871m: Buyside firms banking on brokers to do the heavy lifting? Think again...

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871(m) has struck a chord with delta one desks and tax departments at some of the largest investment banks and broker-dealers; but are buy-side firms taking a backseat on the heavy lift? Not exactly. Buy-side firms, like their counterparts, are still trying to wrap their heads around the latest wave of tax regulation to come out of the US Internal Revenue Service.

So what is all the fuss about then? 871(m) will establish up to a 30% withholding tax on foreign investors on dividend-equivalent payments under equity derivatives referencing US underliers (including indices with US components). There are a wide range of products that fall into this camp, including swaps, options, futures, convertible debt, structured notes and other customized derivative products. These equity link instruments will face a tax withholding if the delta, or ratio of change to the fair market value, is 0.8 or greater.

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The good news for the buy side is that it can focus most of its efforts on pre-trade screening to determine the types of transactions covered by the scope of these rules. Generally speaking, the buy side has not been as attuned to the 871(m) implications because it may not be directly in the chain of withholding from an operational standpoint. Tax regulations typically put the onus on the broker to determine whether that trade is subject to 871(m). The buy side does not actually withhold or pay the dividend equivalent to counterparties when it is on the long side of a transaction. There is also no withholding when the buy side paying a broker is a Qualified Derivative Dealer (QDD). In this instance, the broker then conducts the proper withholding and reporting. There are, of course, exceptions to the rule, such as when a fund is trading on the short side of the trade with a counterparty that is not a broker or a broker that is not a QDD.

So just screening, then, sounds simple right? Not so fast. The regulations also stipulate that the combination rule must be applied. If two or more separate transactions were entered into in connection which each other, then the combined transaction would be subjected to the delta test. If two single transactions have a delta of 0.5, these will be out of scope. However, if they're entered into together and the delta is 0.8 or greater, withholding will apply. The application of the combination rule will result in increased compliance burdens. The fund will need to speak to traders about their trading strategies and analyze all of the positions within its portfolio with the same underlying security. Trying to manually conduct this process within a short timeframe becomes an onerous task.

The buy side also has to keep its brokers in check. A process needs to be put in place to understand how the broker is withholding and if the delta information is correct. Are the amounts recorded within the books and records accurate and appropriate? If there is an error in withholding how will this impact the fund?

By no means are buy-side firms taking the easy way out. There is a fair share of work to go around, and a joint effort must be had between buy-side firms and brokers. For both parties, there is a short window of opportunity to crack the code for compliance ahead of the January 1, 2017, deadline. The best course of action is to put processes in place and look to a solution which will flag trades subject to withholding. Funds should also review different strategies with different portfolio managers to get a handle on their

risk profiles. Another top tip: Start analyzing what will potentially fall into scope come 2017 based on last year's books and records. With 66 days left to go, the countdown has begun and the clock is ticking for the buy side to get into shape and do some lifting.

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