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871(m) - A new US-Tax regulation keeping the FS-Industry busy

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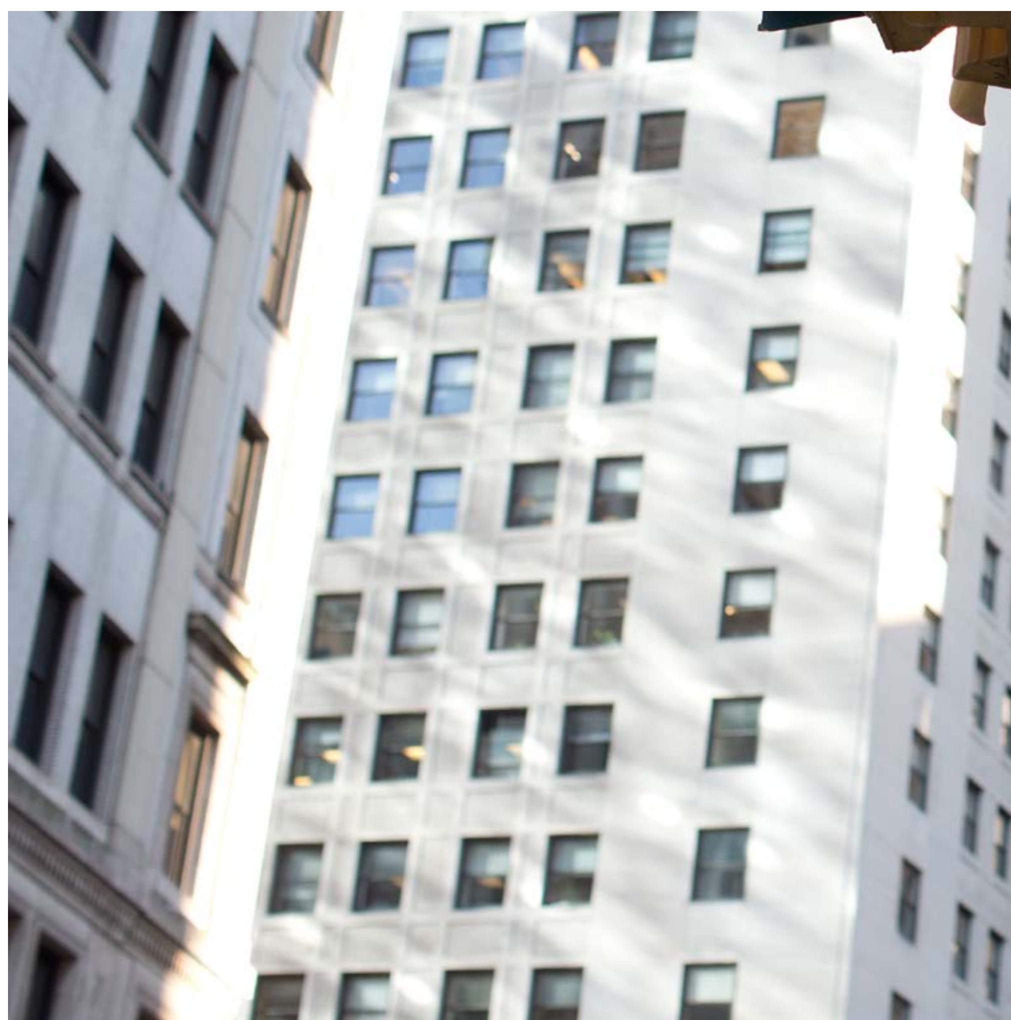
Recently, the US Treasury Department announced that products with US-underlying securities that are not Delta One products may never come under the scope of Section 871(m). While we wait on final official confirmation via a notice or similar guidance, the IRS has confirmed via Notice 2017-46 that the current state of taxation on Delta One products only will remain until the end of 2018.

This gives custodian banks which have postponed elements of their 871(m) projects, such as strategic decisions regarding 871(m) product offerings, the application of Qualified Derivative status or the handling of counterparty reporting, etc., the necessary time to identify impacts and adjust the affected processes.



While wave 1 has barely been implemented, wave 2 is approaching and broadening impacts

On 1 January 2017, the first wave of the 871(m) regulation went live. The main aim of the US with this regulation is to close the tax loophole for global investors who invest in derivatives with US-underlying securities issued anywhere in the world.

The impact of the regulation is limited in 2017/18 due to the application of a so-called 'good faith' trial period and a limited product scope. The major impact for the financial services industry is expected from 1 January 2019 with 'wave 2' if a series of non-Delta One products come under the scope of the regulation, presenting challenges for the issuers of the products and for custodians which have clients investing in such products and holding them in custody.

In this article, we would like to take a step back into the history of relevant US tax regulation for Swiss banks and show you why 871(m) is a logical progression from past regulations. Furthermore, we aim to provide you with an overview of the obligations a financial institution might be facing. In addition, we would like to shed some light on the key challenges for 2017/18 that must be managed in order to comply with the regulations in a smart and cost-efficient manner.

Evolution of US tax regulations with relevance for global financial institutions – the five stages

Benjamin Franklin's famous quote 'Nothing can be said to be certain, except death and taxes' has cropped up rather frequently over recent years. In the history of US tax regulation, the following five stages have been key from the perspective of global financial institutions and have culminated in the creation of 871(m).

Stage 1: Taxation of foreign investors: Pre-QI

Even prior to the introduction of the Qualified Intermediary regime, a withholding tax of 30% was levied on interest and dividend payments made to non-US persons. Double taxation relief under the terms of a treaty was granted solely based on the address of the recipient (the 'Address Method'). For a Swiss bank, this meant that 15% was withheld by the US withholding agent, plus a supplemental 15% withheld under Swiss regulations. In effect, this meant that all investors with assets in custody at Swiss banks were subject to the full 30% withholding. Swiss-domiciled investors were able to reclaim the supplemental 15% from the Swiss tax administration but investors domiciled outside Switzerland were only able to submit claims directly to the IRS.

From the perspective of the IRS, there were two main issues with the Address Method for withholding: (i) treaty shopping and (ii) avoidance of tax by US persons. Under the treaty shopping issue, the IRS identified investors from countries that do not have double taxation agreements as still benefiting from reduced withholding rates on dividends by maintaining their investment accounts with financial institutions in countries with double taxation agreements. As a second issue, the IRS identified US persons who were able to avoid reporting taxable income to the US tax authorities by maintaining accounts with financial institutions outside the US.

The IRS sought to mitigate these issues by introducing the Qualified Intermediary regime and placing the responsibility on non-US custodians of US securities to determine the US or non-US status and the true domicile of each recipient of US income.

Stage 2: QI regime – Interest and dividend taxation for non-US investors

QI was the first US tax regime that directly affected the global FS industry. Banks had the 'choice' of becoming Qualified Intermediaries and, as such, deducting tax withholding at reduced rates on payments of dividend income to non-US investors in accordance with the appropriate double tax treaty of the investor's home country with the US. In Switzerland, most banks became Secondary QIs and handed over the withholding duties to US upstream custodians (e.g. Brown Brothers Harriman, CITI) or to the Swiss Central Securities Depository (CSD) 'SIX SIS AG'. Documentation of recipients of US income, withholding reconciliation and regulatory reporting duties (Forms 1042-S/1042) have been key obligations of banks in this regard since then.

Stage 3: FATCA

In the late 2000s, several factors (including the financial crisis, the UBS case, etc.) brought the topic of tax avoidance by US persons to the attention of the IRS and the US Department of Justice and eventually led to the inclusion of FATCA in the 2010 Hiring Incentives to Restore Employment (HIRE) Act. With FATCA, financial institutions operating outside of the US were forced to identify all account holders that are US tax payers or financial institutions which do not comply with the regulation – so-called 'Non-Participating Foreign Financial Institutions' – and withhold 30% on dividend and interest income from US products of these clients. In Switzerland, the implementation of FATCA was similar to QI. Banks and other financial institutions conduct 'client identification' and fulfil the 'reporting' obligation towards the regulator (8966 Report) while upstream custodians or CSDs conduct the withholding on their behalf.

With FATCA, the loophole of US tax evaders investing in shares and bonds has been successfully closed.

Stage 4: 305(C) – Taxation of investors in convertible bonds and warrants which benefit from conversion rate changes

The impact of 305(c) on the global FS industry was only limited, as the amount of US-issued convertible bonds and warrants which face conversion rate changes throughout their product lifecycle are relatively rare. Moreover, only few investors with non-US banks hold affected products. On top of that, upstream custodians such as Euroclear, Clearstream or SIX SIS AG quickly found solutions to determine affected securities and send taxation information through the SWIFT messaging system (corporate actions). Should your financial institution not have a smooth 305(c) compliance process we are happy to discuss options to ensure compliance in that regard.

However, even after the introduction of stages 1–4, investors could still circumvent US withholding tax by investing in derivative contracts or securities-lending/sale-purchase transactions that reference US equities as an underlying investment. A new US tax regulation had to be introduced: 871(m), which had a far broader impact on global financial institutions due to the fact that derivatives with US-underlying securities issued worldwide fall within the scope of this regulation.

Stage 5: 871(m)

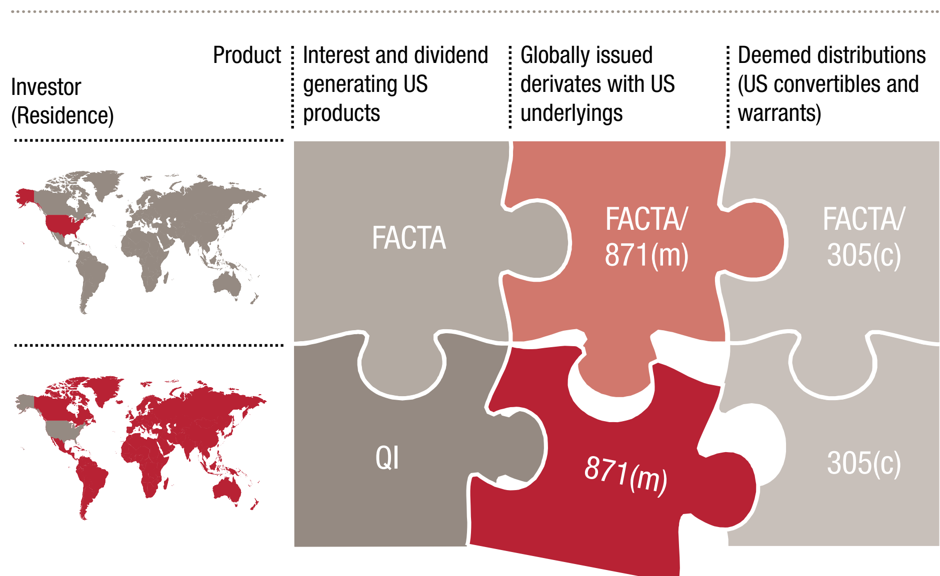
With 871(m), multiple paradigm shifts are affecting the global FS industry. For the first time, products issued outside the US are subject to US taxation. Secondly, with the taxation of 'dividend equivalents', taxes may arise even if the investor does not receive any cash. This may lead to cashless withholding. Thirdly, the withholding is not calculated and deducted by upstream custodians and CSDs, as is the case for QI or FATCA, but has to be conducted by the issuer of the product or – if the issuer fails to do so – by the custodian bank of the investor who holds the taxable product.

The following illustration shown in Figure 1 puts the five stages into the context of time and tax subject/object, while Figure 2 places 871(m) logically within the context of existing US tax regulations.

Figure 1: US tax regulation with relevance for global financial institutions

	I IRC	II QI	III FATCA	IV 305(c)	V 871(m)
Implemented	**1926**	**2001**	**2014**	**2017**	**2017**
Taxable Persons	US persons	Non-US persons	Undisclosed US individuals and Non Participating Foreign Financial Institutions	US and Non-US Persons	US and Non-US Persons
Taxable Products	Income; wealth; interest and dividends	US sourced Income (interest and dividends)	US sourced Income (interest and dividends)	Options, convertible bonds and other rights to acquire stock with conversion rate changes	Portfolios contain instruments linked to US equities and hence are considered US source payments
Tax Rates	Individual tax rates	30% or double tax treaty rates	30%	30% or double tax treaty rates	30% or double tax treaty rates

Figure 2: Relation of 871(m) to existing key US tax regulations



How have the financial institutions respond to 871(m)?

The 871(m) regulation has a significant impact on financial institutions and asset managers whose portfolios contain instruments linked to US equities, including a broad range of equity derivatives, as well as equity-linked notes and convertible debt instruments. This puts a lot of pressure on the tax operation departments.

Most global financial institutions have already conducted an assessment to identify how they are impacted. They then implemented a programme that addresses the 871(m) requirements along two lines:

1. efforts to address the requirements that took effect on 1 January 2017, and
2. a strategic program designed to build a controlled and sustainable 871(m) operational environment including the potential extended requirements in 2019.

While major product issuers globally and in Switzerland have made significant efforts to comply with the regulation, 871(m) has been flying 'below the radar' for many custodian banks.

Main obligations for financial services providers

Even though the impact of the 871(m) regulation is rather limited in 2017/18 due to the restricted scope, there are some significant obligations for financial services providers that need to be taken into account after wave 1 of the regulation has already been put in place. The obligations vary depending on whether an institution is an issuer of impacted derivative products, or only has clients who are invested in 871(m)-impacted products, and/or simply acts as broker/dealer. In the following, we show you the major obligations to be considered.

Build awareness about what areas of the organisation will be impacted

If not already conducted, a brief impact assessment will ensure that financial institutions are aware of all areas that are impacted by the regulation. This includes impacted entities, departments, products, systems and, last but not least, clients.

Identify which products fall within the scope

Financial institutions need to gain clarity as to which products in their sphere of influence fall within the scope and whether they have obligations as an issuer, a broker/dealer of third-party products or as a custodian. Financial institutions should consider whether 871(m)-impacted products should still be issued and, if yes, what needs to be done in order to stay compliant with the Qualified Intermediaries regime.

In Switzerland, the main issuers of 871(m)-impacted products currently apply the default 30% withholding which makes these products 'care-free' for custodian banks (in terms of withholding obligations). However, currently the majority of 871(m)-impacted products are being issued abroad and are generally flagged as 'potentially in scope' by financial information providers. This requires a judgement as to whether the product is within or outside the scope of 871(m) by the custodian bank. The lack of information provided by issuers and financial information providers forces custodian banks to reach out to the issuers to receive clarity on 871(m) taxation. Due to high data volumes, smart handling of this 'counterparty reporting' process is key. The fallback option of not issuing 871(m)-impacted products or blocking trades of products with 871(m) status is overly restrictive and leads to the loss of business and competitiveness.

Withhold and report tax to the IRS

Issuers need to determine if 'issuer-led' withholding is the only long-term solution, or if the CSDs or downstream custodians can handle the withholding and reporting obligations.

Custodian banks themselves can end up with withholding obligations if the issuer has not already conducted the withholding. This is mainly relevant when investors buy products from outside Switzerland where information is missing as to whether issuer-led withholding has been applied or not. A strategic decision on whether the business should be blocked or enabled is necessary. If it is enabled, it needs to be determined whether the withholding process should be conducted manually or if the setup of an automated withholding solution is more efficient. This inevitably leads to the question of the long-term QI status. A bank aiming to implement an 871(m) withholding solution should consider whether the switch from 'secondary QI' to 'primary QI' status is an option. Additionally, new reporting obligations arise in the area of the revised 1042-S and 1042 reporting where a new 871(m) tax type needs to be reportable.

Achieve and maintain qualified derivatives dealer (QDD) status

This issue is mainly relevant for financial institutions which are currently issuing 871(m) products or are intending to issue such products in the future. The QDD status ensures that no double taxation of FDAP payments occurs, firstly on the dividend income of the hedge and secondly on the dividend equivalent income on the derivative product. For 2017 and 2018, being a QDD enables an issuer to receive dividend income without tax deduction. However, being a QDD does come with regulatory obligations such as the calculation of net delta exposure. A proper business case is key to ensuring that the right decision is taken. With our project-proven QDD business case template, we can support you in your decision-making.

In January 2019 the product scope increases from delta one products to products with a delta larger than or equal to 0.8 in relation to US-securities and includes complex products

This may mean that options (OTC or exchange-traded), a variety of structured products, warrants and convertible bonds move into the scope of 871(m) tax. The following chart provides an overview of which products will fall under the scope of 871(m) in 2017, 2018 and 2019:

Figure 3: Products under the scope of 871(m)

Impact on Product Taxation

Issuer	Product group	Product	Delta	Taxable in 2017	Taxable in 2018	Taxable in 2019[1]
Own issued	**OTC Derivatives**	Swaps	1	✓	✓	✓
		Options	<1 (unless strike price = 0)			✓
		Forwards	1	✓	✓	✓
Own and 3rd party issued	**Listed Products**	Tracker Certificates	1	✓	✓	✓
		Actively Managed Certificates	1	✓	✓	✓
		Other Certificates and Notes	<1 or Complex Products			✓
		Warrants	<1 (unless strike price = 0)			✓
Own and 3rd party issued	**Exchange-traded Products (3rd party only)**	Futures	1	✓	✓	✓
		Mini-Futures	Close to 1			✓
		Options	<1 (unless strike price = 0)			✓
		Convertible Bonds	<1			✓

1) Final decision pending as the approach is under reconsideration

Taxable products taxable in FY 19

Unrelieved Product Groups based on October 2016 IRS-Relief-Announcements / IRS Notice 2017-42

The 'good faith' period for wave 1 products is ending

Financial institutions need to ensure full compliance with the wave 1 requirements as of January 2019, when the grace period is no longer applicable. At the same time, financial institutions need to consider the potential extended scope and applicable obligations for 2019. Today financial institutions should already be considering their implementation needs for the withholding calculation, regulatory reporting duties (1042/1042-S) which will include 871(m) 'dividend equivalent payments' in March 2018 for the first time, the counterparty reporting process, and the application of the combination rule (if not waived before end of 2018). Should you rely on third-party providers like core banking outsourcing partners or product-issuing vehicles, a solid check of whether they cover all your obligations seems advisable in order not to put your QI status at risk.

For the wave 1 go-live, assumptions had to be made because the final regulations were not ready. For financial institutions that had to make such assumptions, it is worthwhile revisiting assumptions and checking if they are still valid for 2018/19.

locking, withholding and partial solutions

Financial institutions need to make informed decisions on which route they will choose. To make matters worse, financial institutions may be dependent on other market players in this decision: What will the information providers be able to offer? How will the competition react? How will the IRS handle possible reclaims?

Conclusion

While a new regulation is rarely welcomed, §871(m) is a logical step in the IRS's overall endeavour to eliminate regulatory loopholes in the taxation of US source payments (e.g. interest and dividends).

Even though the §871(m) regulations came into effect at the beginning of this year, there are still key operational questions to be answered. In 2016 and early 2017 tactical solutions have been implemented in response to the requirements of §871(m). These must be transferred in late 2017 and in 2018 into a strategic, efficient and competitive run the bank model. In the end, it comes down to whether or not a financial institution is able to deal with the regulation in a smart and cost-efficient manner. We are happy to discuss the topic further with you and support you by leveraging templates and expertise from key clients worldwide.

PwC Switzerland’s service offering

PwC Switzerland is the leading audit and advisory company in Switzerland. Within PwC Switzerland, around 3,000 employees and partners in 14 locations in Switzerland help organisations and individuals create the value they are looking for.

PwC Switzerland’s Tax Operations Competence Centre offers tailored strategic support to meet its clients’ specific needs. The team collaborates closely with the industry’s leading banks to address the evolving regulatory demands and the changes in market risks. The interdisciplinary core competencies of PwC Switzerland in the area of tax, compliance and operational effectiveness include:

Measuring differences: supporting you from strategy to execution, through:

- Compliance effectiveness – reducing the total cost of compliance through process automation, robotics process automation (RPA) and the use of artificial intelligence
- Impact assessments (overall 871(m) impact / QDD relevance analysis)
- Tax technical advice (application of combination rule / withholding obligation for custodians)
- A standardised rules engine for tax, compliance, AML/ KYC , CID, MIFID etc., rules to ensure client on-boarding rules (local / regional and global) are always up to date
- Regulatory transformation support on compliance frameworks for QI / FATCA / OECD CRS (AEI) / 871(m) / 305(c) and many more regulations
- Supporting and developing IT implementation
- Project coordination with further regulatory requirements

Contacts

Tailored solutions

We recognise that every business is different. How your 871(m) approach is set up and whether you should become a Qualified Derivatives Dealer depends on size, international reach and whether you are impacted as a custodian or an issuer. We look forward to meeting with you for further discussion.

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