



Preparing for the Implementation of Sections 871(m) and 305(c)

Canadian Insights on U.S. Tax Updates

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The U.S. Internal Revenue Service (IRS) has released final, temporary, and proposed regulations under IRC 871(m). These regulations incorporate some of the industry's suggestions with respect to the previously released proposed regulations. In follow-up to our June 2016 paper, ["Upcoming Regulatory Changes – 871\(m\) and the Common Reporting Standard,"](#) this communication sets out practical information regarding the January 1, 2017 implementation date, including insights on the IRS' final regulations, the in-scope derivative products that CIBC Mellon holds in custody and will perform withholding on, and updates on accounting and accruals. Please note that the following information does not constitute tax, legal, or compliance advice and cannot be relied upon in the discharge of regulatory and/or legal obligations. Clients are encouraged to consult with their legal, compliance and tax advisors for specific guidance.

INTRODUCTION TO SECTION 871(M)

871(m) is a U.S. withholding regime designed to address a perceived gap in the current withholding rules. The U.S. government had concerns over investors' use of derivatives to circumvent payment of U.S. tax on dividends from U.S. corporations. These rules, which took effect on January 1, 2017, are designed to close the gaps by imposing U.S. withholding on dividend equivalents from derivative products with underlying U.S. assets. While the IRS has moved to finalize some of the guidance, there are areas that the IRS has yet to issue final guidance on, and which are still open for comment.

BACKGROUND INFORMATION ON SECTION 305(C)

Related to the 871(m) regulatory change, the U.S. Treasury Department and IRS also issued proposed regulations on the U.S. non-resident withholding tax requirements for deemed distributions payments under Internal Revenue Code (IRC) Section 305(c). The proposed regulations for 305(c) relate to convertible debt. Conversion price or ratio changes in convertible debt may be treated as deemed dividends subject to withholding. They may also be treated as dividend equivalents under section 871(m).

A withholding agent is obligated to withhold with respect to the deemed distribution under 305(c) only if: (a) the withholding agent has actual knowledge of the deemed distribution before the Form 1042 due date for the taxable year in which the deemed distribution occurred; or (b) the issuer of the convertible Instrument complies with the reporting obligations with respect to the deemed distribution before the Form 1042 due date for the calendar year in which the deemed distribution occurred (a "Withholding Accrual Event"). If a Withholding Accrual Event is attributable to the withholding agent's knowledge of a deemed distribution, the Withholding Accrual Event will not be deemed to arise until January 15 of the year following the calendar year of the deemed distribution.

CIBC Mellon will use the information available on its custody system, along with information sourced from a new vendor application, to determine eligibility for 871(m) and 305(c) withholding. When the information required to make an eligibility decision is not available, CIBC Mellon will be required to reach out to the client to provide such information. Please note that CIBC Mellon will not be calculating the delta – to determine if the instrument is in-scope - on behalf of its clients.

REGULATORY UPDATES AND TIMELINES OF THE FINAL REGULATIONS

In Canada, we are concerned about how dividend equivalents and U.S. withholding tax on such payments will be treated from a Canadian tax perspective. We brought our concerns to the industry associations' attention and the associations have requested guidance from the Canada Revenue Agency (CRA). We understand that the CRA is looking into this at the time of publication; however, we expect it to take some time before the CRA can release such guidance.

On December 2, 2016, the IRS released its transition guidance for section 871(m) during the phase-in period. IRS Notice 2016-76 offers transitional relief for the 871(m) regulations, providing taxpayers with guidance for complying with final and temporary regulations under section 871(m). According to the IRS notice, the 871(m) regulations apply to transactions issued on or after January 1, 2017 that have a delta of one. This includes notional principal contracts (NPCs) and equity-linked instruments (ELIs) that are either simple contracts or complex contracts. Furthermore, the regulations will apply to transactions issued on or after January 1, 2018 that are non-delta-one transactions. The delta threshold of 0.8 will remain in effect.

In the IRS' update, a withholding agent will be considered to have satisfied its deposit requirements in a timely manner for section 871(m) dividend equivalent payments if it makes deposits of the amount withheld for dividend equivalents during any calendar quarter on or before the last day of that calendar quarter. This relief is only for 2017 and will not be operable beginning in 2018.

The regulations provide that a dividend equivalent is not considered to be made until the later of when the amount of a dividend equivalent is determined, and a payment occurs with respect to the 871(m) transaction. Therefore, generally speaking, withholding is required when money or other property is paid to or by the long party, or when the long party sells, exchanges, transfers, or disposes of the section 871(m) transaction such as by settlement, offset, termination, expiration, lapse, or maturity. In the final regulations released in January 2017, the IRS allows withholding agents (other than Qualified Derivative Dealers (QDDs)) the option to withhold at the time the dividend on the underlying equity is paid. CIBC Mellon is updating its systems, processes and procedures to accommodate this regulatory change.

The combination rule treats two or more transactions as a single transaction for the purposes of determining whether a potential Section 871(m) transaction is covered by the regulations. The IRS has provided guidance on this rule. Accordingly to this guidance, a withholding agent will only be required to combine transactions entered into in 2017 for the purposes of determining whether the transactions are section 871(m) transactions, and when the transactions are over-the-counter (OTC) transactions, if they are priced, marketed, or sold in connection with each other. Withholding agents will not be required to combine any listed security transactions that are entered into in 2017.

The IRS has included a list of Exchange Traded Notes (ETNs) that are out-of-scope until 2020, even if they are issued on or after January 1, 2017, regardless of delta. Any such ETNs issued on or after January 1, 2020 will be considered in-scope. In its notice, the IRS included additional guidance related to Qualified Derivatives Dealers (QDDs). This guidance will be analyzed by CIBC Mellon and further communication will be forthcoming.

REGULATORY UPDATES AND CIBC MELLON'S ROLE

CIBC Mellon confirms it will perform 871(m) and 305(c) withholding on the following securities held in custody at CIBC Mellon.

Derivative Products In-Scope:

- Rights
- Warrants
- Convertibles Bonds
- Exchangeable Convertibles
- Reverse Convertibles
- Certificates
- Structured Notes

The following products are not held in custody at CIBC Mellon. Therefore, they have been deemed by CIBC Mellon to be out-of-scope for 871(m) and 305(c) for its project purposes because it does not hold these products for its clients. CIBC Mellon expects its clients to work with the dealer/broker involved in the transaction to withhold and remit to the IRS.

Derivative Products Out-of-Scope:

- Exchange-Traded Options
- Exchange-Traded Futures
- Derivatives Over Index
- Derivatives Over Partnerships
- OTC Derivatives (Swaps, Options, Futures, Forwards)

Furthermore, out-of-scope are assets which are recorded as "Assets Not Held."

CIBC Mellon is working with BNY Mellon to identify in-scope derivative products for both 871(m) and 305(c), note the underlying assets associated with the in-scope derivatives, monitor for income events that could give rise to deemed dividends or dividend equivalents and calculate the dividend equivalent/deemed dividend and the applicable withholding tax. Additionally, the process includes sending notifications of impending withholding to clients (where applicable) no later than 72 hours prior to the payment date (business days), and producing withholding events in CIBC Mellon's custody system, CMS.

CIBC Mellon will use the information available on its custody system, along with information sourced from a new vendor application, to determine eligibility for 871(m) and 305(c) withholding. When the information required to make an eligibility decision is not available, CIBC Mellon will be required to reach out to the client to provide such information. Please note that CIBC Mellon will not be calculating the delta – to determine if the instrument is in-scope - on behalf of its clients.

If the security is considered both 871(m) and 305(c) eligible, the 871(m) dividend equivalent amount calculated will be reduced by the 305(c) deemed dividend amount provided that the client received the deemed dividend under section 305(c). The 871(m) withholding tax amount will then be re-calculated against the reduced 871(m) dividend equivalent amount.

871(m) and 305(c) Withholding

CIBC Mellon confirms it will perform 871(m) and 305(c) withholding on the following securities held in custody at CIBC Mellon.

Derivative Products In-Scope:

- Rights
- Warrants
- Convertibles Bonds
- Exchangeable Convertibles
- Reverse Convertibles
- Certificates
- Structured Notes

CIBC Mellon will charge withholding based on the current withholding rates on clients' accounts. CIBC Mellon recommends ensuring that every client account is properly documented for IRS purposes in order for the appropriate treaty rates to be applied on 871(m) and 305(c) eligible events.

NOTIFICATION OF WITHHOLDING

CIBC Mellon will charge withholding based on the current withholding rates on clients' accounts. CIBC Mellon recommends ensuring that every client account is properly documented for IRS purposes in order for the appropriate treaty rates to be applied on 871(m) and 305(c) eligible events.

Clients will receive two notifications of withholding for 871(m). The first notification would be sent out at the time of the announcement and it would be delivered via SWIFT, fax or Workbench, based on the client's current method of receipt for notifications. The second notification would be sent by email 72 hours prior to the account being debited - excluding 305(c) transactions. For 305(c) transactions, the withholding will occur on the entitlement date, which will be outlined in the 305(c) notification alert.

The application must assign a payment date for the 871(m) withholding tax which is the later of the determination date for the 871(m) dividend equivalent amount (i.e. ex-date-1) and the date a payment occurs with respect to the 871(m) security. To limit the situations in which a short party has to withhold, but lacks funds from which to withhold, the new regulations provide that withholding is not required until the later of two events: a payment is made by either party, or the derivative is disposed of or terminates and the dividend equivalent amount is determined. The IRS agreed to allow a withholding agent (other than a QDD) to elect to withhold at the underlying dividend payment date so long as the election is applied to all Section 871(m) transactions of the same type (such as securities loans or notional principal contracts). CIBC Mellon, as withholding agent, has opted to process the tax withholding on the payment date of the regular dividend, which also minimizes the accrual period.

The dividend equivalent amount is generally determined on the earlier of the dividend record date and the day immediately preceding the ex-dividend date.



871(M)	305(C)
<p>DETAILS OF FIRST 871(M) NOTIFICATION:</p> <ul style="list-style-type: none"> 871(m) Security Name, Identifier and Description Units Held of the 871(m) Security Delta of 871(m) Security Underlying Security Identifier and Name Details of Cash Distribution/Optional Dividend Event (e.g. Event Type, Ex-date, Record Date, Cash Dividend Rate) 	<p>DETAILS OF FIRST 305(C) NOTIFICATION:</p> <ul style="list-style-type: none"> Security Name, Identifier and Description Units Held of the 305(c) Instrument Underlying Security Identifier and Name Details of the 305(c) Alert (e.g. Alert Date, Trigger, Trigger Date, 305(c) Alert Status, Entitlement Date, Deemed Dividend Rate)
<p>DETAILS OF SUBSEQUENT 871(M) NOTIFICATION:</p> <ul style="list-style-type: none"> 871(m) Security Name, Identifier and Description Units Held of the 871(m) Security Ex-date of Cash/Optional Dividend Record Date of Cash/Optional Dividend Payment Date of Cash/Optional Dividend 871(m) Dividend Equivalent in USD Tax Withholding Amount in USD 	<p>DETAILS OF SUBSEQUENT 305(C) NOTIFICATION:</p> <ul style="list-style-type: none"> 305(c) Security Name, Identifier and Description Units Held of the 871(m) Security Ex-date of Cash/Optional Dividend Record Date of Cash/Optional Dividend Payment Date of Cash/Optional Dividend 305(c) Deemed Dividend Amount in USD Tax Withholding Amount in USD

REPORTING

Withholding will be completed by BNY Mellon. It will report and remit the amounts to the IRS on behalf of CIBC Mellon. Note that while 1042-S is not issued to clients who provide CIBC Mellon with W8-BEN-E forms, it is still included in CIBC Mellon's pooled reporting to the IRS. The 1042-S forms are only issued to non W8-BEN-E clients such as W8-IMY or ECI. There will not be any tax slips issued to clients who have provided us with a W8-BEN-E.

ACCOUNTING TREATMENT

CIBC Mellon's initial approach is to record the applicable withholding expense on a cash basis. Based on materiality and client requests, other options may be available.



SECTION 305(C) WITHHOLDING

The U.S. Treasury Department and IRS issued proposed regulations on the U.S. non-resident withholding tax requirements for deemed distribution payments under IRC Section 305(c). A withholding agent is obligated to withhold with respect to the deemed distribution under 305(c) only if: (a) the withholding agent has actual knowledge of the deemed distribution before the Form 1042 due date for the taxable year in which the deemed distribution occurred; or (b) the issuer of the convertible Instrument complies with the reporting obligations with respect to the deemed distribution before the Form 1042 due date for the calendar year in which the deemed distribution occurred (a "Withholding Accrual Event"). If a Withholding Accrual Event is attributable to the withholding agent's knowledge of a deemed distribution, the Withholding Accrual Event will not be deemed to arise until January 15 of the year following the calendar year of the deemed distribution.



CIBC Mellon is working with BNY Mellon to identify in-scope derivative products for both 871(m) and 305(c), note the underlying assets associated with the in-scope derivatives, monitor for income events that could give rise to deemed dividends or dividend equivalents, and calculate the dividend equivalent/deemed dividend and the applicable withholding tax.

Further Information

CIBC Mellon will continue to provide updates to clients as more information becomes available and as our clients determine their organization's specific obligations and requirements under these regulations. If you have any questions about the information presented in this article, please contact your Service Director or Account Manager.

About CIBC Mellon

CIBC Mellon is a Canadian company exclusively focused on the investment servicing needs of Canadian institutional investors and international institutional investors into Canada. Founded in 1996, CIBC Mellon is 50-50 jointly owned by The Bank of New York Mellon (BNY Mellon) and Canadian Imperial Bank of Commerce (CIBC). CIBC Mellon's investment servicing solutions for institutions and corporations are provided in close collaboration with our parent companies, and include custody, multicurrency accounting, fund administration, recordkeeping, pension services, exchange-traded fund services, securities lending services, foreign exchange processing and settlement, and treasury services. As at March 31, 2017, CIBC Mellon had more than C\$1.7 trillion of assets under administration on behalf of banks, pension funds, investment funds, corporations, governments, insurance companies, foreign insurance trusts, foundations and global financial institutions whose clients invest in Canada. CIBC Mellon is part of the BNY Mellon network, which as at March 31, 2017 had US\$30.6 trillion in assets under custody and/or administration. CIBC Mellon is a licensed user of the CIBC trade-mark and certain BNY Mellon trade-marks, is the corporate brand of CIBC Mellon Global Securities Services Company and CIBC Mellon Trust Company, and may be used as a generic term to refer to either or both companies.

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