Association of Institutional INVESTORS™

August 26, 2014

Mr. Karl Walli
Senior Counsel (Financial Products)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington D.C. 20220

Re: Dividend Equivalents From Sources Within the United States Under Section 871(m) of the Internal Revenue Code

Dear Mr. Walli:

The Association of Institutional INVESTORS ("Association") truly welcomed the opportunity to engage in a meaningful conversation with you regarding the proposed rule under Section 871(m) of the Internal Revenue Code ("Code") entitled "Dividend Equivalents From Sources Within the United States" (the "Proposed Rule") on April 22, 2014. The Association is appreciative of the chance to provide follow-up comments to our April meeting and thus, would like to further address issues centered on delta, broad-based indices, and financial transactions conducted in the ordinary course of business. These select issues highlight our general concern with the administrative feasibility of the Proposed Rule.

The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty we have to these organizations. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

I. BACKGROUND

On March 18, 2010, Code Section 871(m) was enacted as a part of the Hiring Incentives to Restore Employment Act. The section addresses the treatment of dividend equivalent payments. Specifically, Section 871(m)(1) generally provides that a dividend equivalent shall be treated as a dividend from sources within the United States. A "dividend equivalent" is: (1) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; (2) any payment made pursuant to a specified notional principal contract ("SNPC") that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; or (3) any other payment determined by the Secretary to be a substantially similar type of payment.

The purpose of the section was to prevent avoidance of tax withholding by use of stock lending and swap transactions. The Senate Permanent Subcommittee on Investigations issued a report (the "PSI Report") identifying certain transactions involving payments of dividends and certain dividend equivalents to non-U.S. persons, which had indications that tax avoidance was the purpose. Such indicia included: (1) a short duration of a transaction; (2) payments equaling greater than 70% of a dividend were paid out by the short party; (3) the fees charged by the short party were tied to tax savings; (4) the long party would sell the shares before dividends were declared and reacquire them after; (5) appearance of sales by use of third-party intermediaries; (6) the sale and repurchase of stocks are coordinated to minimize risk of financial loss; and (7) treatment of the transaction as creating tax risk and setting "risk limits." Indeed, the purpose of Section 871(m) and the regulations thereunder is to prevent those transactions that "enable non-U.S. persons to dodge payment of U.S. taxes on U.S. stock dividends." It was soon after the release of the report that there were proposals that treat certain payments that are contingent upon, or determined by reference to, the payment of a dividend as a U.S.-source dividend.

Given the legislative and administrative intent concerning the avoidance of tax withholding, the Association is confident that the Proposed Rule can be modified to preserve the intent without being overbroad and unduly burdensome at an administrative level.

II. SCOPE OF TRANSACTIONS COVERED

a. Generally

The Association acknowledges the purpose of the Proposed Rule is to curb tax avoidance schemes and transactions for dividend-related payments that escape the withholding regime. At the same time, the Association is mindful that sweeping changes may cause unpredictability, advantage sophisticated parties while disadvantaging ordinary investors, and negatively impact the capital markets. Considering the foregoing, we kindly urge the Treasury and IRS to strike a balance between minimizing the risk of tax avoidance and minimizing the risk of unintended market disruption.

Taxpayers acquire various structured notes, exchange-traded notes, and other derivative financial instruments for legitimate business purposes. For example, some taxpayers enter into short-U.S. equity derivative contracts to hedge their exposure to U.S. equities. In doing so, a financial institution offers guarantees against equity market downturns that may be subject to the Proposed Rule, when in fact, the guarantees are simply provided for business reasons. Further we believe that the Proposed Rule would impact numerous foreign banks as well, who offer such contracts in the ordinary course of business, and not for the purpose of avoiding dividend withholding.

In our prior comment letter, we had recommended carving out an exception for hedging transactions as defined under Code Section 1221 to curb the over-breadth of the Proposed Rule in this specific regard. The Association still feels the risk of tax avoidance using such instruments is low, and seeks guidance from the Treasury and IRS to ascertain a safe harbor of sorts for these types of transactions. In particular, the Association continues to believe that as long as a contract is established to be a valid hedging transaction for purposes of Code Section 1221, the Proposed Rule should not apply. A revised rule would not impair the ability of Code Section 871 to reach the intended abusive transactions.

b. Annuity Contracts

During our April meeting, we had discussed, in particular, whether or not variable annuities that reference U.S. equities would be subject to the Proposed Rule. The Association does not consider variable annuity contracts as a vehicle for obtaining dividends and dividend-related payments to avoid withholding, and thus, we believe should not be subject to the Proposed Rule. In fact, the taxation of payments received as an annuity is currently imposed under a well-established regime under Code Section 72 and withheld pursuant to Section 1441. We believe that imposing dividend equivalent taxation rules to the underlying investments would completely disrupt the intended tax accounting of annuity contracts from a timing and character perspective given the rules already in existence.

The Association recommends that the definition of 'equity-linked instrument' exclude commercial annuities as defined by Code Section 3405(e)(6) ("an annuity, endowment, or life insurance contract issued by an insurance company licensed to do business under the laws of any State"). This definition mirrors the description of annuities in Section 72 providing that "gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under *an annuity, endowment, or life insurance contract*."

III. APPLICATION OF DELTA

a. Practical Application of Delta Calculations

Under the Proposed Rule, taxpayers would be required to determine the delta of a possible Section 871(m) transaction when the contract is acquired. Additionally, provided that the transaction is a Section 871(m) transaction, there would be another delta calculation to determine the amount of withholding. Conceptually, these steps do not pose a major burden, but when carried out on a large scale, it will require a substantial amount of time and investment of resources to repeatedly calculate delta. In its comment letter dated May 7, 2014, the Securities Industry and Financial Markets Association ("SIFMA") correctly recognized that this means

U.S.-equity-linked financial instruments trading in secondary markets outside the United States would change their withholding state as they were acquired by different holders at different times, and particular instruments could be subject to different amounts of withholding at maturity, depending on when they had been acquired, and for how long they had been held, by prior investors. The practical challenges of calculating delta on a large scale impose a tremendous administrative burden.

b. Recommendation for Delta Calculations

The Association recommends the use of a reasonable market close calculation rather than the time of trade calculation. Having a fixed point to calculate delta would provide administrative relief since multiple transactions involving the same instrument would have a single delta calculation to rely upon for that day. This approach is consistent with brokerage systems, which do not track intraday data on securities, but information with the information being recorded at market close. It appears that right now, there is not the technology available to properly track the delta calculations and assign a specific withholding tax liability that is recalculated each time the financial instrument changes hands. The reasonable market close calculation would not only provide administrative relief, but would allow some valuation consistency.

To further ease the administrative burdens and facilitate compliance with the Proposed Rule, the Association encourages the Treasury and IRS to consider a one-time delta calculation for determining whether or not the financial instrument is subject to the Proposed Rule. Our recommendation here does away with the frequency of delta calculations. A financial instrument would either be subject to the Proposed Rule or not for the life of its existence. This one-time delta calculation could be determined using the reasonable market close calculation.

IV. EXCEPTION FOR CONTRACTS REFERENCING BROAD-BASED EQUITY INDICES

During our April meeting, we discussed the possibility of removing the 'qualified index' exception altogether. In doing so, the concern was raised that permitting the exception could lead to tax avoidance schemes and transactions that avoid the withholding regime. The Association acknowledges those concerns; however, we believe that qualified index can be defined in such a way to eliminate this potential for tax avoidance without hindering the financial system. Importantly, we note that the PSI Report was "not to condemn the use of complex financial transactions that utilize stock swaps, stock loans, or other forms of structured finance, which can be used for legitimate business purposes such as facilitating capital flows, reducing capital needs, and spreading risk."

To preserve the intent of the PSI Report, we believe that the Treasury and IRS should permit an exception for highly broad-based indices (referencing 100, or even 200, or more stocks) that are not susceptible to abuse, without such indices needing to meet other requirements such as rebalancing at regular intervals, or being referenced by futures or options that trade on a national exchange. Specifically, when the index is highly broad-based and in existence for some time, it seems unlikely that such an index would be used for an abusive purpose. Indeed, most highly broad-based indices have been established for a purpose other than to concentrate high-dividend paying stocks into a single index. The Association is confident that such an exception would strike a balance between eliminating tax avoidance and not hindering transactions entered into for legitimate business purposes.

V. EFFECTIVE DATE OF THE PROPOSED RULES

In our previous comment later dated March 5, 2014, the Association raised its concern with the effective dates of the Proposed Rule. While we applaud the Treasury and IRS in publishing Notice 2014-14, which will limit specified ELIs to those issued on or after 90 days after the date of publication of the final rules, the overarching concern is that member firms may not have adequate lead time to be in full compliance with the Proposed Rule on its effective date. First, member firms will undertake the large-scale upgrades required to track multiple delta calculations and withholding rates. Second, member firms will be tremendously burdened by applying the Proposed Rule to payments made after the effective date, despite arising from pre-existing contracts. Absent advanced notification of the expected effective date, the Association kindly urges that the Proposed Rule should apply to financial instruments issued or entered into after a reasonable amount of time has passed after publication of the final rule.

VI. CONCLUSION

Again, the Association truly welcomed meeting with you. The Association recognizes the extensive time and effort put forth in implementing this new standard for dividend equivalents and appreciates your consideration of our concerns. Please feel free to contact me with any questions you may have on our comments at jgidman@loomissayles.com or (617) 748-1748.

On behalf of the Association of Institutional INVESTORS,

John R. Gidman

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