SwissBanking

Dana Trier
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave, NW
Washington, DC 20220

Daniel Winnick
Associate International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20224

Karl Walli
Senior Counsel - Financial Products
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20224

John Sweeney
Office of Associate (Chief Counsel), International
Chief, Branch 8
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mark Erwin
Office of Associate Chief Counsel (International)
Chief, Branch 5
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

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Section 871(m) comments

Ladies and Gentlemen

This letter provides comments of the Swiss Bankers Association (SBA) regarding Internal Revenue Code Section 871(m) ("871(m)") requirements for U.S. equity derivatives. We appreciate the opportunity to present you with our comments. We also wish to thank you for incorporating suggestions from our letter dated August 31, 2016, relating to 871(m) and Qualified Intermediary (QI) issues, and for extending certain 871(m) relief provisions through 2018 in Notice 2017-42.

Swiss Bankers Association
Schweizerische Bankiervereinigung
Association suisse des banquiers
Associazione Svizzera dei Banchieri

Aeschenplatz 7
PO Box 4182
CH-4002 Basel

T +41 61 295 93 93
F +41 61 272 53 82
office@sba.ch
www.swissbanking.org

The 871(m) requirements are extremely complex, raising several technical and operational challenges for Swiss banks. Despite these complexities, Swiss banks are fully committed to comply with 871(m). Nevertheless, we respectfully request Treasury and IRS to grant the relief described in this letter in order to provide adequate time for implementation. Please note that our letter primarily addresses concerns raised by Qualified Intermediaries not acting as Qualified Derivative Dealers (QDDs), and the requested relief is still needed after the release of Notice 2017-42.[1]

Our comments may be summarized as follows:

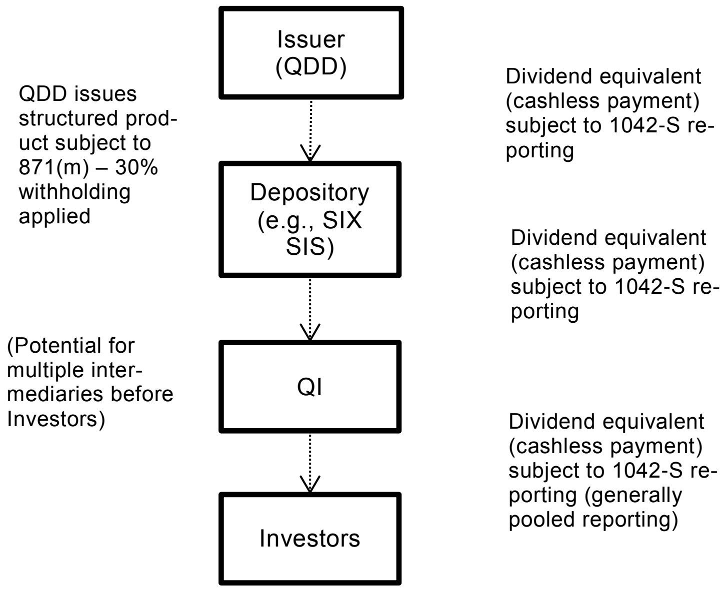
- Although U.S. withholding tax at the statutory 30 percent rate is generally applied by issuers under 871(m), Form 1042-S reporting is extremely complicated due to: (1) the requirement to report dividend equivalents, not cash dividends; and (2) the complex operational process relating to these products.
- To give the Swiss market adequate time to implement Form 1042-S reporting under 871(m), Treasury and IRS should exempt QIs (not acting in a QDD capacity) from filing Forms 1042-S for the next three years (calendar years 2017-2019) with respect to dividend equivalents under 871(m). At the very least, the "good faith" transition relief in Notice 2016-76 (as extended by Notice 2017-42) should: (1) be expanded to cover 871(m) requirements for QIs acting as intermediaries (not just as QDDs); and (2) extend the relief period from 2017-2018 to also include 2019.
- Treasury and IRS should clarify the scope of the "combination rule" to exclude QIs acting purely in an intermediary (not principal) capacity, unless the QI has actual knowledge that the long party has entered into potential 871(m) transactions in connection with each other.
- A QI – whether acting as a QDD or as intermediary – should not be obligated to provide the notification required under 871(m). At the very least, in light of the late notification of these rules, the effective date should be deferred two years.
- Treasury and IRS should make permanent the withholding exemption for dividends received by QDDs on physical securities held as hedges.

Current practice in Switzerland – 30 percent withholding known as the "Issuer Solution"

It may first be helpful to understand how the market in Switzerland (and apparently other countries as well) has evolved to handle 871(m). Swiss banks frequently hold, as intermediaries, structured products traded on the secondary market and subject to 871(m). In such cases, the structured products are held through a central depository (such as SIX SIS) and the issuer generally applies U.S. withholding at a 30 percent rate. Reduced withholding rates (due to income tax treaty, etc.) are generally not allowed at the issuer level due to current operational limitations.

[1] We also recognize that other industry associations have made broader comments on the need to roll back much of the 871(m) requirements (see SIFMA Letter dated July 31, 2017) and we support these efforts.

This approach has been referred to as the "Issuer Solution" in the Swiss market and may be illustrated by the following diagram:



<u>Form 1042-S relief needed for QIs reporting dividend equivalents</u>

Although the Issuer Solution described earlier provides a relatively blunt fix to the problem of U.S. withholding – the QDD issuer will withhold at the statutory 30 percent rate – Form 1042-S reporting is another matter.

As suggested by the Issuer Solution diagram, Form 1042-S reporting depends on a reliable flow of accurate 871(m) data from each link in the chain to the next, starting with QDD issuer on down to the QIs. Prior to 2017, these data flows simply did not exist since QDD issuers generally paid only non-U.S. source income exempt from Form 1042-S reporting. Given the novelty of reporting cashless items, more time is needed to add the necessary processes.

Furthermore, the data required by 871(m) for Form 1042-S reporting is completely different from other income types. Before 871(m), Form 1042-S reporting for QIs was entirely based on actual cash payments. Now, with 871(m), reporting is required for cashless dividend equivalents, and operational processes that trigger reporting based on cash payments are irrelevant. Again, additional time is needed to build the processes to identify and report cashless items.

In light of the significant Form 1042-S reporting challenges presented by 871(m), the SBA requests Treasury and IRS to exempt QIs (not acting in a QDD capacity) from filing Forms 1042-S for dividend equivalents for the next three years (calendar years 2017-2019). At the very least, the "good faith" transition relief in Notice 2016-76 (as extended by Notice 2017-42) should: (1) be expanded to cover 871(m) requirements for QIs acting as intermediaries (not just as QDDs); and (2) extend the relief period from 2017-2018 to include 2019 for Form 1042-S reporting.

Potential application of "combination rule" to foreign intermediaries (such as QIs)

The scope of the "combination rule" is not entirely clear for foreign intermediaries, such as QIs. According to Treasury Regulation §1.1441-1(b)(4), a QI would not be required to apply the combination rule unless it had actual knowledge that a long party entered into a potential 871(m) transaction "in connection with" any other potential 871(m) transaction. Consequently, absent actual knowledge, a QI does not need to apply the presumption rules of Treasury Regulation §1.871-15(n)(3).

871(m) notification

A QI acting in the capacity of a QDD must notify each payee in writing that the QDD will withhold on the dividend payment date. QI Agreement Sec. 3.03(B).

In addition, a separate regulation issued in January 2017 requires a similar notification by QIs that are NOT acting in the capacity as a QDD. Reg. 1.1441-2(e)(7)(v). It appears the notification is intended to inform a non-US person of the timing of 871(m) tax when recipient-specific Form 1042-S reporting applies. However, there does not appear to be any reason for the notification when the non-US person is subject to pooled reporting.

Both notification requirements mentioned above were not included in the proposed QI Agreement issued in 2016. Accordingly, we propose that a QI – whether acting as a QDD or as intermediary – should not be obligated to provide the notification required under 871(m). At the very least, in light of the late notification of these rules, the effective date should be deferred two years.

Withholding exemption for dividends received by QDDs on physical securities – permanent relief needed

Part of the relief in Notice 2017-42 continues – through 2018 – the withholding tax exemption for dividends on physical shares received by a QDD in its capacity as an equity derivatives dealer. This exemption was scheduled to expire at the end of 2017.

SBA believes this withholding tax exemption should be made permanent. There is no reason why dividend equivalents received by a QDD (in its capacity as equity derivatives dealer) should enjoy a permanent exemption, yet actual dividends on physical shares do not. Both income types serve the same purpose: allowing the QDD to hedge its obligations to make payments on equity derivatives. Tax rules should not prefer one method of hedging (via derivatives) over another (with physical securities).

In the Swiss market, issuers of structured notes frequently hedge with physical securities. Beginning 2019, dividends on these hedges would be subject to U.S. withholding tax, resulting in two separate levels of withholding – once on the hedge, and another on the derivative held by the client. Such excess withholding would significantly damage the market for such products.

We have taken note of the rationale, why Treasury and IRS deem the disparate treatment of QDDs using physical hedges (withholding tax beginning 2019) and derivative hedges (permanent exemption) being justified. According to Notice 2017-42, Treasury and IRS "were concerned that the exemption from withholding on dividends paid to a QDD, when combined with the net delta exposure method, could result in U.S. source dividends escaping U.S. tax completely in certain circumstances." It is not clear to us what these circumstances are. If Treasury and IRS have specific concerns of abuse, then specific rules should be developed to target them. The application of withholding tax on all physical hedges is simply an excessive approach for such a vague concern.

We also wish to point out that moving from physical hedges to derivative hedges is not a simple task for QDDs. Many significant operational and regulatory hurdles exist. Consequently, Treasury and IRS should not assume that Swiss QDDs can make an easy shift from physical hedges to derivatives.

Accordingly, SBA recommends that Treasury and IRS should make permanent the withholding exemption for dividends received by QDDs on physical securities held as hedges.

Thank you for considering our comments. Please do not hesitate to contact us (petrit.ismajli@sba.ch / +41 61 295 93 02) if you have additional questions about this letter.

Yours sincerely,
Swiss Bankers Association

Petrit Ismajli Urs Kapalle