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By Electronic Delivery

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Office of Chief Counsel
Internal Revenue Service
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RE: Regulated Investment Companies and
Definition of Broker under Section 871(m)

Dear Mr. Walli and Mr. Musher:

The Investment Company Institute¹ asks the Treasury Department and the Internal Revenue Service (“IRS”) to make one clarification to the recently issued regulations under section 871(m). Specifically, we ask the government to specify that the definition of “broker” for purposes of section 871(m) does not include regulated investment companies (“RICs”). Without this clarification, certain RICs could be subject to the determination requirements and reporting obligations set forth in the new regulations, even though the RICs’ counterparties typically would be brokers/dealers that are better suited to carrying out these responsibilities.

Definition of “Broker”

The definition of the term “broker” is important for purposes of section 871(m) because it is a significant factor in identifying the party to a potential section 871(m) transaction who is responsible for determining whether the transaction is a section 871(m) transaction and, if so, determining and reporting to the counterparty or customer the timing and amount of any dividend equivalent.² That party also is required to report to other parties to the transaction, upon request, (i) information regarding the amount of each dividend equivalent; (ii) the delta of the potential section 871(m) transaction; (iii) the amount of any tax withheld and deposited; (iv) the estimated dividend amount; (v) the identity of any transactions combined pursuant to the regulations; and (vi) any other

¹ The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s U.S. fund members manage total assets of \$17.9 trillion and serve more than 90 million U.S. shareholders.

² Treas. Reg. § 1.871-15(p)(1).

information required under the regulations.³ That party further is required to retain records containing sufficient information to establish whether a transaction is a section 871(m) transaction, including documentation and work papers supporting the delta calculation, and the amount of any dividend equivalents.⁴

Generally, if one party to a potential section 871(m) transaction is a broker or dealer, that party is required to determine, report, and retain the information described above. The regulations provide, however, that if both parties to a potential section 871(m) transaction are brokers or dealers, the short party is responsible for determining and reporting this information.⁵

The regulations under section 871(m) use the term “broker” as that term is defined in section 6045(c), which requires brokers to provide information returns to the IRS regarding gross proceeds from sales of property.⁶ Section 6045(c) defines a broker as: (a) a dealer, (b) a barter exchange, and (c) any other person who, for consideration, regularly acts as a middleman with respect to property or services. The regulations provide further that a broker is “any person ..., U.S. or foreign, that, in the ordinary course of a trade or business, stands ready to effect sales to be made by others.”⁷ For this purpose, a broker includes “a corporation that regularly redeems its own stock.”⁸

RICs that are open-end mutual funds are “brokers” for purposes of section 6045, as they are corporations that regularly redeem their own stock. As such, open-end RICs are required to file information returns under section 6045 with respect to redemptions of their shares. Closed-end funds, on the other hand, do not “regularly redeem” their own stock and therefore are not brokers for purposes of section 6045.

Application of Section 871(m) to RICs

RICs sometimes enter into transactions with foreign counterparties that could be potential section 871(m) transactions and therefore would need to be tested under the rules. For example, a RIC may wish to hedge a long U.S. stock position by entering into a short derivative referencing that stock. Funds typically enter into these types of transactions with financial institutions (*i.e.*, U.S. and foreign banks) that are brokers/dealers.

Because open-end funds are “brokers” under section 6045, they could qualify as brokers for purposes of the section 871(m) regulations. Even though the RIC’s counterparty also is a broker or

³ Treas. Reg. § 1.871-15(p)(3).

⁴ Treas. Reg. § 1.871-15(p)(4).

⁵ Treas. Reg. § 1.871-15(p)(1).

⁶ Treas. Reg. § 1.871-15(a)(1).

⁷ Treas. Reg. § 1.6045-1(a)(1).

⁸ *Id.*

dealer, the RIC, if it is the short party, could be responsible for, among other things, determining the delta of the derivative and the amount of any dividend equivalents, reporting this information to the counterparty, and retaining records to support the delta calculation. In such a case, the foreign broker/dealer counterparty would be better suited for making the determinations and undertaking the reporting obligations required under the regulations. As a broker/dealer that regularly engages in such transactions, these counterparties will have systems and procedures to ensure compliance with section 871(m). Absent clarification of the rules, however, the RIC ultimately still could be liable for a failure to properly comply with the regulations.

Although open-end funds clearly are brokers under section 6045, their role as brokers relates to the redemption of their shares. Treating open-end funds as brokers in that context makes sense, because the fund is responsible for information reporting on those shares. The fact that open-end funds redeem shares on a regular basis has no bearing on whether they should be treated as brokers with respect to potential section 871(m) transactions. RICs thus should not be treated as brokers for purposes of section 871(m).

If open-end funds were treated as brokers under the section 871(m) regulations, this would create a disparity between the treatment of RICs based solely on their organization under the securities laws. Closed-end funds, in comparison, are not brokers under section 6045 and thus are not treated as such for purposes of section 871(m). Therefore, closed-end funds have no determination, reporting, or information-retaining obligations under the section 871(m) regulations.

Request for Clarification

RICs often enter into potential section 871(m) transactions with foreign counterparties that are brokers/dealers. Because RICs are brokers as defined under section 6045, they technically could be responsible for the requirements under section 871(m) if they are the short party in such transactions. RICs, however, will not have the necessary procedures or systems in place to meet the section 871(m) requirements, given that they are not brokers/dealers with respect to their portfolio transactions. The long parties to the transactions, on the other hand, which typically are brokers/dealers, will be better equipped to make the determinations and provide the information required under the section 871(m) regulations.

Therefore, the Institute requests that the Treasury Department and the IRS clarify that the term “broker,” as used explicitly for section 871(m), does not include RICs.⁹ This would ensure that the proper party to any potential section 871(m) transactions would be responsible for the required information. Further, it would ensure that open-end funds and closed-end funds all would be treated similarly.

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⁹ In the unlikely event that the RIC’s counterparty is not a broker or dealer, then the RIC, as the short party, still would be responsible for the requirements in the regulations.

ICI Letter re Section 871(m) Regulations

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We appreciate your consideration of our request. If you have any questions or would like to discuss it further, please contact me at (202) 371-5432 or kgibian@ici.org.

Sincerely,

/s/ Karen L. Gibian

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cc: Marjorie Rollinson
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