

COMMITTEE ON CAPITAL MARKETS REGULATION

March 5, 2014

Via Electronic Delivery:

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
The Internal Revenue Service
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Department of the Treasury (“**Treasury**”) Proposed Rule under Section 871(m) – Dividend Equivalents From Sources Within the United States (REG-120282-10) (the “**Proposed Rule**”)

Dear Assistant Secretary Mazur:

The Committee on Capital Markets Regulation (the “**Committee**”) is grateful for the opportunity to comment on the Proposed Rule,¹ issued by the Department of the Treasury (the “**Treasury**”), which would implement Code section 871(m), added by the 2010 Hiring Incentives to Restore Employment Act (the “**HIRE Act**”).²

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-three leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Proposed Rule would impose U.S. withholding tax on certain convertible debt issued by U.S. companies and held by foreign investors if the U.S. issuer pays a dividend to its shareholders.³ This withholding tax would be in addition to any withholding tax already applied to interest on convertible debt held by foreign investors. The Proposed Rule would apply withholding tax to convertible debt acquired by a foreign investor when the “delta” of the convertible bond exceeds 0.70, at the time the convertible debt is acquired.⁴ (“Delta” is a theoretical estimate of relationship between the change in value of the convertible debt and the change in the conversion value.)⁵ The amount of the Proposed Rule’s withholding tax would be determined by multiplying the delta by the dividends paid.⁶ The Proposed Rule would require U.S. issuers to use reasonable diligence to determine the delta of their convertible bonds for

¹ Dividend Equivalents From Sources Within the United States, 78 Fed. Reg. 73,128 (proposed Dec. 5, 2013).

² Hiring Incentives to Restore Employment Act § 541, 26 U.S.C. § 871 (2012).

³ Dividend Equivalents From Sources Within the United States, 78 Fed. Reg. 73,128, 73,132-73,133 (proposed Dec. 5, 2013).

⁴ *Id.* at 73,133.

⁵ *Id.* at 73,132.

⁶ *Id.* at 73,143.

withholding purposes, and the prime brokers holding the bond on behalf of the foreign investor would be required to withhold the appropriate payments.⁷

The Committee is concerned that the Proposed Rule would have a significantly negative effect on the attractiveness of convertible debt to foreign investors and thus impede the ability of U.S. companies to raise capital. In 2013, U.S. companies raised approximately \$38.6 billion in capital through convertible debt issuances, increasing the size of the U.S. convertible debt market to approximately \$200 billion, a significant proportion of which is likely held by foreign investors.⁸

Rationale of the Proposed Rule

The Committee believes that the Proposed Rule is inconsistent with the statutory intent of section 871(m) of the HIRE Act, whose purpose is to tax financial instruments that seek to replicate stock returns while enabling their holders to avoid dividend withholding taxation.⁹ The Committee does not believe that the returns from holding convertible debt replicate stock returns, nor does it believe foreign investors invest in convertible debt in order to avoid tax on dividends.

Convertible debt returns are inherently different than the returns on dividend-paying equities, as convertible debt holders do not receive dividend payments made to shareholders. Indeed, foreign investors in convertible debt could not possibly be using convertible debt to avoid taxation on dividend payments, as they are not receiving these dividend payments. Furthermore, the Proposed Rule does not provide any justification for why a delta in excess of 0.70 is an appropriate predicate for taxation purposes, since the delta of convertible debt does not cause a foreign holder to receive dividends paid to shareholders. Indeed, the Proposed Rule includes no rationale for applying section 871(m) to convertible debt.

The Proposed Rule would increase the cost of capital of U.S. issuers of convertible debt, as it would require prime brokers to charge foreign holders of convertible debt for the amount of the 871(m) withholding tax, which will reduce their return. This would reduce overall demand for U.S. convertible debt, and therefore require issuers to pay higher coupons to attract investment. The Committee is further concerned that appropriate systems do not exist to determine the applicable withholding tax. The Proposed Rule does not set forth a methodology for calculating delta, and the determination of delta on convertible debt can vary significantly based on each party's pricing model. Moreover, the standard identifier for U.S. securities, including convertible debt, does not differentiate between bonds based on the holder of a bond, so it would be particularly difficult for a U.S. issuer to determine who holds their convertible debt in order to determine whether the appropriate tax has been withheld.

The Committee thus recommends that the Treasury exempt convertible debt from application of section 871(m).

⁷ *Id.* at 73,141.

⁸ *2013 Annual US Capital Markets Watch*, PricewaterhouseCoopers LLP 1, 27 (2013), http://www.pwc.com/en_US/us/transaction-services/publications/assets/pwc-2013-us-capital-markets-watch.pdf; *Preaching to the Converted*, Morgan Stanley 1 (Mar. 2013).

⁹ Hiring Incentives to Restore Employment Act § 541, 26 U.S.C. § 871 (2012); *see also* Dividend Equivalents From Sources Within the United States, 78 Fed. Reg. 73,128, 73,132 (proposed Dec. 5, 2013).

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Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu); its Executive Director of Research, C. Wallace DeWitt (cwdewitt@capmksreg.org); or John Gulliver, Research Fellow (jgulliver@capmksreg.org), at your convenience.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'H.S.C.', with a long horizontal flourish extending to the right.

Hal S. Scott
DIRECTOR