Challenges for Swiss Compliance With U.S. Dividend Equivalent Regs

by Paul Foster Millen

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In this article, the author discusses section 871(m) rules and how well (or poorly) the critical elements of 871(m) compliance are faring for Swiss market participants.

For Swiss issuers and custodians of derivative instruments, the first business day of 2017 promised a plunge into the unknown. January 1 marked the onset of the U.S. section 871(m) regulations, and in Switzerland the financial institutions affected by the incoming U.S. tax regime still had plenty of questions about their implementation and commercial effect. Over the prior year, the leading players met during numerous forums to share interpretations and devise a common approach for the Swiss marketplace.

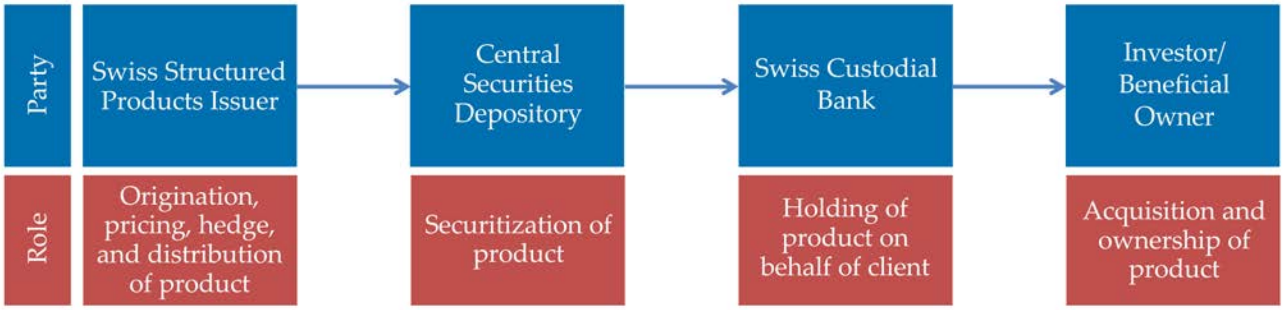
A unified plan remained elusive, however, partly because of various complexities: the complexity of the derivatives business itself, of the section 871(m) rules, and of the application of those rules to the operational processes for payments. The challenges of implementing new U.S. withholding tax rules on a previously unaffected market were exacerbated by the delays in the release of guidance, some of which was revoked or revised. Although the U.S. Treasury provided significant temporary relief on key concerns in December 2016, the general mood heading into 2017 was pessimistic but resolute: We'll have to do the best we can and see how it goes.

After eight months of the new regime, the question is how well the critical elements of section 871(m) compliance are faring for Swiss market participants. Compliance was never going to be simple. The regime is meant to identify non-U.S.-issued derivative instruments that substantially replicate the economic benefits of holding U.S. equities directly and then convert specific payments (including cashless deemed payments) arising from those instruments into U.S.-source dividends subject to withholding under chapter 3 of the Internal Revenue Code. To accomplish that, the IRS sought to piggyback on the withholding architecture of the qualified intermediary system, under which intermediaries withhold U.S. tax (or delegate that withholding) on specific income payments from U.S. securities — notably, on dividend payments.

While a piggyback approach was perhaps necessary, it generated two problems. First, the structure of derivative instruments and their methods of payment are far more diverse than standard equity setups, resulting in difficult in-scope testing calculations and the need for a systematic overhaul of some withholding functions. Second, to hinder the foreseeable evolution of investment strategies designed to avoid section 871(m) withholding, the IRS sought to thwart the development of those strategies through broad, far-reaching standards.

Fortunately, in the wake of industry feedback, the IRS opted to phase in the regulations, focusing on the taxation of instruments that performed most like the underlying equities and temporarily stripping out several of the more complicated aspects of the section 871(m) regulations. Once Notice 2016-76, 2016-51 IRB 834, released in

Simplified Scenario for the Distribution of Structured Products in the Swiss Marketplace



December 2016, had deferred such problems as the combination transaction rule and the substantial equivalence test for so-called complex contracts, the core Swiss concerns for 2017 distilled to three main topics:

- whether the Swiss "issuer withholding" solution will be workable;
- whether communication and coordination across the industry will stumble as a result of differing technical interpretations and states of operational readiness; and
- whether, even if all goes well, the withholding tax will destabilize the market for derivative instruments (especially for structured products).

Based on interviews with assorted Swiss derivative product issuers, custodial banks, and other involved parties, this article addresses those questions. It also provides an overview of section 871 compliance in Switzerland, along with suggestions for improvements to the regime based on lessons learned during its initial eight months.

The Issuer Withholding Solution

One recurrent theme during the 2016 group discussions was the identity of the party that would conduct the withholding on in-scope payments and make the corresponding deposits with the IRS. The section 871(m) regulations assign the withholding responsibility (and thus potential liability for non-withholding) to multiple parties within a typical transaction.

For example, in the standard structured product transaction shown in the figure: An issuer deposits a structured note with the central securities depository (CSD), from which an investor purchases and holds it through her custodian bank. In this scenario, the issuer, the CSD, and the custodial bank all qualify as withholding agents for section 871(m) purposes. Accordingly, each party must either withhold tax on an in-scope payment or risk a demand from the IRS in the event of any unpaid tax on such a payment.

As section 871(m) piggybacks off the QI regime, the QI infrastructure serves as a model for section 871 withholding as well. Therefore, the natural candidate for section 871(m) withholding responsibility is the primary withholding agent for QI purposes. In many jurisdictions, that party is the custodial bank, which also has the best knowledge about the end investor and access to account funds for escrow or the like, if needed. In Switzerland, however, very few custodial banks assume primary withholding responsibility as so-called primary QIs. Instead, Swiss custodial banks tend to operate as non-primary QIs, delegating withholding responsibility upstream. Some custodial banks contemplated setting up the new infrastructure to operate as a primary withholding agent solely for section 871(m) purposes, but the cost, complexity, and uncertainty has prevented that so far.

The party one step upstream from the custodial bank in our typical structured product scenario is the CSD. For a structured product sold by a Swiss issuer and held by a Swiss custodial bank, the CSD is overwhelmingly SIX SIS Ltd., which claims primary QI status for withholding on conventional dividend payments. However, even when SIX SIS intermediates the sales of structured products, it does not necessarily intermediate their dividend equivalent payments (as defined by section 871(m)) because dividends tend to be reinvested into the product at the issuer level. That absence of cash flow denies SIX SIS the opportunity to impose the withholding with established methods used for cash payments. Some possible solutions were discussed to address the phantom income problem but ultimately rejected on structural and commercial grounds. Consequently, the CSD in the standard structured product scenario was not considered the appropriate party to conduct the section 871(m) withholding in Switzerland.

The sole party remaining in the structured product scenario is the product issuer. In some ways, the withholding assignment made sense because many issuers were considering the qualified derivatives dealer (QDD) status and thus would be obligated to assume primary withholding in that role. Conversely, however, the issuers were less fit for the withholding duty because they did not have information on the beneficial owners, thereby depriving qualifying investors of reduced withholding rates. As a result, every in-scope payment would be taxed at 30 percent.

Because many buyers of structured products in Switzerland are entitled to rates of 15 percent or even 0 percent on U.S.-source income payments, opponents of issuer withholding argued against a reduced rate of return and the bad deal for investors. In principle, those investors could reclaim the over-withholding from the IRS, but that required costly interaction with a foreign tax authority and supporting documentation that did not appear easy to obtain (for example, a U.S. taxpayer identification number and Form 1042-S is required for the beneficial owner of a payment if the QI custodian conducted pooled reporting). The Swiss market adopted the issuer solution to the withholding question, an inherently blunt solution whose negative operational and commercial effects were not clearly outweighed by its efficiency.

After eight months, the issuer withholding solution has fulfilled its threshold purpose: settling the identity of the withholding party for Swiss-issued structured products in an implementable way, while simultaneously relieving other parties (notably, smaller, under-resourced private banks) of their residual withholding obligations. Further, by disregarding investor entitlements to reduced treaty rates, it simplified and standardized the withholding calculations. In sum, once the operational processes were set up — namely, ensuring communication to the marketplace — and any preliminary missteps purged, it functioned as an effective and pragmatic solution to a thorny problem.

Even so, all parties concede that any declaration of victory is premature. One lingering fear is that the IRS will express a negative position on the blanket application of 30 percent withholding without any effort to document the beneficial owner of the payment, thereby fatally undermining the solution. The likelier concerns revolve around reporting and refund claims. The absence of a cash payment and payment communication for section 871(m) withholding creates an information gap for many of the parties that must submit forms 1042 and 1042-S to the IRS (and clients).

Reporting is an unavoidable component of any withholding solution. Issuers must distribute reportable information to the appropriate intermediary parties, who must then be able to reconcile information received against payments and holdings, process the information, and satisfy their own reporting duties. Doubts persist regarding the mechanics and timing of those information exchanges.

Other reporting problems could also emerge. Collecting information for reporting might expose defects in the issuer withholding solution by revealing that some payments on in-scope products were not subject to withholding. Also, some issuers could impose unanticipated withholding on payments from products not yet identified as in-scope, so the Form 1042-S arrives as an unwelcome surprise to the downstream intermediary (especially if a QI is not coded as a QI on the form). Thus, the industry will not claim that the issuer withholding solution is proven before a successful reporting season has occurred.

Moreover, even if the issuer-led solution satisfies the compliance needs of the affected financial institutions, investors eligible for reduced withholding rates remain entitled to compensation for over-withholding. The process for refund claims (unless the custodian bank applies collective refund procedures under the QI agreement) requires the aggrieved party to file a return with the IRS (which is itself daunting for newcomers) and to attach the relevant Form 1042-S as evidence of the over-withholding.

Under the Swiss QI system, however, the beneficial owners of payments do not typically receive a Form 1042-S because their custodian bank reports their payments on a pooled and anonymized basis. While the 2017 revisions to the QI agreement require the provision of Form 1042-S on request, the Swiss market is unsure of the volume and effect of those requests. The prevailing consensus is that the time and money involved in submitting a refund request will heavily outweigh the value of a refund, thus deterring most retail investors. As such, most Swiss reporting parties regard the investor's right to a refund claim as an unlikely operational burden, albeit one with significant nuisance potential.

Counterparty Communication and Coordination

One unavoidable problem with regulating an interdependent financial system is that everyone must be compliant, even if not everyone knows it. While the parties most affected by the section 871(m) rules, such as the larger product issuers, custodial banks, and the respective industry associations, wrestled with interpreting and implementing the regulations, other affected parties were not so diligent in pursuing compliance.

Like the proverbial groundhog, many Swiss private banks had awakened and surveyed the U.S. tax regulatory landscape, beheld the looming shadow of section 871(m), and decided to hibernate until the big banks had sorted out an approach. That decision was rational, given the more pressing burdens stemming from the OECD common reporting standard, and the U.S. Foreign Account Tax Compliance Act and other regulations. Many smaller Swiss banks simply lacked the resources to devote time and personnel to yet another new regime. That neglect, however, created a problem for the big banks implementing section 871(m), because many serve as subcustodians for other Swiss banks and handle many QI compliance activities on their behalf.

To continue in that role under section 871(m), the big banks needed to notify their smaller client banks of the changes on some derivative instruments held on their behalf and of the potential shift of in-scope instruments from non-QI to QI accounts, updating the documentation in the process.

Overall, the complacency of the smaller banks in the Swiss marketplace was rewarded. Thanks to the advent of the issuer withholding solution, the banks could rely on the derivative instrument issuers to handle withholding on structured products on their behalf, thereby relieving them of the most pressing compliance activity. While that relief helped preserve the market, it let the smaller parties continue to disregard their section 871(m) compliance duties — a passivity that cannot endure. Next year, many smaller banks need to fulfill Form 1042-S reporting responsibilities on payments emerging from structured products, their readiness for which is in doubt. And in the absence of clear, simple IRS guidance on reporting responsibility and mechanics, many smaller banks remain reluctant to invest in the needed resources and processes.

Further, the communication and coordination problems across the section 871(m) ecosystem go beyond reporting on structured product withholding. For over-the-counter transactions, the issuer withholding solution is inapplicable, and many small and midsize parties are unaware of their full withholding obligations on those trades.

In so-called mirror trades, for example, smaller custodian banks usually assume the short-party side of the trade against their clients and then contract under the same terms with an issuer as the long party. The banks view themselves as intermediaries between the client and the issuer on a single mirror trade transaction, but section 871(m) treats them as principals on two distinct transactions, both of which are potentially in-scope for withholding. If the smaller custodial bank is not a QDD, it cannot serve as a bridge to link the two transactions, and the mirror trade will result in cascading withholding. Many affected parties consider most of their mirror trading activities to be out-of-scope for 2017 and 2018 because they involve options, but further scrutiny may unearth some that are in-scope and thus subject to prompt re-documentation and retroactive withholding.

Subcustodial operations were not the only potential source of communication and coordination confusion for Swiss custodial banks. Although some had considered limiting the derivative instruments held by their account holders under their section 871(m) attributes (for example, those subject to issuer withholding only or from QDD issuers only), few or no restrictions were ultimately feasible on commercial, operational, and customer service grounds. Accordingly, the banks had no control over the section 871(m) consequences from the derivative instruments held with them. Thus, for example, while a custodial bank could reasonably assume that a Swiss structured product would be subject to issuer withholding, that reliance was unavailable for the same type of product issued by a non-QDD from a jurisdiction without issuer withholding. In those circumstances, the custodial bank might need to ask the issuer its intentions for those instruments and to provide documentation. The lurking fear was that the non-Swiss issuers would turn out to be oblivious to, and not sufficiently concerned about, the gathering section 871(m) storm.

As it turned out, that fear was overblown. Most prominent structured products issuers in Europe adopted an issuer-led withholding solution (because, for example, they were QDDs or their CSD mandated it) or stopped offering potentially in-scope products. Accordingly, Swiss custodians are no longer overly worried that large dividend equivalent payment volumes on non-Swiss structured products went undetected. However, several custodians also expressed their intent to reexamine their holdings to be certain.

One additional critical review activity is to ensure that any in-scope derivative instruments are held in QI-designated accounts. If they are not, an upstream withholding agent could treat relevant dividend equivalent payments as made to a non-QI on the subsequent Form 1042-S. Once outside the QI system, the intermediary on the payment would lose the privilege of pooled reporting and would need to report on a per-payee basis. Unless the upstream withholding agent consented to revise the provided Form 1042-S, the intermediary would find itself squeezed between the IRS and Swiss banking secrecy.

Investor Reaction

No amount of planning, coordination, or communication could predict the factor most critical to the success of section 871(m) implementation in the Swiss (or any) marketplace: the way investors would react. In the most pessimistic scenario, the market would crater as investors abandoned in-scope derivative instruments en masse once they realized that the post-tax yields of holding the underlying equities were the same as those for the derivative instruments referencing them. More optimistic forecasts said the market would remain stable because the advantages of local tax treatment and lower transaction costs offered sufficient compensation for the increased counterparty risk from holding derivative instruments that otherwise perfectly replicate the economic consequences of holding the underlying equity. Going into 2017, however, no one knew for sure.

So far, investor reaction has been neutral, which qualifies as an unalloyed positive in light of the issuers' anxieties (although subject to the caveat that a future negative shift is possible either on the demand or supply side). Respondents for this article unanimously agreed that they have not observed a marked reduction in the demand for sales of structured products or other in-scope derivative instruments. Their views on the credit to minimize the commercial impact of section 871(m) were more diverse. Most agreed that the introduction of the issuer withholding solution eliminated disruptions to the marketplace that otherwise might have irreparably damaged it. Several pointed to the assorted nontax reasons for holding derivative instruments rather than the underlying equity itself, and many also seemed inclined to blame opacity and obliviousness. In light of the dividend equivalent payment reinvestment mechanism for structured products and the disclosure of the withholding tax in the thickets of the general terms and conditions, few retail investors are aware that the tax on those products increased materially this year. Whether the broader investor base will eventually digest the implications of section 871(m) withholding for product yield and thus reconsider the acquisition of affected products is unknown. It seems clear, however, that they have not yet done so.

On the supply side, some affected financial institutions struggle to justify the cost of section 871(m) compliance relative to the revenue earned on in-scope derivative instruments in the marketplace. As a result, they are contemplating limiting their issuance or custody services to a subset of in-scope products. One tempting limitation is to avoid all in-scope derivative instruments that are not delta one. In light of several provisions (for example, the combination transaction rule, deemed reissuances), a reduction like that may not be as seamless as hoped. Despite that, investors willing to tolerate the additional taxation may find that the compliance burden associated with some products decreases the variety and range on offer.

Lessons Learned in Switzerland

After eight months of an active (albeit phased-in) section 871(m) regime, the compliance situation is stable, but not yet settled. The most dire prognostications of market chaos and a collapse in sales volumes did not transpire, but the costs to the affected parties have not been negligible (and have far outstripped the taxes on dividend equivalent payments deposited). Further, with the first reporting on the horizon and the sunset of the phase-in rules in 2019, we are not yet near the end of the implementation transformation cycle; rather, we are perhaps at the end of its beginning, to misappropriate a famous phrase.

With that in mind, the market participants interviewed for this article expressed relief at the effectiveness of their 2017 compliance programs with a sense of unease about the future. During conversations on needed or wished-for amendments to the section 871(m) regime, the same themes recurred. Most frequently cited was the elimination of the combination transaction rule — either in full or only in applying it to intermediaries — or a simplification of it in line with the version in force for 2017 and 2018.

Because of the prevalence of omnibus accounts, any institution operating as a subcustodian will struggle to determine whether two transactions have been entered into in connection with one another because they will not even know if the end investor is one party or multiple parties that happen to be clients of the same custodian bank with a single omnibus account. The same problem applies to an issuer of structured products because the CSD is the account holder for virtually everything it issues, so the presumption rules for short parties provide scant relief. The Swiss consensus is that the rule is operationally unworkable.

Other concerns are equally common (although not so dread-inducing as the combination transaction rule). One problem is the return of withholding on dividends paid to QDDs, which will result in cascading withholding that further widens the gap between actual withholding and required withholding for beneficial owners entitled to reduced withholding rates. Finally, in light of the difficulties for withholding and reporting on the phantom income associated with structured products, several issuers are wary of the future events of phantom income embedded in the section 871(m) regulations — namely, on lapsed options. In those circumstances, a custodian may need to debit an account rather than withhold a percentage of a payment. Clients are unaccustomed to subtractions to their account balance, so prickly questions are expected.

In closing, all respondents voiced appreciation for the timely release of Notice 2017-42, noting that clear and pragmatic rules can be implemented, with sufficient forewarning. Some felt compelled to add, however, that that universal statement of operational optimism does not apply to the combination transaction rule, which they do not think any amount of advanced notice can salvage. ■