ISDA®

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD
United Kingdom
Telephone: 44 (20) 3088 3550
Facsimile: 44 (20) 3088 3555
email: isdaeurope@isda.org
website: www.isda.org

December 21, 2009

The Honorable Max S. Baucus
Chairman
U.S. Senate Committee on Finance
511 Hart Senate Office Building
Washington, DC 20510

The Honorable Charles E. Grassley
Ranking Member
U.S. Senate Committee on Finance
135 Hart Senate Office Building
Washington, DC 20510

Re: Tax Extenders Act of 2009 – Section 541

Dear Chairman Baucus and Ranking Member Grassley:

We respectfully submit our comments regarding section 541 of H.R. 4213, the Tax Extenders Act of 2009 (the "Bill"), as passed by the House of Representatives on December 9, 2009. Section 541 of the Bill ("Section 541") would impose U.S. withholding tax on certain "dividend equivalent payments" made with respect to equity swaps and certain other financial arrangements. Section 541 represents a successor to the provisions of section 501 of H.R. 3933, The Foreign Account Tax Compliance Act of 2009 (the "Predecessor Bill"), on which we submitted comments in a letter dated November 19, 2009 (the "Prior Letter"). For your convenience, a copy of the Prior Letter is attached.

We are pleased that Section 541 appears to reflect some of the comments and observations we made in the Prior Letter. Section 541 represents an improvement from the Predecessor Bill, but certain aspects of Section 541 nonetheless could cause serious disruptions in both the equity swap and securities lending markets. These concerns can be mitigated, however, with fairly modest changes to the Bill, including reasonable changes to the effective date.

Summary of Section 541

In brief, Section 541 would treat "dividend equivalent payments" as if they were dividends from U.S. sources and impose a 30 percent U.S. withholding tax on those payments. For this purpose, a dividend equivalent payment is any substitute dividend, or any payment with respect to a "specified notional principal contract" (an "SNPC") that directly or indirectly is contingent upon or determined by reference to the payment of any dividend from sources within the United States, or any payment determined by the Treasury Department to be substantially similar. An SNPC initially is a notional principal contract that meets one of four specified criteria or is specified in Treasury regulations. One of the four criteria is "in connection with entering into such contract, any long party transfers the underlying security." After two years following the date of enactment, every notional principal contract is treated as SNPCs unless specifically excepted by Treasury regulations as one that does not have the potential for tax avoidance. The provisions of Section 541 would apply to payments made more than 90 days following enactment of the Bill. We will describe certain provisions of Section 541 in greater detail below in conjunction with our comments.

By including "any substitute dividend" in the definition of a dividend equivalent payment, Section 541 departs from the Predecessor Bill insofar as it appears to immediately revoke IRS Notice 97-66 (1997-2 C.B. 372), which grants relief from the imposition of U.S. withholding tax on certain substitute dividend payments on borrowed U.S. equities in cases that otherwise could result in over-withholding. Section 541 gives the Treasury Department limited authority to issue regulations that address potential over-withholding in securities lending transactions.

Summary of our Principal Recommendations

We recommend with respect to the equity swap provisions of Section 541:

1. The first criterion for determining if a swap is an SNPC should be modified or clarified so that unless Treasury Department regulations provide otherwise, withholding will not be required unless the long party transfers the underlying security to the short party.

2. Delay the effective date of the legislation relating to SNPCs to one year (instead of 90 days).

3. Grandfather all transactions entered into prior to enactment.

4. Require the Treasury Department to issue regulations within six months.

5. Notional principal contracts that become SNPCs only because they are designated as such by the Treasury Department should not be treated as SNPCs unless the swap contract is entered into after six months following the designation.

We recommend with respect to the substitute dividend provisions of Section 541:

1. Delay the effective date of the legislation relating to substitute dividend payments to 18 months (instead of 90 days).

2. Require the Treasury Department to issue regulations within six months.

3. Require, or at least authorize, the Treasury Department to exclude from the withholding tax substitute dividends if it can be shown that the underlying stock is held by a taxable U.S. person (not just a foreign person).

“Transfers In Connection With . . .”

Proposed Code section 871(l)(3)(A)(i) would treat a notional principal contract as an SNPC if the “long party” transfers the “underlying security” in connection with entering into the notional principal contract. However, it is entirely possible that such a transfer could take place with no knowledge or participation of the dealer counterparty. Under such circumstances, Section 541 would impose a withholding obligation on the dealer, even though it is plainly unreasonable to do so. Although the Joint Committee Explanation accompanying the Bill states that the Treasury Department could issue regulations to limit the application of this rule in the case of third party sales, there is nothing in the Bill that would require the Treasury Department to do so.

Dealers will be reluctant to assume the risk of withholding agent liability relating to the interpretation of “transfer . . . in connection with.” Therefore, since the typical customer base for equity swaps is hedge funds that are active traders of securities, it will be difficult to enter into any new contracts upon enactment of Section 541 without detailed clarification of that provision. Similarly, for existing contracts, dealers would face the same dilemma regarding interpretation of this language and would be forced to terminate any swap that posed risk of withholding liability. The problem for existing swaps is compounded by the fact that the systems dealers have in place might be able to identify when transfers were made directly to the dealer in connection with entering into a swap, but cannot identify what other kinds of transfers may have taken place. The systems in place had no reason to, and thus do not, capture this information. Accordingly, it is vitally important to modify Section 541 to avoid significant market disruptions that will arise as a result of this change. We propose that the legislation be modified to provide that proposed Code section 871(l)(3)(A)(i) apply only to transfers of the underlying security to the short counterparty. To address concerns that may exist about other transfers, the Treasury Department could be given authority to issue regulations that would bring other appropriate dispositions into the scope of proposed Code section 871(l)(3)(A)(i). We cannot overemphasize the degree of market disruption that would take place if this suggestion is not adopted (or the effective date of the provision is materially delayed to permit the issuance of regulations relating to third party sales).

Effective Date

We appreciate that Section 541 has made some effort to address problems with the effective date of the Predecessor Bill that we commented on in the Prior Letter. Nonetheless, the Section 541 effective date remains unworkable in several respects.

General Effective Date - SNPCs

Section 541 generally would become effective 90 days following the date of enactment. As we discussed in the Prior Letter, the operational systems required to determine whether withholding is required and, if so, implement proper withholding, cannot possibly be put into place in so short a period of time. Thus, if Section 541 were enacted in its current form, dealers would be faced with withholding obligations that they are not able to determine or comply with.

In the case of new transactions, dealers would be forced to enter only into transactions that clearly comply with the provisions of Section 541 to avoid any withholding obligation because they are not equipped to properly implement the required withholding regime. While we appreciate the fact that an effort was made with respect to the provisions of Section 541 that become effective in 90 days, to limit the withholding obligation to what was perceived to be transactions that dealers could easily enough avoid entering into, that proposition is simply inaccurate. Numerous interpretive issues remain, including the uncertain application of proposed Code section 871(l)(3)(A)(i), as well other issues discussed at the end of this letter, even if all the modifications and clarifications we request are adopted.

For outstanding equity swaps, dealers naturally will be unwilling to bear any withholding risk. Therefore, in the face of uncertain application of the rules, they will need to act swiftly to amend or terminate large volumes of swaps that pose a risk of subjecting the dealer to a withholding obligation. Just like the case with “transfers” discussed in the prior section, dealers’ systems in place have not been set up to capture and distill all of the other information necessary to determine whether withholding is required by the new regime. Because of the absence of automated systems, dealers essentially would need to make a contract-by-contract determination, and then work to amend or terminate those contracts for which there is a risk of being subject to a withholding obligation. Given the enormous volume of contracts, dealers would suffer a considerable administrative burden in devoting adequate resources to conduct this process in a short period of time. We also note that the termination notice period required by many contracts simply would make termination within 90 days impossible. For those contracts that can’t be timely terminated (either because the dealer could not devote sufficient resources to the task, could not get clients to react timely to needed changes in documents, or the contract did not permit termination within the time frame), dealers will face an unworkable situation in two ways. First, dealers will have to manually determine any withholding tax liabilities. Second, since payment flows normally are automatic, dealers will need to adjust the systems that process those automatic payments to reflect the new withholding tax within a very short time frame.

With the provisions of Section 541 as written, to avoid the significant disruptions that the 90 day effective date would cause, we recommend a delay in the effective date for notional principal contracts to payments made on or after the date that is one year after the date of enactment. Moreover, the Treasury Department should be mandated to issue guidance within six months of the date of enactment in order to allow time for operational systems to be adapted to whatever guidance is given. However, if our suggested change to proposed Code section 871(l)(3)(A)(i) is adopted, as discussed above, the one year time frame could be reduced to six months. In addition, given the immense difficulty of applying the new rules to transactions executed prior to enactment, under operational systems not designed to capture all the information required by the new regime, we believe all outstanding transactions should be grandfathered.

Two Year Effective Date

After two years, all notional principal contracts would be treated as SNPCs unless excepted by regulations. We appreciate the recognition that additional time is necessary to allow dealers to adapt to a potentially more complex set of rules. Nonetheless, as the Prior Letter stated, considerable time is needed *after* the issuance of regulations in order to adapt operational systems appropriately. Section 541 does not assure the issuance of regulations with sufficient time for systems development prior to the two year point. Thus, dealers could be left unable to comply with whatever rules the Treasury Department issues. Accordingly, for the same reasons we discuss above, we recommend that Treasury be mandated to issue guidance within six months after date of enactment, so that dealers have 18 months to implement the systems needed to comply with the new rules.

Application of General Effective Date to Transactions Designated by Regulations

The Treasury Department may designate any type of notional principal contract that it chooses as an SNPC, and the effective date of the designation would be 90 days after the date of enactment, even if the designation occurred after the 90 day effective date period. Consequently, this rule has the potential to create a withholding obligation retroactively. For the reasons explained above, the industry needs sufficient time to react to any new rules. Therefore, any notional principal contracts so designated by the Treasury Department should not be treated as SNPCs unless the contract is entered into more than six months following the designation.

General Effective Date – Securities Lending

With respect to securities lending transactions, absent further guidance on the issues discussed below, enactment of Section 541 will immediately create a huge disruption in the marketplace. As is the case with equity swaps, there are significant operational challenges that must be overcome in order to implement the proposed changes to the applicable rules - in particular, the tracing of securities lending transactions. The necessary operational changes simply cannot be implemented within the 90 day time frame. Thus, even disregarding the need for clarifications and procedures to be provided in Treasury Regulations, which undoubtedly will take some time, 90 days does not provide dealers with sufficient time to make the necessary changes (such as modifying Securities Lending agreements, terminating contracts, creating tracing procedures and withholding systems, etc.) that will be required to address these new rules.

Accordingly, for securities lending transactions, we recommend delaying the effective date so that Section 541 would apply to substitute dividend payments made on or after the date that is 18 months after the date of enactment. Given the significant departures from present law and practice and the fact that the new rules apply to all cross border securities lending transactions (i.e., not just a small subset of transactions that could more readily be avoided), we believe the longer delay is necessary to allow dealers to implement the entirely new withholding systems required. Moreover, because of the operational and systems changes that we anticipate will be needed to respond to regulations, the Treasury Department should also be mandated to issue guidance with respect to securities lending transactions within six months. Swift action by the Treasury Department is particularly important in this area. In the absence of proper guidance, dealers will need to make major changes to their securities lending arrangements in anticipation of an impending effective date. For example, dealers might restructure their international operations in order to avoid the second fact pattern described in the next section. Depending on the content of the guidance issued, the changes may ultimately prove to be an unnecessary and wasted effort that can be avoided with the recommended change to the effective date.

Securities Lending Issues

IRS Notice 97-66 provides relief from the over-withholding that admittedly would result from applying the sourcing rule of Treasury Regulation sections 1.871-7(b)(2) and 1.881-(2)(b)(2) (all substitute payments relating to U.S. source dividends are treated as U.S. source payments) to substitute dividend payments made by a non-U.S. person to another non-U.S. person. The IRS has indicated informally that it intends to revise Notice 97-66. However, it appears that Section 541 has the effect of revoking Notice 97-66 without having any replacement for it in place. It is not clear to us whether this was intended. If it is not intended that Section 541 revoke Notice 97-66, we believe that should be clarified. On the other hand, if revocation of Notice 97-66 was intended, we believe that doing so further underscores the need to delay the effective date as we discussed above and also to assure that replacement rules are put into place in connection with the statute's becoming effective in order to deal with the large volume of non-abusive transactions that will be adversely affected.

Proposed Code section 871(l)(6) ("Prevention of Over-Withholding") acknowledges the need to address over-withholding in non-abusive situations. For example, a typical case where Notice 97-66 currently is applied to eliminate acknowledged over-withholding involves a foreign dealer that borrows stock of a U.S. corporation from an unrelated foreign dealer and then lends that stock to a foreign customer (or repos the stock with that foreign customer). Without Notice 97-66, both the foreign customer and the middle foreign dealer are required to withhold on the substitute dividends paid. Although Section 541 gives the Treasury Department authority to eliminate this over-withholding, it does not *require* the Treasury Department to exercise that authority. Accordingly, even in this benign fact pattern, withholding would be required until such time as appropriate relief is provided. We therefore believe that the statute should (1) require the Treasury Department to issue appropriate regulations rather than merely permit the issuance, and (2) adopt our requested change in the effective date relating to securities loans to allow for the orderly issuance of regulations and adaptation of dealer withholding and other operational systems.

Beyond the transitional issues, the grant of authority to the Treasury Department is inadequate to address certain obvious cases of over-withholding. Proposed Code section 871(l)(6) as written would permit the Treasury Department to act to alleviate over-withholding only in cases where there is a "chain of dividend equivalents . . . one or more of which was subject to tax . . ." and "the taxpayer can establish that such tax has been paid . . . ." This provision would not cover the very common situation where the original lender in the chain is a U.S. person so no withholding tax at all should be due on the transaction. For example, many firms use their non-U.S. (e.g., U.K.) broker-dealers, rather than their U.S. broker-dealers, to lend U.S. securities to non-U.S. clients. The principal reason for using the non-U.S. dealer is to achieve greater netting of credit exposure with the non-U.S. client. However, the non-U.S. broker-dealer will often borrow the U.S. securities from their U.S. dealer affiliates or otherwise source the U.S. stock from an unrelated U.S. person. Because the U.K. broker-dealer is in the middle of the chain, a U.S. withholding tax may arise under Section 541 that would not otherwise occur if the end customer had borrowed directly from the U.S. person. Assuming a dealer can trace these transactions to prove that nothing abusive is happening, there should be no U.S. withholding tax collected. Therefore, proposed Code section 871(l)(6) should require the Treasury Department to eliminate U.S. withholding in this situation just as in the foreign lender to foreign lender chain example outlined above.

<u>Other Important Issues Requiring Clarification</u>

Clarification regarding a number of additional issues is very important.

First, proposed Code section 871(l)(3)(A)(iii) refers to securities that are "readily tradable on an established securities market." The quoted words are not defined. While it appears that the quoted words essentially mirror those used in Treasury Regulation section 15A.453-1(e), it would be very helpful to clarify the precise definition. In addition, we note that Treasury Regulation section 15A.453-1(e) only applies to debt obligations, so if the provision intended to refer to that regulation, clarification that the terms of the regulation would be applied as if it referenced equity securities also would be helpful.

Second, proposed Code section 871(l)(4)(C) would treat a basket of securities referenced in an equity swap as a "single security." Although certain standardized baskets of securities (e.g., the S & P 500) may meet the "readily tradable" standard if treated as a single security, most custom baskets of securities and many indices (e.g., an S & P sector index) would not, even if each of the component securities met the standard individually. It should be clarified that in the case of an index or fixed basket of securities, the "readily tradable" requirement of proposed Code section 871(l)(3)(A)(iii) applies to each component of the index or basket and not the index or basket itself. Otherwise, dealers could be forced to enter into dozens or hundreds of single name swaps rather than one swap that covers a tailored basket.

Finally, Section 541 would treat a notional principal contract as an SNPC if in connection with entering into the transaction the short party posts the underlying security as collateral. Although it seems to be strongly implied that collateral would have to be posted *to the long party* for this provision to apply, the rule does not appear to be so limited, so long as the posting is considered to be "in connection with" the transaction. It would make no sense to require withholding on a swap relating to an underlying security that the short party happens to post as collateral to a third party at the same time as entering into the swap (thus perhaps, "in connection with"). We suggest clarification that this was not intended.

Conclusion

We appreciate your willingness to continue constructive dialog toward the development of workable rules that would eliminate abuses without hindering legitimate commercial transactions and practices. We are available to discuss our comments with you at your convenience. I can be reached at 212-325-7486. Alternatively, you may call ISDA's counsel, Bruce Kayle, at 212-530-5956.

Sincerely yours,

Thomas Prevost

Thomas Prevost

Copies to:

Congressman Charles Rangel
Congressman Dave Camp
Congressman Richard E. Neal
Congressman Patrick J. Tiberi
Mary Baker, Senate Committee on Finance (Majority Staff)
Thomas Barthold, Joint Committee on Taxation
John Buckley, House Committee on Ways and Means (Majority Staff)
Tony Coughlan, Senate Committee on Finance (Minority Staff)
Sean Hailey, House Committee on Ways and Means (Minority Staff)
Hon. Michael Mundaca, Assistant Secretary of the Treasury (Tax Policy)
Stephen Shay, Treasury Department Office of Tax Policy
Karl Walli, Treasury Department Office of Tax Policy
John Harrell, Treasury Department Office of Tax Policy