notice fit within the overall QI/QDD regime without the release of the final QI agreement, which we understand may not be available until very close to the end of the year, and the revisions to the section 871(m) regulations, which we understand may not be published until sometime in early 2017.

Our primary concern is the announcement that Treasury and the IRS intend to revise the section 871(m) regulations to provide that a QDD will remain liable for tax under section 881(a)(1) and subject to withholding under chapters 3 and 4 on actual dividends received. The final section 871(m) regulations were published over a year ago, and since that time, withholding agents, QIs and other affected financial institutions and their third party service providers have used those regulations as the basis for developing detailed project plans and building or making changes to existing withholding and reporting systems. These plans and systems were designed under the assumption that withholding agents would not be required to withhold under chapters 3 and 4 on actual dividends paid to a QDD. **The proposed change announced in the Notice signals a significant change that simply cannot be made in the extremely short time remaining between now and January 1, 2017, the proposed implementation date for the QDD regime, particularly since many large financial institutions typically impose a "freeze" on any additional systems changes at the end of the calendar year.**

The Notice also states that "a withholding agent is required to withhold on any actual dividend paid to a QDD, whether the dividend is paid to the QDD in its capacity as a dealer in equity derivatives *or otherwise*" [*emphasis added*]. There is no commentary in the Notice to further explain the meaning of this sentence, and whether it is intended to mean that a withholding agent is expected to withhold on dividends paid to a QI/QDD in its QI capacity, which would be another unexpected and significant change. There also is not enough information in the Notice for withholding agents to understand how to properly document QI/QDDs, track the capacity in which the QI/QDD is receiving a payment, and how these separately tracked payments should be reported on Form 1042-S. It seems likely that separate accounts would need to be

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.

opened by withholding agents to facilitate the tracking of payments to QI/QDDs received in different capacities, and (assuming that this is a correct interpretation) it is highly unlikely that an administrative task of this magnitude could be completed in time for January 1, 2017. Furthermore, the Notice refers only to a QDD providing a valid Form W-8IMY to a withholding agent certifying its status as QDD; it is unclear whether the withholding agent must now also document the QDD using a valid Form W-8BEN-E to obtain the QDD's chapter 3 and 4 statuses, and to complete treaty claim information with respect to the actual dividend payments on which the withholding agent must now carry out withholding. We also note that the recently published Form W-8IMY (September 2016), and possibly the Form W-8BEN-E (April 2016), and their instructions, are now out-of-date and will require further amendments to accommodate and explain the changes announced in the Notice.

While it is difficult to fully understand the reasoning behind these changes without any explanation in the Notice, and without the revised QI agreement, we also see this change as a fundamental shift in principle which could potentially undermine what we understood to be one of the primary purposes behind the QDD regime – to reduce the potential for duplicative or cascading taxation where the QDD is not realizing economic benefit from the dividends actually received. The QDD regime as originally proposed, while complex, required the QDD to calculate its residual economic exposure to an underlying security and calculate and remit to the IRS the appropriate amount of withholding tax. In this respect, the proposed "net delta" concept in the Notice is a welcome change to the QI agreement to simplify the calculation of the section 871(m) amount and the QDD tax liability, but even this change will require sufficient time for QDDs to review their existing delta calculations, make any necessary modifications to complete the new net delta calculation, and assess the impact on hedging strategies. It seems unlikely that this analysis can be completed within the few weeks that remain before the January 1 implementation date.

We also note that the changes proposed to the section 871(m) regulations (barring the release of any further guidance or changes that would provide for additional withholding tax offset or credit forward provisions) will impose withholding tax on both the dividend equivalent payments made <u>by</u> the QDD and the actual dividends paid <u>to</u> the QDD (on the underlying securities hedging the contract). The ability of the QDD to reduce its calculated QDD tax liability on the section 871(m) amount by the amount of tax paid by the QDD on the actual dividend payments would likely provide only nominal relief from duplicative withholding tax as most QDDs are required by regulation to essentially be fully hedged. As such, it is not anticipated that QDDs will incur significant excess net delta and QDD tax liability. Also, if the IRS does not intend to implement a "credit forward system" offsetting the withholding tax on the dividend equivalent payments made against the amounts already withheld on the actual dividends, there will be no relief from cascading withholding where potential 871(m) transactions are hedged against actual securities, and this may have the effect of driving dealers to hedge potential section 871(m) transactions synthetically. Further, even if the IRS intends to implement a "credit forward system", this would place the initial up-front burden of the withholding tax squarely upon the shoulders of the QDD, a somewhat ironic result for regulations that were created to facilitate withholding on dividend equivalent payments. QDDs may be required to revise the terms of their contracts with counterparties, and even then, this could be further complicated if a QDD and a counterparty are subject to different rates of withholding. Without the additional guidance and commentary which we expect will be part of the revised QI agreement, we are unsure whether the intention of Treasury and the IRS was to essentially change the elements and requirements of the QDD regime from that which was originally proposed and for which it was intended.

For all of the above reasons, we recommend that Treasury and the IRS do not implement these announced changes requiring withholding agents to withhold on the actual dividends paid to QDDs, at least not before conducting a full consultation with industry, including withholding agents and QI/QDDs. To this end, we note the proposed material changes to the section 871(m) regulations and the QI agreement announced in the Notice are not subject to a formal review and comment period. We think it is critical that industry be given time to digest and respond formally to these revisions. Furthermore, it is not unreasonable for potential QI/QDDs to be able to fully understand the requirements of these regimes before submitting their applications to the IRS or before certifying status (under penalties of perjury) to withholding agents as potential QDDs.

Finally, we strongly urge Treasury and the IRS to grant a general one-year delay in the implementation date of both section 871(m) (to January 1, 2018) and the new QI Agreement (by extending the validity of the current QI Agreement to December 31, 2017). This would allow the time necessary for additional industry consultation and additional guidance to be published, to allow the IRS to process QI/QDD applications, and for changes to withholding and data transfer infrastructure to be completed. It would also eliminate the need for introducing the new transitional concept of identifying "delta-one/non-delta-one" transactions.

We greatly appreciate the ongoing work and dialogue with the industry on these matters. 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,

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