Alternative asset management firms need to address the impact of final Section 871(m) regulations.
Alternative investment funds need to evaluate the impact of recently issued Section 871(m) final regulations on a wide range of notional principal contracts, derivatives and other “equity-linked instruments” with payments that reference (or are deemed to reference) dividends on US equity securities. The analysis will have to focus on understanding the pre-trade, execution, withholding and reporting requirements of the final rules with respect to the affected product as well as the potential impact on internal business areas (tax, accounting, trading, reporting) and external counterparties (brokers, administrators, trading counterparties). Although some of the effective dates are phased in over a two-year period, certain provisions require action to be taken effective from 1 January 2016.

Section 871(m) – in-scope transactions

The following criteria are used to assess the status of a given transaction: whether it is an in-scope product,¹ if the referenced security is a US equity, the type of contract (simple or complex based on availability of delta) and if the value of the delta is more than or equal to 0.8 or the substantial equivalence test for complex transactions.

1. Section 871(m) imposes 30% US withholding on dividend equivalent amounts (DEAs), which potentially arise in the following products, any substitute dividend that references a US source dividend made pursuant to a securities lending or sale-repurchase transaction; 2. any payment that references a US source dividend made pursuant to a specified NPC; 3. any payment that references a US source dividend made pursuant to a specified equity linked instrument (ELI); or 4. any other substantially similar payment. A payment references a US source dividend if the payment is directly or indirectly contingent upon a US source dividend or determined by reference to such a dividend.

Section 871(m) – combined transactions

Definition: When (i) a long party (or a related person) enters into two or more transactions that reference the same underlying US security; (ii) two transactions are not entered into in connection with each other, then the deltas of the two transactions will need to be combined to see if the 0.8 delta threshold is reached.

• Presumptions: For a short party, the regulations state where a broker may presume that transactions are not entered into in connection with each other if the long party holds the transactions in separate accounts, or if the transactions were entered into two or more business days apart
• Neither presumption is applicable if the broker (i.e., short party) has actual knowledge
• Similar presumptions apply to the IRS Commissioner
• In addition, neither presumption is applicable to the long party, which is required to treat two or more transactions as combined regardless of when the transaction was entered into

The Commissioner may rebut the first presumption with facts and circumstances showing that separate trading books were created or used to avoid Section 871(m), and may rebut either presumption with facts and circumstances showing that the transactions in question were entered into in connection with each other

Ernst & Young LLP observations:
• The effect of the rule generally shifts identification responsibility and consequences of non-compliance to the long party. Hedge funds and asset managers should consider creating:
  • Policies and procedures to raise internal awareness and have documentation for audit
  • Operational systems logic to flag as many combined transactions as possible

Section 871(m) – exceptions and additional key elements

• Qualified Derivatives Dealer (QDD) exception: expands the existing qualified intermediary regime for non-US banks and brokers that receive dividends as intermediaries for the account of customers
• Foreign Withholding Partnership: certain types of foreign persons may receive US source payments free of withholding and assume primary withholding/reporting responsibility with respect to FDAP income that is subject to chapter 3 withholding by becoming partners of a U.S. partnership or substantial equivalence test for complex partnerships
• Contingent interest: if the delta threshold or substantial equivalence test is met in an instrument with contingent interest, then the interest will not be eligible for the portfolio interest exemption and will be treated as a dividend equivalent; it is not anticipated that many debt instruments will reach the threshold requirements
• Convertible debt and 305(c) coordination: conversion price or ratio changes in these instruments may be treated as dividends subject to withholding

² Examples of typical in-scope products include, but are not limited to: swaps, futures, convertible debt, structured notes, options (listed and OTC), securities lending, derivatives over equity-linked indices, certain compensation arrangements, forwards, repurchase agreements, other equity-linked contracts, contracts for differences.
² Fixed, Determinable, Annual, or Periodical (FDAP) income is all income, except gains derived from the sale of real or personal property (including market discount and option premiums, but not including original issue discount) and items of income excluded from gross income, without regard to the U.S. or foreign status of the owner of the income, such as tax-exempt municipal bond interest and qualified scholarship income.
An 871(m) assessment from the perspective of technology and operations

- Does the front office have the data available to make a determination of scope prior to the trade?
  - Type of contract (simple vs complex)
  - Tax status of the recipient (non-US vs US)
  - Tax-appropriate delta risk of simple contracts (above, at or below .80 at issuance)
  - Substantial Equivalence Test for complex contracts
  - Source of the dividend income on the referenced securities (US vs non-US)

- How do you calculate and store DEA for both simple and complex contracts?
- How do you accrue dividend amounts?
- Can you apply the delta to calculate the DEA?
- Can you apply a treaty withholding rate?
- What is the NAV impact of the DEA?

- Do you know who is the determining party in the trade? Who is the withholding agent?
- Are you storing the delta calculation at the time the contract was issued?
- Can you notify the counterparty that the trade is subject to withholding under Section 871(m)?
- Are you able to provide an estimate of the withholding amounts?
- Can you explain to the counterparty or client how the disposition of the contract may affect its tax treatment?
- What information do you need to send to prime brokers or fund administrators?

How can Ernst & Young LLP help?

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<th>Our approach and key activities</th>
<th>Readiness assessment outputs</th>
<th>Benefits</th>
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<tr>
<td>Agree on the in-scope products relative to your fund for this assessment</td>
<td>Trade process flow and accounting flows</td>
<td>Provides an inexpensive and expeditious way for our clients to get a high-level understanding of the challenges they’ll face with 871(m)</td>
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<tr>
<td>Develop data and process requirements based on the agreed product</td>
<td>Summary of process, system and data challenges observed</td>
<td>Facilitates our clients’ 2016 budget conversations</td>
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<td>Hold targeted walkthroughs with the middle office operations and front-office contacts</td>
<td>Review of vendor and service provider readiness</td>
<td>Provides our clients with educational awareness of 871(m) and demonstrates our knowledge in this space</td>
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<tr>
<td>Create a workflow diagram and data requirement table incorporating your current operational landscape and the information obtained from the scenario walkthroughs</td>
<td>Plan for efficiently performing a deeper gap analysis and implementation of 871(m) recommendations</td>
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<td>Review observations with key stakeholders and refine</td>
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<td>Present final assessment and propose next steps</td>
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