871m: the death knell for US equity derivatives?

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First there was FATCA, then CRS. Now financial institutions have a new tax mandate to meet – Section 871(m). So what do these three numbers mean and will it really sound a death knell for US equity derivatives? The death knell is perhaps a bit over exaggerated but the clanging of the bell is certainly going to cause compliance headaches.

On September 17, 2015 it appeared to be third time lucky for the IRS after two unsuccessful tries to iron out guidance under 871(m). So why after three attempts were 871(m) regulations at last finalised? Continued concerns over dodging withholding tax on US securities' dividend pay outs through carefully timed swaps and other equity derivatives.

The new regulations will establish up to a 30% withholding tax on foreign investors on dividend-equivalent payments under equity derivatives. There are a wide range of products that fall into this camp including swaps, options, futures, convertible debt, structured notes and other customised derivative products. These equity link instruments will face a tax withholding if the delta, or ratio of change to the fair market value, is.08 or greater.

The good news is that delta will only be calculated when the equity derivative is issued instead of when it is acquired. The bad news? Banks and brokers must create new systems and processes in order to monitor which products may be subject to the new regulations but also implement withholding and reporting when required. The even worse news - banks and brokers can still be caught out. Even if the delta threshold isn't met in one transaction, if two transactions are entered in connection with each other, then it will fall under 871(m).

Some have called it 'taxation without representation.' Others have bemoaned that it breaches bilateral income tax treaties. The bottom line is that banks and broker dealers will likely bear the brunt in calculating the withholding tax and making the deduction of payments. The clock is now ticking as brokers scramble to buy or build systems and procedures to apply to transactions issued on or after January 1, 2017.

Even if they get their house in order, there could be consequences for the wider financial market. Foreign investors may decide to exit the US market, although it's unlikely this will be in droves. It also begs the question as to whether or not new products will be designed, creating yet another loophole. Tax compliance is dead, long live tax compliance.

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