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U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

via the Federal eRulemaking Portal at  
[www.regulations.gov](http://www.regulations.gov)

## Review of Regulations

Dividend Equivalent Payments and Qualified Derivatives Dealers

July 31, 2017

Dear Sir or Madam,

On January 30, 2017, President Donald J. Trump signed Executive Order 13771, *Reducing Regulation and Controlling Regulatory Costs*, to direct agencies to eliminate two regulations for each new regulation issued and to limit costs for this fiscal year to zero. On February 24, 2017, the President issued Executive Order 13777, *Enforcing the Regulatory Reform Agenda*, which requires agencies to convene a regulatory reform task force to assist in the implementation of Executive Order 13771. In a Request for Information published on June 14, 2017 (82 F.R. 27217), the Treasury Department invited members of the public to submit views and recommendations for Treasury regulations that can be eliminated, modified, or streamlined in order to reduce burdens.

### Enclosures

Sample calculation regarding  
combined transactions

The German Banking Industry Committee<sup>1</sup> and the German Derivatives Association<sup>2</sup> welcome the opportunity to outline our concerns

<sup>1</sup> The German Banking Industry Committee (GBIC) is the joint committee operated by the central associations representing the interests of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Association of German Banks (Bundesverband deutscher Banken, BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. The member associations of GBIC engage in a collective opinion-forming and decision-making process on legal, political and practical issues relating to banking. These include, in particular, questions concerning prudential regulation, securities legislation and tax law.

<sup>2</sup> Deutscher Derivate Verband (DDV), the German Derivatives Association, is the industry representative body for the 15 leading issuers of derivatives in Germany. The largest association of its

regarding the regulations under Section 871(m) of the Internal Revenue Code and regarding the requirements for qualified derivatives dealers ("QDDs") published in Revenue Procedure 2017-15.

## 1. Regulations under Section 871(m) of the Internal Revenue Code

We are very concerned about the tremendous side effects on the German securities market caused by the regulations under Section 871(m) of the Internal Revenue Code. In addition, implementation efforts required from financial institutions providing custodial and depository services are far beyond what seems appropriate with respect to the objectives of the law.

Section 871(m), enacted as part of the HIRE Act in 2010, addresses former arbitrage opportunities which allowed offshore hedge funds to receive the economics of U.S. dividends tax-free by engaging in notional principal contracts, securities lending or sale-repurchase transactions rather than directly holding the underlying stock referenced in these transactions. The statute stipulates that payments on certain financial instruments that generate a return based on the payment of a U.S. source dividend are treated as "dividend equivalents". Final regulations were issued by the former U.S. administration in September 2015<sup>3</sup> and then reissued in modified form on January 24, 2017<sup>4</sup>.

The German Banking Industry Committee represents more than 1,600 German banks, the vast majority of which act as qualified intermediaries (QIs). Due to the fact that the 2015 final regulations widened the scope of withholding obligations to include certain equity-linked instruments, all of our members providing custodial and depository services became affected by the regulations under Section 871(m).

The reason for this is that two types of equity-linked instruments are very popular on the German securities market. These are warrants and securitized structured notes ("Zertifikate") referring to a variety of underlyings, including U.S. equities and numerous types of indices.<sup>5</sup> These products are usually issued and distributed by German and other European banks and are typically acquired by (German) retail clients that hold these securities in their custodial accounts. The total volume of the German structured products market amounted to EUR 67.0 billion in December 2016.<sup>6</sup>

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kind in the world, DDV serves as a political interest group in Brussels. DDV's members are among the most important certificate issuers in Germany, representing more than 90 percent of the total market. DDV is an advocate of self-regulation, and it works in conjunction with its members and sponsoring members to set industry standards.

<sup>3</sup> T.D. 9734 (2015).

<sup>4</sup> Dividend Equivalents From Sources Within the United States, 82 Fed. Reg. 8,144 (2017).

<sup>5</sup> For further information please refer to the following URL of the DDV: [https://www.derivateverband.de/MediaLibrary/Document/Derivate-Liga\\_A3\\_2013\\_EN.pdf](https://www.derivateverband.de/MediaLibrary/Document/Derivate-Liga_A3_2013_EN.pdf).

<sup>6</sup> For further information please refer to the following URL of the DDV: <https://www.derivateverband.de/DE/MediaLibrary/Document/PM/12%20Marktvolumen%20-%20Dezember%202016,%20EN.pdf>.

We appreciate the considerable efforts made by the Treasury Department and the IRS to implement the provisions of Section 871(m) IRC. Yet we strongly believe that warrants and securitized structured notes were not within the initial scope of the statute simply because these types of products do not have the potential for tax avoidance. The final regulations in their current form are lengthy, complex and ambiguous, and they go far beyond what is necessary to address abuse. The burdens imposed on financial intermediaries by the Section 871(m) regulations are substantial, and costs may exceed the amount of tax that the Treasury Department can expect to collect as a result of the new rules.

In addition, the implementation of Section 871(m) beyond "delta one" contracts may be the source of political tension with a number of countries. We have learned that Germany, together with France, Italy, Spain and the United Kingdom (hereinafter the G5 countries), wrote to the U.S. Treasury Department in 2016 stating their position that dividend equivalent payments under Section 871(m) IRC do not qualify as dividends under the applicable United States Double Taxation Treaty when paid by non-U.S. entities. As far as we are aware, the United States has not yet resolved this point with the G5 countries.

Moreover, we have received a letter from the German Ministry of Finance stating that our national tax administration does not regard dividend equivalent payments under Section 871(m) IRC as dividends according to Article 10 of the Double Taxation Treaty with the United States. Instead, these payments would fall under the "Other income" Article 21 of the Double Taxation Treaty. Thus, the U.S. would have no taxation right, and if German taxpayers were subject to withholding tax on dividend equivalent payments in circumstances overriding the Double Taxation Treaty, Germany would not grant a credit against their German tax liability.

As such, we consider it unfair to put foreign custodial institutions in a position of having to choose between their obligations under the QI agreements and the view of their local tax administration. We believe the US government should discuss the implementation of Section 871(m) with these countries under their respective Double Taxation Treaties.

*Request: Withdrawal of the September 2015 and January 2017 regulations*

In view of the above, and considering the huge administrative challenges in connection with the Section 871(m) withholding on warrants and securitized structured notes, we respectfully request the new U.S. administration to review the described policy issues created by the final Section 871(m) regulations. In order to reduce unnecessary burdens, the September 2015 and January 2017 regulations should be withdrawn or substantially modified. Instead, the statutory withholding rules that were in effect up until December 31, 2016, which we believe operated effectively to address the types of tax-avoidance transactions that were targeted by Congress in 2010, should be applied indefinitely.

*Alternative request: Indefinite extension of the transitional rules contained in IRS Notice 2016-76*

The January 2017 final Section 871(m) regulations left in place a January 1, 2017 effective date for withholding on so-called "delta one" transactions. The administrative challenges described above will be far more significant after January 1, 2018, when the delta threshold in the regulations is reduced to 0.80. Therefore, in case the Treasury Department declines to recognize our appeal to withdraw the September 2015 and January 2017 regulations, we respectfully request an indefinite extension of the transitional rules contained in IRS Notice 2016-76. Thus, withholding obligations should remain limited to delta one transactions and the simplified standard for determining whether transactions are combined transactions (see below) should be prolonged, both permanently.

For the purposes of determining whether transactions are Section 871(m) transactions, the 2015 final regulations treat two or more transactions as a single transaction when a long party (or a related person) enters into multiple transactions that reference the same underlying security, the combined potential Section 871(m) transactions replicate the economics of a transaction that would be a Section 871(m) transaction, and the transactions were entered into in connection with each other (§ 1.871-15(n)).

It is our understanding that § 1.1441-1(b)(4)(xxiii) would require withholding agents – generally including German banks that act as qualified intermediaries and that assume primary withholding responsibility for the purposes of Chapters 3 and 4 – to apply the rules for combined transactions under § 1.871-15(n). Moreover, § 1.1441-1(b)(4)(xxiii) also permits withholding agents to rely on one or more of the presumptions set out in § 1.871-15(n)(3)(i) or (ii) (applying those paragraphs whether or not the withholding agent is a short party by substituting "withholding agent" for "short party"), provided the withholding agent does not otherwise have actual knowledge that the long party (or a related person) entered into the potential Section 871(m) transaction in connection with any other potential Section 871(m) transactions.

Notice 2016-76 provides a simplified standard for withholding agents to determine whether transactions entered into in 2017 are combined transactions. A withholding agent will only be required to combine transactions entered into in 2017 for the purposes of determining whether the transactions are Section 871(m) transactions when the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Withholding agents will not be required to combine any transactions in listed securities that are entered into in 2017. This simplified standard only applies to withholding agents, and does not apply to taxpayers that are long parties to potential Section 871(m) transactions. This simplification of the combined transaction rules is very welcome relief for the financial industry in Germany and, from our point of view, this is and will continue to be the only feasible approach for securitized structured notes and warrants.

As a matter of fact, we currently do not see any technical solution for implementing the combined transaction rules of the 2015 final regulations that would be workable for the mass market of warrants and securitized structured notes held in custodial accounts. From our perspective, implementing these rules would mean that a custodial institution acting as a withholding agent would need to run a daily check across all their custodial accounts to compute whether any of their clients has a combined transaction in its custodial account.

As circumvention would be very easily achieved for a long party, e.g. by simply choosing two different custodians for its securitized transactions, these rules are highly disproportionate in relation to the enormous effort that would be required on the part of the custodians.

Apart from that, we believe that a combination of securitized transactions would not be economically sensible from an investor's perspective. The associated transaction costs for such a combination would be relatively high, and this would probably offset any fiscal advantages. We have enclosed an example to support this statement.

Therefore, in case the Treasury Department declines to recognize our appeal to extend the transitional rules as a whole, we kindly request at least an indefinite extension of the simplified standards for determining whether transactions are combined transactions with respect to warrants and securitized structured notes so that final responsibility for identifying and performing calculations with respect to combined transactions of these securities would generally lie with the long party because the custodians or other withholding agents do not have knowledge of the combined transactions.

## **2. Requirements for Qualified Derivatives Dealers**

The Qualified Intermediary (QI) Agreement published in Revenue Procedure 2017-15 allows certain foreign persons to enter into an agreement with the IRS to act as qualified derivatives dealers ("QDDs") pursuant to regulations issued under Section 871(m) of the Internal Revenue Code and to assume primary withholding and reporting responsibilities on all dividend equivalent payments that they make.

The Proposed QI Agreement published in Notice 2016-42 provided rules for how a QDD calculates its Section 871(m) amount and determines its QDD tax liability. Under the proposed QI agreement, a withholding agent was not required to withhold on payments with respect to potential Section 871(m) transactions and payments with respect to underlying securities made to the QDD when the QDD is acting as a principal, provided the QDD furnishes a valid withholding certificate to the withholding agent.

Notice 2016-76 revised the methodology for determining the Section 871(m) amount to use a net delta approach and announced that the regulations under §1.871-15(q)(1) would be revised so that a QDD will remain liable for tax under Section 881(a)(1) and subject to withholding under Chapters 3 and 4 on dividends on physical shares and deemed dividends received.

Because of this revision of the methodology, the hedging strategies that are typically used by German issuers of warrants and securitized structured notes will become subject to withholding under Chapters 3 and 4 and the additional effort that is necessary to fulfil the reporting obligations and to determine the QDD tax liability outweigh the potential benefits of the QDD status. Hence, the QDD status is no longer attractive for these issuers. Furthermore, the QDD status results in higher costs for internal controls and audits as well as additional standards for the necessary periodical reviews and certifications by the Responsible Officer.

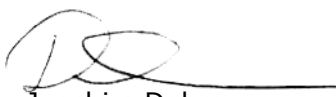
Request: Dividends on physical shares and deemed dividends received by the QDD should not be subject to withholding under Chapters 3 and 4

To increase the attractiveness of the QDD status, the regulations should be changed so that dividends on physical shares and deemed dividends received by the QDD when the QDD is acting as a principal are not subject to withholding under Chapters 3 and 4.

In addition, the requirements regarding the QDD's reporting obligation and the additional standards for the internal controls, periodical reviews and certifications should be simplified. Furthermore, the credit forward system that was introduced as part of Notice 2010-46 to address instances of excessive or cascading taxation not addressed by the Qualified Securities Lender rules has proved effective in practice and should be retained under the QDD regime.

We would appreciate your consideration of our concerns and views and welcome an opportunity to discuss the issues raised in this letter with you or your staff members. Please do not hesitate to contact us in this regard.

Yours sincerely,  
on behalf of the German Banking Industry Committee,



Joachim Dahm

Member of the Management Board



Mario Labes

Division Manager

on behalf of the German Derivatives Association,



Lars Brandau

Managing Director

Enclosure

**Sample calculation regarding a combined transaction containing Discount Certificates and Call Warrants referencing the same U.S. equity (e.g. shares of Apple Inc.) with identical strike and cap**

1. Upside exposure with respect to the U.S. equity can be achieved through the acquisition of a Call Warrant, which results in a (securitized) long position of a call option:

Call Warrant on Apple Inc.  
Maturity: 21.12.2018  
Strike: 150.00 USD  
Ratio: 1:10  
Quotations (13.07.2017 - 15:54:46):

⇌	WKN	Emittent	Basispreis	Fälligkeit	Geld Kurs	Brief Kurs	Omega	Implizite Volatilität	Spread	Bezugsverhältnis
Ausgewählte Produkte der Commerzbank										Anzeige
<input type="checkbox"/>	CE6KAM	Commerzbank	150,000 USD	19.12.2018	1,420 EUR	1,440 EUR	4,678	27,50%	1,40%	0,100
<input type="checkbox"/>	UW7LLA	UBS	150,000 USD	21.12.2018	1,360 EUR	1,370 EUR	4,926	25,11%	0,74%	0,100
<input type="checkbox"/>	VN6T15	Vontobel	150,000 USD	21.12.2018	1,400 EUR	1,410 EUR	4,835	25,61%	0,72%	0,100
<input type="checkbox"/>	TD860M	HSBC	150,000 USD	19.12.2018	1,370 EUR	1,400 EUR	4,835	25,83%	2,16%	0,100
<input type="checkbox"/>	CY1953	Citi	150,000 USD	20.12.2018	1,410 EUR	1,420 EUR	4,791	25,97%	0,70%	0,100
<input type="checkbox"/>	DM1QCM	Deutsche Bank	150,000 USD	19.12.2018	1,420 EUR	1,430 EUR	4,776	26,00%	0,70%	0,100
<input type="checkbox"/>	PR1U20	BNP Paribas	150,000 USD	21.12.2018	1,410 EUR	1,420 EUR	4,763	26,11%	0,71%	0,100
<input type="checkbox"/>	SG6EHK	Société Générale	150,000 USD	21.12.2018	1,410 EUR	1,420 EUR	4,751	26,14%	0,70%	0,100
<input type="checkbox"/>	GL57A3	Goldman Sachs	150,000 USD	21.12.2018	1,410 EUR	1,420 EUR	4,749	26,11%	0,70%	0,100
<input type="checkbox"/>	HW2SX3	UniCredit	150,000 USD	19.12.2018	1,410 EUR	1,420 EUR	4,747	26,33%	0,70%	0,100
<input type="checkbox"/>	CE6KAM	Commerzbank	150,000 USD	19.12.2018	1,420 EUR	1,440 EUR	4,678	27,50%	1,40%	0,100

Price<sup>\*)</sup>/Average Offer in EUR: **1.415 EUR**  
Price<sup>\*)</sup>/Average Offer in USD<sup>\*\*)</sup>: 1.6138 USD

Delta < 0.80 → product is a potential Section 871(m) transaction but not a specified ELI

2. Downside exposure with respect to the U.S. equity can be achieved through the acquisition of a Discount Certificate. This type of financial instrument replicates the economics of a zero bond and a short position of a put option:

Discount Certificate on Apple Inc.  
Maturity: 21.12.2018  
Cap (= Strike): USD 150.00  
Quotations (13.07.2017 - 15:54:46):

⇌	WKN	Emittent	Discount in %	Cap	Fälligkeit	Geld Kurs	Brief Kurs	Seitwärtsrendite p.a. in %
<input type="checkbox"/>	TD81NT	HSBC	12,43%	150,00 USD	21.12.2018	112,340 EUR	112,400 EUR	9,74%
<input type="checkbox"/>	PR4QJR	BNP Paribas	12,01%	150,00 USD	21.12.2018	112,880 EUR	112,980 EUR	9,38%
<input type="checkbox"/>	CY3HVT	Citi	11,90%	150,00 USD	20.12.2018	113,060 EUR	113,110 EUR	9,38%
<input type="checkbox"/>	DM3LAH	Deutsche Bank	11,71%	150,00 USD	19.12.2018	113,140 EUR	113,190 EUR	9,26%

Price<sup>\*)</sup>/Average Offer in EUR: **112.920 EUR**  
Price<sup>\*)</sup>/Average Offer in USD<sup>\*\*)</sup>: 128.785 USD

Delta < 0.80 → product is a potential Section 871(m) transaction but not a specified ELI

\*) Remark: the securitized derivatives are usually priced at 85% of the implied dividends as the issuer gets taxed on the hedge

\*\*\*) Foreign exchange rate (13.07.2017 - 15:54:46): 1 EUR = 1.1405 USD



## Enclosure

### 3. Comparison: Combined Transaction vs. Direct Investment:

#### a) Combined Transaction

Price for the acquisition of 1 Discount Certificate and 10 Warrants: 144.92 USD

Payout:

Assumed value of Apple Inc. shares on 21/12/2018:	150.00 USD	170.00 USD	190.00 USD
Return on the combined transaction (excl. transaction costs):	5.08 USD	25.08 USD	45.08 USD

Assumption: no WHT on dividend equivalent payments

#### b) Direct Investment

Price for the acquisition of 1 Apple Inc. share (13.07.2017 - 15:54:46): 146.85 USD

Dividend payments:

Date	Dividend forecast (Source: Reuters)	Dividend forecast less 15% WHT	Dividend forecast less 30% WHT
4 Aug 17	0.58 USD	0.493 USD	0.406 USD
3 Nov 17	0.62 USD	0.527 USD	0.434 USD
2 Feb 18	0.62 USD	0.527 USD	0.434 USD
4 May 18	0.68 USD	0.578 USD	0.476 USD
3 Aug 18	0.68 USD	0.578 USD	0.476 USD
5 Nov 18	0.65 USD	0.553 USD	0.455 USD

Cumulated dividend payments after WHT: 3.256 USD 2.681 USD

Payout:

assumed value of Apple Inc. shares on 21/12/2018:	150.00 USD	170.00 USD	190.00 USD
Return on direct investment (incl. dividends less 15% WHT; excl. transaction costs)	6.41 USD	26.41 USD	46.41 USD
Return on direct investment (incl. dividends less 30% WHT; excl. transaction costs):	5.83 USD	25.83 USD	45.83 USD

#### c) Conclusion

At first sight, the acquisition of the combined transaction (144.92 USD) seems to be cheaper than the direct investment (146.85 USD). However, the benefit of the combined transaction (1.93 USD) at the moment of purchase cannot compensate for the loss of dividend payments in connection with the direct investment (2.681 USD in case of 30% WHT). Furthermore, we would like to point out that most of our clients are eligible to benefit from the reduced 15% WHT according to the DTT. Thus, even if the dividend equivalent payments were not to be withheld upon, the total return on the direct investment would be constantly higher than the return on the combined transaction, regardless of the assumed future value of the underlying (e.g. 5.83 vs. 5.08 USD if shares of Apple Inc. had a value of 150.00 USD at maturity of the combined transaction). Taking the transaction costs for twice the number of necessary transactions for the purchase and disposition into account, the combined transaction would be even less attractive than the direct investment. Because of the double transaction costs we consider this example to be valid in general.