May 15, 2012

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Issued Under Section 871(m)

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations issued under section 871(m). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Rudolph R. Ramelli
Chair-Elect, Section of Taxation

Enclosure

cc: Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    Manal S. Corwin, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
    Michael J. Caballero, International Tax Counsel, Department of the Treasury
The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Matthew Stevens of the Committee on U.S. Activities of Foreigners and Tax Treaties and the Committee on Financial Transactions. Substantial contributions were made by Michael Bauer, Julio Castro, Lucy Farr, Bill Fendley, Jared Hermann, Kevin Jacobs, Robert Kantowitz, Jonathan Marseglia, Alan Munro, Erika Nijenhuis, and Matthew Sontag. Helpful comments were received from Michael Farber and Kevin Sullivan. The Comments were reviewed by Alan I. Appel, Chair of the Committee on U.S. Activities of Foreigners and Tax Treaties and by Lucy Farr, Chair of the Committee on Financial Transactions. The Comments were further reviewed by Fred Murray of the Section's Committee on Government Submissions, by Joan Arnold, Council Director for the Committee on U.S. Activities of Foreigners and Tax Treaties, and by Steve Rosenthal, Council Director for the Committee on Financial Transactions.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 15, 2012
I. Background

On January 23, 2012, the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) published a Notice of Proposed Rulemaking in the Federal Register\(^1\) containing proposed regulations (the “Proposed Regulations”) that provide guidance under section 871(m)\(^2\) which treats dividend equivalents, as defined therein, as dividends from sources within the United States. This letter is in response to the request in the Preamble to the Proposed Regulations for comments.

Sections III and IV of these Comments describe the history and overview of section 871(m), and Sections V and VI contain our recommendations. Recognizing the detail of the Comments, our recommendations are summarized in Section II.

II. Executive Summary

1. Definition of substantially similar payment.

Section 871(m) imposes tax on a payment that is a dividend equivalent, which includes a substitute dividend made in a securities lending or sale-repurchase transaction, any payment on a specified notional principal contract that is contingent on or determined by reference to the payment of a U.S. source dividend, and any payment that is “substantially similar” to the first two types of payments.

As described in Section III below, the Congressional policy that appears to underlie the enactment of the statute is founded on two inter-related concerns: (1) concern about notional principal contracts that were in large part motivated by tax-avoidance objectives; and (2) a belief that tax-motivated transactions frequently manifest themselves as quasi-agency arrangements, whereby the underlying equity being held by one party (the short party)\(^3\) is essentially being held on behalf of the party receiving the 871(m) type payment (the long party).\(^4\) We believe that these policy foundations should be taken into account in determining the set of instruments to which section 871(m) “dividend equivalent” treatment should apply.

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\(^1\) Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing, Dividend Equivalents From Sources Within the United States, 77 Fed. Reg. 3202 (January 23, 2012).

\(^2\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

\(^3\) For this purpose, the term “short party” means, with respect to any underlying security of any notional principal contract, any party to the contract which is not a long party with respect to such underlying security. See I.R.C. § 871(m)(4)(B).

\(^4\) For this purpose, the term “long party” means, with respect to any underlying security of any notional principal contract, any party to the contract that is entitled to receive any payment pursuant to such contract which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to such underlying security. See I.R.C. § 871(m)(4)(A).
We believe that numerous types of equity linked instruments (“ELIs”) do not implicate the policy concerns that motivated the enactment of section 871(m) and therefore should not give rise to payments subject to tax thereunder. First, non-delta one instruments, such as virtually all convertible bonds, options, and principal-protected structured notes and many non-principal-protected notes linked to equities, do not serve as a proxy for investment in, and do not have returns that approximate the total returns on, the underlying securities. Second, synthetic financial instruments such as range accrual and digital or algorithmic notes (the terms of which are described in more detail below) similarly do not approximate in any meaningful way the underlying returns on the linked equity securities. As a result, these instruments are unlikely to be chosen by an investor for tax avoidance motives and do not create a “quasi-agency” based indirect investment in the underlying security, and thus do not implicate the policy concerns underlying section 871(m).

We believe that the definition of ELIs in the Proposed Regulations is overly broad. We recommend that such definition be limited to instruments that provide their holders with a return that provides all or substantially all of the return on a specific underlying security (or a customized index) the dividends on which would be U.S. source.

Additionally, the Proposed Regulations do not discuss when re-sourcing should occur with respect to amounts that are notionally reinvested under an ELI, and in what amount. We recommend that this be specifically addressed in final regulations.

2. Specified Notional Principal Contracts.

Our second broad area of comment relates to the definition of a specified notional principal contracts or “SNPCs”. The Proposed Regulations provide that a notional principal contract (an “NPC”) will be an SNPC if any of seven tests are met. The summary of the Comments on this topic is as follows.

- “In the market” - To accommodate the practical realities of large trading firms, we propose that a taxpayer be able to overcome “in the market” status by demonstrating that the triggering stock purchase or sale was not pursuant to a plan to facilitate a continuing economic investment in the underlying security.

- “Underlying posted as collateral” - So that the ten percent triggering threshold for this test is not met as the result of market fluctuations in collateral value independent of the actions of the parties, we recommend that the testing date

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5 Very generally, a non-delta one instrument is one that does not provide its holder with the same participation in the positive and negative price movements of the underlying asset over its term as would holding the underlying asset.

6 Prop. Reg. § 1.871-16(c).

7 The “in the market” test is found at Prop. Reg. § 1.871-16(c)(1)(i).
be limited to the pricing date and any date on which the short party posts additional shares of the underlying security as collateral.  

- **“Term less than 90 days”** – We are of the view that the 90-day factor does not, as a substantive matter, appear well suited to target tax avoidance transactions.  
We believe no term factor is required.  If one is required, we recommend that it be no longer than 30 days.

- **“Significant holding”** - To avoid triggering SNPC status due to decreases in liquidity subsequent to when the contract was put into place, we recommend that this five percent test apply only as of the pricing date for the swap.  
We also believe there is no need for a rule that limits the size of the notional amount on a swap by reference to the average daily trading volume of the stock, and we therefore recommend that this prong be eliminated or at least applied on a single-day, single swap basis.

- **“NPC provides for the payment of a special dividend”** – We recommend that the final regulations clarify the tax treatment of the first of what are intended to be recurring dividends as distinct from true special dividends.  
We recommend that Treasury consider adopting a rule that ordinary dividends paid more than one year after a special dividend has been paid will not be dividend equivalents by reason of that special dividend.

We also suggest that a safe harbor be added pursuant to which, notwithstanding that an ELI or NPC satisfies one of more of the seven specified factors, such instrument will not be treated as an SNPC or ELI if the instrument does not provide for adjustments for ordinary dividends, unless the special dividend factor is present.  We also recommend that, if a contract becomes an SNPC during its term, the retroactive aspect be limited to dividend-related payments made within one year prior to the event that caused the contract to become specified.  
Also, we believe that the anti-abuse rule in Proposed Regulation section 1.871-15(e) results in significant and unnecessary uncertainty and we recommend it be deleted.

### 3. Liability of Withholding Agent

The third area of comment relates to the impact of section 871(m) on withholding agents, specifically the strict liability imposed under section 871(m), and certain transition rule issues related to the effective date of tax liability.  The Proposed

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8 The ten percent triggering threshold is found at Prop. Reg. § 1.871-16(c)(3).
9 The 90-day factor is found at Prop. Reg. § 1.871-16(c)(4).
10 The five percent test is found at Prop. Reg. § 1.871-16(c)(6)(i)(A).
11 The trading volume limit is found at Prop. Reg. § 1.871-16(c)(6)(i)(B).
12 The special dividend rule is found at Prop. Reg. § 1.871-16(c)(7).
13 Retroactive effect of specified NPC status is provided for in Prop. Reg. § 1.871-16(d)(1).
Regulations provide strict liability for a withholding agent who fails to withhold on a payment re-sourced under section 871(m), regardless of whether the withholding agent knew, or reasonably should have known, that the payment was subject to tax under section 871(m) by virtue of being made with respect to an SNC or ELI. We recommend that the final regulations include a “know or has reason to know” standard, which could be satisfied by a withholding agent based upon representations by the counterparty upon which the withholding agent reasonably relied. Also, we recommend that the final regulations incorporate a mechanism similar to the “Qualified Securities Lender” status of Notice 2010-46, relieving a withholding agent of tax liability when dealing with certain “Qualified NPC Counterparties.”

Regarding the effective date of the Proposed Regulations, we recommend that: (i) ELIs and NPCs that have “specified” status only because of the new specified factors not produce dividend equivalents if they were entered into before the promulgation of the Proposed Regulations; (ii) if such ELIs and NPCs became “specified” after December 31, 2012, dividend-related payments be treated as dividend equivalent payments only with respect to dividends paid on the underlying equity after such date; and (iii), if the Proposed Regulations are not finalized this year, the effect of the Temporary Regulations be extended through the end of 2013 to avoid having the broad version of section 871(m) (i.e., the rule that makes all NPCs over U.S. equities SNPCs) come into effect.

4. Technical comments

Our final area of comment concerns minor technical points and clarifications that should be addressed in the final regulations. Among other items, we suggest that final regulations provide:

- That an ELI must meet one of the “specified” tests given for NPCs before dividend related payments on it are re-sourced under section 871(m);
- That, for payments determined by a formula which includes, among other factors, the amount of a dividend, the “dividend equivalent payment” is only that portion that is contingent upon or determined by the amount of the dividend, not the entire payment;
- That the long party to an NPC be defined as the one who economically benefits from in the payment of dividends on, or an increase in the price of, the underlying stock;
- The situations in which the long party will be deemed to control the short party’s hedge; and

That the determination of whether an NPC or ELI is treated as “specified” is made without regard to actions taken by a preceding or subsequent holder, other than one who is related to the taxpayer.

III. History of Section 871(m)

Prior to the enactment of section 871(m) in March 2010, stock lending transactions and equity NPCs had become the focus of various investigations and proposals by Congress, the Obama Administration, and Treasury.

1. Congressional Investigations & Proposals

Discussion in Congress of the use of certain equity swap and lending transactions to avoid U.S. withholding tax began in earnest in September 2008. Most importantly, these discussions took the form of a hearing by the Senate Permanent Subcommittee on Investigations (“PSI”), chaired by Senator Carl Levin (D-Mich.).

A report released at the hearing addressed the perceived abuses related to these transactions and identified a number of “red flags” the PSI believed signal the presence of an abusive transaction: (i) the short-term duration of the transaction; (ii) dividend payments to the short party exceeding 70% of the dividend; (iii) swap or stock loan pricing and fees tied to the amount of tax savings; (iv) the sale and subsequent repurchase of shares by the long party after the dividend distribution; (v) the use of third parties to give the appearance of a market sale; (vi) coordination of stock sales and repurchases to minimize or eliminate the risk of financial loss; (vii) the use of offshore entities in connection with stock loan transactions for the primary purpose of eliminating dividend withholding; and (viii) the short party treating nonpayment of dividend withholding taxes as a “tax risk” and setting “risk limits.”

Less than one year after the PSI Report was issued, in March 2009, Senator Levin and Representative Doggett introduced proposed legislation imposing dividend withholding on substitute dividend payments made on swaps that refer to U.S. equity securities. If enacted, the Levin/Doggett proposals would have resulted in the treatment of any payment contingent on or referring to the payment of a dividend on a U.S. stock (or substantially similar or related property under any NPC) as a U.S. source dividend.

2. The Obama Administration Proposal

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In March 2009, the Obama administration also issued a proposal to require dividend withholding on income earned through the use of securities lending transactions and equity swaps that refer to U.S. equities. With respect to NPCs specifically, this proposal would have subjected income earned by the long party to withholding to the extent the income was derived from dividends paid by a domestic corporation. The proposal included an exception to the proposed source rule for NPCs with all of the following characteristics: (i) the terms do not require the long party to post more than 20% of the value of the underlying stock as collateral; (ii) the terms do not include any provision addressing the hedge position of the short party to the transaction; (iii) the underlying stock is publicly traded and the notional amount represents less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume; (iv) the long party does not sell the stock to the short party at inception (“crossing in”), or buy the stock from the short party at termination (“crossing out”); (v) the prices of the underlying security used to measure the parties’ entitlements and obligations are based on an objectively observable price; and (vi) the NPC has a term of at least 90 days.

3. Treasury & Service Audit Priorities

Although various derivative and other financial instrument trading activities at significant financial institutions had been the subject of increased Service scrutiny for a number of years, the Service first published an industry-wide directive on total return equity swaps in January 2010. The Service Directive was issued to provide its auditors and examiners field guidance and sample information document requests targeting the following four situations that the Service considered representative of potentially abusive total return equity swaps: (i) cross-in/cross-out; (ii) cross-in/inter-dealer broker out; (iii) cross-in/foreign affiliate out; and (iv) fully synthetic positions. However, the Service’s level of concern with swaps in the fourth category was substantially lower. A few months after the Service Directive was issued, Congress enacted section 871(m).

IV. Overview of Section 871(m)

Congress enacted section 871(m) in March 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act to address concerns that certain stock lending transactions and equity NPCs were being used to avoid U.S. withholding taxes on dividends from U.S. equities.

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21 See n. 16.
1. Dividend Equivalent Payments

In general, section 871(m) treats “dividend equivalent” payments as U.S. source dividends for purposes of sections 871(a), 881, and 4948(a), as well as chapters 3 (withholding of tax on nonresident aliens and foreign corporations) and 4 (taxes to enforce reporting on certain foreign accounts). The statutory definition of a “dividend equivalent” under section 871(m)(2) encompasses: (i) a “substitute dividend” pursuant to a securities lending or sale-repurchase transaction, (ii) a payment pursuant to a “specified notional principal contract” that, under either definition, is (directly or indirectly) contingent upon or determined by reference to the payment of a U.S. source dividend, or (iii) any other payment determined by the Secretary of the Treasury (“the Secretary”) to be “substantially similar” to those described in section 871(m)(2)(A) or (B).

2. Specified Notional Principal Contracts

In turn, section 871(m)(3) defines a “specified notional principal contract” as: (i) any NPC where the underlying security is (a) transferred by the “long party” to the “short party” upon entering the NPC; (b) transferred by the “short party” to the “long party” at or before termination of the NPC; (c) not “readily tradable on an established securities market”; or (d) posted as collateral by the short party upon entering the NPC with the long party; (e) any NPC identified by the Secretary as an SNPC; or (ii) in the case of payments made after March 18, 2012, any payment unless the Secretary determines that the NPC does not have the potential for tax avoidance.

3. Definitions

For purposes of section 871(m), a “payment” pursuant to an SNPC includes any gross amount used in computing any net amount transferred to or from the long party, even if the SNPC expressly provides for netted payments. Under section 871(m)(4)(C), an “underlying security” refers to the security on which a dividend equivalent payment under section 871(m)(2)(B) is paid with respect to any NPC; any index or fixed basket of securities is treated as a single underlying security.

4. Discretion to Reduce Withholding

Section 871(m)(6) grants the Secretary discretion to reduce the tax imposed under sections 871(a) and 881 in the case of any chain of dividend equivalents, but only to the extent that the taxpayer can establish that such tax has been paid with respect to another dividend equivalent in such chain or is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in such chain. For these purposes, a dividend is treated as a dividend equivalent.

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22 I.R.C. § 871(m)(1).
23 I.R.C. § 871(m)(5).
V. Major Policy-Oriented Comments on the Proposed Regulations

1. What is included in the definition of a “substantially similar payment”?

As noted above, section 871(m)(2) defines a “dividend equivalent” as including (A) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, (B) any payment made pursuant to an SNPC that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and (C) “any other payment determined by the Secretary to be substantially similar” to a dividend equivalent. Proposed Regulation section 1.871-15(b)(1)(iii) operates similarly, defining the term “dividend equivalent” to include “[a]ny substantially similar payment as defined in [Proposed Regulation section 1.871-15(d)].” Proposed Regulation section 1.871-15(d), in turn, provides two categories of substantially similar payments: (i) gross-up payments with respect to dividend equivalents, and (ii) dividend-related payments made pursuant to ELIs. As more fully discussed below, we recommend further consideration of the proposed treatment of dividend-related payments made pursuant to ELIs.

The remainder of this Part V.1 is divided into four major subparts. First, we describe the overall policy considerations that in our view should be taken into account in determining the set of instruments to which section 871(m) “dividend equivalent” treatment should apply. Second, we describe several broad categories of instruments to which we believe such treatment should not apply. Third, it is our view that, outside of the context of NPCs, several of the seven “specification” factors identified as abusive transactions in Proposed Regulation section 1.871-16 are not in fact motivated by tax avoidance (i.e., the factors are overly-inclusive). Fourth, we recommend a more restrictive definition of an “equity-linked instrument” to address the tax policy goals of section 871(m) outside the core NPC context.

a. Overall policy considerations on “substantially similar payments.”

The regulations state that “[a]ny payment, including the payment of the purchase price or an adjustment to the purchase price, is a dividend equivalent if made pursuant to an equity-linked instrument that is contingent upon or determined by reference to a dividend…from sources within the United States.” An “equity-linked instrument” is a “financial instrument or combination of financial instruments that refers to one or more underlying securities to determine its value, including a futures contract, forward contract, option, or other contractual arrangement.” This category of substantially similar payments, payments pursuant to “equity-linked instruments,” is very broad, with the potential to cover virtually any category of contract linked to equity in a domestic corporation.

As noted above, we recommend further consideration of the definition of “equity linked instruments.” In order better to understand these concerns, we believe it useful to begin with a review and analysis of the policy considerations that initially prompted the enactment of section 871(m). We first identify two swap transactions at opposite ends of the spectrum of concern. In the first type (“Type One”), the non-U.S. investor holds a long position in stock and, aware that an ex-dividend date is approaching, sells the stock to a financial institution and simultaneously enters into an NPC with that institution over the stock, where the initial price on the NPC equals the price for which the taxpayer sold the stock to the institution. This transaction is, of course, squarely within the ambit of section 871(m) as enacted. At the other end of the spectrum of concern, in the second type of transaction (“Type Two”), a taxpayer enters into a two-year NPC over a highly liquid stock, never having owned the physical stock. The NPC is not terminated early, and when it is terminated, the taxpayer does not acquire the stock from the dealer or otherwise. While Congress did not explicitly bless the existing tax treatment of dividend related payments on Type Two swaps, it is reasonably clear from the drafting of section 871(m) that Congress believed that Type Two swaps were sufficiently distinguishable from Type One swaps that the regulations should not subject dividend related payments made thereon to U.S. withholding tax. If not, Congress could simply have subjected all dividend related payments on an NPC over the stock of a U.S. corporation to U.S. withholding tax, rather than crafting a narrower set of rules for the two years following the statute’s enactment and authorizing the Treasury to write regulations identifying transactions that did not present a potential for tax avoidance. Stated more succinctly, notwithstanding that the taxpayer in a Type Two transaction would pay less U.S. income tax than he would have paid had he owned the stock directly, Congress did not view such transaction as having a potential for tax avoidance within the meaning of section 871(m).

While the congressional conclusion as to the importance of the distinction between Type One and Type Two swaps is relatively clear, the rationale for that conclusion is somewhat murky. It appears that Congress’s policy concern was founded on two inter-related concepts. First, Congress appeared concerned about NPCs that were in large part motivated by tax avoidance objectives. Second, Congress appears to have believed that these tax-motivated transactions frequently manifested themselves in quasi-agency arrangements, whereby the short party’s hedge is essentially being held on behalf of the long party. These two concepts are intertwined; a taxpayer who, in a world without tax, would prefer to hold the underlying stock directly is also likely to be a taxpayer who enters into a swap transaction that very closely resembles holding the actual stock in terms of cost and economic exposure. Congress appears to have viewed such situations as sufficiently motivated by tax avoidance to alter the taxation of the dividend-related payments. Conversely, because an investor entering into an ELI with economics very different from those of the underlying equities would have been unlikely to acquire the actual stock instead, investment goals, not tax avoidance, must have motivated the acquisition of the instrument.

In our view, the proposed expansion of the section 871(m) regime to all ELIs does not reflect the foregoing policy concerns as reflected in the legislation as drafted. We believe that the decision to extend “substantially similar payment” treatment to a wide variety of ELIs that do not economically replicate direct investment in the underlying
stock is not consistent with Congressional intent because investing in such instruments cannot fairly be viewed as a proxy for direct investment in the underlying stock. Additionally, even in the case of an instrument that does approximate physical ownership of stock, the Proposed Regulations’ very broad definition of ELIs will pull within the scope of section 871(m) transactions in which a tax avoidance motive was utterly lacking.

b. Instruments that do not implicate the policy concerns of section 871(m).

There are many types of equity-linked derivative instruments that may meet one of the “specified” tests, but that, as a policy matter, we recommend not be subject to the section 871(m) re-sourcing rule. The first such instrument constitutes an equity derivative that is a “non-delta one” instrument. We define a “non-delta one” instrument as an instrument with a delta other than one. “Delta” generally represents the amount by which the value of a derivative changes when the value of the underlying property changes by a very small amount. Included in this category of non-delta one instruments would be such common instruments as convertible bonds, options, principal-protected structured notes linked to equities, and many non principal protected notes linked to equities. It is considerably more difficult to characterize a non-delta one instrument as creating an agency relationship between the parties than it is to characterize a delta one instrument as creating such a relationship. In particular, a derivatives dealer that is the short party to a non-delta one instrument, such as an option to acquire stock, will ordinarily “dynamically hedge” the option by buying more shares as the underlying stock price goes up and selling shares as the underlying stock price declines. Alternatively, the short party may hedge by entering into offsetting derivatives positions (e.g., in the listed option market). In either case, the risk of a mismatch between the short party’s hedge and the derivative being hedged is fully borne by the short party, because the short party’s success or failure in choosing and continuously adjusting its hedge will not flow through under the terms of the option to the long party. By contrast, in a delta one derivative, the short party’s hedge is (typically) to hold a fixed number of shares of the underlying stock, a transaction that offers the short party much less opportunity for loss and profit.

A non-delta one instrument will not, as a general matter, function as a proxy for a physical stock position. A long party that wishes to obtain “total return” exposure to shares of stock would not be likely to choose instead to acquire an option on that stock,

See Prop. Reg. § 1.871-16(c).

It is possible for a non-delta one instrument to become a delta one instrument. For example, an option that becomes very-deep-in-the-money will perform like the underlying equity. Likewise, an in-the-money option becomes close to delta one as the option expiration date approaches. We recommend that the categorization of an instrument as delta one (or “near” delta one) be done when the instrument is entered into, rather than requiring periodic retesting. That would avoid complexities arising because of a change in the instrument from non-delta one to delta one or vice versa, and would be consistent with the general notion that the tax status of an instrument is to be determined at the time the instrument is entered into. Such a test would also make sense if the objective is to reflect the tax avoidance potential of a transaction, since the taxpayer’s motivation would be based on the economics at the time the trade is entered into.
given the different return profile and the different embedded costs that a dealer will charge for options as compared to swaps. The converse is also true: an investor who acquires an equity option or structured note with optionality is often very specifically seeking that particular return profile and would find a physical stock holding materially less attractive. For example, an investor might buy a principal-protected note linked to XYZ stock, where the investor is exposed to some or all of the upside potential of XYZ shares but no downside potential; that investor might not be willing to hold physical shares of XYZ stock because of their perceived downside risk. Alternatively, an investor may view a stock’s price as likely to rise, but only by a small amount, so it may buy a note providing for double the increase in value of XYZ shares subject to a cap. In short, because of their different return profiles, there are nearly always very significant non-tax (i.e., economic) motivations for choosing to acquire a non-delta one equity-linked contract rather than the underlying stock.

In addition to the non-delta one instrument, other instruments also appear to be a poor substitute for physical ownership of stock, and do not implicate the quasi-agency principles that motivated the enactment of section 871(m). In a “range accrual note” or “digital note,” for example, a fixed amount may be due (made in the form of a coupon, for a range accrual note, or at maturity, for a digital note) depending on the value of a specified number of shares of a particular equity. For example, a note may provide for a monthly coupon payment of seven percent per annum multiplied by the percentage of trading days in the monthly period in which ABC Corporation stock closes above $100. As another example, although arguably closer to the transactions about which Congress was concerned, consider an algorithmic note, which might provide for the execution of a particular investment strategy, such as a note that provides the total return from the “Dogs of the Dow,” with rebalancing among stocks done quarterly. Here, the investor is usually investing in a particular strategy, which by definition cannot be a mere substitute for the underlying stock investment. We recommend that these types of instruments not be viewed as proxies for direct investment in the underlying stock.

As a result of these fundamental distinctions between non-delta one and algorithmic instruments, on the one hand, and equity swaps, on the other hand, we suggest that treating non-delta one instruments as fully subject to section 871(m) is not warranted by the basic concerns underlying section 871(m). Moreover, as discussed above, we believe that by instructing the Secretary to define “substantially similar payments,” Congress intended Treasury to draw a meaningful line between transactions that were similar in character to equity swaps, and therefore raised the same concerns.

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28 Under the “Dogs of the Dow” strategy (or at least one variation), an investor annually selects for investment the ten Dow Jones Industrial Average stocks whose dividend is the highest fraction of their price. This approach is based on the idea that blue chip companies do not alter their dividend to reflect trading conditions and, therefore, that the dividend is a measure of the average worth of the company; the stock price, in contrast, fluctuates through the business cycle. This should mean that companies with a high yield, with high dividend relative to price, are near the bottom of their business cycle and are likely to see their stock price increase faster than low yield companies. http://en.wikipedia.org/wiki/The_Dogs_of_the_Dow.
and those transactions that were materially different.\textsuperscript{29} We recommend, therefore, that the final regulations be modified to limit the types of equity-linked contracts that are subject to section 871(m).\textsuperscript{30}

\textit{c. The specified factors tend to over-identify a tax avoidance purpose.}

Under the Proposed Regulations, many ELIs will be “specified” for reasons that do not indicate an agency relationship or a potential for tax avoidance. As a fairly stark example, an “equity-linked instrument” would include a purchase contract by one corporation to acquire all of the stock of a second corporation. Consider the case where a non-U.S. acquirer enters into a contract to acquire a U.S. target corporation for cash. The stock purchase agreement may provide for a reduction in the purchase price for dividends paid between the time of signing and closing of the agreement, in order to protect the acquirer from a reduction in the value of the company it has agreed to purchase. If a purchase price adjustment actually occurs, and the transaction closes, this will be a cross out, such that the purchase price adjustment will be treated as U.S. source income. We believe this would be an unexpected and unwarranted result. There is considerable case law on whether pre-purchase dividends should be treated as income to the seller or the buyer, but to our knowledge it has never been suggested that if the dividend belongs to the seller for tax purposes, the buyer nevertheless has income.

Less dramatically, options and convertible or exchangeable bonds are frequently physically settled, which would also be treated as a “cross out” under the statute.\textsuperscript{31} While Congress may have considered a “cross out” on an NPC to be rare, and therefore indicative of potential abuse, the practice of settling physically options is obviously long-standing and cannot reasonably be viewed as an indicator of tax avoidance or of a quasi-agency relationship.\textsuperscript{32} Moreover, many options, including exchange-listed options, have for many years been issued with terms shorter than 90 days; we recommend that such

\textsuperscript{29} See I.R.C. § 871(m)(2)(C).

\textsuperscript{30} The broadening of the rules to cover debt instruments linked to equities has a surprising, and perhaps unintended, consequence to the portfolio interest exemption. Take the case of a principal-protected note linked to a 20-stock basket that provides for a single payment at maturity linked to this basket, with notional reinvestment of any dividends on the underlying stocks during the term of the note. Under current law, although “contingent interest” is excluded from the portfolio interest exemption under I.R.C. § 871(h)(4), the exclusion does not apply to interest linked to dividends on actively traded stocks, and therefore this final payment (assuming actively traded stocks) would be interest under the contingent payment debt instrument rules that is eligible for portfolio interest treatment. I.R.C. § 871(h)(4)(C)(v)(II); Reg.§ 1.1275-4(a). It is unclear whether the regulations intended to override the portfolio interest exemption in this context.


\textsuperscript{32} Indeed, prior to 1976, when present-day section 1234(c)(2)(A) was added to the Code, it was at least arguable that only physically-settled options constituted options for tax purposes. See Saunders v. United States, 450 F.2d 1047 (9th Cir. 1971), rev’d 294 F. Supp. 1276 (D. Hawaii 1968) (cash settlement feature meant that owners were not bound to sell and convey subject property, and for that reason purported option was not afforded capital gains treatment by section 1234).
options not be viewed as potentially abusive merely for that reason. In the case of convertible debt instruments, investors frequently short the underlying stock on the date they purchase the convertible debt. Such investors clearly are not investing in convertible debt as a substitute for holding the underlying stock directly; indeed, the point of such hedging is often to eliminate exposure to the stock to the extent feasible.

The definition of “equity-linked instrument” in the Proposed Regulations appears broad enough to apply to certain forms of equity-based compensation. Consider the case where a Chinese employee works for the Chinese subsidiary of a U.S. corporation and receives restricted shares of stock of the U.S. corporate parent as compensation. It would appear that the contractual rights held by the employee constitute an “equity-linked instrument” in that they are a “financial instrument” linked to the U.S. parent corporation’s stock. The ELI would in this case be “specified” because it will, unless the employee leaves the company before the shares vest, settle in shares of the U.S. corporation’s stock, and might also be “specified” for other reasons (such as if the U.S. corporation is privately held). Nothing in the regulations would appear to exempt any dividend paid or credited to the employee under the compensation arrangement from the re-sourcing of section 871(m), with the result that what would otherwise have been foreign source services income would become U.S. source dividend income. We recommend that the final regulations clarify this is not the result.

Finally, we note that the currently proposed definition of “equity linked instrument” is broad enough to apply to many transactions that would also be within the scope of section 305. Consider a physically-settled convertible note in which the conversion ratio adjusts to compensate the holders for a payment of an extraordinary cash dividend on the issuer’s common stock. While such a payment would constitute a “dividend equivalent” within the meaning of the Proposed Regulations, it would also constitute a deemed dividend under section 305(c) and (b)(2). In order to avoid the possibility of double taxation, we recommend that the final regulations provide that no amount treated as a dividend under Subchapter C will be treated as a dividend equivalent. Additionally, we recommend that consideration be given to whether, and under what circumstances, an ELI, such as a convertible note, might provide for a dividend equivalent in an amount greater than the amount of the dividend deemed paid on such instrument.

d. Refining the definition of an “equity linked instrument.”

We recommend that there be an additional requirement in order for an instrument that is not an NPC to be an “equity linked instrument.” Specifically, we recommend that such term be limited to an instrument that provides its holder with all or substantially all of the return on one or more specific underlying securities. In crafting this limitation, the definition of “constructive ownership position” in section 1260(d)(1) would seem to be

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34 Id.
an appropriate place to begin (with an exclusion for sales of more than 50% of the stock of a corporation, to avoid picking up the cross-border cash acquisition described above). Additionally, we recommend that the limitation exclude any contract or arrangement subject to section 83.

In recommending this approach, we are not unduly troubled by the line drawing operation required for distinguishing true options from those that are sufficiently deep in the money so as essentially to constitute prepaid forward contracts. We believe that the history of section 1259 is instructive in this respect. The statute defines a “forward contract” as meaning “a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.”\(^{35}\) The legislative history to this definition indicates that taxpayers are to use option pricing models to determine whether this standard was satisfied.\(^{36}\) While the Treasury has never issued any guidance defining the term “forward contract” or any related term, it is our experience that practitioners have adopted informal guidelines that accord with the intent of section 1259\(^{37}\) and that these guidelines are sufficiently satisfactory to the Treasury that no additional guidance has been thought necessary. We believe that a similar approach would be equally successful here. In any case, we believe that given the large number of options that are clearly not entered into with a principal purpose of tax avoidance, the policy arguments support drawing the line between delta one and the non-delta one products.

2. Timing and Amount of Dividend Equivalent Payments

Many NPCs and ELIs provide adjustments for extraordinary dividends and, less commonly, ordinary dividends. The operative language of the Proposed Regulations provides that a payment is deemed made when it is taken into account for purposes of determining any net amount that is due to any party under the contract. In the simple case at which section 871(m) was aimed (an equity swap that provided for all dividend-related payments to be immediately passed through to the long party or credited against amounts otherwise owing by the long party to the short party), this approach produces reasonable results as to both timing and amount. It is not the case, however, that dividends are always passed through immediately to the long party. Instead, they may be reinvested in additional shares of the underlying stock or they may be used to reduce the notional purchase price of the underlying stock. In these circumstances, both the timing of a dividend equivalent payment and the amount of the dividend equivalent payment can be ambiguous, as the following examples indicate.

The first circumstance in which the timing and amount rules of the Proposed Regulations do not provide a clear answer involves an instrument drafted such that dividends are reinvested. Consider an instrument drafted so that, when a dividend of $10 is paid in year two on shares of the underlying stock that are worth $100 each, the

\(^{35}\) I.R.C. § 1259(d)(1).
\(^{37}\) See, e.g., 96 TNT 46-35, NYSBA Analyzes Short-Against-The-Box Legislation (March 1, 1996).
instrument adjusts so that the original notional number of shares underlying the option is increased by $10/$100, or 1/10 of each share. Assuming the instrument is otherwise a specified NPC or ELI (e.g., because it will be physically settled), it appears that the deemed reinvestment of the dividend related payment will result in a payment that is indirectly “contingent upon” or “determined by reference to” that dividend. Now suppose that the final and only payment on the instrument is made in year three. Suppose also that, when the final payment is made, the 1/10 of a share is worth only $8 because the value of the stock has decreased. When should withholding occur, and what should be the amount withheld?

As noted above, under the Proposed Regulations, a dividend equivalent is deemed made to a person when any gross amount is used in computing any net amount that is transferred to or from the relevant person. Applying this language, it is not clear to us whether, at the time the dividend is paid on the underlying stock in year two, the dividend is “used in computing any net amount” that is transferred to the long party, because the long party is not entitled to receive any amount in year two, when the underlying dividend is paid. This suggests with reasonable clarity that the dividend equivalent would be deemed paid for withholding tax purposes at the time the additional shares of stock actually result in an increased right to payment in year three.

While the amount of the dividend equivalent payment is less clear, it seems reasonable to conclude that such amount is just the amount of the original dividend taken into account in the notional reinvestment transaction, even if the shares of stock purchased in that transaction have increased or decreased in value since the notional reinvestment. A contrary conclusion would allow (in the case of a share price decline) the taxpayer to deduct the capital loss attributable to the decline in the value of the shares and (in the case of a share price increase) would require the taxpayer to include in income the economic gain from the gain on the stock, which normally would not be subject to U.S. tax in the hands of a nonresident alien. It appears that the Proposed Regulations currently reach this result, although we recommend that some clarification be undertaken.

This clarification is more critical in the case of an option under which a dividend is notionally credited in the form of a reduced strike price. As noted above, under the temporary regulations, a dividend equivalent is deemed made to a person when any gross amount is used in computing any net amount that is transferred to or from the relevant person. If the option expires worthless, it appears that the gross amount of the dividend would never be “used in computing” a net amount that is transferred to or from the relevant person because the holder would, even in the absence of the reduced strike price, have been entitled to nothing upon expiration of this option. We believe that this clearly is the correct result from a policy perspective, as there has been no accession to the wealth of the investor, and also appears to be embodied in the current rule, although as noted above, a clarification on the point, and perhaps an example, may be useful.

A technically more challenging problem arises in the case of an option where a reduction in a strike price causes the option to be exercised by the long party, but where, in the absence of the reduction, the option would not have been exercised. Consider an
option that initially allowed the holder to purchase one share of common stock for a price of $10 at a time when the price of the common stock is $9.00. The common stock pays a special dividend of $1.00/share. As a result, the strike price of the option is decreased to $9.00. The price of the stock at expiry is $9.40, and the holder exercises the option for $9.00 and immediately sells the stock for $9.40, earning $0.40 of income. Here, while the dividend paid on the underlying stock was $1.00, the taxpayer has only benefited by $0.40 (the difference between the strike price of the option and the fair market value of the underlying stock. The question is how much, if any, dividend equivalent payment the taxpayer should be deemed to have received. While the underlying stock paid a dividend of $1.00, the taxpayer only benefited to the extent of $0.40, and so it appears that its dividend equivalent payment should be limited to this amount. This would appear at first blush to run afoul of the rule discussed above, to the effect that a reduction in the value of the shares should not be deductible in determining the taxpayer’s dividend equivalent payment, because the amount of income inclusion is in effect being limited by the relatively modest value of the shares. However, given the harshness of taxing income that the taxpayer did not actually receive, we believe it is worth making an exception to this principle in a circumstance where the dividend equivalent payment would otherwise exceed the taxpayer’s entire income from the contract.

3. Definition of specified SNPCs

   a. “In the market.”

   An NPC triggers the “in the market” factor if the long party to the NPC is “in the market” with respect to the underlying security on the same day or days that the parties price the NPC or on the same day or days that the NPC terminates. The long party is “in the market” with respect to the underlying security if the long party: (i) sells or otherwise disposes of the underlying security on the same day or days that the parties price the NPC, (ii) purchases or otherwise acquires the underlying security on the same day or days that the NPC terminates; or (iii) either purchases or disposes of the underlying security at a price that is set or calculated in such a way as to be substantially identical to or determined by reference to an amount used to price or terminate the NPC. Under a de minimis exception, however, the long party will not be deemed to be in the market with respect to the underlying security if the amount of the underlying securities disposed of on a pricing date or acquired on a termination date is less than ten percent of the notional principal amount of the NPC.

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38 We have no comments in this part on the “regularly traded” factor in the Proposed Regulations.
39 Prop. Reg. § 1.871-16(c)(1).
40 We also note that the regulation uses the phrases “price the NPC” and “terminate the NPC.” The Treasury may wish to clarify that these events occur on the dates that initial pricing and final pricing occur, respectively.
41 Prop. Reg. § 1.871-16(c)(1).
42 Prop. Reg. § 1.871-16(c)(1)(ii).
We understand that the Treasury adopted the “in the market” standard, as opposed to the statutory “transfer in connection with” standard, in order to provide greater objectivity, and therefore greater administrability, to both taxpayers and the Service. We believe that this is a desirable goal. However, we are concerned about the reach of the "in the market" criterion in the case of many large market participants, because this factor could be present even though the taxpayer's actions are not within the scope of the activity at which section 871(m) is aimed. As described above, we believe that section 871(m) is intended to re-source, and thereby impose a withholding tax on investors who generally would invest in the underlying physical shares but for the withholding tax advantage of investing through a derivative. We understand and agree with the Proposed Regulations that an investor who is selling shares on the date the swap is priced would generally meet this standard. Consider, however, the case of a large hedge fund that employs different fund managers for different portions of its portfolio. It could easily be the case that one manager might be entering into a swap over stock in a particular corporation, while a different manager might be selling physical shares of stock on the same day in entirely unrelated transactions. In our judgment, treating the NPC as an SNPC merely because of a functionally unrelated transaction entered into by an independently-motivated individual does not comport with the policy underlying section 871(m). Other similar examples could easily be constructed, particularly in light of the Proposed Regulations’ adoption of the related party standards contained in sections 267(b) and 707(b).

In order to address this issue of over-breadth and better reflect the intent of the statute, we recommend that the final regulations restore the transactional, or "in connection," test as an element of the "in the market" standard. While we believe that the “in the market” test provides a bright line rule that many taxpayers will find easy to comply with, we would also revise the final regulations to provide that a long party who was in the market on the pricing date or the termination date would nonetheless not have an SNPC unless the stock purchase or sale was made pursuant to a plan to facilitate a pre-existing or continuing economic investment in the underlying security. The final regulations could provide a rebuttable presumption that physical transactions involving stock on which the taxpayer also has an NPC are pursuant to such a plan, placing on the long party the burden of proving that the physical transaction was functionally unrelated to the inception or termination of the NPC. The final regulations could further provide that a long party could overcome this presumption based on a combination of written policies, reporting lines, course of dealing, and books and records that demonstrate that the trading decisions were made independently. We would expect that taxpayers likely to be affected by this rule would develop written policies establishing the independent motivation of the two transactions. We believe that the allocation of the burdens of

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Prop. Reg. § 1.871-16(e)(1). This factor is especially important to modify if our suggestion to remove non-delta one derivatives from the definition of equity-linked instruments is not taken. It would be particularly inappropriate to subject to re-sourcing, and thus withholding tax a dividend equivalent payment on a cash-settled call option merely because a different portfolio manager in the same fund is shorting stock on the same day the option is priced or because the taxpayer acquires the underlying stock when the option matures.
evidence and proof would adequately protect the Treasury's interests in upholding the intent of section 871(m).

b. **Underlying security posted as collateral.**

An NPC will trigger this factor if the short party to the NPC posts the underlying security with the long party as collateral and the underlying security posted as collateral represents more than ten percent of the total fair market value of all the collateral posted by the short party on any date that the NPC is outstanding. We recommend that the testing date here be limited to the pricing date, unless the short party posts additional shares of the underlying security as collateral, including by reason of a substitution of collateral. Otherwise, this factor could be triggered if other marketable securities, together with the underlying security, were posted as collateral, and the value of the other marketable securities declined, while the value of the underlying security stayed constant. Indeed, as currently drafted, the factor could be triggered if the short party posted cash collateral, together with the underlying security, and the value of the underlying security increased during the term of the swap.

c. **Term less than 90 days.**

An NPC will trigger this factor if it has a term of fewer than 90 days. For purposes of this factor, the term of any NPC is the number of days that the contract is actually outstanding, including the date on which the NPC is terminated, but not the date that the NPC was entered into. For purposes of determining whether a contract is an SNPC, an NPC is treated as terminated, in whole or in part, on the date that a long party enters into any position within the meaning of Regulation section 1.246-5(b)(3) to the extent that the position offsets a portion of the long party's position with respect to an underlying security in the NPC.

We believe that the 90-day factor does not appear well suited to identify dividend withholding tax avoidance transactions targeted by Congress. In enacting this factor, the Treasury may have been considering other provisions in the Code that are aimed at requiring minimum holding periods to enable a shareholder to receive a tax benefit for

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44 Prop. Reg. § 1.871-16(c)(3).
45 Prop. Reg. § 1.871-16(c)(4).
46 Prop. Reg. § 1.871-16(c)(4)(ii).
47 The citation to Reg.§ 1.246-5(b)(3) is curious. Why not cite to Reg.§ 1.246-5(a), which refers to the operative concept of a “position with respect to substantially similar or related property?” By referring only to the definition of “position,” the Treasury leaves it unclear as to what standard is to be applied in determining whether an “offset” has occurred. If the Treasury actually intends to adopt the same standard as Reg.§ 1.246-5 (which we believe is the correct policy answer if a term factor is to be imposed at all), then the citation should be changed to Reg.§ 1.246-5(a). If, on the other hand, the Treasury intends to establish a lower threshold (e.g., the substantial diminution standards of section 1092(d)) (which may be difficult to support as a policy matter), then an appropriate cross-reference should be inserted.
certain dividends (e.g., section 1(h), section 246(c), and section 901(k)). In those transactions, in the absence of the holding period requirement, a taxpayer who had no economic interest in the underlying stock could buy the stock, receive the tax-favored dividend, and then sell the stock quickly, taking steps all the while to avoid any economic exposure to the stock. For example, in the transaction that was the subject of the Compaq\textsuperscript{48} case, a taxpayer who had capital gains from other, unrelated transactions could buy stock that paid a foreign source dividend subject to a foreign withholding tax, claim the foreign tax credit, and then use the resulting capital loss against his other capital gains. The taxpayer could thus use the dividend capture transaction to shelter an unrelated capital gain from U.S. tax.

In the context of an offshore investor, however, no such potential exists from an “in and out” transaction of the type in Compaq, because the investor by definition is subject only to the U.S. gross basis taxing regime and will therefore not be able to bring to bear any U.S. tax attributes, such as capital losses, to earn a substantial after-tax profit even where the investor’s pre-tax profit was negligible or negative. Of course, in the absence of the 90-day factor, an investor who obtains derivative exposure to the stock over a very short period will not suffer withholding tax on the dividend equivalent, but he will also not be able to use a tax attribute (e.g., the resultant capital loss) to offset U.S. tax on his unrelated capital gains. Such a transaction, then, would not generate a profit from the U.S. tax system in the way that the Compaq transaction did.

To be sure, a taxpayer who did want to maintain exposure to the stock would avoid the U.S. withholding tax by investing in it through an NPC rather than through physical ownership. This, however, is true of every NPC, and yet, as discussed above, the Proposed Regulations appropriately do not treat all NPCs as SNPCs. Thus, the mere fact that some U.S. withholding tax will be avoided should not permit the inference that the sought-to-be prohibited tax avoidance motive is at work. Additionally, in order for the 90-day factor to be relevant, none of the other six factors may be present. Accordingly, any taxpayer who is contemplating entering into a swap with a term shorter than 90 days and who holds the underlying stock prior to entering into the swap must accept at least one day’s worth of price risk at both the inception and the termination of an NPC (i.e., because otherwise, the “in the market” factor would be tripped, and the NPC would be a specified NPC regardless of its term). For most investors, as an economic matter, exposing themselves to the risk of an uptick in the stock during the time they were out of the position would more than outweigh the benefits of avoiding the dividend withholding tax. For example, consider a stock with a price of $100/share and a $2 annual dividend. The quarterly dividend is therefore $0.50, and the withholding tax on such dividend would be $0.15. Thus, a mere overnight uptick in the stock price of only $0.15, or 15 basis points of the price of the stock, would be sufficient to wipe out the advantage of the withholding tax exemption. It is therefore very unlikely that an investor who already holds the stock would enter into an otherwise-non-specified NPC to avoid withholding tax on a dividend.

\textsuperscript{48} Compaq Computer Corp. v. Comm’r, 277 F.3d 778 (5th Cir. 2001), rev’d 113 T.C. 214 (1999).
Third, the interaction between the 90-day factor and the obligations of withholding agents places a substantial burden on many commonplace transactions. One example is the imposition of retroactive liability for tax because a previously non-specified NPC has triggered the 90-day factor. While other factors (e.g., a cross out), can also trigger retroactive withholding tax liability, those factors are generally better indications of tax avoidance activity and are potentially more clearly identifiable by the short party. It is therefore easier to justify subjecting such transactions to tax. By contrast, if withholding tax liability is created by the 90-day factor being triggered, it is highly likely that the investor will simply have changed his view about the desirability of being exposed to the underlying stock, and decided to terminate his exposure.

Fourth, outside of the context of NPCs, the use of a 90-day factor raises other significant issues. For one thing, if it is determined that, contrary to our recommendation set forth above, a non-delta one derivative can be an SNPC, many such instruments, such as exchange traded options, about which little tax avoidance concern should exist, will be treated as SNPCs. This concern also would arise in the case of algorithmic notes where the underlying investment changes according to a pre-determined formula. For another thing, the application of the 90-day test to actively traded instruments, such as exchange traded notes, requires at a minimum the drafting of additional rules to answer the questions that arise from an application of the existing 90-day test to such instruments. Presumably, these rules would provide that the “specified” test should apply separately to each holder, and not to the instrument as a whole, such that the 90-day test restarts every time a new holder acquires the instrument. Such rules will be difficult to draft, because they must strike a balance between providing certainty to withholding agents without either requiring excess withholding or permitting tax avoidance transactions.

All of that having been said, if the Treasury determines it is necessary to have a factor that triggers SNPC status for short-term swaps, we think 90 days is much longer than necessary to address whatever policy concerns many exist. As noted above, there are numerous examples throughout the Code in which Congress requires taxpayers to either establish or eschew exposure to an equity security in order to get particular tax benefits. With the exception of section 246(c), which only applies to certain dividend arrearages, none of these provisions employs minimum holding periods as long as 90 days. We believe that whatever policy the 90-day factor serves could be addressed just as well by a term requirement of 30 days. Additionally, the same arguments made above for adopting an “in connection with” requirement for the crossing in and crossing out requirements apply here with equal force, and we recommend that the same relief

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49 For example, in section 1091, Congress requires taxpayers to wait more than 30 days after selling a stock before reacquiring it (or certain derivatives in such stock) in order to recognize the loss. In section 1259, Congress permitted taxpayers to avoid constructive sale treatment for an appreciated equity position by re-establishing exposure to that appreciated equity position for a specified 60 day period. In section 246(c)(4), Congress required taxpayers to hold stock for more than 45 days in order to receive the dividends-received deduction (with an exception for certain preference stock). In section 901(k) and (l), a more than 15 day holding period was required. Finally, in section, Congress required individuals to hold stock for more than 60 days to be allowed to treat the dividends paid thereon as qualified dividends.
provision be adopted here, subject to the same parameters (such as a presumption that that the “in connection with” requirement has been satisfied unless the taxpayer can show otherwise).

d. Significant holding.

An NPC will trigger this factor if the notional principal amount of the underlying security in the NPC is greater than: (i) five percent of the total public float of that class of security, or (ii) twenty percent of the 30-day average daily trading volume determined as of the close of the business day immediately preceding the first day in the term of an NPC. In making this determination, a taxpayer must aggregate the notional principal amounts of all NPCs for which the taxpayer is the long party that refer to the same underlying security.

Regarding the five-percent test, we are not aware of any policy rationale for applying this test on an ongoing basis once a swap has been put into place. As discussed above, we understand that this factor is generally intended to identify circumstances in which the lack of liquidity forces a broker-dealer to hold physical shares, thus causing the transaction to more closely resemble a leveraged long position. We believe, however, that a lack of liquidity arising after the swap has already been entered into does not implicate this policy concern. Presumably, the dealer has already entered into a hedge at this point, and while it is possible that this internal hedge may have to be terminated, and a new hedge may be difficult to put on, the Code does not concern itself with the dealer’s hedging activity in determining whether a NPC should be respected as such. Moreover, unlike the 90-day test, the five-percent test cannot be manipulated by the parties (i.e., the parties cannot increase the public float of the underlying securities) and the burdens on the parties to determine whether this factor has been satisfied may be substantial. We therefore recommend that this five-percent test apply only as of the pricing date for the swap.

Turning to the technical considerations involving the five-percent test, the Proposed Regulations do not define what is meant by the term “public float,” and there is no readily available tax definition of this term. This term appears to be intended, at a minimum, to exclude outstanding stock of a corporation that is held by a corporate parent. It is not clear, however, whether it also excludes restricted stock held by corporate insiders, such as officers and directors, and whether it excludes stock held by large long-term investors (e.g., private equity funds). While different arguments could be made for including or excluding shares held by various persons, we recommend that the definition be included, and that the definition rely on readily available information. Regarding the average daily trading volume (“ADTV”) test, we recommend that the test be eliminated. It appears that this rule originated among the practitioner community out of a concern about the potential for crossing in or crossing out inadvertently by “swamping the exchange” (i.e., having the hedging shares constitute so large a portion of

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50 Prop. Reg. § 1.871-16(c)(6).
the amount traded on a particular day that an indirect cross was likely to occur). This issue, however, has been completely resolved by the prohibition against a long party’s being “in the market.” Absent this concern, it would seem to us the only potential policy rationale for this prohibition is to ensure that the dealer's hedging remains "objective" in some sense, i.e., can be done in a "regular way" on the exchange (if the dealer wants to hedge, and to do so by buying stock) without moving the market much. There is no reason why a dealer could not assemble its hedge over time in a regular way; the size of the swap thus has no logical connection to the total notional size of the long party's hedge(s). Accordingly, we recommend that this prong of the “significant holding” factor be eliminated. If it is thought necessary to retain, we recommend that it be applied on a single-day, single swap basis.

e. **NPC Provides For The Payment of a Special Dividend.**

The post-2012 definition of SNPC will extend to NPC arrangements entered into on or after the announcement of a special dividend and prior to the ex-dividend date for such dividend. For such purposes, the term “special dividend” means a nonrecurring payment to shareholders of corporate assets that is in addition to a recurring dividend payment, if any (even if paid in conjunction with a recurring dividend). As currently drafted, where a special dividend has been announced, and the stock also pays a recurring dividend, re-sourcing and withholding tax would apply to both under the Proposed Regulations. While we understand why the Treasury would wish to taint ordinary dividends on any swap on which a special dividend has been paid because of the possible link to tax avoidance, we see no policy reason to tax the ordinary dividends for an indefinite period of time after the special dividend is paid. We recommend that the final regulations adopt a rule such that ordinary dividends paid more than one year (or some other reasonably long period) after a special dividend has been paid will not cause a payment to be a dividend equivalent.

f. **Safe harbor.**

In addition to our specific comments on the specified factors listed above, we recommend the adoption of a safe harbor factor that, if satisfied with respect to an NPC, would prevent that NPC from being considered “specified” except as specifically described below. Notwithstanding whether an ELI or NPC satisfies one or more of the seven specified factors, we recommend that such instrument or NPC should not be treated as an SNPC or ELI if the instrument does not provide for adjustments for ordinary dividends, unless a special dividend has been announced and the ex-dividend date with

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51 For example, if only 10,000 shares of stock were traded on the date the short party put on its hedge by buying 6,000 shares, and the long party sold 6,000 shares on that date, practitioners were concerned that the Service could successfully argue that an indirect cross had occurred because the short party could not physically have purchased all 6,000 shares without buying at least some of the long party’s shares.

52 Prop. Reg. § 1.871-16(c)(7).

53 *Id.*
respect to such special dividend has not yet occurred (i.e., the “special dividend” factor, discussed above, is triggered). It seems clear that a contract providing only for adjustments on unannounced dividends is not motivated by dividend withholding tax but rather by preserving the economic deal between the parties. Such adjustments are necessary to preserve the parties’ economic arrangement; without them the long party would be at risk of having the synthetic asset it had purchased disappear in part. While an actual adjustment, resulting in a withholding tax liability, is a fairly rare event, the rarity of the event does not provide a justification for allowing it to happen. For parties that may need to renegotiate contracts and put in place monitoring and other systems necessary to address the potential withholding obligations, the rarity of an actual extraordinary dividend will do little to reduce the costs and burdens associated with such systems. For these reasons, we recommend excluding from the ambit of section 871(m) all instruments (including NPCs) whose only dividend-linked amount relates to a special dividend (other than those instruments for which the “special dividend” has been announced prior to the trade date of the contract and for which the ex-dividend date has not yet occurred).

**g. Retroactively becoming an SNPC after the contract is entered into.**

We understand the rationale behind the general rule requiring the retroactive imposition of “specified” status on contracts that become SNPCs during the term of the contract. In particular, the 90-day requirement is best policed by hindsight, given the ease of terminating certain contracts and the sometimes-undocumented intentions of contractual parties. Moreover, there is a built-in limitation to the potential harshness of retroactive application of “specified” status in the context of the 90-day requirement (assuming the parties know that the limitation has been breached), because it is only dividend-related payments made during the first 90 days of the NPC that can be subjected to re-sourcing and withholding tax by this factor. Other factors, however, can operate more punitively to taxpayers. Consider, for example, a three-year swap that only becomes “specified” on the final day due to a cross out. We do not believe it would be equitable to subject three years’ worth of dividend-related payments on the NPC to re-sourcing and withholding tax merely because of a cross out, especially if the Final Regulations do not accept our recommendation to restore an “in connection with” trigger for transactions involving the physical stock. Moreover, the longer the term of the swap, the less likely it is that an improper intent of the taxpayer can reasonably be imputed back to the beginning of the swap, but the more dividend-related payments will have been made, and the more withholding tax will be owed. This feature of the Proposed Regulations -- making longer-term swaps riskier for the taxpayer from a re-sourcing and

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54 For example, consider the case where a party purchases an option to acquire stock in XYZ Co. at $100 a share, when XYZ is worth $100 a share. If XYZ pays a dividend of $20, the value of an XYZ share will immediately decline to approximately $80. Without an adjustment of some form to the option, the option would immediately be worth significantly less because it would now be 20% out of the money.

55 Prop. Reg. § 1.871-16(d)(1).
withholding tax perspective -- seems incongruous with the concern about swaps with a term shorter than 90 days.

It also seems to us that this retroactive provision is highly likely to operate in practice as a trap for the unwary. A taxpayer who is aware of an impending event that would require all of the dividend-related payments to be treated as dividend equivalent payments can simply modify an NPC sufficiently to trigger the issuance of a new NPC for tax purposes prior to the occurrence of the event. When the event subsequently occurs, any retroactivity will affect only dividend-related payments that were made after the modification. Thus, the taxpayers who are affected by the retroactive specification rule as it currently stands will be those who were not aware of the impending occurrence of the specified factor, and therefore could not plan around it.

To address these issues, we recommend that the final regulations provide that if a contract becomes an SNPC during its term, that the retroactive aspect be limited to dividend-related payments made within one year prior to the event that caused the contract to become specified. This, we believe, will be sufficiently stringent to accomplish the policy goals of the retroactivity provision, and yet will not impose inappropriately punitive levels of taxation on taxpayers who inadvertently permitted a specified factor to come into existence.

4. Basket swap issues

The Proposed Regulations provide that “[i]f an NPC references more than one security or a customized index, each security or component of such customized index is treated as an underlying security in a separate NPC for purposes of section 871(m), Proposed Regulation section 1.871-15, and this section.” Based on the inclusion of a separate definition of a customized index in the Proposed Regulations, it seems apparent that the drafters intended to exclude non-customized indices entirely from the ambit of section 871(m). The Proposed Regulations, however, treat NPCs referencing more than one security as a series of NPCs covering one reference security each. That rule applies to NPCs referencing non-customized indices as well, according to the Preamble to the Proposed Regulations. It appears, then, that there is some ambiguity in the Proposed Regulations as to whether NPCs on customized indices can be SNPCs. We recommend that the final regulations make it clear that a taxpayer not be required to look through such a non-customized index to the underlying stocks. We also believe the definition of “customized index” is too narrow to accomplish the statutory purpose. The term

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57 Prop. Reg. § 1.871-16(f)(1) (“[i]f an NPC references more than one security or a customized index, each security or component of such customized index is treated as an underlying security in a separate NPC for purposes of section 871(m), §1.871-15, and this section.”); see also Prop. Reg. § 1.871-15(d)(3) (“[a]n equity-linked instrument is a financial instrument or combination of financial instruments that references one or more underlying securities to determine its value . . . .”) (emphasis added).
“customized index” means any index, as determined on the date that the long party and short party enter into an NPC, that is: (i) a narrow-based index; or (ii) any other index unless futures contracts or option contracts on such index trade on a qualified board or exchange, as defined in section 1256(g)(7). 59 In turn, the term narrow-based index means an index: (i) that has nine or fewer component securities; (ii) in which a component security comprises more than 30 percent of the index's weighting; (iii) in which the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or (iv) in which the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with 15 or more component securities, $30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security. 60

We believe that this definition of a non-customized index is too narrow, because there are numerous broadly-based indexes for which no futures or options contracts are traded, but with respect to which there is little if any potential for tax avoidance. Thus, for this purpose, we recommend that a non-customized index should include: (i) any benchmark index, (ii) any index on which futures, options or ETFs trade, and (iii) any index with at least 20 stocks that is a proprietary index of a third party that was developed for other purposes and that is licensed to one of the parties in the transaction. If an index includes any index described in (i), (ii) or (iii), we recommend that portion of the index also be considered non-customized. A "benchmark" index generally means a long-standing index on a sector of the economy or market, formulated pursuant to rules that are made public, and that is widely used as a point of comparison for the performance of funds or other similar investments. Examples would be the S&P 500, Dow Jones and its subsectors, Russell 3000, MSCI EAFE and similar indices.

5. Anti-abuse rule

Proposed Regulation section 1.871-15(e) provides that “[i]f a taxpayer enters into a transaction or transactions with a principal purpose of avoiding the application of Proposed Regulation sections 1.871-15 or 1.871-16, payments made with respect to such transaction or transactions may be treated as a dividend equivalent to [the] extent necessary to prevent the avoidance of these rules” (the “Anti-abuse Rule”). We believe that the inclusion of such a broad rule will foster needless doubt and uncertainty regarding whether a particular transaction produces dividend equivalent payments. As described above, the Proposed Regulations clearly permit a taxpayer to enter into an NPC over a U.S. stock and receive dividend-related payments thereunder without being

deemed to have engaged in “tax avoidance” provided that the NPC does not possess any of the seven specified factors. Presumably, the phrase “the avoidance of” these rules does not mean simply that the taxpayer has avoided triggering any of the seven specified factors, even if, from a non-tax perspective, the taxpayer might have been inclined to do so (e.g., to have crossed in at the beginning of a swap). It is unclear, however, what the phrase “the avoidance of” those rules is intended to mean. This ambiguity will result in difficult judgment calls for taxpayers and their advisors who must interpret the Anti-Abuse Rule.

Additionally, the Proposed Regulations contain a number of mechanical rules that have numerical components (e.g., the 90-day factor and the ADTV test). Such rules are positive because of the clarity and certainty they otherwise provide, but the clarity and certainty is then obscured by the vagueness of the anti-abuse rule. As is the case within any bright line numerical rule in the Code or the regulations, taxpayers may be tempted to come as close as they can to a particular rule without violating it (e.g., remaining in an NPC for two additional days with a principal purpose of exceeding a 90-day holding period). It appears that such a line-approaching exercise would be permitted in this context (as it generally would be in, for example, the wash sale context), because it seems difficult to say that the taxpayer could properly be said to have entered “into a transaction or transactions with a principal purpose of avoiding the application” of the Proposed Regulations. Instead, it appears that the taxpayer merely deferred entering into a transaction (i.e., the termination of the NPC) for the prohibited purpose, but did not enter into such transaction for that purpose. A closer case, perhaps coming out the other way, would be presented where the taxpayer terminated a swap early to avoid the five-percent ceiling rule (e.g., because the taxpayer knew that a substantial redemption of stock, and therefore a reduction in the public float, was about to occur).

Because this uncertainty will make it more difficult for taxpayers and advisers to enter into many innocuous transactions while possibly allowing the Service to address a minority of those that are prescribed, we recommend that the Anti-Abuse Rule be deleted. If, however, it is retained, then the final regulations should provide several examples that illustrate the application of the Anti-Abuse Rule. In particular, it is important that the examples illustrate situations in which the rule may reasonably be thought to be implicated but does not apply.

6. Issues Primarily Affecting Withholding Agents
   
a. Ameliorating Potential Strict Liability of Withholding Agent
   
i. The Existence of Strict Liability for Withholding.

Under the section 1441 withholding regime, a withholding agent generally must withhold 30 percent of any payment of an amount subject to withholding made to a foreign payee unless it has obtained and properly relies upon appropriate documentation
enabling it to withhold at a reduced rate.\textsuperscript{61} A withholding agent who fails to properly withhold in accordance with the foregoing generally remains strictly liable for actual taxes owed as well as potential interest and penalties.\textsuperscript{62} Because a short party in an SNPC transaction is a withholding agent, it generally must withhold tax at a rate of 30\% on dividend-equivalent payments to foreign payees. Many withholding agents are concerned that if an NPC is or becomes an SNPC, they might be liable for withholding tax even if they reasonably believed, based on documentation they received from the long party, that the NPC was not an SNPC and that the dividend-related payments were foreign source. This concern is heightened by Regulation section 1.1441-3(d)(1), which provides that if a withholding agent does not know whether or to what extent the amount of a payment is subject to withholding tax because the "determination of the source" or the calculation of the amount subject to tax "depends upon facts that are not known at the time of payment," the withholding agent must withhold the amount that is "necessary to assure that the tax withheld is not less than 30\% . . . of the amount that will subsequently be determined to be from sources within the United States or to be subject to tax."

We understand, however, some contend that, under Regulation section 1.1441-7(b)(1), a withholding agent in an NPC may rely upon representations made by a long party to avoid having to withhold tax. That regulation provides that, "[f]or purposes of the regulations under sections 1441, 1442, and 1443, a withholding agent may rely on information or certifications contained in, or associated with, a withholding certificate or other documentation furnished by or for a beneficial owner or payee unless the withholding agent has actual knowledge or reason to know that the information or certifications are incorrect or unreliable . . . ." Thus, a withholding agent who relies on valid documentation (e.g., a withholding certificate) in applying a reduced rate of withholding is fully relieved of any risk of such withholding tax liability, regardless of whether such documentation is inaccurate, unless the withholding agent knows or has reason to know of such inaccuracy. Some practitioners and taxpayers believe that representations made by a long party that, if true, would establish a foreign source for the dividend-related payments on an NPC would constitute "documentation." If so, receipt of such representations would allow a withholding agent not to withhold on a dividend-related payment unless it knew or had reason to know that such representations were incorrect. This conclusion, however, is subject to doubt.

Regulation section 1.1441-7(b)(1) arguably may not create an exemption from withholding. Rather, it could be contended that such exemptions are created elsewhere in the section 1441 regulations. For example, Regulation section 1.1441-1(b)(1) provides that a withholding agent must withhold 30\% of any payment of an amount subject to withholding made to a payee that is a foreign person unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is a U.S. person or as made to a beneficial owner that is a foreign person

\textsuperscript{61} See Treas. Reg.§ 1.1441-1 \textit{et seq.}  

\textsuperscript{62} I.R.C. § 1461.
entitled to a reduced rate of withholding. Specific manifestations of this general rule appear at other places in the regulations under section 1441.\(^{63}\) It does not appear, however, that either the general rule in Regulation section 1.1441-1(b)(1) or any specific instance of that rule allows a withholding agent to rely on documentation to determine that income is not subject to withholding tax because such income is foreign source. Moreover, while the language of Regulation section 1.1441-7(b)(1) is not entirely clear, it could be contended that that provision does not establish an independent ground for failing to withholding tax. Instead, Regulation section 1.1441-7(b) could be viewed merely as describing the circumstance in which a withholding agent may rely on otherwise authorized documentation relating to the status of the beneficial owner of a payment or a claim for a treaty benefit (i.e., reliance is permissible in the absence of actual knowledge or reason to know that such documentation is incorrect or unreliable).

In summary, given the general rule in Regulation section 1.1441-3(d)(1), and the somewhat unclear language in Regulation section 1.1441-7(b)(1), a withholding agent who reasonably but mistakenly determines that dividend-related payments on an SNPC are foreign source has real cause for concern about incurring liability for withholding tax on those payments.

ii. Adverse Consequences of Strict Liability

In light of the foregoing, unless the Treasury provides an exception for purposes of section 871(m), a withholding agent might reasonably opt to treat all U.S. equity derivatives as SNPCs (and withhold tax accordingly) in order to eliminate the risk of having to pay withholding tax. In that case, the corresponding long party would need to request a refund from the Service if the NPC was not in fact specified. It follows that the market for these equity derivative instruments may become significantly less attractive from a prospective long party’s standpoint. Moreover, if many withholding agents choose this path, the Service would be required to process a large number of refund requests. We do not think that these potential consequences were intended.

iii. “Know or Reason to Know” Exception to Withholding Tax Liability

To remedy these problems, we suggest that certain representations be added to the existing categories of documentation the receipt of which will permit a withholding agent to avoid liability for withholding tax, interest and penalties unless the agent knows or has reason to know of the falsity or one or more of such representations. In establishing this safe harbor, the principal questions that would arise would be: (i) what types of representations would suffice to establish a prima facia case for reliance by the

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\(^{63}\) See, e.g., Reg. § 1.1441-1(e)(1)(i) (describing payments that a withholding agent may treat as made to a foreign person that is a beneficial owner); Reg. § 1.1441-4(a)(2)(i) (describing documentation upon which a withholding agent may rely to treat income as being effectively connected with the conduct of a trade or business in the United States); Reg. § 1.1441-6(b)(1) (describing documentation on which a withholding agent may rely in support of a claim that a beneficial owner is entitled to a reduced rate of withholding based upon an income tax treaty).
withholding agent, and (ii) what would constitute knowledge or reason to know that such representations were inaccurate. As to the form and content of the representations, the final regulations could provide (in a similar manner to existing Regulation section 1.1441-4(a)(3)(ii)) that a payment will not be treated as U.S. source income under section 871(m) if the payee provides certain representations in a master agreement that governs the transactions in notional principal contracts between the parties (for example an International Swaps and Derivatives Association (ISDA) Agreement, including the Schedule thereto), or in the confirmation on the particular NPC transaction. Treasury could issue a revenue procedure with sample representations that would cover facts uniquely within the knowledge of the long party (i.e., whether the long party had entered into a short position covering the underlying stock which did not involve the short party). As to the “know or have reason to know” standard, we would generally expect that a short party would be held to have reason to know of transactions that it engaged in if such transaction involved the same business unit, but would not otherwise have reason to know of transactions executed with another business unit. Either or both of these aspects of the safe harbor could be expanded or contracted as necessary on a going forward basis through administrative pronouncements.

b. “Qualified SNPC Counterparty” Approach

Just as in the context of securities lending transactions, a concern arises in the NPC context regarding cascading withholding taxes. Suppose a U.S. broker-dealer enters into an NPC with a foreign broker-dealer, who in turn enters into a swap with a customer. Suppose further that both of the NPCs are “specified.” (Assume that the two dealers are unrelated, such that the exception in Proposed Regulation section 1.871-16(e)(2) does not exempt the transaction from “specified” status.) In that case, because both of the NPCs are “specified,” there would be cascading withholding tax liability (potentially reduced but not eliminated by an applicable tax treaty). This result is, clearly, inappropriate from a policy perspective. To avoid this problem, certain market participants, such as non-U.S. banks, insurers and reinsurers, broker-dealers, custodians and clearing organizations that regularly engage in derivatives transactions, or hold such positions on behalf of others (“Qualified NPC Counterparties”) could be permitted to assume withholding and payment obligations in respect of payments under U.S. equity NPCs that each receives, in a manner similar to the proposed “qualified securities lender” arrangement set forth in Notice 2010-46.64

Under this approach, we anticipate that withholding agents could rely on certifications to the effect that a long party qualifies for such special status to avoid withholding obligations on amounts payable to such party under U.S. equity NPCs. Generally, where a Qualified NPC Counterparty receives such a payment and has to make an offsetting payment with respect to the same underlying security, such Qualified NPC Counterparty would not be liable for U.S. gross-basis tax on the payment it receives (in case such payment qualified as a dividend equivalent) but would be required to properly withhold and report with respect to payments it makes to the extent that payment

64 n. 14.
If the Qualified NPC Counterparty receives a payment under U.S. equity NPC for which it has no obligation to make an offsetting payment, the Qualified NPC Counterparty would be liable for tax under section 871(a) or section 881(a) if the payment received under the U.S. equity NPC qualified as a dividend equivalent. The interests of the Treasury would be protected via certifications provided by such Qualified NPC Counterparties and audits of such institutions, along the lines of the proposals set forth in Notice 2010-46.

This approach has several potential advantages. First, it should provide comfort to withholding agents that neither “blanket withholding” nor forcing foreign institutions to book trades in their U.S. branches is necessary in respect of U.S. equity derivatives entered into by qualifying foreign financial institutions. As a result, this proposal would continue to allow access to U.S. equity derivatives to a large segment of non-U.S. market participants and avoid blanket withholding and its negative implications. Second, it would eliminate the need for qualifying institutions to provide representations in respect of the classification of a derivative as a SNPC, which may be difficult for the long party to provide (especially if the “in connection with” standard is not adopted). Finally, and also importantly, it could eliminate the risk of cascading withholding in respect of dividend equivalent payments.

If the Treasury adopts our proposed Qualified NPC Counterparty approach set forth above, such a system would also deal with the problem that arises under the Proposed Regulations where the long party in the transaction is the dealer (i.e., because the customer wishes to be short synthetically). In such circumstances, the dealer will frequently sell short the underlying security on the same day it enters into the NPC. Under the Proposed Regulations, a dealer who does so will be considered “in the market,” and the NPC will be a SNPC. While this is of no concern when the dealer is a domestic entity, or is the U.S. branch of a foreign entity, when the dealer is a foreign person, the payments made by the short party (i.e., the dealer’s customer) generally will be subject to re-sourcing and therefore U.S. withholding tax. We do not believe this result is consistent with the intent of Congress in enacting section 871(m), since the dealer was in the market to hedge a position entered into in its capacity as a dealer, not to avoid U.S. withholding tax on a long position in securities. The Qualified NPC Counterparty approach would address this issue, so long as the dealer agreed to withhold U.S. tax on the dividend equivalent payment due on the stock borrowing.

As an interim matter, the Treasury could consider adopting a rule to the effect that if a dealer enters into a long position under a NPC or ELI in the ordinary course of its trade, the dealer will not be considered “in the market,” and the NPC will be a SNPC.

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65 Id.

66 This was not of concern under the statute unless the dealer (i.e., the long party) transferred the stock to the customer (i.e., the short party) in connection with the entry into the swap or the customer transferred the stock to the dealer in connection with the termination of the swap. While the withholding can be avoided in the context described in the text with a back-to-back swap with a domestic party, this structure may not be practical for some dealers, and should not in any case be required where unnecessary to accomplish the purposes of section 871(m).
business as a dealer, such an NPC or ELI would not be treated as specified. This rule
would be based on the view that such a dealer is acting to earn a spread from its dealer
activity rather than trying to avoid U.S. withholding tax. This solution would have the
advantage of not requiring the U.S. counterparty of the dealer to adopt complex systems
for withholding tax compliance (which systems would be necessary if the Qualified NPC
Counterparty approach were not adopted). We can understand, however, that the
Treasury may be concerned about the potential for withholding tax avoidance by the non-
U.S. securities dealer in this situation, and, on balance, we believe that the benefits of
having a robust Qualified NPC Counterparty approach to prevent cascading withholding
taxes is an important goal. Accordingly, we recommend that the definition of a SNPC
exclude an NPC for which the long party is a dealer in derivatives who enters into such
NPC in the ordinary course of its trade or business as such.

7. Retroactivity of the Proposed Regulations

The Proposed Regulations’ effective date is based on when a dividend equivalent
is paid rather than on when the underlying contract was entered into. This creates a
number of issues relating to the equity and administrability of the Proposed Regulations.
In summary, we recommend that: (i) ELIs and NPCs that have “specified” status only
because of the new specified factors not produce dividend equivalents if they were
entered into before the promulgation of the Proposed Regulations; (ii) if such ELIs and
NPCs become “specified” after December 31, 2012, dividend-related payments should be
treated as dividend-equivalent payments only with respect to dividends paid on the
underlying equity after such date; and (iii) if the Proposed Regulations are not finalized
this year, the effect of the Temporary Regulations be extended through the end of 2013
to avoid having the broad version of section 871(m) come into effect.

The first set of issues relates to the rules for ELIs and to the new factors for
SNPCs. As noted above, we have serious concerns with the manner in which the
Proposed Regulations apply generally to ELIs other than simple NPCs, and we believe
that transition rules need to be relaxed for several reasons. For ELIs such as options,
prepaid forwards, and equity-linked debt instruments, there was little reason to believe
the rules would apply prior to January 2012. Moreover, many of these instruments, such
as exchange traded notes, provide no contractual rights for the parties to terminate early
in the event of a change in tax law. To the extent that all of the “specification” factors
apply to the ELIs (notwithstanding our prior recommendations discussed above in Part
IV.1), some of the SNPC categories require looking back to the start of the contract (e.g.,
long party “in the market” at inception, or to check the specific standards for illiquidity).
Such contracts may have been entered into before the regulations were proposed and
even before section 871(m) was enacted. It is not clear that the parties to the contract
ever had the relevant information, given that it would not have been recognized as
important until promulgation of the Proposed Regulations. Similar equitable concerns
apply to NPCs that are specified solely because of a non-statutory factor, such as the
maximum size factor (i.e., the limitation on the notional principal amount of the NPC to

See Prop. Reg. §§ 1.871-15(f), 1.871-16(g).
the lesser of: (i) five percent of the total public float of that class of security and (ii) twenty percent of the 30 day ADTV). In the interest of equity and administrability, then, the rules treating dividend-related payments on ELIs (and the new specification factors) as dividend equivalents should apply only to transactions entered into after the date of promulgation of the Proposed Regulations.

As a technical matter, there is some ambiguity in the Proposed Regulations regarding the treatment of payments made after December 31, 2012, in two respects. First, the rule in the Proposed Regulations that imposes the section 871(m) regime on SNPCs and ELIs is proposed to be effective on the general effective date of the regulations, which is the date final regulations are published in the Federal Register. If this occurs prior to January 1, 2013, then a NPC could be deemed “specified” if it satisfied one or more of the seven specification factors. In such event, there is a technical argument that re-sourcing and therefore U.S. withholding tax would be imposed on payments made after December 31, 2012, even if such payments related economically (i.e., under a dividend reinvestment feature of the type discussed above) back to dividends on the underlying stock that had been paid earlier. If this interpretation were adopted, the tax effects of an ELI entered into years ago (before Treasury and the Service proposed to add that category to contracts potentially subject to section 871(m)) could be significantly altered. To resolve these issues, we recommend that Treasury clarify the effective date of the application of section 871(m) to these transactions so that it applies only to dividend-related payments the relevant dividends for which were paid after December 31, 2012.

Our final comment relates to a potential glitch that may arise if the Proposed Regulations are not finalized before the end of this year. If they are not, as a technical matter, the applicable regime is the expanded version of statutory section 871(m) that would subject all dividend equivalents on all NPCs to re-sourcing and withholding. Conversely, no re-sourcing and thus no withholding would be required on other ELIs. While this set of rules would not be in effect for a long period, long parties and withholding agents would nevertheless be required to comply with this regime during the time (e.g., six weeks) that it was in effect. To avoid these burdens, we urge Treasury and the Service to finalize the regulations well before the end of this year. If that is not possible, we recommend that Treasury and the Service issue a notice by November 15 extending the Temporary Regulations through 2013 to allow time for adequate consideration of Final Regulations when promulgated, and to adjust systems to take the new rules into account.

V. Minor Changes and Technical Clarifications

1. Parity Between ELIs and NPCs

As a technical matter, there is some ambiguity as to whether an ELI must meet the same tests as an NPC in order for dividend-related payments on it to be subject to section 871(m) regime on SNPCs and ELIs.
871(m); or whether, on the other hand, a dividend-related payment on any ELI is subject to re-sourcing under section 871(m). On the one hand, section 871(m)(2)(C) treats as a dividend equivalent “any other payment determined by the Secretary to be substantially similar” to a dividend equivalent. Similarly, Proposed Regulation section 1.871-15(b)(1)(ii) defines “dividend equivalent” to include: (i) a dividend-related payment made pursuant to a SNPC, and (ii) a “substantially similar payment.” Proposed Regulation section 1.871-15(b)(1)(iii) operates in a similar manner, defining the term “dividend equivalent” to include “[a]ny substantially similar payment as defined in [Proposed Regulation section 1.871-15(d)].” Critically, however, Proposed Regulation section 1.871-15(d)(1)(ii) does not define “substantially similar payment,” but states merely in pertinent part that:

Any payment, including the payment of the purchase price or an adjustment to the purchase price, is a dividend equivalent if made pursuant to an equity-linked instrument that is contingent upon or determined by reference to a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States.

This last provision could be read to mean that a dividend-related payment on every ELI is U.S. source income, regardless of whether the ELI possessed any of the seven factors necessary for an NPC to be “specified.”

On the other hand, the Proposed Regulations also provide that an ELI that provides for a payment that is a substantially similar payment within the meaning of Proposed Regulation section 1.871-15(d) is treated as a NPC for purposes of section 871(m) and the Proposed Regulations. This language suggests that not all ELIs are to be treated as SNPCs, but only those that trigger one of the seven factors. Because it appears illogical to subject a dividend related payment on a forward contract to re-sourcing and thereby U.S. withholding tax where the same payment on an economically similar NPC would not be subject to such tax, it appears that the Treasury intended to require the application of the “specified” tests to ELIs. It would be helpful, however, for the final regulations to clarify that an ELI must meet one of the “specified” tests before dividend related payments on it are subject to section 871(m).

2. Definition of “dividend equivalent” payment

Proposed Regulation section 1.871-15(d)(ii) defines a dividend equivalent to include “any payment … if made pursuant to an equity-linked instrument that is contingent upon or determined by reference to a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States.” The above definition appears to be broad enough to include the full amount of any payment the amount of which is determined by an algorithmic formula, even in which only one component of such formula is determined by reference to a dividend (i.e., a dividend equivalent payment is not limited to the portion of any

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payment that is contingent upon or determined by reference to a U.S.-source dividend). We recommend that the Final Regulations be amended so that it is made clear that a payment that is determined by an algorithmic formula should be broken into the separate components of the formula so that the dividend equivalent payment would be limited to the portion of the formula that is contingent upon or determined by reference to a dividend, rather than including the full amount of the payment of which only a portion is contingent upon or determined by reference to a dividend.

3. Definition of “Long Party”

Given the wording of section 871(m)(4)(A) (which was adopted by the Proposed Regulations), it is technically possible to write the contract such that the party who wishes to have a synthetic long position receives fixed periodic payments but is required to pay over to the short party the excess of those fixed payments over the actual dividend, if any, paid on the underlying stock. We recommend that the Final Regulations provide that the long party is the one that economically benefits from an increase in dividends on, or price of, the underlying stock.

4. SNPCs: “Not regularly traded” factor

An NPC will trigger the “not regularly traded” specification factor if the underlying security in the NPC is not regularly traded. For this purpose, an underlying security is regularly traded if such security is listed on one or more qualified exchanges at the time the NPC is priced and the underlying security was traded on at least 15 trading days during the 30 trading days prior to the date the parties price the NPC. In the case of an initial public offering of a security, however, such security is regularly traded if such security is traded during at least 15 trading days on one or more qualified exchanges during the 30 trading days subsequent to the initial offering. For purposes of applying these tests, the underlying securities will be considered traded only on those days in which the underlying securities are traded in quantities that exceed ten percent of the 30-day average daily trading volume.

We generally believe that this factor represents a reasonable interpretation of section 871(m)(3)(iii). However, it is unclear how the special rule for initial public offerings relates to the main rule. Presumably, the Proposed Regulations are not intended to mean that if the “15 out of 30” test is satisfied following an initial public offering, the stock will forever be treated as passing this test. Instead, it seems that the Treasury intended that if the 30 trading day period prior to the pricing date for the NPC included an initial public offering (hence causing the stock not be traded for 30 days prior to the offering date), the taxpayer would be required to consider a number of days following the

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70 Prop. Reg. § 1.871-16(c)(2).
72 Prop. Reg. § 1.871-16(c)(2)(B).
73 Prop. Reg. § 1.871-16(c)(2)(C).
pricing date such that the total number of trading days from initial offering to the last day in the period equaled 30, for purposes of determining whether the 15 out of 30 “test” was satisfied. We think this is a reasonable result, and recommend that that the regulation be revised to make this result explicit.

6. SNPCs: “Special Dividend” factor

An NPC will become specified once a special dividend has been announced, even if the taxpayer terminates the swap before receiving the special dividend.\textsuperscript{74} Even if the tax on ordinary dividend related payments is generally retained, the fact that the taxpayer terminated the NPC prior to receiving the special dividend should be viewed as conclusive evidence that the taxpayer did not have a tax motivated purpose in entering into the transaction in the first place. We recommend that the regulations be modified to reach this result.

7. SNPCs: “Long Party Controls Short Party’s Hedge” factor

The Proposed Regulations expand the SNPC definition to include NPCs in which the long party controls the short party's hedge.\textsuperscript{75} Although arguably ascertainable from the full text of the proposal, as set forth below, the Proposed Regulations are not entirely clear as to the circumstances under which a long party will be deemed to “control” the short party’s hedge. We recommend revising the Proposed Regulations to clarify "control" to refer to the long party’s ability to "direct" the short party's “acquisition or disposition” of its hedge.

Under the Proposed Regulations, an NPC is an SNPC if the long party: "(i) controls contractually or by conduct the short party's hedge of the short position; or (ii) [t]he long party enters into an NPC using an underlying equity control program." The Proposed Regulations, however, do not include a definition of what constitutes "control." In the absence of a formal definition of "control," guidance as to its intended scope may be gleaned from its use elsewhere in the Proposed Regulations. We turn first to the proposal's description of "underlying equity control program" in which "control" is equated with the long party's ability: (i) to direct how the short party hedges its exposure under an NPC, and (ii) to acquire itself, or to cause the short party to acquire, an underlying security which would ultimately hedge the short party's exposure under an NPC.\textsuperscript{76}

The Preamble to the Proposed Regulations refers only to situations in which the long party has the ability to: (i) control the “acquisition” of the stock ultimately used by the short party to hedge its exposure under the contract, or (ii) direct the short party to “dispose” of the underlying stock on a specified date at a specified price.\textsuperscript{77} Contrast the

\textsuperscript{74} Prop. Reg. § 1.871-16(c)(7).
\textsuperscript{75} Prop. Reg. § 1.871-16(c)(5)
\textsuperscript{76} Prop. Reg. § 1.871-16(f)(2).
\textsuperscript{77} n. 1.
foregoing with the proposal’s example illustrating what does not constitute an "underlying equity control program." Under the electronic trading platform example (direct market access), the long party places an order with the dealer whereupon the dealer's computer identifies the corresponding hedge. The notional amount on the confirmation reflects the cost of the dealer's hedge in addition to the applicable market spread. The long party did not have the ability to direct the manner by which the dealer hedged its position. Thus, it appears that the Proposed Regulations are intended to encompass arrangements whereby the long party is able to direct the short party’s acquisition or disposition of its hedge. As such, the text stating "(i) [t]he long party controls contractually or by conduct the short party’s hedge" suggests an interpretation of the term “control” that would require the long party to have an existing ability to direct the manner by which the short party acquires or disposes of the stock underlying its hedge. We recommend that the Proposed Regulations be revised to clarify and confirm the foregoing interpretation.

8. SNPCs: Special rule for separate holders

Because of the possibility that an NPC or an ELI will be sold after it is created, we recommend that the final regulations clarify that whether an NPC or ELI is treated as “specified” is made without regard to actions taken by a preceding or subsequent holder, other than one who is related to the taxpayer. Thus, if a particular holder is “in the market” when it acquires an exchange-traded note or other actively traded instrument, the note is not tainted with respect to subsequent holders (at least those who are unrelated to the initial holder). Similarly, we recommend that it be explicitly stated that only the period during which an instrument is held by a particular holder or a related party is considered in determining whether the 90-day factor is satisfied.

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