

US IRS SECTION 871(M) REGULATIONS (01.2017)

SOLUTION PACKAGE FOR 871(M) WITHHOLDING AND REPORTING

OUR SOLUTION PACKAGE AT A GLANCE

- _ interactive workshop to get all 871(m)-stakeholders of a bank up-to-speed
- _ technical parametrisation guide, withholding tax order, reversal task, order books and blockings for a step-by-step and robust implementation
- _ retroactive 871(m) withholding tax calculation allows to charge withholding taxes for orders since 1.1.2017
- _ solution package should enable a qualified intermediary to comply with the "good-faith effort"-requirements set by the US government (Internal Revenue Service)

Confinale is a consulting and software development company which focuses on tax digitalisation projects in the banking and finance sector. **Confinale is an official Special Service Partner of Avaloq in the field of taxation, compliance and advisory and the 871(m) withholding and reporting solution provider for Avaloq banks.**

Confinale has set up a dedicated 871(m)-team which is analysing the new US tax regulations with the support of external US specialists, other market players and infrastructure providers. We offer the Avaloq community an 871(m) solution package that allows banks to implement the new US requirements in Avaloq in an efficient and robust way.

CHALLENGE

The 871(m) regulations, a set of anti-avoidance rules introduced by the IRS, fundamentally widen the definition of **US source income** that is subject to US withholding and reporting. Going forward, the definition also includes certain amounts arising in **derivative transactions that are referencing US equities** even where such derivatives have been issued by Non-US persons (e.g. payments under a covered warrant or a structured product with a US underlying issued by a Swiss issuer).

Under the QI-Agreements, QIs have agreed to comply with certain withholding and reporting obligations on US source income that is paid to their account holders. As a result, any QI has to comply with 871(m) in order to remain compliant under its QI-Agreement. This again means, every QI has the obligation to identify and quantify 'US source income' that is caught by 871(m) and has to withhold and report as required.

Due to the inherent complexity of the products and transactions that fall under 871(m), the US-style codification & guidance and the tight implementation timeline, these regulations represent a very challenging set of rules.

TIMETABLE

The 871(m) regulations enter into force on 1 January 2017 and apply to transactions executed on or after that date. On 2 December 2016 the IRS provided further guidance regarding the implementation timeline in notice 2016-76¹:

- In 2017 withholding and reporting obligations only apply to so-called "delta-one" transactions. Since the notice does not define the term "delta-one" explicitly, it is still open whether a mathematical delta of 1.00 applies or whether the term has to be interpreted in a more "trading-related" jargon.
- In 2018 withholding and reporting obligations apply to all 871(m) relevant transactions including the "non-delta-one" transactions.
- In 2017 and in 2018 withholding agents must show "good-faith effort" in complying

with the new regulations by setting up appropriate internal procedures and operations, documentation and withholding instruments.

For some more details on the IRS-notice refer to SBVg Circulaire No. 7915 of 22.12.2016.

'IN-SCOPE' PRODUCTS AND TRANSACTIONS

The 871(m) regulations divide derivative contracts into three general types:

- Securities lending and repos
- Notional principal contracts (NPCs), e.g. swaps
- Equity-linked instruments (ELIs), e.g. futures, forwards and options

For each type of derivative, the regulations define the logic to assess whether a derivative is in-scope. Thereby the rules are partly overlapping. In relation to NPCs and ELIs the 871(m) regulations generally speaking apply a 'delta-concept' to determine whether a derivative is in-scope. The delta of a derivative is a measure of the relationship between changes in value of the derivative and changes in value of the underlying equity based on historical volatility data. If an instrument has a delta of one, changes in the value of the derivative should be equal to the changes in the value of the underlying equity. Under the final 871(m) regulations, derivatives with a delta of at least 0.8 upon initial issuance of a derivative transaction (or upon a material modification) are in-scope (except, as outlined above, for calendar year 2017 where only "delta-one" transactions are in-scope). A derivative with a delta of less than 0.8 when issued is not caught (absent a significant modification and absent the contract becoming part of a so called 'combined transaction') even if its delta later increases. This onetime delta value is then also used for determining the amount of the taxable 'dividend equivalent payment'. For derivatives with an indeterminate delta special rules apply.

While this delta-based concept might appear straightforward, the devil is in the detail and there are many aspects, which represent quite a challenge for their implementation.

¹ <https://www.irs.gov/pub/irs-drop/n-16-76.pdf>

MAIN ASPECTS

The new regulations affect the complete value chain of the equity derivative industry. Starting with the product structuring of issuers, it also affects global custodians, brokers, clearing houses, and, last but not least, all banks holding depository accounts for their clients with derivatives, incl. structured products, with a (direct or indirect) US equity underlying. The main aspects such depository banks need to establish and understand are:

- what their withholding and reporting responsibilities are under 871(m) resp. under their OI-agreement
- how the 'in-scope' logics of clients, assets and transactions work and how they need to be applied
- which of their client assets/contracts/transactions are actually in-scope (2017 vs 2018 and ongoing years) and where the relevant assets are held (custodian and sub-custodian structure)
- what 871(m)-approach the respective issuer/custodian/sub-custodian applies and what that means for the bank's 871(m)-responsibilities
- what asset- and transaction-data they need to comply with the new rules and from which sources they can get that data
- how to tackle so-called Combined Transactions
- what third-party information provisions exist
- what it means for the client-onboarding and -reporting and the broader client-interaction (e.g. contracts, suitability check, relationship management).

HOW CONFINALE CAN SUPPORT YOU

Avaloq currently does not intend to deliver a kernel solution for these new 871(m) rules.

A dedicated 871(m)-team of tax experts and business analysts of Confinale is familiar with the new US regulations and is offering the Avaloq community an 871(m) withholding and reporting solution package within Avaloq for 2017, 2018 and ongoing years. Our package consists of:

1. Interactive workshop with the 871(m)-stakeholders of the bank
2. SIX VDF 871(m)-data feed
3. Setting up static data requirements and building a withholding mechanism for all relevant transactions
4. Semi-automatic mechanism for charging withholding tax on dividend equivalents (retroactively from 1.1.2017 on)
5. Product-blocking filters (if required by a bank)
6. Automated client-notice (if required)
7. 1042-OI-reporting, including the 871(m) withholding tax reporting, within Avaloq

Using the Confinale solution package should allow banks to comply with the "good-faith effort" requirements as defined by the IRS both in 2017 and 2018.

For more information or a concrete offering please contact us.

CONTACT



Roland Staub
Partner
+41 76 364 82 78
roland.staub@confinale.ch



Birol Izel
Manager
+41 78 808 98 96
birol.izel@confinale.ch