ISDA. Safe, Efficient Markets

May 16, 2014

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

Karl Walli
Senior Counsel for Financial Products
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Danielle Rolfes
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

William Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Regulations under Section 871(m)

Ladies and Gentlemen:

On behalf of the North American Tax Committee of the International Swaps and Derivatives Association ("ISDA"), I am writing in support of the comments submitted by the Securities Industry and Financial Markets Association ("SIFMA") in its letter dated May 7, 2014 (the "SIFMA Letter") with respect to the recently re-proposed regulations under section 871(m) ("Proposed Regulations"). In addition to endorsing the statements and recommendations made in the SIFMA Letter, and as discussed further below, I would like to highlight the following points: (i) because the Proposed Regulations impose extensive and unprecedented burdens on withholding agents to provide information, to make determinations as to the application of withholding under section 871(m) and to withhold taxes under section 871(m) even where no payment is being made, we encourage the government to simplify the regulations and to provide appropriate relief from these onerous responsibilities; (ii) while we generally appreciate the need for the combined transactions rule in Prop. Reg. § 1.871-15(l) (subject to the comments regarding such rule made in the SIFMA Letter), we believe that such rule should be broadened to permit a taxpayer to net related long and short positions in determining whether such transactions constitute a section 871(m) transaction; and (iii) the final regulations should include provisions to expand the qualified dealer exception of the Proposed Regulations and to mitigate cascading withholding.

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 F 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

Since 1985, ISDA has worked to make the global OTC derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 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.

Challenges Facing Withholding Agents

While the Proposed Regulations are targeted at collecting withholding tax from non-U.S. taxpayers on U.S. equity-linked derivatives, the Proposed Regulations impose massive operational and administrative burdens on broker-dealers and other market participants responsible for withholding and information reporting. At the very least, the withholding regime set forth in the Proposed Regulations would impose enormous costs (in terms of both money and time expended) on financial institutions and financial intermediaries, and the complexity of the rules may result in substantial confusion in terms of how to comply properly with the new regime. Even simplified rules will require multinational financial groups to substantially enhance existing transaction systems along with such systems' interface with various client and market data systems for multiple legal entities. In addition, the requirement to withhold in circumstances when no payments are made and to apply withholding to combinations of instruments will be particularly challenging for withholding agents because existing systems do not currently track combinations or contemplate phantom payments or withholding on phantom payments. Furthermore, the Proposed Regulations would also cause entities that had never been required to withhold U.S. tax to undertake U.S. withholding tax responsibilities.

Moreover, the Proposed Regulations would require an unprecedented amount of trade-specific and holder-unique data to be shared among marketplace participants on a real-time basis, and it is not clear how financial institutions and financial intermediaries could collect, sort and verify all this information in the manner contemplated by the Proposed Regulations. This aspect of the Proposed Regulations raises particular concerns for custodians for structured notes and listed derivatives on U.S. equities, who would need to withhold even though they may not have the information needed to determine whether withholding applies or the amounts to be withheld. For those reasons, we especially stress the importance of the recommendations for relief with respect to listed derivatives contained in the SIFMA Letter.

We strongly urge you to simplify these rules and to establish simple safe harbors for withholding and information reporting to reduce the administrative and operational burdens for

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 F 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

all marketplace participants and to ensure that the rulemaking can be implemented evenly and fairly within the industry as intended.

Expansion of the Combined Transactions Rule to Allow Netting of Long and Short Positions

As currently drafted, the combined transactions rule in the Proposed Regulations requires two or more derivative transactions referencing the same underlying security to be treated as a single transaction for purposes of determining whether each derivative is a section 871(m) transaction if a person (or a related person) is the long party with respect to each derivative and the transactions are entered into in connection with each other. Our understanding of the combined transactions rule is that it is intended to prevent taxpayers from dividing their long exposure to an underlying security among different derivatives in order to avoid the application of section 871(m) by keeping the initial delta of each individual derivative below 0.70. We recognize that the government has a legitimate interest in preventing taxpayers from separating their exposure to an underlying security into different transactions in order to avoid U.S. withholding tax.

We strongly support SIFMA's recommendation that the combined transactions rule be modified to clarify both the circumstances in which transactions will be treated as entered into in connection with each other and when broker-dealers will be treated as having actual knowledge that two or more transactions should be combined for withholding and information reporting purposes. In particular, the combination rule should be limited to situations in which the combination of derivatives is intended to be an economic substitute for an investment in the underlying security. With respect to application of the combined transactions rule to withholding agents, it is understandable that a broker-dealer that actually prices two transactions together or markets or sells such transactions together as a single unit would be deemed to have knowledge that a foreign counterparty has entered into such transactions in connection with each other. We think it is important to clarify, however, that a broker-dealer does not have an obligation to investigate whether a foreign counterparty has otherwise entered into related transactions on the same underlying security that were not priced, marketed or sold together.

In addition to these recommendations, we believe that the combined transactions rule should be expanded to permit a taxpayer to net long positions and short positions referencing the same underlying security when such transactions are entered into in connection with each other.

The combined transactions rule presumably reflects a policy determination that when a taxpayer enters into closely related transactions on the same underlying security, section 871(m) is appropriately applied by viewing such transactions as a single transaction. Such a determination, if appropriately applied, is a sensible approach in that it prevents form from being elevated over substance. Once the decision has been made to impose withholding tax only on those derivatives with a delta above a threshold level, the relevant inquiry should be whether the taxpayer's exposure to a single security through a transaction or a series of related transactions

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 F 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

exceeds that delta threshold. There is no apparent justification for limiting the combination of related transactions to circumstances where such a combination increases (rather than decreases) a taxpayer's withholding tax liability.

When a taxpayer's overall economic exposure to a single security is in fact below 0.70 through a combination of long and short positions, the taxpayer generally could have achieved the same or a substantially similar economic result by entering into a single derivative with an initial delta of less than 0.70, thereby avoiding the application of the Proposed Regulations. But there are significant non-tax reasons why a taxpayer may wish to achieve its desired economic position through a series of derivatives rather than a single derivative position. It is unclear why a taxpayer should need to enter into a single derivative, rather than a series of related derivatives (where doing so would otherwise be preferable), simply to prevent any of the derivatives from being treated as a section 871(m) transaction.

For example, a taxpayer that purchases a call option with a delta in excess of 0.70 and simultaneously writes a call option at a higher strike price on the same underlying security (*i.e.*, enters into a call spread) may have an overall delta of less than 0.70 with respect to the underlying security once both options are taken into account. The taxpayer's overall position with respect to the underlying security will be significantly different from the position of an owner of the underlying security. For that reason, we do not believe that section 871(m) withholding should apply to such a taxpayer. Even where a taxpayer initially holds a high-delta derivative and later reduces or eliminates its economic exposure to the underlying security by entering into a short derivative, the taxpayer should be able to reduce its delta based on the economic effect of the short derivative at the time such derivative is acquired.

In order for such netting of related long and short positions to have practical effect, a taxpayer should be permitted to identify to the relevant withholding agent which of its positions are entered into in connection with each other, so that the withholding agent will know when to combine such transactions in making its withholding tax determination. A withholding agent receiving such an identification of taxpayer positions to be combined should be permitted to rely on such identification for withholding and information reporting purposes.

For the foregoing reasons, we urge that the final regulations under section 871(m) provide for a netting of all of a taxpayer's long and short positions on the same underlying security entered into in connection with each other for purposes of determining whether such transactions constitute a section 871(m) transaction.

<u>The "Qualified Dealer" Exception and the Need for Relief from Cascading Withholding</u>

We strongly recommend that SIFMA's proposals for expanding the definition of "qualified dealer" be adopted because, as explained in the SIFMA Letter, the existing definition is unnecessarily limiting and does not provide relief from cascading withholding in many appropriate cases. A common example of where the cascading withholding arises is where a

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 F 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

foreign entity (which may not be a "qualified dealer" under the Proposed Regulations) issues structured notes linked to the value of U.S. equity securities to investors and hedges its risk with respect to the structured notes by entering into a "back-to-back" derivative with a U.S. person (which would not necessarily be an affiliate of the foreign person). In these circumstances, the withholding tax imposed should be limited to that imposed on the investor purchasing the structured notes because the investor is the only party to the transaction that is gaining net long exposure (with the foreign person effectively rendering a service by providing it with an efficient means to gain long exposure). The long party could have achieved the same exposure (with only one level of withholding tax being imposed) by entering into the transaction directly with the U.S. party to the back-to-back arrangement, but there are many business, regulatory and other reasons why these arrangements are structured using back-to-back derivatives. We see no policy justification for imposing two levels of withholding tax in such circumstances.

In addition, we think it is critical that, regardless of what changes to the qualified dealer definition are ultimately incorporated into the final regulations, a "credit forwarding" system also be adopted to allow cascading withholding tax to be avoided in situations where tax avoidance potential is not present. We understand that the government may have concerns about permitting credit forwarding in applying section 871(m) because of potential economic divergence between the hedge position and the position being hedged. To the extent this is viewed as a significant issue, we see no reason why guidance could not be drafted in a way to prevent abuse by addressing this concern appropriately while still providing relief. At a minimum, relief should be provided where the hedge position and position being hedged reflect the same economic exposure to the underlying security, such that no economic divergence would be present.

We would be pleased to discuss any aspect of this letter with you further.

Yours truly,

Thomas Prevost

Thomas Prevost

cc: 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

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 F 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO