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Transition relief won't ease the pain of Section 871(m)

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Banks and buysides thought the holidays came early this year as the IRS issued transition relief guidance for Section 871(m) in the form of Notice 2016-76. There were sounds of rejoice with changes to the threshold for US equity derivatives products.

The notice highlights that the regulations will only apply to delta-one transactions for 2017, those with a threshold of 1.0 or higher. Non-delta one transactions will be deferred to 2018. Despite this reprieve, firms shouldn't start celebrating just yet. It turns out that products which have variable delta, such as listed options, could in fact reach a delta of one and fall into scope for 2017. Unfortunately, it's not time to dash out of the office to finish the holiday shopping. Instead check the list twice to make sure a pre-trade screening tool is in place to identify these trades. Moreover, for delta-one products, the calculation of the Dividend Equivalent Amount (DEA) must still be made and appropriate withholding determined.

Buysides shouldn't be thinking sugar plums either. Changes to the Qualified Derivatives Dealers (QDD) regime could leave them caught out too. They must ensure that they are either working with a US broker dealer or a foreign broker dealer with QDD status, otherwise they run the risk of having to conduct withholding.

The IRS has also given the industry an early present with its 'good faith' efforts. For phase-in years 2017 and 2018, the IRS will take into account good faith efforts by the taxpayer to comply with requirements applicable to those years for enforcement purposes. But will these efforts be good enough? Having a process or systems in place,

even though imperfect, may serve as an argument against penalties in the event of an audit. There should be a trail of efforts taken to comply with Section 871(m) requirements.

So before you get ready to ring in the New Year, remember that 2016 still leaves some work to be done. Industry participants will have to continue to put systems and processes in place to account for screening and withholding before 2017.

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