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April 25, 2012

The Honorable Emily S. McMahon
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Douglas H. Shulman
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 on Proposed and Temporary Regulations under Section 871(m)

Dear Ms. McMahon, Mr. Wilkins and Mr. Shulman:

We are pleased to submit New York State Bar Association Tax Section Report No. 1264. The report conveys the recommendations and comments of the Tax Section of the New York State Bar Association regarding the recently issued proposed and temporary regulations (the "Regulations") under Section 871(m).

Section 871(m) was enacted in March 2010 in response to concerns about the use of equity swaps by foreign taxpayers to avoid U.S. withholding tax on U.S.-source dividends, in particular when the foreign "long" party sold the underlying stock to, or bought the underlying stock from, the counterparty in connection with a swap entered into shortly before a dividend payment date. Section 871(m) provides that any "dividend equivalent" will be treated as a U.S.-source dividend subject to U.S. withholding tax. The term "dividend equivalent" includes certain payments on contracts ("specified notional principal contracts," or "SNPCs") that are considered to have the potential for abuse.

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The Regulations were issued on January 19, 2012 to provide further guidance on the application and operation of Section 871(m). The Regulations expand both (i) the definition of a dividend equivalent to include payments made pursuant to certain equity-linked instruments and other transactions, and (ii) the categories of contracts that will be treated as SNPCs and therefore within the scope of Section 871(m).

The Regulations pose many challenges for the withholding tax system, including an expansion of the contexts in which a foreign person will be required to act as a withholding agent, the increased potential for withholding in the absence of an actual payment, and the possibility that payments will become subject to withholding on a retroactive basis. The Report comments on the many technical issues that arise under the Regulations.

A substantial majority of our members believe that Section 871(m) should be limited to arrangements that provide near total return, or "delta one," exposure to the underlying security. This limitation is consistent with the principal purpose of Section 871(m), which was to capture U.S. withholding tax on arrangements that provide synthetic ownership, including exposure to the full economic risk and reward of the underlying security. If the Regulations are not limited in this fashion, Section 871(m) would reach many other financial instruments and arrangements, including options and convertible debt that are not economic substitutes for actual ownership. Applying Section 871(m) to instruments and arrangements of this kind will raise a host of conceptual difficulties and compliance burdens, without furthering any compelling policy goal. For example, in some circumstances a strike price adjustment to an option may be treated as a dividend equivalent payment subject to withholding, even though the holder will derive no benefit from the adjustment if the option expires out-of-the-money.

The report also comments on each of the seven tests for SNPC status and more generally on the appropriate SNPC status testing date for particular types of transactions. The report asks for clarification on the application of the SNPC tests in the context of modifications and transfers and recommends that the Regulations provide further guidance on when actions taken to purge a contract of SNPC status would be subject to challenge under the general anti-abuse rule of the Regulations and what sort of actions may terminate the SNPC status of an existing transaction. Some of the SNPC triggers under the Regulations may apply to actions by parties and their global affiliates that have no nexus whatsoever to the transaction at issue. We believe such an approach, while certainly objective, will raise serious compliance issues, in particular for participants who enter into transactions not intended to facilitate the avoidance of U.S. withholding tax on dividends. The report therefore recommends that only actions taken "in connection with" the transaction at issue be taken into account in determining SNPC status.

The report also recommends that withholding agents be entitled to rely on appropriate representations from counterparties in determining whether payments are subject to withholding. Finally, the report recommends that SNPCs should be extended the same relief from cascading withholding tax available to securities loans, under principles similar to the documentation-based system outlined in Notice 2010-46.

The report also includes many other comments and recommendations.

Respectfully submitted,

Andrew W. Needham
Chair

Enclosure

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