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March 28, 2016

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1340 on Section 871(m) Regulations*

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report of the Tax Section commenting on final, temporary, and proposed regulations under section 871(m), which were issued on September 18, 2015.

Section 871(m) addresses concerns about the use of derivatives to avoid withholding tax on U.S. source dividends. Section 871(m)(1) treats "dividend equivalent payments" as U.S. source dividends for withholding tax purposes, so they are subject to withholding tax when paid to a non-U.S. recipient.

Since this is the Tax Section's fourth report on section 871(m), this report focuses on issues that have not been considered in prior reports. Our principal recommendations are as follows:

1. In the final regulations, we recommend clarifying when delta should be tested. In general, it should be tested on the earlier of: (a) the trade date, or (b) the date on which all material economic terms have been determined (as long as this "pricing date" is within 14 days of the trade date). We also recommend giving guidance about how issuers can ensure that overallotment options have the same section 871(m) status as the original issuance.

2. In the temporary regulations, we recommend clarifying that the test for simple contracts should be used whenever transactions offer economic exposure to an ascertainable number of shares, including instruments that include an automatic adjustment for mergers and stock splits, instruments that are "net share settled," and put and call spreads.

3. In the temporary regulations, complex contracts have to be compared with a "closely comparable simple contract." More guidance should be offered about the criteria for determining that a simple contract is "closely comparable." The regulations should clarify that this is a hypothetical instrument, and that the material terms, including the treatment of dividends, should be consistent with the terms of the complex contract (aside from the terms that make the contract complex, as well as the terms that make the delta of the closely comparable benchmark 0.8).

4. In the final regulations, the Treasury and IRS should consider changing the safe harbor for indices with a relatively modest U.S. component. To prevent taxpayers from tailoring the index to make tax-advantaged investments in specific U.S. stocks, the index should have to be widely traded, and also should not have been formed for the purpose of avoiding U.S. withholding tax.

5. In the final regulations, loans and sale-repurchase transactions of convertible securities can qualify as section 871(m) transactions in some cases, as can swaps and other equity-linked instruments based on the value of convertibles. Guidance is needed about whether the "underlying" in these potential section 871(m) transactions is the convertible or the stock.

6. In the final regulations, the Treasury and IRS generally have struck a reasonable balance by ordinarily basing the dividend equivalent on the actual dividend, but allowing taxpayers to elect to use an estimate, as long as this choice is made in advance. It is important, moreover, for the Treasury and IRS to enforce the requirement that estimates have to be reasonable.

7. In the final regulations, section 871(m) withholding is not required when section 305(c) already imposes withholding. Similar relief should be offered when a section 871(m) transaction is subject to withholding for a reason other than section 305(c), such as when a periodic payment is treated as "FDAP" income.

8. In the final regulations, withholding generally is deferred until a payment is made. We assume the intention also is to delay the foreign holder's tax liability – not just the obligation to withhold – and ask the Treasury and IRS to clarify that this is the case.

9. In the final regulations, the obligation to withhold is paired with the obligation to decide whether withholding is necessary. The regulations generally seek to rely on a broker or dealer. When both parties are brokers or dealers, the regulations rely on the short party. But this does not make sense when the long party sells in the secondary market, since the short party may not even be aware of the sale. In this circumstance, it would make more sense for the long party's broker to withhold. The Treasury and IRS also should work with industry to ensure that sufficient information is shared among brokers to avoid duplicative withholding.

10. In the final regulations, guidance is also needed about who is responsible for determining whether equity linked notes are section 871(m) transactions and for withholding on these instruments. If the issuer is a broker or has an affiliate that is a broker, the issuer should be tasked with these responsibilities.

11. In the final regulations, further guidance is needed about what information the responsible party has to provide. The regulations require a range of information, including delta and the amount of the dividend equivalents. But if the transaction is not a section 871(m) transaction, the other parties arguably no longer need this information, and it is potentially costly to provide. The regulations should clarify what must be shared in this circumstance.

We appreciate your consideration of our recommendations. If you have any questions or comments on this report, please feel free to contact us and we would be happy to assist in any way.

Respectfully submitted,

Stephen B. Land
Chair

enclosure

ccs:

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