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871m: Making tax a front office issue?

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The focus of the front office is all about executing trades and generating return. Since when have traders had to focus on tax? That task has always been bestowed on the back office but things are about to change. Enter in 871(m).

The new regulation will establish up to a 30% withholding tax on foreign investors on dividend-equivalent payments under equity derivatives from January 1st 2017. So why should traders care? They will now have the responsibility of screening or assessing their trading strategies to see if their investments are subject to 871(m) withholding. Simple, right? That depends on the contract of course.

The IRS guidelines break down screening of trades based on either 'simple' or complex derivatives contracts. Simple contracts are those referencing a fixed number of shares of a US security with a single exercise date. These contracts fall within the realm of 871(m) if the delta is 0.8 or greater. The delta calculation is essentially the ratio of change to the fair market value.

For complex contracts like certain structured products or basket notes, delta doesn't apply. Instead the IRS has created what it calls the substantial equivalence test which requires financial modelling to determine whether the contract substantially replicates the economic performance of the underlying security.

When these scenarios occur, the trade will need to be flagged for withholding. The big question for the front office – will they have enough data available to prescreen their trades to determine if it's in scope? Given the necessity to manage potentially high volumes of trading data, the broader organisation must understand the potential tax exposure and contribute to building practical solutions to address it.

The deadline is quickly approaching and the rest of 2016 will be a time for traders to assess the impact on their strategies and whether these need to be revised based on

the potential imposition of US withholding. The ones who are successful will be those that power their decisions with the right tools and technology to accurately prescreen and to determine what's in or out of scope.

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