

February 10, 2015

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

Re: Request for Delay in the Application of Final Regulations under Section 871(m)

Dear Mr. Mazur:

I am writing on behalf of the North American Tax Committee (“NATC”) of the International Swaps and Derivatives Association (“ISDA”)<sup>1</sup> to respectfully request a modification to the effective date of the anticipated Treasury regulations under Internal Revenue Code section 871(m). NATC members are concerned that application of the regulations to payments made prior to January 1, 2017, and to certain instruments entered into or issued prior to such date, will make compliance with such regulations extremely challenging and potentially cause market disruptions that were not intended by Congress or the Treasury department and Internal Revenue Service. Therefore, we strongly urge that the Treasury department and Internal Revenue Service provide the relief requested below.

The currently proposed Treasury regulations under section 871(m) generally would, when finalized, impose U.S. withholding tax with respect to dividend equivalent payments made on or after January 1, 2016 on a notional principal contract (“NPC”) that is considered a “specified NPC” or an equity-linked instrument (“ELI”) that is considered a

---

<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 67 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

“specified ELI.” Notwithstanding the general effective date provision (which would have applied to NPCs or ELIs, regardless of when entered into or issued), Notice 2014-14 subsequently announced that the final section 871(m) regulations will regard an ELI as a specified ELI only if it is issued on or after 90 days after the date on which the section 871(m) regulations are finalized. No similar grandfathering rule was provided for NPCs.

Given the overwhelming administrative and technical difficulties entailed in building systems and amending agreements to implement withholding under the anticipated section 871(m) regulations, as described in greater detail below (and subject to the potential sunset rule discussed below), the NATC respectfully requests that the final section 871(m) regulations:

1. apply to treat a payment pursuant to an NPC or ELI as a “dividend equivalent” only if such payment is made on or after January 1, 2017<sup>2</sup> and references the payment of a dividend from an underlying security on or after that date; and
2. apply to:
  - a. any “delta one”<sup>3</sup> NPC or ELI that is either an over-the-counter derivative or a single stock future, in either case only if it is entered into or issued on or after January 1, 2016 (the “delta one grandfathering rule”),<sup>4</sup> and
  - b. any other NPC or ELI only if it is entered into or issued on or after January 1, 2017.

Incorporation of these requests into the final section 871(m) regulations would relieve administrative burdens that threaten to cause disruption in derivative markets as a result of the implementation of the section 871(m) regulations. More specifically:

1. Time to Build Systems to Implement Withholding. Once the regulations are finalized, financial institutions will need time to fully understand the regulations, clarify any

---

<sup>2</sup> We have proposed an effective date of January 1, 2017 based on the assumption that the final regulations will reflect certain simplifications and clarifications recommended by industry groups and that no significant new complexities are raised in the final regulations. To the extent that is not the case, we may need to seek an additional extension to the effective date.

<sup>3</sup> By a “delta one” instrument, we are referring to an instrument with a “constant delta” (within the meaning of Prop. Reg. § 1.871-15(g)(2)). Any instrument that is more complex than a basic “delta one” instrument (*e.g.*, a structured note that pays two times the upside and one times the downside) would be covered under the January 1, 2017 grandfathering date.

<sup>4</sup> We have intentionally excluded listed options from the delta one grandfathering rule because section 871(m) withholding on listed options will be extremely complex to implement.

remaining ambiguities and then build systems to ensure that the withholding regime set forth in the regulations is properly and consistently applied and to otherwise comply with the regulations. While the challenge of building these systems will be especially acute with respect to non-delta one derivatives and listed derivatives, the systems building process will involve a major expenditure of time and resources even for delta one products (such as total return swaps). This will be particularly true for delta one products such as price-return derivatives, derivatives with automatic reinvestment features and derivatives linked to an index (other than a qualified index). In order to facilitate withholding, various payment systems for different derivative products will need to be linked to trading and market data systems to capture and store various data points. Even if the final regulations were issued in the next few weeks, there simply is not enough time during the remainder of 2015 (*i.e.*, before the effective date in the proposed regulations) to build appropriate systems in an orderly manner that ensures consistency and accuracy throughout the market. Moreover, from the perspective of logistics and efficiency, it is important to build the withholding systems for delta one and non-delta one instruments at the same time, which is why we are asking for withholding under section 871(m) to start at the same time for all contracts. In order to calculate the withholding on ELIs, the marketplace needs sufficient time to develop and implement systems to identify and track transactions to which the final regulations will apply. Firms generally have no withholding systems currently in place for NPCs and ELIs because those transactions generally do not involve payments of U.S. source FDAP. Moreover, firms do not currently have processes in place to track deltas, to link delta calculations to payment systems or to handle other complexities that will need to be addressed. Adding to the complexity, many offshore firms that enter into NPCs and ELIs linked to U.S. equities currently have no U.S. withholding tax systems at all. Such offshore firms will need to build withholding systems from scratch in many locations. Operationally, the development of these systems will be an enormous task even if the regulations do not turn out to involve greater complexity than market participants currently expect. Consequently, starting withholding before January 1, 2017 would be extremely difficult for firms to implement and impose a serious hardship on the industry at a time when it is struggling to handle all of the tax and non-tax regulatory requirements that have been imposed on the industry. In this regard, we note that many of the same resources that will be needed to build the necessary systems for section 871(m) withholding are also engaged with implementation for U.S. FATCA, U.K. FATCA, OECD Common Reporting Standard, cost basis reporting and other government-mandated regimes. For these reasons, we request that the final regulations not apply to any payments made on an NPC or ELI prior to January 1, 2017.

2. Time to Make Documentation Changes and Identify When Withholding Applies. It is essential that the allocation of withholding taxes and payment mechanics in ISDA standard-form documentation and other relevant ELI contracts be modified to reflect the potential for withholding tax under the section 871(m) regulations for any transaction that

**International Swaps and Derivatives Association, Inc.**

360 Madison Avenue, 16<sup>th</sup> Floor  
New York, NY 10017  
P 212 901 6000 F 212 901 6001  
[www.isda.org](http://www.isda.org)

NEW YORK	WASHINGTON
LONDON	BRUSSELS
HONG KONG	SINGAPORE
TOKYO	

may have a term that extends beyond the date on which withholding on payments begins. Such modifications should be made before the transactions at issue are executed in order to clearly define who is responsible for the tax and to determine appropriate pricing. Many market participants have been reluctant to amend their contracts potentially impacted by the section 871(m) regulations without knowing what the regulations will ultimately provide, which means that most contracts for existing trades still need to be addressed. Because ISDA protocols for section 871(m) have generated relatively few adherents, most contracts will need to be negotiated bilaterally in order to address section 871(m) withholding. Other ELIs are not even subject to a market protocol so all such contracts will need to be bilaterally negotiated and amended if payments thereon may be made after the effective date for the final regulations. In addition, firms have not previously needed to collect U.S. tax forms, such as Form W-8s, with respect to NPCs and many ELIs and will now need to gather such forms prior to the effective date for the regulations. The massive amount of contracts that must be amended and withholding tax forms that must be collected to address section 871(m) withholding is an overwhelming task for all firms. There has to be an orderly progression as to how this gets done. Given delta one contracts are likely somewhat easier to handle (easier to explain to clients, for example) and these contracts should be generating the most withholding tax liability, we believe these contracts should be covered first. Therefore, the recommendation is to apply withholding tax beginning only January 1, 2017 for over-the-counter delta one contracts and single stock futures entered into on or after January 1, 2016. Once these contracts are dealt with, the market can then address all remaining contracts in 2016, which is why, with respect to contracts not covered by the delta one grandfathering rule, we recommend applying withholding tax beginning on January 1, 2017 only to transactions entered into or issued on or after that date. Moreover, applying a lengthier grandfathering period to non-delta one instruments will allow much-needed additional time for building systems to calculate delta reliably and contemporaneously before the instruments subject to withholding are entered into or issued, which will itself be a demanding task.

For the foregoing reasons, to provide time to build systems to track which derivatives are within the scope of section 871(m), to implement accurate withholding on such contracts, to alleviate the burden of modifying the significant number of currently outstanding agreements and to allow time to collect the relevant tax forms, we request that section 871(m) withholding generally should apply only to derivatives entered into or issued on or after January 1, 2017. We recognize, however, that in the case of certain delta one derivatives (*i.e.*, over-the-counter derivatives and single stock futures), the task of identifying which transactions are in scope is less daunting and the government's interest in having section 871(m) apply may be greater, such that we request that section 871(m) withholding apply starting in 2017 to such delta one instruments<sup>5</sup> only if entered into or issued on or after January 1, 2016. As discussed above,

---

<sup>5</sup> Where a taxpayer enters into two or more derivatives, we believe that such derivatives should be considered delta one, at least for purposes of this effective date rule, only where such derivatives are

staggering the grandfathering dates for transactions subject to section 871(m) will allow for a more orderly process of implementation to address the large volume of contracts that have to be amended and tax forms that have to be collected.

We appreciate the strong interest the government has in ensuring that any relief that is granted not be used to allow taxpayers to circumvent the rules or otherwise engage in abusive transactions. With respect to the delta one grandfathering rule, we recognize that a taxpayer could potentially consider entering into a long-term delta one transaction prior to January 1, 2016 in order to benefit from a lengthy exemption from withholding under our proposed effective date. In this regard, we think it would be appropriate to have the delta one grandfathering rule sunset for payments made on or after January 1, 2018 on an instrument entered into or issued more than 90 days after the date of the final regulations. In that case, the maximum benefit of the delta one grandfathering rule for transactions entered into or issued more than 90 days after the effective date would be for one year (assuming that the effective date change requested above is implemented), *i.e.*, from January 1, 2017 to January 1, 2018. We have not proposed a similar payment date limitation for the non-delta one derivatives entered into before 2017 because our view is that these trades involve market risk that impacts pricing enough to ensure that it is unlikely that anyone would enter into a longer dated trade just because the contract is grandfathered from withholding under section 871(m).

In summary, if the grandfathering proposals (as well as the sunset provision) described above were adopted, the section 871(m) regulations would apply as follows:

1. For delta one NPCs and ELIs that are either over-the-counter derivatives or single stock futures:
  - a. full grandfathering if entered into or issued on or before the 90th day after the final regulations are issued;
  - b. grandfathering if entered into or issued more than 90 days after the final regulations are issued and before January 1, 2016, but only for payments made before January 1, 2018; and

---

intended to operate together as a single delta one transaction (*e.g.*, they were priced together as a delta one trade).

**International Swaps and Derivatives Association, Inc.**

360 Madison Avenue, 16<sup>th</sup> Floor  
New York, NY 10017  
P 212 901 6000 F 212 901 6001  
[www.isda.org](http://www.isda.org)

NEW YORK	WASHINGTON
LONDON	BRUSSELS
HONG KONG	SINGAPORE
TOKYO	

- c. no grandfathering if entered into or issued on or after January 1, 2016.<sup>6</sup>
- 2. For all other NPCs and ELIs:
  - a. full grandfathering if entered into or issued before January 1, 2017; and
  - b. no grandfathering if entered into or issued on or after January 1, 2017.

We also have considered whether a taxpayer might structure a derivative to have a delta that is slightly less than one (*e.g.*, 0.99) in order to benefit from the general grandfathering rule rather than being subject to the shorter term delta one grandfathering rule. We believe that a derivative structured for such purpose would likely be subject to the anti-abuse rule currently contained in the proposed regulations, but if necessary, a separate anti-abuse rule or example could be provided to prevent taxpayers from incorporating *de minimis* differences from a delta one derivative in order to benefit from a more favorable grandfathering rule.

For the foregoing reasons, NATC respectfully requests that the application of the final regulations be modified in the manner described above.

Yours truly,



Thomas Prevost

cc: Danielle Rolfes, International Tax Counsel  
Karl Walli, Senior Counsel—Financial Products, U.S. Treasury  
Steven Musher, Associate Chief Counsel (International), IRS Chief Counsel  
Marjorie Rollinson, Deputy Associate Chief Counsel (International), IRS Chief Counsel  
Mark Erwin, Branch Chief, International Branch 5, IRS Chief Counsel  
Peter Merkel, Senior Technical Reviewer, International Branch 5, IRS Chief Counsel  
Karen Walny, Attorney-Advisor, International Branch 5, IRS Chief Counsel

---

<sup>6</sup> However, under our proposal, there would be no withholding until January 1, 2017 as the proposal is to treat a payment as a dividend equivalent only if such payment is made on or after January 1, 2017 and references the payment of a dividend from an underlying security on or after that date.