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Chicago Chapter

Welcome

April 23, 2014

Financial Instruments & Strategies

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Structured Preferred Securities

A Bank's Perspective

Mario Salandra
Managing Director – Global Financial Solutions
The Bank of Tokyo-Mitsubishi UFJ, Ltd.

April 2014

Financial Instruments & Strategies

Global Financial Solutions

April 2014

The Bank of Tokyo-Mitsubishi UFJ, Ltd.
MUFG Americas Capital Company

Members of MUFG, a global financial group

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Mario has over 20 years of experience in the financial services industry providing clients strategic solutions. At MUFG, Mario works with clients throughout the Americas to solve complex technical issues regarding corporate finance, accounting, regulatory capital and international tax by offering tailored value-added solutions to its clients. In addition, Mario works with MUFG Americas Capital Company -- MUFG's merchant bank that focuses on investing in preferred securities of its clients.

Prior to joining BTMU, Mario was a Managing Director at Bank of America, where he was head of the US team responsible for originating and executing complex financing transactions for clients. Prior to banking, Mario was a tax lawyer at Rogers & Wells and Mudge Rose. He received an LL.M (Taxation) from New York University School of Law, a JD from the University of Pennsylvania Law School, and a BBA in Accounting from Iona College. His licenses include: admission to the NY Bar; Series 7 *General Securities Representative*, 63 *Uniform Securities Agent State Law Examination* , & 79 *Limited Representative – Investment Banking*.

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SECTION 1

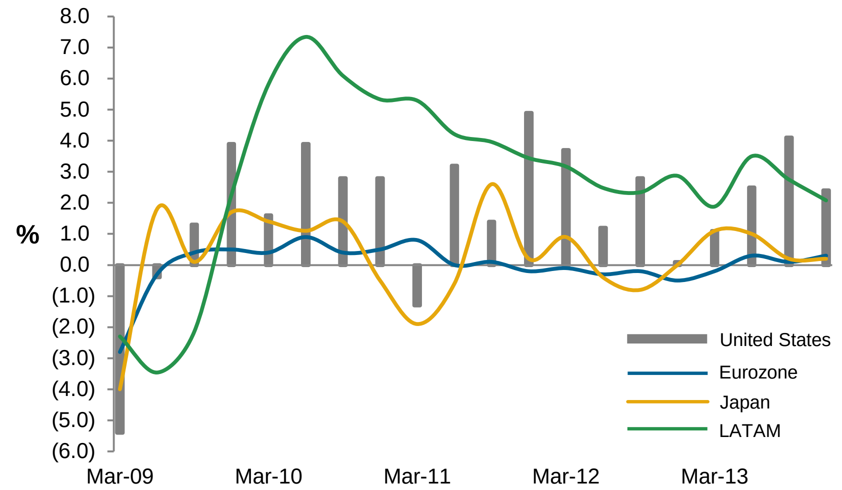
Market Overview

Macroeconomic Trends

Current Global Macro Themes

- The IMF raised its global economic growth outlook for 2014 to 3.7%, with expansion to be fueled by U.S., euro-zone and Japanese growth.
- Growth in the US is expected to be 2.8% in 2014, up from 1.9% in 2013.
- Encouraging signs from Europe as it has broken its streak of six consecutive quarters of negative growth.
- Uncertainty in emerging markets (China, Russia, etc.) has led many investors to look for opportunities in more developed markets (US, Japan, Eurozone, etc.).

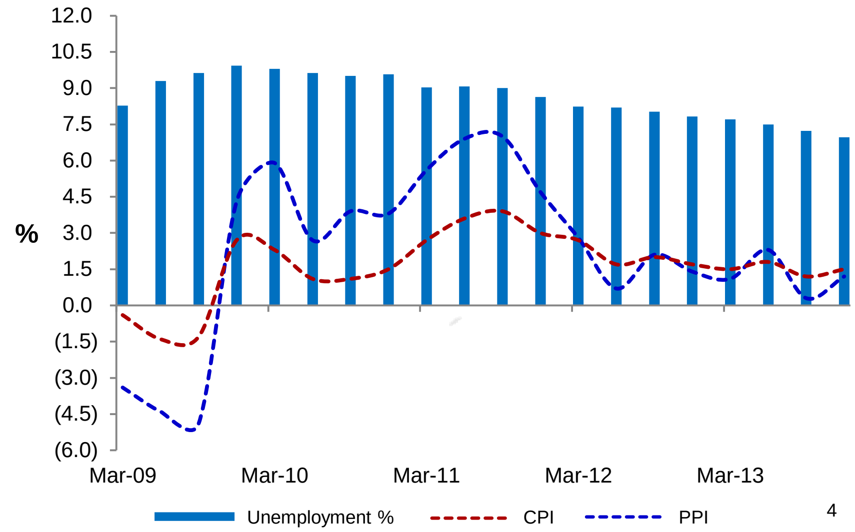
Global GDP Growth



Domestic Macro Themes

- The US economy looks set for a gentle acceleration to around 2.8% GDP growth as the impact of 2014 tax hikes fades.
- Unemployment rate of 6.7% is still above the Fed's target of 6.5%, suggesting continued accommodative policy from the Fed.
- Surge in wealth, due to a recovery in housing and equity prices, has repaired many balance sheets.
- Lower fiscal drag, higher consumer and corporate spending, and increasing home prices will continue to drive growth in the US.

Domestic Trends (Unemployment & Price Indices)



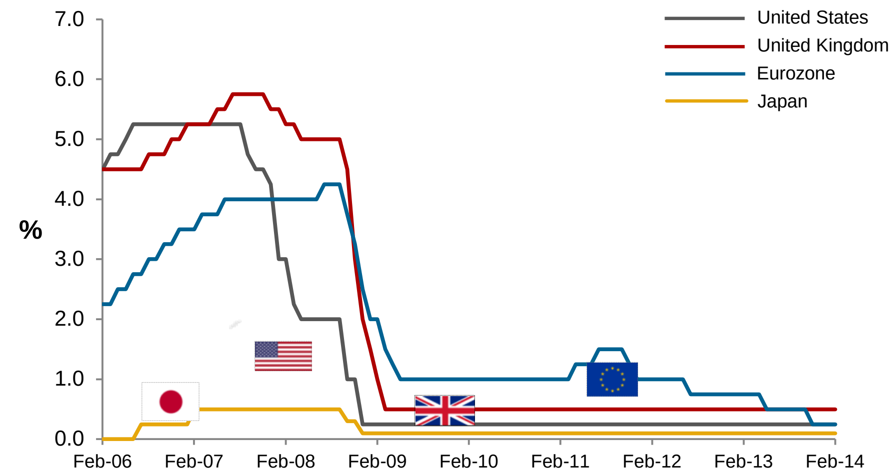
Source: National Bureau of Statistics; Bloomberg

Fiscal & Monetary Policy Trends

Monetary Policy Themes

- Due to unemployment remaining above US Fed targets while inflation remains below historical means, US monetary policy is expected to accommodate growth domestically resulting in a continued low interest rate environment for 2014.
- Although overall monetary policy is expected to be accommodative, the US Fed hopes to end its quantitative easing program by the later half of 2014.
- Real interest rates are expected to rise as quantitative easing is reduced.
- Expectation is for an increase of interest rates by the Fed in 2015.

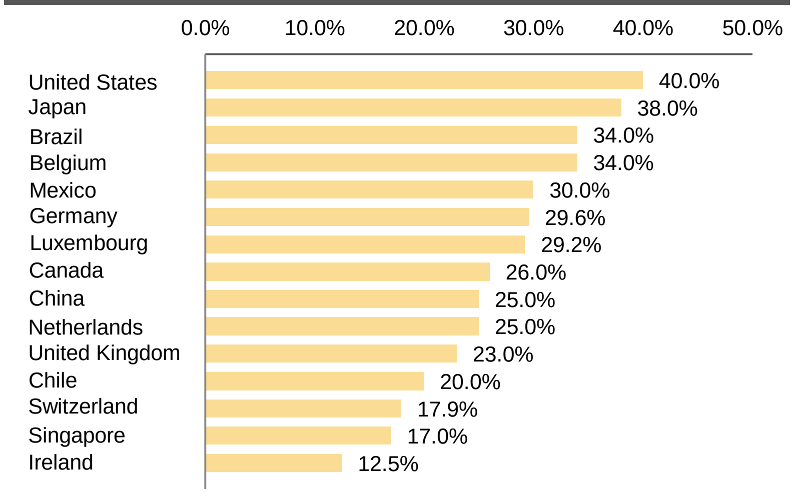
Main Policy Rates



Fiscal Policy Themes

- With constant legislative, regulatory and judicial changes, multinational corporations ("MNCs") are challenged to follow and comprehend ever-changing developments.
- Interaction between US and foreign tax regimes often provides opportunities for MNCs to reduce taxes on a world wide basis, often resulting in permanent cash savings.
- Governments are generally making fewer changes to headline corporate tax rates in 2014 compared to previous years. Instead, more are putting legislative changes in place that will adjust and expand the tax base.
- Nevertheless, it is expected that many countries will continue to lower statutory corporate income taxes in 2014.

Global Corporate Tax Rates (2014)



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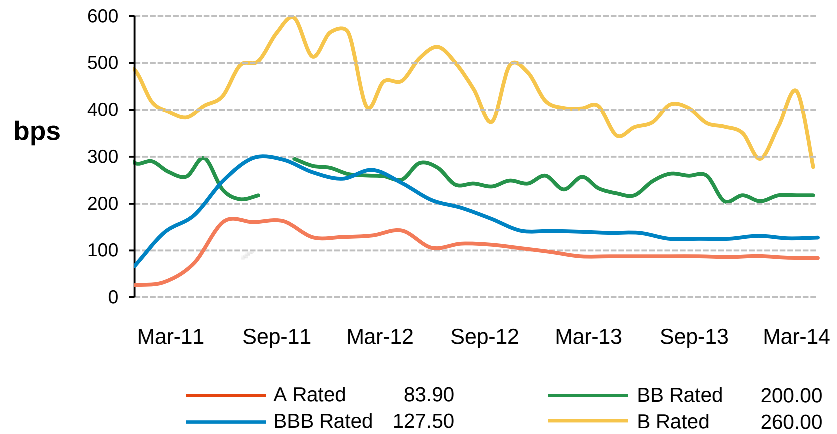
Source: US Federal Reserve; European Central Bank; Bank of England; Bank of Japan; Central Bank of Brazil; KPMG

Banking Trends

Credit and Liquidity Themes

- Loan market continues to be very accommodative.
  - Liquidity in US, Euro, and Asia regions remains strong;
  - Increased market capacity of banks with relatively cleaner balance sheets.
- Investment Grade loan volume was generally down last year:
  - expected slowdown of re-financings;
  - limited event driven financing volume;
  - issuers motivated to lock in historically low pricing.
- Despite the challenge from the wind-down of accommodative US monetary policy, global debt issuances should hold steady for the current year.

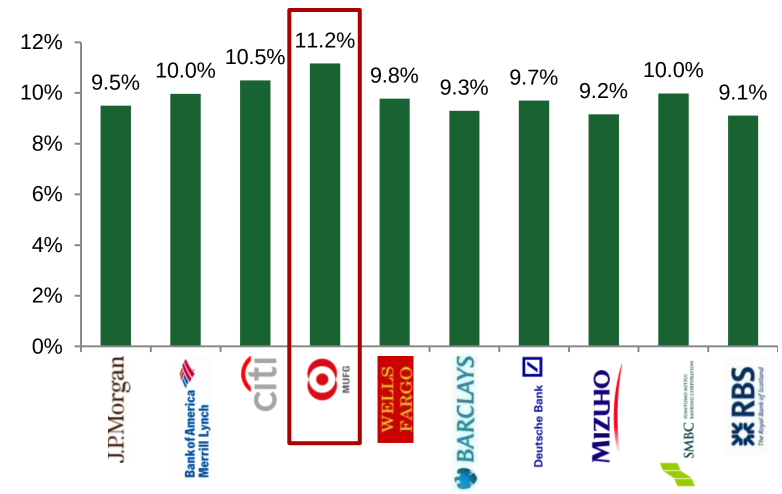
Loan Spreads



Current Regulatory Themes

- In addition to increasing capital requirements, Basel III introduces new liquidity and leverage requirements.
  - New liquidity provisions intended to increase short-term liquidity coverage and long-term balance sheet funding.
  - The Basel Committee will monitor banks' leverage ratios (semi-annually) requiring a minimum ratio of 3%.
- Under new regulations, foreign banks with ≥ $50BN in US assets required to organize subsidiaries under a US Intermediate Holding Company ("IHC") by July 1, 2016.
  - US IHCs are subjected to the same leverage and capital standards as US banks.
  - For larger bank groups, capital costs will rise. Those near $50BN threshold may reduce assets.

Global Banks – Common Equity Tier 1 Capital



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Source: ECB; Federal Reserve; Moody's; Thomson Reuters LPC

SECTION 2

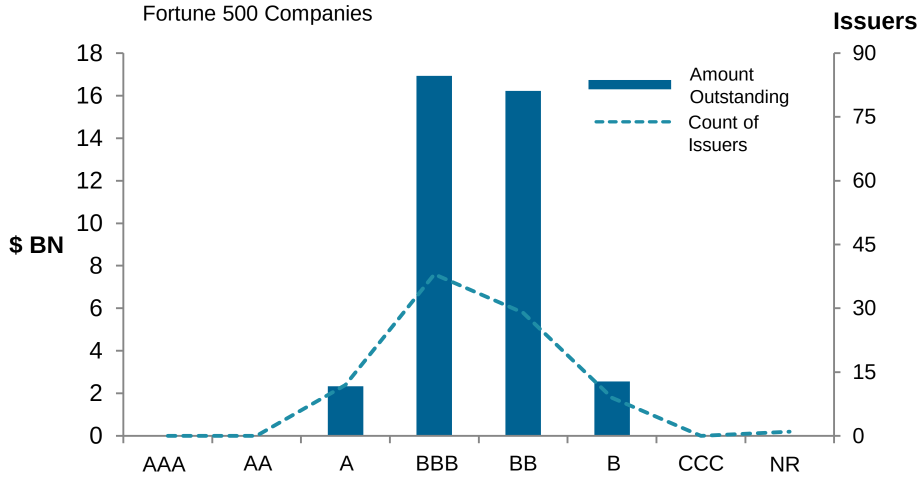
Global Financial Solutions

Global Financial Solutions – Merchant Banking

MUFG Americas Capital Company ("MACC")

- Established by MUFG to provide clients with flexible solutions including liquidity through investments in preferred securities.
- Allows MUFG to hold voting and non-voting preferred securities.
- Preferred securities typically held by MUFG Americas Capital Company ("MACC") distinct from preferred stock issued publicly or to strategic investors.
  - Preferred securities market size determined to be around $38BN outstanding with approximately 89 issues.
  - Typically no conversion right.
  - Issued at subsidiary level as opposed to parent or Holdco level.

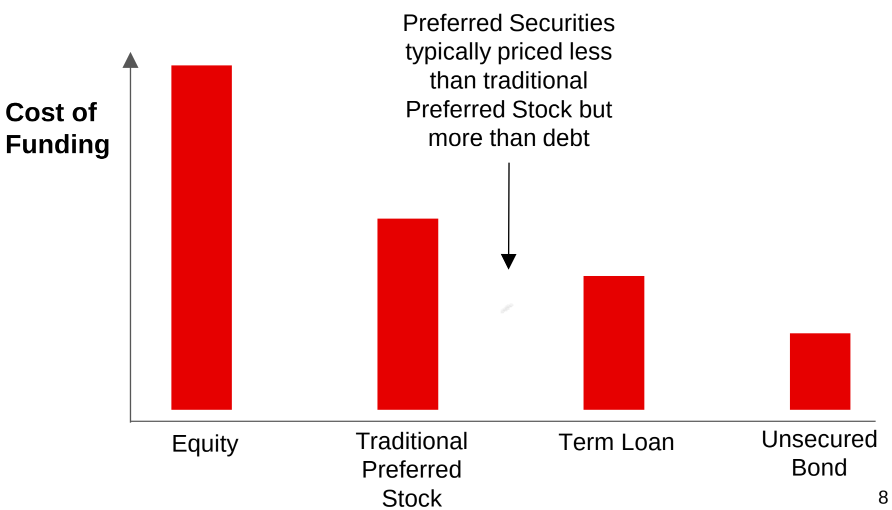
Preferred Securities Market (securities treated as debt)



Pricing and Structural Themes

- Pricing depends on the capital structure and the rights within the instruments.
- Generally priced in between traditional preferred stock and debt.
- Could include limited equity participation.
- Voting rights limited to investor protection situations with no day-to-day management.
- Typically treated as debt for accounting purposes and equity for tax purposes.

Pricing Chart



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Source: Bloomberg

Global Financial Solutions – Recent Transactions

Global Manufacturing Company

$797.5 MM
Structured Loan

Funding provided by
The Bank of Tokyo Mitsubishi UFJ
Sole Arranger

MUFG

Food & Beverage Company

$251 MM
Class A Limited Membership Interest

Funding provided by
The Bank of Tokyo Mitsubishi UFJ
Sole Arranger

MUFG

Media & Entertainment Company

CAD 325 MM
Cross-Border Acquisition Loan

Funding provided by
The Bank of Tokyo Mitsubishi UFJ
Lead Arranger

MUFG

Information Technology Company

£41.1 MM
Structured Loan

Funding provided by
The Bank of Tokyo Mitsubishi UFJ
Sole Arranger

MUFG

Insurance Company

$235 MM
Securities Loan

Funding provided by
The Bank of Tokyo Mitsubishi UFJ

MUFG

Information Technology Company

$62.5 MM
Participating Class A Stock

Funding provided by
The Bank of Tokyo Mitsubishi UFJ
Sole Arranger

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Current Developments in the Dividend Received Deduction

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April 2014

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The Statutory Rules for the Dividend Received Deduction

The Value of the DRD

- The DRD provides a deduction for all or a portion of a dividend paid by a US corporation to another corporation:
  - The DRD is 70% if the payee owns less than 20% of the payer
  - The DRD is 80% if the payee owns 20% or more of the payer
  - The DRD is 100% if the payee and payer are members of the same affiliated group of corporations

Determining Affiliation

- Corporations are members of the same affiliated group if they are connected through a common parent and:
  - The common parent, directly or through one or more affiliated corporations, owns 80% of the voting power & total value of the corporation.
  - Plain vanilla preferred stock is ignored in determining if 80% vote and value test is met.
  - Insurance companies ineligible for inclusion in an affiliated group are treated as affiliated for purposes of the DRD rules.

Determining Ownership

- In determining if the payee owns 20% or more “plain vanilla preferred stock” is ignored.
- Plain vanilla preferred is:
  - Nonvoting
  - Limited & preferred as to dividends & does not participate in corporate growth to any significant extent
  - Does not have a redemption premium in excess of a reasonable redemption premium &
  - Is not convertible

Holding Period Rules

- A corporation may claim a DRD only if has held the stock for 46 days during the 91-day period beginning 45 days before the ex-dividend date.
- The holding period is increased to 91 days during the 181-day period beginning 90 days prior to the ex-dividend date for preferred stocks.
- The date of the acquisition of the stock is not counted, but the day of disposition is counted toward the holding period.

Holding Period Suspension Rules

- The holding period is suspended in 3 circumstances:
  - The payee has an option to sell, is under a contractual obligation to sell or has an open short sale of "substantially identical stock,"
  - The payee wrote an option to sell substantially identical stock; or
  - Under IRS regulations, the payee has diminished its risk of loss by holding 1 or more other positions with respect to substantially identical stock.

Treasury Regulation sec. 1.246-5

- The IRS regulations provide guidance on when a position reduces risk:
  - 70% Overlap for basket (portfolio) positions
  - Facts & circumstances test when a position are "reasonably expected to" move in an inverse relationship to the long stock position
  - Significantly out-of-the-money options do not reduce risk of loss
  - Convertible debt & preferred stock positions can reduce holding period
  - Swaps are disaggregated in determining if they are offsetting

The Non-Statutory Rules for the Dividend Received Deduction

Economic Substance – Substance Over Form - Debt/Equity

- Difficult to economically distinguish debt and equity in today's structured capital markets
- Issuers are influenced to issue debt or equity based on their tax characteristics
- As stated in the legislative history to Section 7701(o)
  - The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these transactions are (1) the choice between capitalizing a business enterprise with debt or equity.

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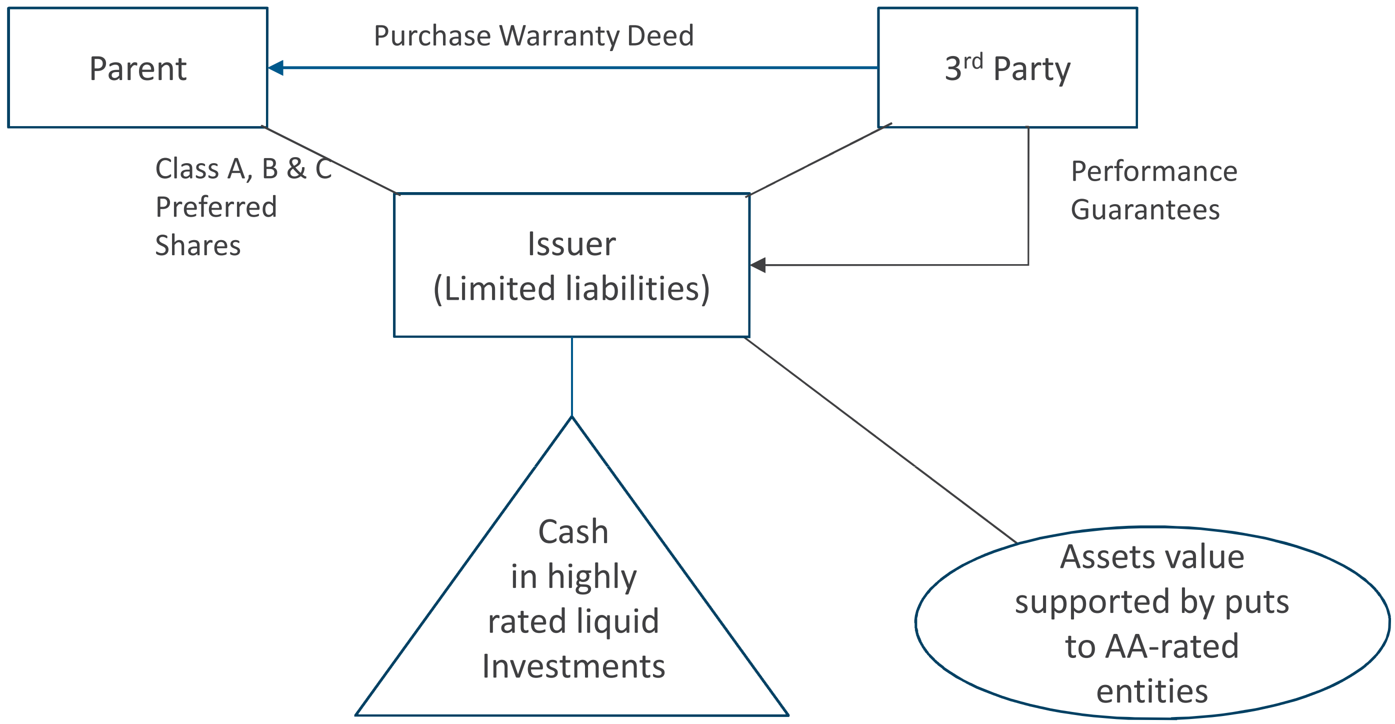
Field Attorney Advice 20121201F (November 10, 2011) 20121202F (November 10, 2011)

Field Attorney Advice 20121201F



Preferred Share Terms

- Issuer has a redemption right in the event of tax event
- A & B shares had a dividend rate determined through an auction rate mechanism (Dutch Auction)
- C shares had fixed rate dividend
- No dividends on common while preferred are outstanding
- Right to appoint directors for control with respect to adverse events

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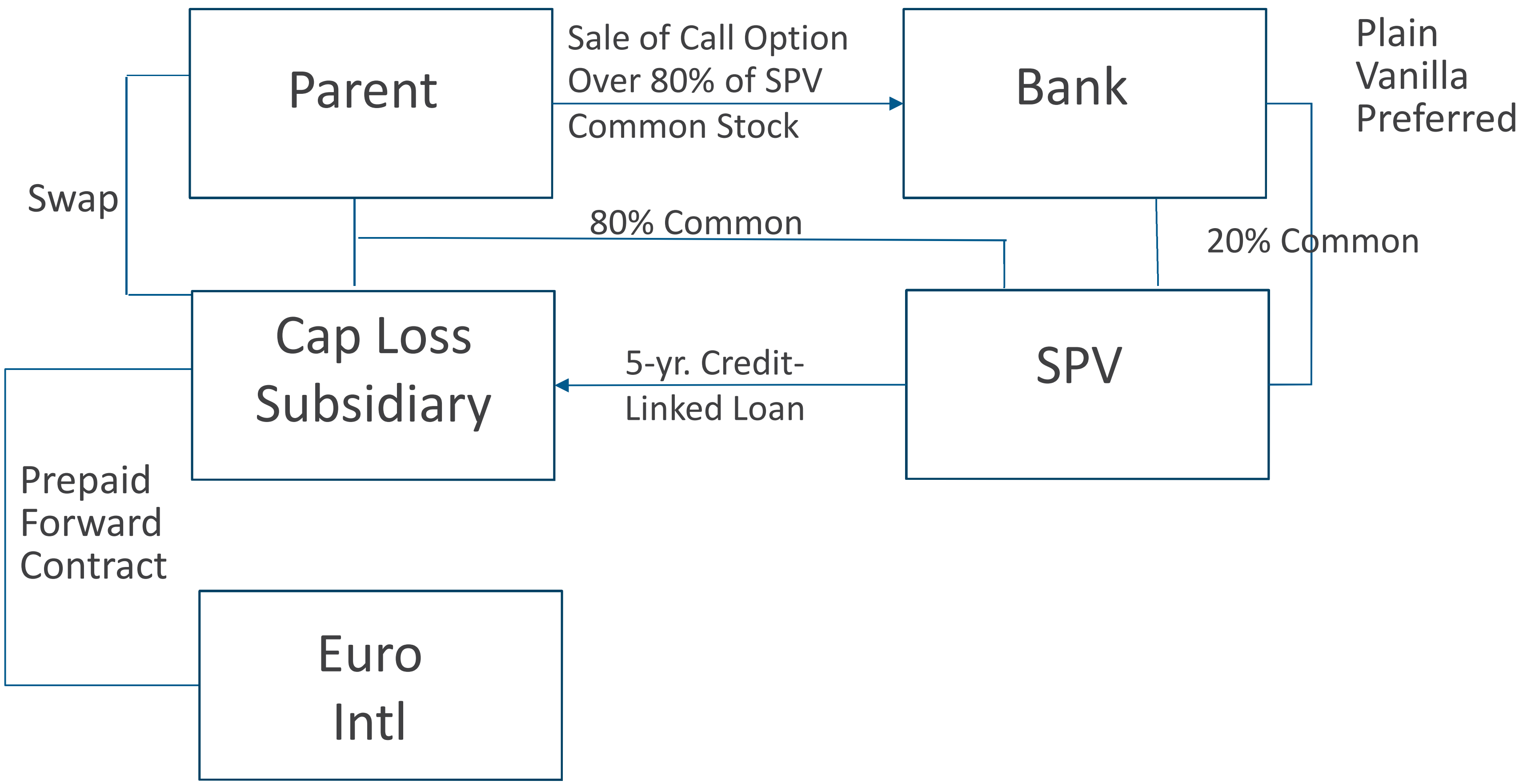
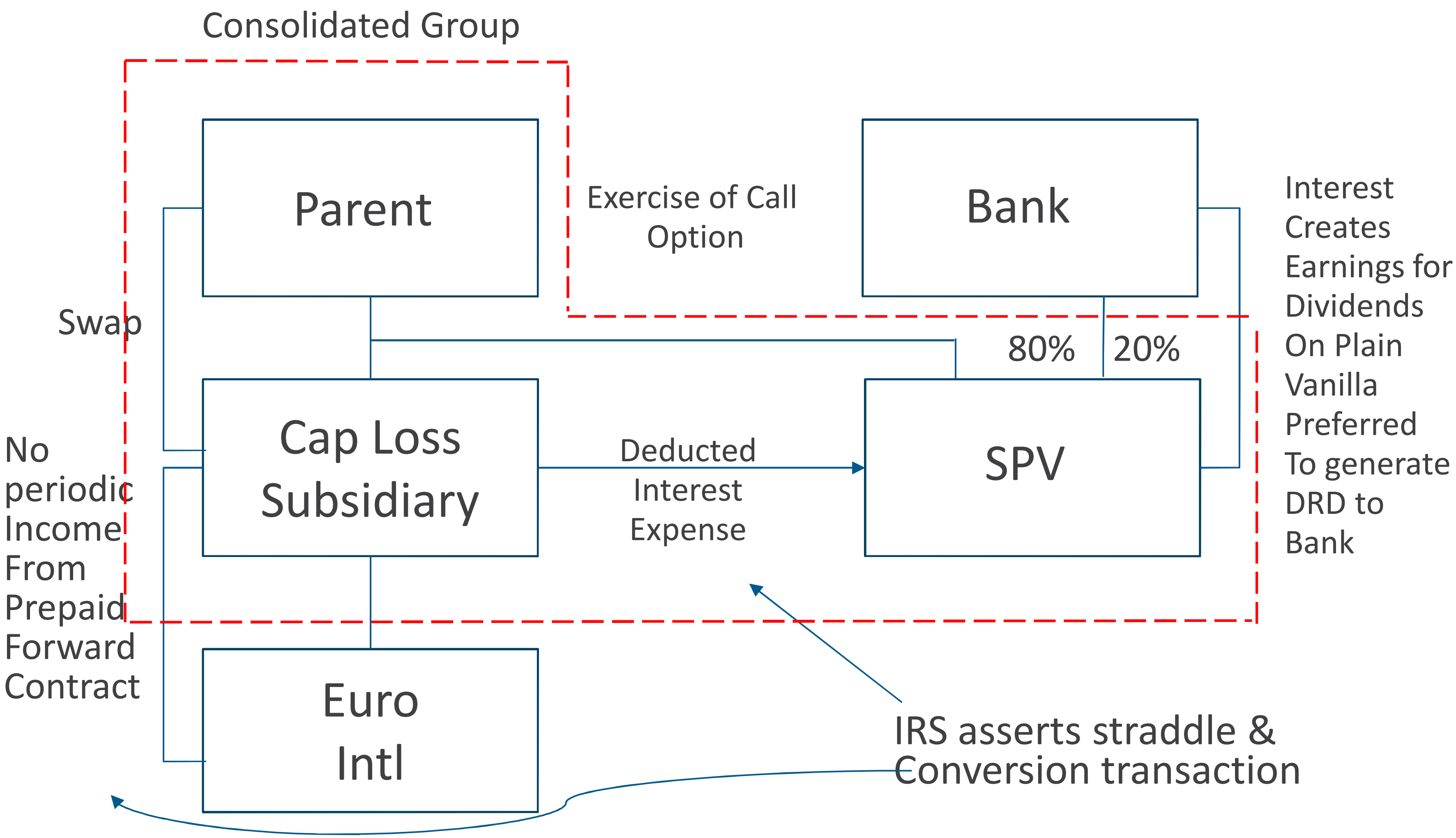
Field Attorney Advice 20131701F (Apr. 26, 2013)

FAA 20131701F Opening Transactions



FAA 20131701F Tax Reporting



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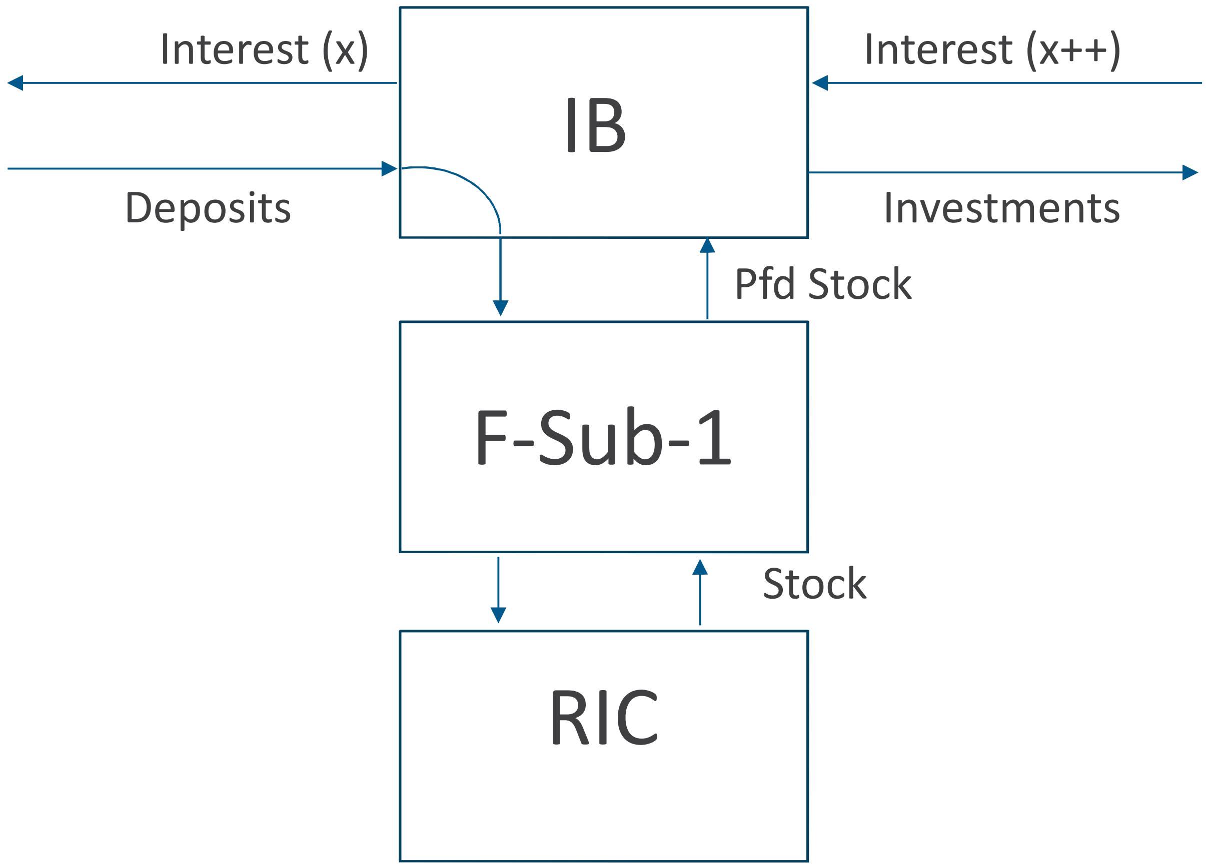
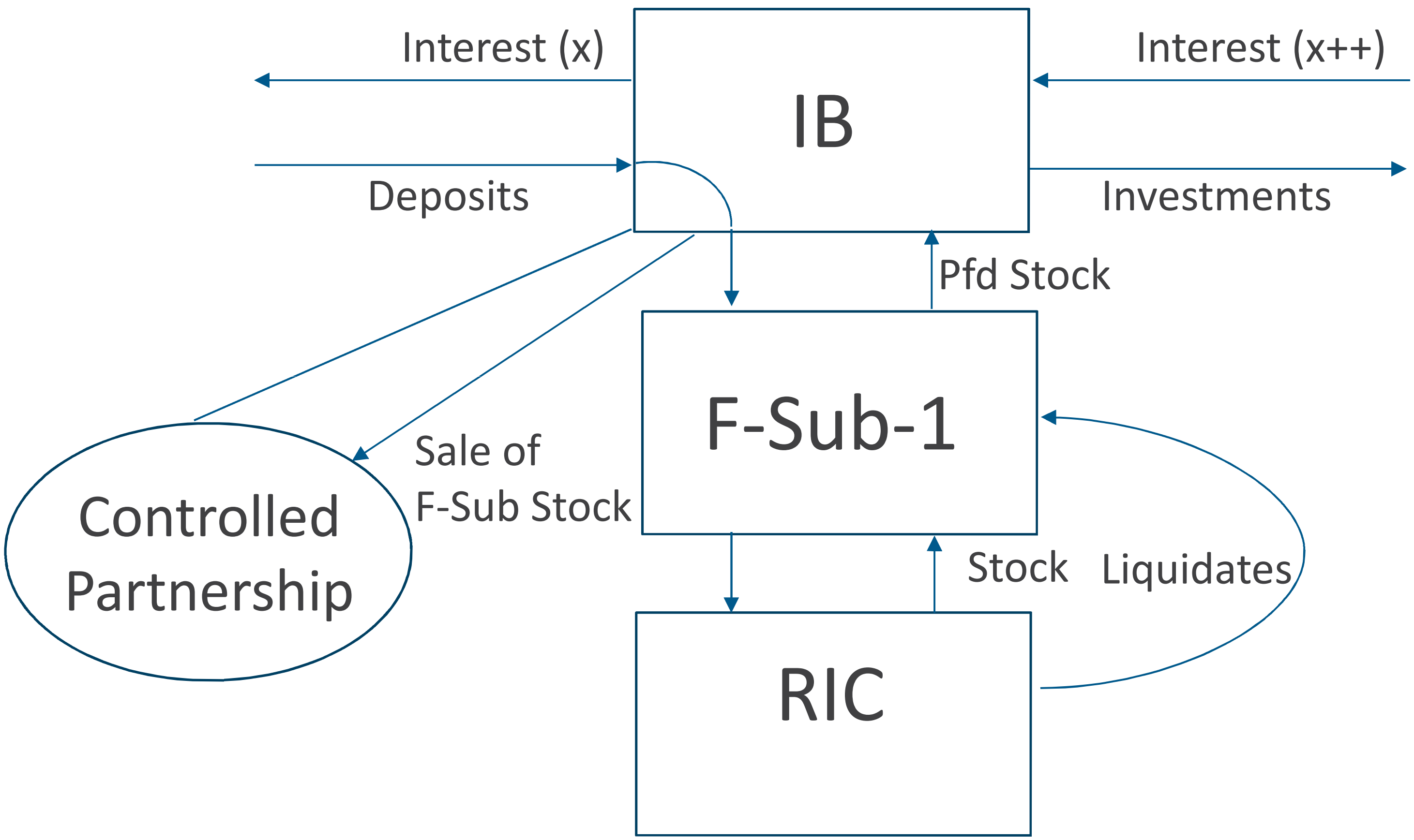
Chief Counsel Advice 201320014 (May 17, 2013)

CAA 201320014 Opening Transactions



CAA 201320014 Closing Transactions



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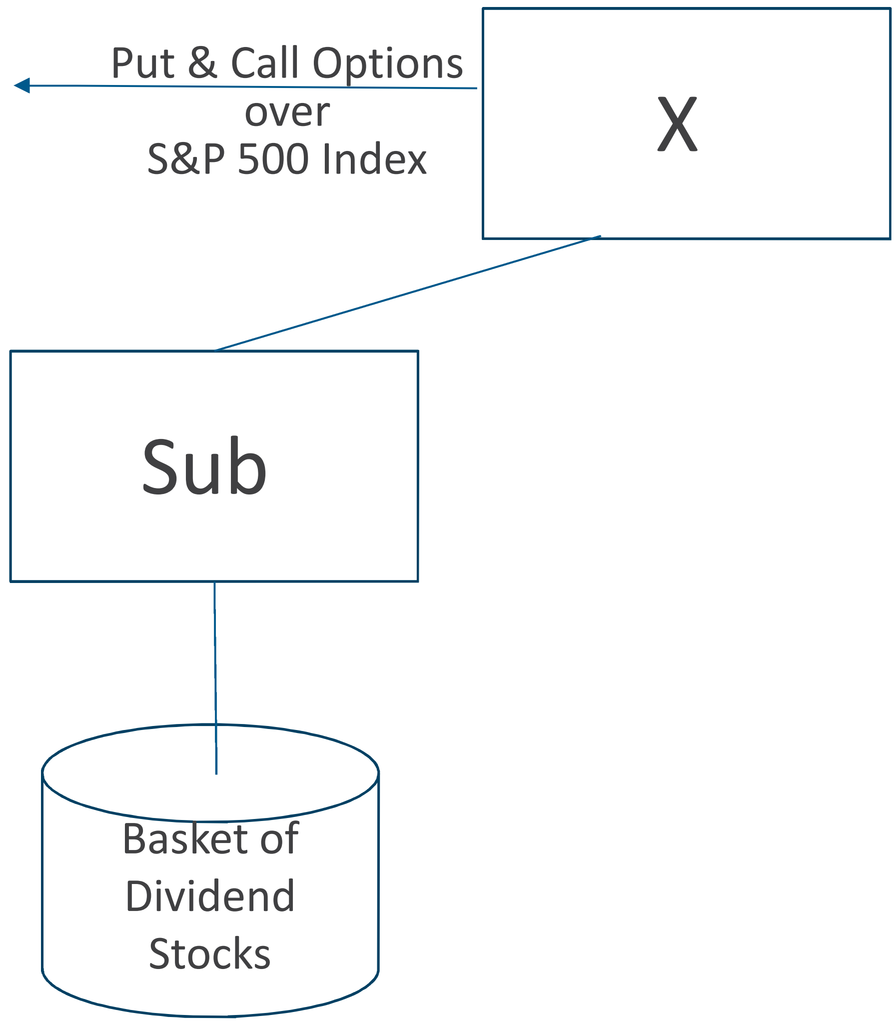
Field Attorney Advice 20131902F (May 10, 2013)

FAA 20131902F Transactions



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Section 871(m): New Proposed Regulations on Cross-Border Equity Linked Instruments

Tony Tuths, Partner, WithumSmith+Brown, PC
Ted Dougherty, Partner, Deloitte

April 2014

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Agenda

- Background
- Current rules
- Proposed regs [effective 1/1/16]
- Delta
- Qualified index exception
- Dividend equivalent amount
- Combination positions
- Special rules
- Determining party/withholding agent

Section 871(m): Brief History

- **March 18, 2010:** HIRE Act enacted
  - Section 871(m) enacted
  - Resourcing provision affecting "Specified NPCs"
- **January 19, 2012:** Temporary and Proposed regulations
  - Temporary regs covered swap payments made after March 18, 2012 but before January 1, 2013
  - Proposed regs were to apply to payments made on or after January 1, 2013
- **August 31, 2012:** Effective date of Proposed regs delayed and Temporary regs extended until December 31, 2013
- **December 4, 2013:** New Final and Proposed regulations
  - Finalized certain of the previous Temporary regulations
  - Withdrew the 2012 Proposed regulations
  - New Proposed Regulations (Prop. Effective Starting January 1, 2016)

Current Law Until January 1, 2016

- Keep doing what you are doing!

- Sec. 871(m): The statute applies to:
  - Payments made under a "Specified NPC" that are contingent upon, or determined by reference to, the payment of dividends on U.S. equities

  - "Specified NPC" is defined to include
    - Cross in
    - Cross out
    - Not readily tradable on an established securities market
    - Underlying posted as collateral

- Regulations have extended the statutory rules until Jan. 1, 2016

- No specific rules (other than common law recharacterization risk) during this period for:
  - MLP Swaps
  - Single Stock Futures

New Proposed Regs – Effective Dates

"871(m) Transaction" defined to include

- Specified NPCs
  - Effective for payments made on or after January 1, 2016
  - No grandfathering for pre-existing transactions

- Equity Linked Instruments
  - Effective for ~~payments made on or after January 1, 2016~~
  - ~~Exception for instruments acquired or entered into before March 5, 2014~~
  - Effective for ELIs issued on or after 90 days after the date the final regulations are published. Notice 2014-14 (March 4, 2014)

Proposed: After January 1, 2016

- Every financial contract referencing a U.S. equity will be a Section 871(m) transaction if the delta at acquisition is equal to or greater than 0.70, except:
  - Qualified Indices
  - *De minimis* U.S. equity reference (i.e., < 10% reference securities)
  - Corporate acquisition (i.e., derivative is part of plan to acquire > 50% value of underlying issuer)
  - Qualified Dealers
- Does not require any adjustment for, or pay-through of, an underlying dividend. Dividends are presumed to exist in every contract that references a U.S. equity (the "Implicit Dividend" rule)
  - Price only contracts may be subject to 871(m) withholding
- Exchange-traded instruments are explicitly covered
- Even debt instruments (e.g., convertible bonds and principal protected notes) can be subject to §871(m) withholding

Proposed Regs: Delta

- Delta is the ratio of change in FMV of the derivative to change in FMV of the underlying referenced security
  - If a $1 move in the underlying security value would produce a $0.75 move in the derivative value, then delta = 0.75
- Delta must be measured separately for each underlying security (except in case of a qualified index)
- Delta cannot be manipulated
  - A constant delta is treated as delta one
- Delta will need to be calculated and disseminated at time of derivative acquisition and, unless one year or less to maturity, each ex-dividend date (or record date, if earlier)
  - Once an 871(m) transaction, always an 871(m) transaction
- Key factors in calculating delta include stock price, time to expiration, interest rates, expected dividends, and implied volatility
- Proprietary data? Non-tax delta determination "ordinarily" is the delta used for 871(m) purposes

Proposed Regs: Qualified Index

- Qualified Index is not disaggregated into its component underlying equity positions and is not treated as an underlying security (i.e., §871(m) is inapplicable)
- A Qualifying Index is any index which, as of the date of acquisition:
  1. Index (TR or price only) has options or futures contracts that trade on a national securities exchange registered with SEC or a domestic board of trade designated by the CFTC
  2. There is a minimum of 25 underlying equities
  3. No one underlying equity makes up more than 10% of the weighting
  4. The index yield does not exceed 1.5 times the S&P500 yield for month preceding acquisition date
  5. References only long positions
  6. Is modified or rebalanced only according to predefined objective rules at set dates or intervals

Proposed Regs: Qualified Index, Cont'd

- More restrictive than 2012 Proposed Regulations
- Restrictive definition may cause mainstream indices to fail, contrary to Treasury intent
  - NASDAQ-100 currently fails (AAPL = 12.5%)
  - Certain Dow components sometimes exceed 10% weighting
  - Dow yield can exceed S&P by > 1.5x
- Measured at time of acquisition means that the same index may be qualified to some holders but not to others, and may be qualified or not *to same holder*
- *Any short position* (other than a short of the entire index) acquired by the taxpayer or a related person "in connection with" the long index position can disqualify the index
  - Withholding agent is held to "reasonable diligence" standard rather than the "know" standard applicable to combination positions

Dividend Equivalent Amount [“DEA”]

- A “dividend equivalent” is any payment pursuant to a specified NPC or specified ELI that references a U.S source dividend payment from a domestic C corporation (referred to as an “underlying security”), or a substitute payment made pursuant to a securities lending or repo transaction that references a U.S. source dividend payment
  - This would now include any amount that references an actual or estimated payment of dividends, whether the reference is explicit or implicit
  - The proposed regulations are broad and suggest that even price only derivatives include a reference to dividends
- For this purpose, a payment includes any gross amount used to compute a net amount
  - A taxpayer may be treated as receiving a dividend equivalent payment even though it is making a net payment

Dividend Equivalent Amount [cont'd]

- Determined at Ex-Dividend date (or record date, if earlier)
- If contract pricing uses estimated dividends or has "implicit dividend", short party can provide amount(s) in writing to long party at inception of trade
- Dividend amount is presumed to be actual dividend amount unless written notice is provided at trade inception and then is the lesser of the two amounts
- Payment is deemed to occur when amount of dividend becomes fixed regardless of payment date (no bullet swaps)
- DEA = # shares referenced x dividends p/s x Delta *at time of dividend* (except for < 1yr transactions)

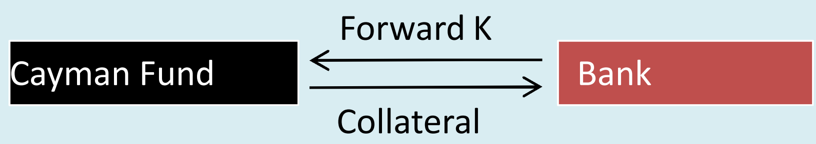
Dividend Equivalent Amount [Cont'd]

- One Year or Less Exception: Transactions with a maximum remaining term of one year or less at time of acquisition – DEA determined at termination / disposition / exercise.
  - Term includes all extension options
  - Lack of a specific term = term of more than one year
- Option Delta is treated as *zero* if option lapses
  - Permits lapsed options to escape withholding totally
- Option Delta is treated as *one* upon exercise
  - Will result in over withholding for exercised options
- Practical Consideration: All transferable options will require a payout formula adjustment to account for possible withholding tax
  - Option could become an 871(m) position for later holder when remaining term is less than one year

Dividend equivalents — Forward contract

- On January 6, 2016, Cayman Fund enters into an over-the-counter forward contract where it agrees to purchase 100 shares of XYZ stock at a price of $5,200 on January 6, 2018
  - The forward price will adjust if XYZ declares a special dividend during the term of the contract
  - At expiration, Cayman Fund has the option to settle the contract in cash or take delivery of the shares
- The forward price was calculated as follows:
  - current market price of the stock (e.g., $50.00 per share),
  - increased by financing and other costs during the term (e.g., 4.00% per annum), and
  - reduced by an estimate of dividends for which an ex-dividend date occurs during the term of the contract (e.g., $0.25 per share per quarter or $1.00 per share per annum)
- The forward contract has a delta of 1.00 because its value changes in an amount equivalent to any price move in XYZ stock
- Assume the contract cash settles at expiry such that Cayman Fund must make a payment to Bank (i.e., XYZ stock price has declined)

- In addition, total U.S. withholding tax of $60.00 is payable to the IRS if dividends of $2.00 per share are paid during the term of the forward contract ($200 x 30%)

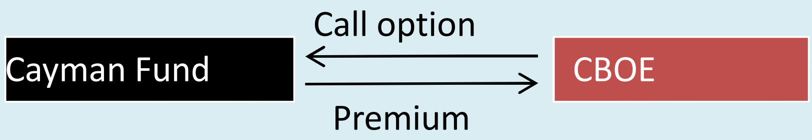


- Underlying security: XYZ stock (a U.S. corporation)
- Number of shares: 100
- Forward price: $5,200
- Adjustment: Special dividends, if any
- Expiration date: January 6, 2018
- Settlement method: Cash or physical

- *CAVEAT:* Neither the settlement method nor the potential adjustment of the forward price for special dividends were relevant to determine whether or not this contract was a specified ELI

Dividend equivalents — Option contract

- Cayman Fund enters into a listed call option on 100 shares of XYZ stock with a strike price of $40.00 per share on January 6, 2016
  - The option is "American style" meaning it is exercisable at any time
- The premium paid reflects a variety of factors including the current market price of the stock (e.g., $50.00) as well as an estimate of future dividends during the term
  - Assume a dividend amount of $0.50 per share during the term of the option
- Cayman Fund submits the trade through its executing broker on the Chicago Board Options Exchange (CBOE)
  - Upon settlement the position clears into Cayman Fund's prime brokerage account with a U.S. Bank
- Assume that the delta of the option at execution is 0.70 and that Cayman Fund takes delivery of the shares at expiry and pays the strike price
  - $50.00 dividend equivalent amount
  - $0.50 per share x 100 shares x 1.00 delta at expiry
- Cayman Fund's prime broker would withhold $15.00 of U.S. tax (i.e., $50.00 x 30%)



- Underlying security: XYZ stock (a U.S. corporation)
- Number of shares: 100
- Strike price: $40.00/share (i.e., $4,000)
- Expiration date: February 21, 2016
- Exercise style: American
- Settlement method: Physical

Proposed Regs: Combination Positions

- In making a determination of whether a transaction is an 871(m) transaction the determining party must combine two or more transactions if:
  - The transactions are entered into "in connection with" each other (regardless of timing)
  - The positions reference the same underlying security; AND
  - The long party to the transaction is the same person or a related person

- Withholding on combination positions is only required if the withholding agent has actual knowledge of the related positions
  - This relates to knowledge of the withholding agent, not the long party or parties
  - This standard does not incorporate the "reason to know" extension
  - Does actual knowledge encompass "institutional knowledge" (i.e., two different desks at single bank know of one position each)?

- For combined transactions, the delta threshold is tested each time the long party (or related person) acquires a combined position
  - However, a retest date cannot remove an 871(m) taint from a pre-existing transaction

Combination Positions: “In connection with”

- Examples provide some insight:
  - Positions acquired simultaneously are entered into in connection with each other
  - Positions acquired to adjust a preexisting economic position with respect to an underlying security are entered into in connection with each other
    - Purchase of six month call option on Stock X (delta = 0.45) followed THREE MONTHS LATER by sale of three month put option (delta = 0.25, call delta then = 0.65)
    - “Because FI wrote the put option referencing Stock X to adjust FI’s economic positions associated with the call option referencing Stock X, these options are entered into in connection with each other and treated as a combined transaction…”
    - Query whether the determination is subjective (e.g., investor’s motivation to adjust existing position) or objective (e.g., same underlying security and coterminous options) . Must require more than just same underlying for limiting words, “in connection with”, to have any meaning.

Proposed Regs: Delta Combinations

Long Call	Short Call	Long Put	Short Put
Delta Positive	Delta Negative	Delta Negative	Delta Positive

- Combined positions can <u>only increase </u>delta, no negative adjustments
  - Butterfly options (long 1 call @ spot-A; short 2 calls @ spot; long 1 call @ spot+A) – results in the addition of two positive deltas but no reduction for the two negative deltas. Causes a limited risk trade to become an 871(m) trade
- One ATM call option = delta 0.5 on 100 shares. Two ATM call options = 0.5 delta on 200 shares. BUT combined delta = 1.0 = 871(m) transaction? On how many shares?
- Does a single complex payoff contract permit delta netting (i.e., one contract with butterfly payoff = low delta)? Delta determined separately only if ELI references "more than one underlying security" that is not a qualified index. But ELI is defined to include "option". "Option" is defined to include options embedded in host contracts.

Proposed Regs: Special Rules

- **Dealer Exception**: 871(m) is inapplicable where long party is "Qualified Dealer" acting in its capacity as a dealer in securities
  - Qualified Dealer is any dealer subject to regulatory supervision by a governmental authority in its home jurisdiction and furnishes a written certification to the short party that it is a qualified dealer and will withhold and deposit tax pursuant to 871(m) if required
    - Certification is not limited to particular transaction, it applies to all required withholdings where foreign dealer is the short party to a §871(m) transaction
  - Exception does not apply to proprietary positions
- **Interests in non-corporate entities**: If transaction references an entity other than a C corporation then a look-through approach is utilized
  - Exception where underlying securities represent 10% or less of notional value
  - Look-through is direct or indirect, mandating multiple level analysis
  - Look-through is for C corporation shares as well as other 871(m) transactions

Proposed Regs: Special Rules [cont'd]

- **Corporate Acquisition** exception – a transaction will not be an 871(m) transaction if:
  - The transaction obligates the long party to acquire [alone or with others, pursuant to a plan] underlying securities representing > 50% of the value of the issuer, and
  - The long party furnishes a statement to the short party under penalties of perjury that this exception applies
- **Anti-abuse Rule**: If a taxpayer directly or indirectly acquires a transaction or transactions with "a principal purpose" of avoiding 871(m), the Commissioner may bring the transaction(s) within 871(m)
  - Extremely broad anti-abuse power

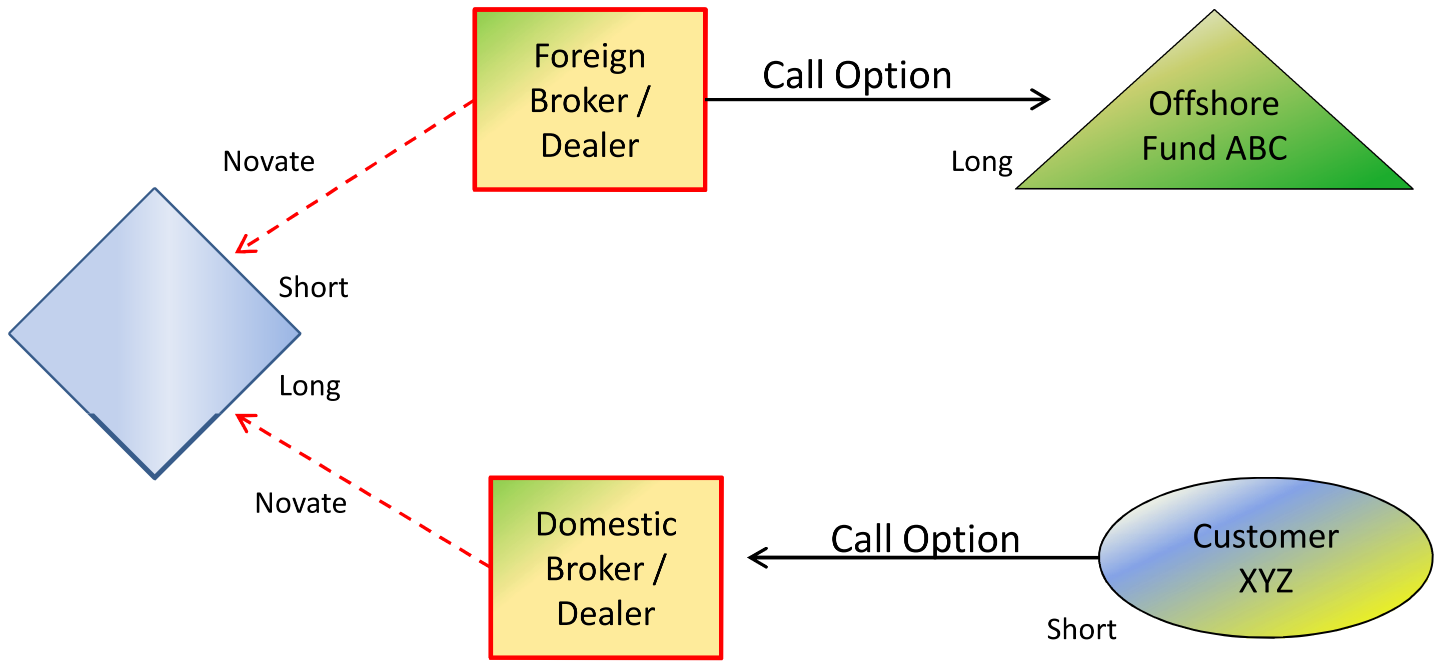
Proposed Regs: Determining Party

- The Determining Party is the short party broker/dealer (or long party if it is the only broker/dealer party to the trade)
  - If no broker/dealer party then the Determining Party is the short party
- Determining party must:
  - Determine if the transaction is an 871(m) transaction
  - Determine and report the amount and timing of dividend equivalent payments
  - Note, this requires delta determination
  - Exercise reasonable diligence
- Determining party must provide, upon request by any broker, withholding agent or party to the transaction:
  - The delta of the transaction (at acquisition and at dividend date)
  - The amount of any tax withheld and deposited
  - The estimated or implicit dividend amounts, if applicable (as provided by the Short Party)
  - Any other information necessary to comply
  - Requests must be complied with within 14 calendar days or less
- Determinations are binding on parties to transaction and withholding agent unless person has actual knowledge or reason to know that information is incorrect (Query the effect, if any, of an independent delta calculation)

Proposed Regs: Withholding Agent

- The withholding agent is any person that is a party to any contract or arrangement that provides for the payment of a dividend equivalent
  - Can be domestic or foreign person
- No adjustment or payment under the derivative is required to trigger the withholding obligation – just the underlying dividend record date
- If there is no net payment to withhold from at the time the dividend equivalent is determined, then withholding agent is permitted to defer its withholding tax payment until the agent is deemed to have:
  - Control over money or property paid to or from the long party;
  - Custody or control over money or property of the long party at any time on or after the amount of a dividend equivalent is determined; or
  - The 871(m) transaction provides for an upfront payment or prepayment of purchase price even though an actual payment has not been made at the time of dividend equivalent determination
- Proposed withholding payment pool includes property of the short party (albeit transferred from the Long Party originally) – this may cause short parties to increase upfront payment amounts and collateral postings by anticipated withholding amounts

Determining Party & Withholding Agent



- Assuming the long call acquired by Fund ABC is an 871(m) transaction
  - Both Foreign Broker/Dealer and the O.C.C. are withholding Agents
  - Is Foreign Broker/Dealer the "Determining Party"? It is the broker/dealer party to the 871(m) transaction but becomes merely a agent / nominee after novation.

Proposed Regs: Withholding Issues

- Exchange traded instruments
  - New example clarifies that both the clearing organization and a non-U.S. clearing member (including a non-QI) can be withholding agents on the same transaction
  - Clearing organization must withhold on certain exchange traded instruments
  - Currently only clearing members have withholding systems
- Withholding by CUSIP, ISIN or other I.D. method will no longer work
  - Due to delta testing at time of acquisition, instruments with a secondary market may be 871(m) trades to some holders and not to others despite otherwise being fungible instruments
  - An instrument once subject to withholding may cease to be when exchanged to new holder
  - Identical OTC instruments will have varied withholding tags due to separate acquisition dates, perhaps even to the same holder (e.g., upsize of existing OTC trade at later date)
  - How do issuers handle delta movement between pricing date and issue date?
  - Portfolio interest is no longer a clean exemption

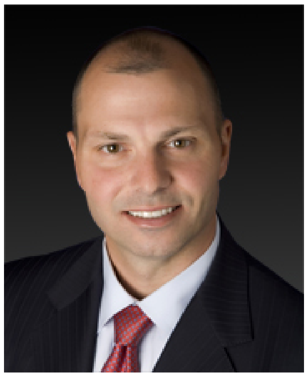
Proposed Regs: Withholding Issues

- Cascading Withholding
  - The proposed regulations make no attempt to counteract the potential for multiple withholdings on the same dividend equivalent payment
  - Previous (2012) proposed regulations elicited numerous comments that final regulations should incorporate specified NPCs and similar instruments into the Notice 2010-46 regime
  - Preamble to 2013 proposed regulations explicitly recognizes the issue but relates it mainly to the sub-issue of non-U.S. dealers facing customers.
    - Issue deemed resolved by allowing for the Qualified Dealer exemption

Section 871(m) Effective Dates

Situation	Payments made from Sept. 18, 2010 - Dec. 31, 2015 (Statute and final regulations)	Payments made on or after Jan. 1, 2016 (Proposed regulations)
NPC: Cross-in trade	871(m) applies	Not relevant
NPC: Cross-out trade	871(m) applies	Not relevant
NPC: Underlying not readily tradable	871(m) applies	Not relevant
NPC: Underlying posted as collateral	871(m) applies	Not relevant
NPCs and ELIs with a delta of 0.7 or more	Not relevant	871(m) applies
Index-linked instruments	No specific rules for index-linked contracts	871(m) does not apply if linked to a Qualified Index
NPC or ELI that is price only or based on estimated dividends	871(m) should not apply	871(m) applies if delta of 0.7 or more
Common law ownership	Still may be asserted	Still may be asserted

Presenter: Anthony Tuths



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Debt-Equity Update

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April 2014

Financial Instruments & Strategies

Agenda

- Review of Basic Principles
- Recent Significant Decisions
  - *Scottish Power, PepsiCo, HP*
- Recent Case Filings
  - *Ingersoll Rand, Tyco International Ltd.* (consolidated cases)
- Select Planning Considerations
  - Guarantee Fees
  - Netting and Cash Management Systems
  - Debt Modification (IRC § 1001)
- OECD and BEPS Discussion Drafts

Debt-Equity

Basic Principles

Basic Principles: Multi-factor Tests

- **Multifactor Tests:** Courts have developed a number of multi-factor tests for determining whether to characterize an instrument as debt or equity. The IRS listed eight factors to be considered in Notice 94-47, 1994-1 C.B. 357.
- **Tax Court Synthesis:** In *Litton Business Systems*, the Tax Court synthesized the tests into three questions.

Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972)
1. Labels 2. Maturity dates 3. Source of principal repayment 4. Enforceability 5. Management participation 6. Subordination 7. Intent 8. Capitalization 9. Identity of interest 10. Source of interest payments 11. Ability to obtain third-party loans 12. Purpose 13. Repayment

Litton Bus. Sys., Inc. v. Comm'r, 61 T.C. 367 (1973)
1. Intent. Was there a "genuine" intent to create a debt? **2. Reasonableness.** Was there a reasonable expectation of repayment? **3. Economic Realities.** Did the intent to create a debt match the economic realities of a debtor/creditor relationship?

Recent Case Law

Traditional Debt-Equity Cases:

NA Gen. P'ship (Scottish Power) v. Commissioner

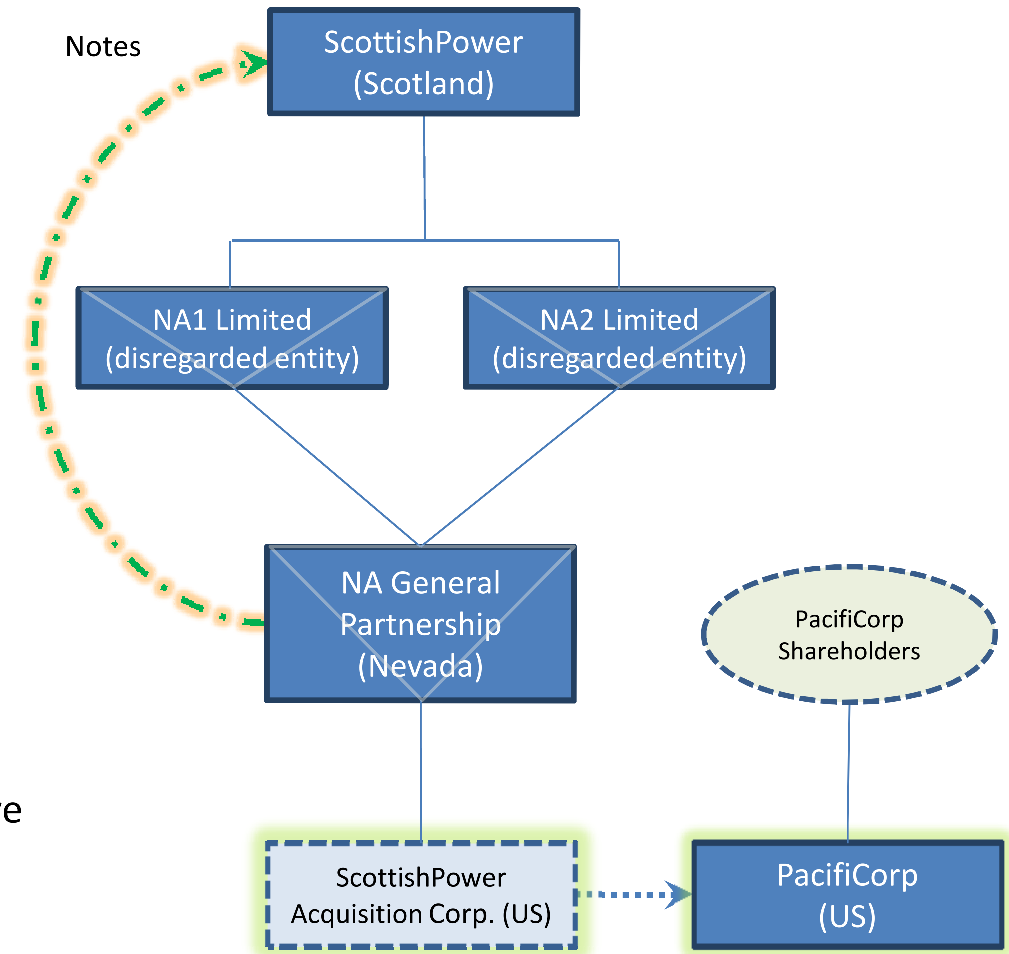
Non-Traditional Debt-Equity Cases:

PepsiCo Puerto Rico, Inc. v. Commissioner

Hewlett-Packard Co. v. Commissioner

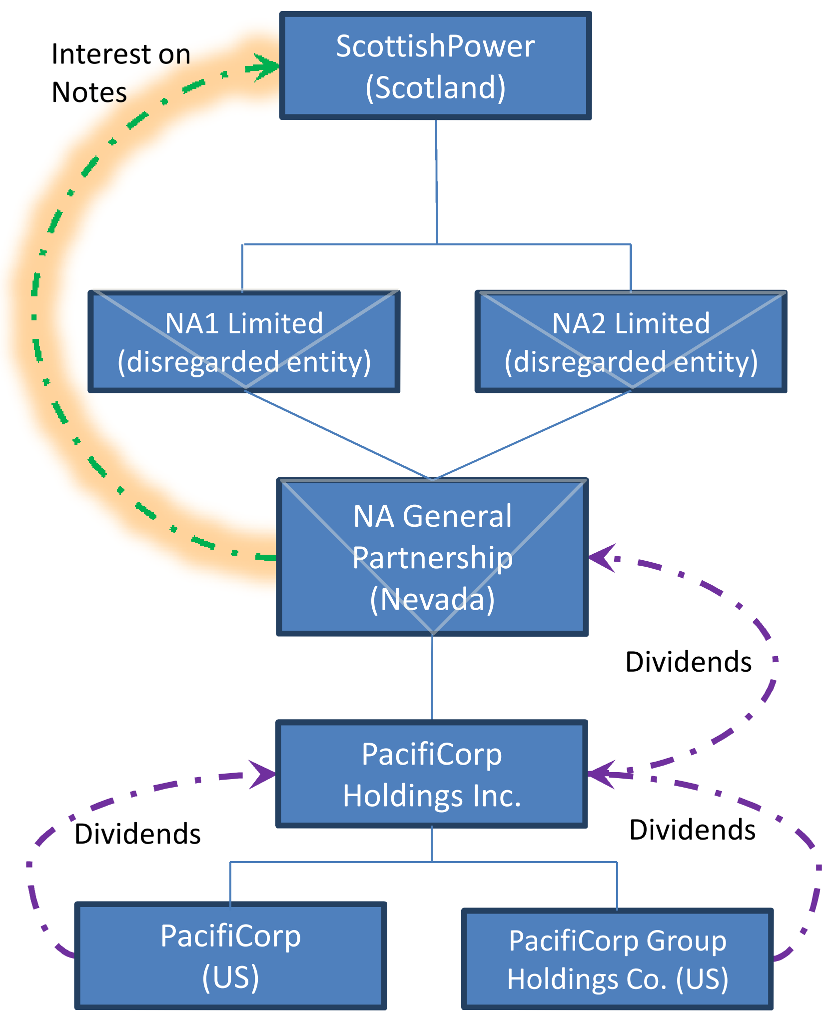
NAGP v. Commissioner (Scottish Power)
Simplified Transaction

- ScottishPower acquired PacifiCorp in a stock-for-stock transaction.
- PacifiCorp became a direct subsidiary of NAGP and issued new shares of common stock to NAGP.
- NAGP issued $4.8 billion of fixed- and floating-rate notes to ScottishPower.
- The notes' principal balance was 75% of the purchase price of PacifiCorp.
- **The Tax Court upheld debt treatment:**
  - Opinion based on Ninth Circuit's *Hardman* multi-factor test.
  - Contrary to IRS assertion, taxpayer's desire to obtain deductions indicates intent to create debt.
  - Later recapitalization not determinative where it was in response to changed economic circumstances.
- Contrast with *Laidlaw* (T.C. Memo 1998-232)



NAGP v. Commissioner (Scottish Power)

Simplified Transaction (continued)

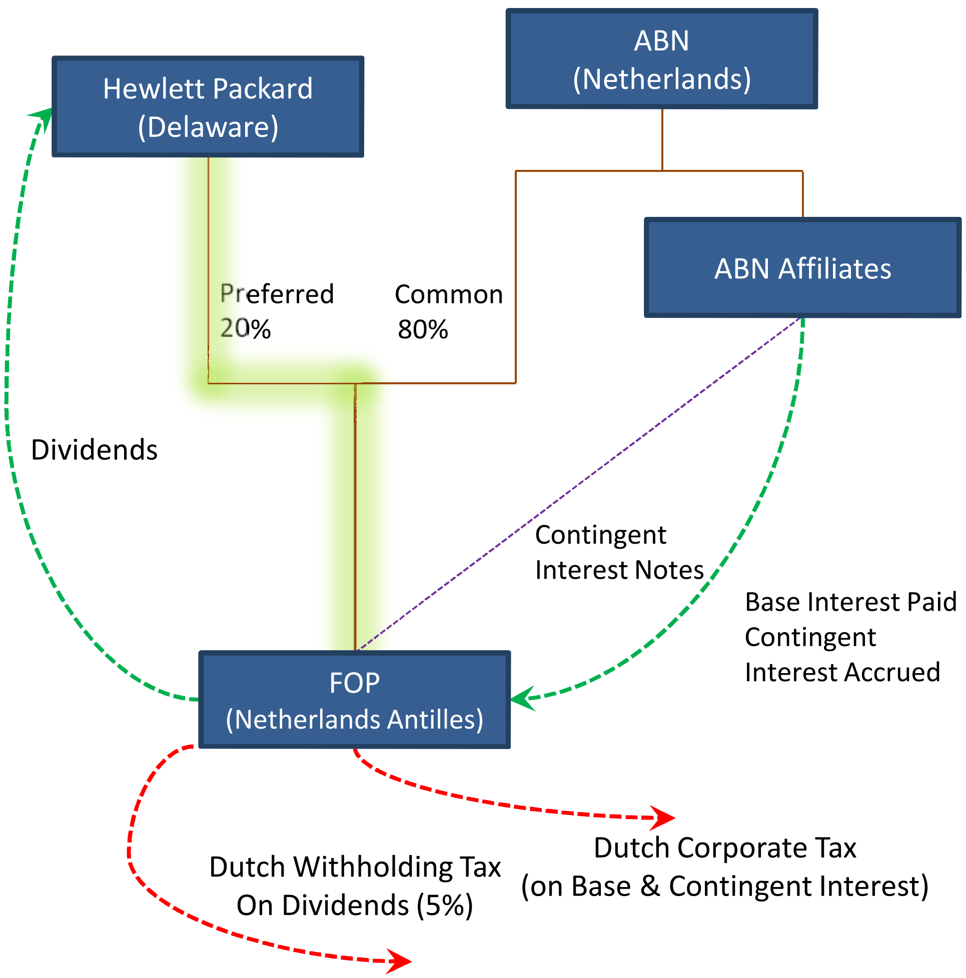


Resulting "Double-Dip" Structure

- **US Tax**
  - **Dividends:** NAGP elects to be treated as a corporation for US tax purposes.
  - **Interest Payments:** NAGP deducts interest payments.
- **UK Tax**
  - ScottishPower treats NA1, NA2 and, NAGP as partnerships.
  - **Dividends:**
    - PacifiCorp payments to NAGP carry tax credits for US taxes paid by PacifiCorp.
    - **Result—**Credits reduce or eliminate UK tax on dividends PacifiCorp pays to NAGP.
  - **Interest Payments:**
    - ScottishPower takes interest deduction for payments made by NAGP.
    - **Result—**No net income for UK tax purposes.

The Court did not address this issue in the opinion.

Hewlett-Packard v. Commissioner
Court's Analysis



Analytical Framework

- The IRS attacked on debt-equity, step-transaction, and economic-substance grounds.
- The Court reached only the debt-equity question, applying the Ninth Circuit's multi-factor test.
- **IRS Wins—**The Tax Court holds HP's investment is debt.

Debt-Equity Analysis

- **Scope of the Analysis:**
  - The Court looks beyond HP's preferred stock.
  - The Court also looks to agreements between HP and ABN.
- **Economic Incentives:**
  - The Court looks to economic incentives created by the agreements between HP and ABN.
  - **Example—Maturity Date.**
    - No maturity date on HP's preferred stock.
    - But HP has a put option exercisable in seven years.
    - And, in seven years, HP would no longer receive the tax benefits of the transaction.

PepsiCo v. Commissioner
Court's Analysis

Debt-Equity Analysis

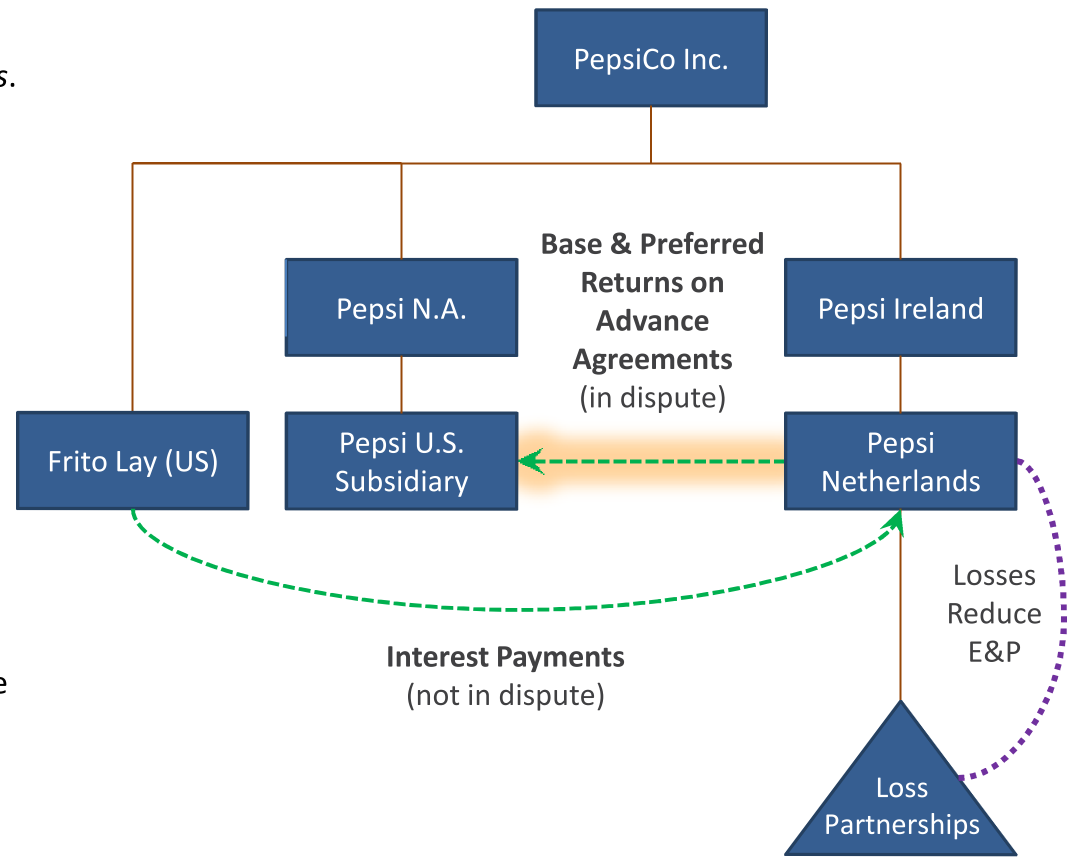
- Applies Tax Court's multi-factor test from *Dixie Dairies*.
- **Taxpayer Wins:** Court finds that Pepsi's investment is equity.

Scope of the Analysis

- Court looks to Pepsi's ruling from the Dutch tax authorities.
- But Court rejects IRS's substance-over-form argument, which the Court criticizes for substantively integrating various Pepsi subsidiaries merely because they are related parties.

Economic Incentives

- The IRS argued that a Dutch tax ruling on the Advance Agreements compelled the Dutch subsidiary to pay base returns with interest from the Frito Lay Notes.
- The Court disagrees:
    - Dutch law did not penalize Pepsi for failing to meet the condition; and
    - And there were no adverse Dutch tax consequences if Frito Lay defaulted and the Dutch subsidiary quit making payments.



Non-Traditional Cases
Reconciling the New Cases

Risk?

- Early cases define "equity" in risk terms. *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694 (3d Cir. 1968) ("risk capital entirely subject to the fortunes of the corporate venture.").
- The Court's analysis in *Pepsi* focuses on evidence that Pepsi's investment was actually at risk.
- Another recent case explicitly centers its debt-equity analysis on risk. *Chemtech v. United States*, 2013-1 U.S.T.C. ¶ 50,204 (CCH) (Feb. 26, 2013).

Economic Substance or Business Purpose?

- **Black Letter Rule:** Whether an investment represents a debt or an equity interest is decided using the multi-factor tests without a separate economic-substance analysis.
- **But . . .**
  - In *Pepsi*, the taxpayer wins, and the Court's findings of fact begin with a detailed discussion of Pepsi's business and the reasons for the restructuring that put the advance agreements in place.
  - In *Hewlett-Packard*, the taxpayer loses, and the Court begins with a discussion of the transaction's origins at AIG Financial Products.

Debt-Equity

Recent Filings

Ingersoll Rand (Petition filed)

Tyco International Ltd. (Petitions filed, cases consolidated)

Recent Filing: *Ingersoll Rand*

- The Tax Court petition (filed November 1, 2013) lays out the basic facts:
  - A US subsidiary of Ingersoll-Rand Co. Ltd. (Bermuda parent) made interest payments to related entities in Luxembourg, Hungary and Barbados (the "Lenders").
  - The treaties with these countries reduced withholding tax on interest to either 0% (Luxembourg & Hungary) or 5% (Barbados).
  - Some of the relevant notes were initially held by a related Bermuda entity, and were contributed to the Lenders prior to the interest payments at issue.
  - On receipt of the interest at issue, the Lenders issued new loans to related Bermuda entities in the amount of the interest received. (In one instance, a series of loans were made, with the final loan being made to a Bermuda entity)
- The IRS position in the Notice of Deficiency is that the interest payments originating in the US should be recharacterized as payments to related entities in Bermuda.
  - With no applicable treaty, the deemed interest payments to Bermuda would be subject to withholding at the full 30% rate under section 1442.
  - The Notice specifically invokes conduit, treaty shopping, substance over form, and step transaction principles.

Recent Filing: *Tyco International Ltd.* (multiple cases)

- Fifteen related cases filed in the Tax Court in June and July 2013.
- The cases were consolidated in February and recently assigned to Judge Kroupa.
- The petitioners were all subsidiaries of Tyco International Ltd. (Bermuda parent) during the 1997–2000 years at issue.
- The petitions describe the basic facts:
  - The petitioners, many of which were formerly independent companies acquired by Tyco during the years at issue, had capital structures including both debt and equity.
  - The debt portion of the capital structures generally consisted of loans from a related entity based in Luxembourg.
  - Among other factors indicating the character of debt, the petitioners made timely interest payments and consistently treated the loans as debt in both the borrower and lender jurisdictions.
- The IRS position in the Notices of Deficiency is that the debt is not *bona fide* indebtedness for U.S. tax purposes (i.e., this is a traditional debt-equity controversy).
  - A related IRS position is that because the debt should be recharacterized as equity, the interest payments should be treated as dividends subject to withholding tax at a 5% treaty rate.

Debt-Equity: Planning Considerations

Guarantee Fees

Definitions and Principles

Arm’s Length Pricing

Guarantee Fees: Is it a Guarantee?

- **Traditional Definition:** "a promise to answer for the payment of some debt . . . in case of the failure of another who is liable in the first instance." *Black's Law Dictionary.*
- **A number of intercompany arrangements could be considered guarantees:**
  - **Letters of Awareness**—statements by a parent that it is aware of a transaction between a subsidiary and a third party;
  - **Comfort Letters—**statements by a parent of its present intent regarding a subsidiary (*e.g.*, a statement that a parent does not intend to make changes in ownership or that a parent will exert its influence to ensure the subsidiary meets its obligations);
  - **Keep-Well Agreements**—agreements under which parent promises to provide specified amounts of funds to the subsidiary to ensure the subsidiary can meet its obligations; and
  - **Implicit Support**—benefits a subsidiary enjoys because of its passive association with a group of affiliated companies.

Guarantee Fees: Is it Compensable?

- **No Guidance**
  - In 2006, the Treasury Department announced that it intended to issue transfer pricing guidance on financial guarantees. *See* T.D. 9278, 2006-2 C.B. 256.
  - Treasury has yet to offer guidance and neither section 482 nor the regulations provide guidance on when compensation is required for an intercompany guarantee.
- **ABA 2012 Comments - Proposed Standard:**
  - Did the guarantee provide “direct and identifiable economic benefits to an affiliate?”
  - Examples:
    - Difference in interest rates with and without the guarantee; and
    - Reduced administrative costs related to less restrictive covenants.

Guarantee Fees: What is the Arm's Length Price?

- **Available Methodologies**
  - If the Services Regulations apply, the only applicable specified method is the CUSP Methodology.
  - If the Services Regulations do not apply, available approaches would include unspecified methods, including:
    - Financial-Insurance Cost Approach (pricing based on insurance pricing models);
    - Put Option Approach (treating guarantees as being akin to a put option and pricing accordingly);
    - Yield-Spread Approach (determining the guarantee's value by determining the yield spread on the issuance with and without the guarantee and allocating the value between borrower and guarantor); and
    - Credit Default Swap Pricing Approach (pricing based on the market prices for credit default swaps).

Guarantee Fees: What is the Arm's Length Price?

- **What is the role of implicit support?**
  - **ABA 2012 Comments**: Implicit support should not play a significant role in the pricing of a guarantee.
  - **OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (2013):**
    - Credit enhancement resulting only from implied support of the parent is non-compensable.
    - Credit enhancement resulting from a formal guarantee is compensable.
- **GE Capital Canada case—Canadian Federal Court of Appeals**
  - At issue in GE was the value of a parent's explicit guarantee of a subsidiary's debt.
  - While the taxpayer prevailed, the Court rejected the argument that any consideration of implicit support was inconsistent with arm's length analysis.
  - Instead, the Court held that the issue is how much the addition of an explicit guarantee, on top of implicit support, would affect the interest rates at which the subsidiary could borrow.

Guarantee Fees: Future Developments

- **Forthcoming Guidance**
  - The IRS first announced that it intended to issue guidance in 2006. *See* T.D. 9278, 2006-2 C.B. 26.
  - Since then, the Service has stated that it is continuing to analyze financial guarantee issues, including whether an intercompany financial guarantee is compensable and if so, the methods for pricing the applicable fee. *See* 18 Tax Mgmt. Trans. Pric. Rep. (BNA) 1007.
- **Stay Tuned . . . .**

Debt-Equity: Planning Considerations

Netting and Cash Management Systems

General Principles

Authorities

Interaction with Cash Management

Netting and Cash Management: General Principles

- Courts generally respect the separate economic ownership of cash pooled/deposited in a cash management system.
  - This issue comes up in bankruptcy and tort actions, where the purported intermingling of funds in a cash management account gives rise to a claim by creditors/plaintiffs that the corporate form should not be respected and a parent should be liable for the debts or tort liability of its subsidiary.
- In a Tax context, cash management systems are not *per se* suspicious or disregarded, but their treatment is heavily fact-dependent.
- See, e.g., *Gulf Oil v. C.I.R.*, 87 T.C. 548 (1986):
  - The Tax Court respected a cash management account used by Gulf Oil, but rejected the application of an exception to Section 956 that Gulf Oil was relying on.
  - Gulf Oil argued that the FIFO convention should apply to foreign subsidiaries' cash deposited with a U.S. entity, but due to its inability to trace individual transactions, the Tax Court held that the subsidiaries' persistent positive balances did not fall within the exception for indebtedness repaid within one year from the time it was incurred.
  - "The cash management system of Gulf and its affiliates apparently satisfied its avowed purposes of avoiding inefficient movements of cash and centralizing cash assets to take advantage of investment opportunities. Nevertheless, this does not alter the fact that the payable balances of the cash management system create one of the situations at which section 956 was aimed." *Id.* at 574.

Netting and Cash Management: Recent Authorities

- *Rent-A-Center v. C.I.R.*, 142 T.C. No. 1 (2014) (reviewed decision)
  - Captive insurance case involving a Bermudian insurance subsidiary, Legacy.
  - The payment of premiums via intercompany netting prompted differing views from Tax Court judges:
    - J. Foley majority: ". . . petitioner established that there was nothing unusual about the manner in which premiums and claims were paid. Finally, respondent contends that the netting of premiums owed to Legacy during 2003 is evidence that Legacy was a sham. We disagree. **This netting was simply a bookkeeping measure performed as an administrative convenience**." slip op. at 18.
    - J. Lauber dissent: ". . . Legacy **did not actually pay 'loss claims'** submitted by the supposed 'insureds.' **Rather, the parent's accounting department netted 'loss reimbursements' due to the subsidiaries from Legacy against 'premium payments' due** . . . This modus operandi shows that Rent-A-Center regarded Legacy not as an insurer operating at arm's length but as a bank account into which it made deposits and from which it made withdrawals ." slip op. at 74.

Netting and Cash Management: Recent Authorities

- *Kimberly Clark v. Commissioner of Revenue*, No. C282754, Mass. App. Tax Bd. (Jan. 31, 2011); *aff'd* 83 Mass. App. Ct. 65 (Jan. 11, 2013).
  - Advances made through a cash management system were not considered debt due to "factors which indicated the permanent nature of the excess cash advances made within the appellants' cash-management system, including the absence of requests for, effort toward, or expectation of repayment or actual repayment…"
  - Regarding a separate royalty deduction issue, the board denied that royalties were paid when the payments "effectively were immediately returned to [parent], by way of the cash-management system." 83 Mass. App. Ct. at 70.
- CCA 201334037 (Chief Counsel Advice) (released Aug. 18, 2013):
  - Taxpayer could not deduct interest under section 267 where it routinely received additional advances (in various forms) from its foreign parent or subsidiaries of the foreign parent. In some instances, the additional advances were earmarked for payment of interest.
  - Some of the interest payments described were paid by netting a new advance against accrued interest, although the CCA does not focus on this distinction.
  - "In form, foreign parent [lender] received wire transfers in 'payment' of claimed interest but, because of the further advance of further funds to the taxpayer, in substance actually achieved no economic change in position."
  - This fact pattern echoes *Laidlaw*, T.C. Memo 1998-232.

Netting and Cash Management: Interaction with Debt-Equity

- Two of the key debt-equity precedents reference netting and cash management, but these systems were not determinative of the Court's ultimate decision or reasoning.
  - *See Nestlé Holdings*, 70 T.C.M. 682 (1995) (upholding debt treatment, with interest paid "primarily through the Nestlé netting system"); *Laidlaw Transportation*, 75 T.C.M. 2598 (1998) (rejecting debt treatment on advances made through "Centralized Cash Management System").
- However, we have seen the IRS raise questions about the use of netting and cash management accounts in debt-equity disputes:
  - One argument is that a borrower used advances on its cash management account to pay interest; this casts doubt on the borrower's ability to service the loan without additional borrowing.
  - If a lender acts as a pooling entity in the cash management system, then the IRS may raise economic substance, sham, or circular flow theories, i.e., the loan never existed because the *principal* was immediately repaid when it was put on deposit with the lender.
  - The IRS may argue that payment of *interest* is circular, i.e., the debtor drew down on its cash management account balance with the lender in order to pay interest on its formal debt with the lender.
- The common theme is that the IRS may try to disregard the separate economic and legal ownership of cash held in a cash management account.

Netting and Cash Management: Interaction with Debt-Equity

- IRS guidance mentioning cash management often addresses situations where the systems were purportedly used to effect circular flows of funds:
  - FSA 200050013 (2000): Corp X made a series of loans to Corp Z followed immediately by dividend distributions from Corp Z to Corp X. These transactions were reflected by journal entries in a CMA utilized by all the corporations. . .The transaction did not have economic substance because there was no net change in the economic position of the parties. *See also* FSA 200014014 (1999) (similar).
  - FSA 1996 WL 33320985: Parent established revolving lines of credit with its Subs. Because the Subs received more in additional loans than they paid in interest, the IRS believed that most of the transfers can be disregarded as circular. Additionally, "[t]o the extent the payments were not directly circular, we can argue that, because of the cash management account, [the borrowers] never actually paid off the purported debt."
- The IRS may also criticize CMA agreements that do not pay/charge interest on balances or that fail to use terms and covenants similar to third-party banking arrangements or lines of credit.

Debt-Equity: Planning Considerations

Debt Modification (IRC § 1001 Events)

Debt Modification: General Principles

- **Section 1001 generally addresses the computation of gain or loss on the sale or disposition of property.**
  - Under the regulations, certain modifications to debt instruments will be considered an exchange that triggers gain or loss. Treas. Reg. §§ 1.1001-1(a), 1.1001-3(a) .
  - The modification must "significant" to be considered an exchange.
  - This regime applies to related-party debt as well as third-party debt.
- **What constitutes a modification?** (Treas. Reg. § 1.1001-3(c))
  - A modification is broadly defined as any alteration, including the addition, removal or alteration of legal rights.
  - A modification can occur through the conduct of the parties, although forbearance by the issuer in exercising a right under the instrument for up to two years will not be considered a modification.
  - Alterations occurring by operation of the debt instrument are often excluded, e.g., trigger events that alter the interest rate.
    - Certain major alterations occurring by operation of the instrument will still count as modifications, including changes in the obligor, in the recourse nature of the debt, or that effectively convert the instrument into equity.

Debt Modification: General Principles

- **What makes a modification significant?** (Treas. Reg. § 1.1001-3(e))
- **The regulations provide specific tests for certain common alterations** (with multiple changes to a particular term considered cumulatively)**:**
  - Yield: For fixed rate instruments, only changes of more than 25 bps or 5% of the existing yield (whichever is greater) will be significant.
  - Payment timing: Significant if the change results in a “material deferral” determined under all facts and circumstances, with a safe harbor for deferral of the lesser of 5 years or 50% of the life of the instrument (measured from the due date of the first deferred payment).
  - Change in obligor or security interest: Varies by type of debt (e.g., substitution of obligor for recourse debt = always significant, non-recourse = not significant).
  - Addition or removal of co-obligors is not significant unless the change affects payment expectation or is part of a plan to substitute one obligor for another.
  - Changes that effectively turn debt into equity are significant.
  - Changes in recourse will generally be significant, except for changing recourse debt to nonrecourse debt where the collateral and payment expectations are unchanged.
  - Accounting or financial covenants: Adding or removing “customary” covenants is not significant.

Debt Modification: General Principles

- **What makes a modification significant? (continued)**
  - For alterations not covered by a specific rule, the modification is significant if it is "economically significant" given all facts and circumstances.
  - Modification of provisions not covered by specific rules are considered collectively, i.e., several insignificant changes may result in a significant change overall.
- **Modifications affecting debt vs. equity status** (Treas. Reg. § 1.1001-3(f)(7))
  - Evaluating whether a modification changes an instrument from debt to equity requires evaluating the modified instrument under the traditional multi-factor tests. *See, e.g., Estate of Mixon*, 464 F.2d 394 (5th Cir. 1972), *Litton Business Systems*, 61 T.C. 367 (1973).
  - Deterioration of the obligor's financial condition in the time since the debt was issued is generally not considered, even though poor financial condition would be a significant consideration for new debt.

Debt-Equity: Recent Developments

OECD: BEPS Discussion Drafts

OECD: BEPS July 2013 Action Plan

- One of the 15 actions identified by the OECD in the July 2013 BEPS Action Plan was to "neutralize the effects of hybrid mismatch arrangements."
- Specifically, Action 2 proposed consideration and further study of:
  - (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;
  - (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor;
  - (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);
  - (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and
  - (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.

OECD: March 2014 Discussion Drafts

- Two discussion drafts related to Action 2 were released on March 19, 2014
- One draft discusses suggested changes to domestic laws
  - A common theme is that the law should target the mismatch itself, rather than focusing on rules for establishing in which jurisdiction a tax benefit arises.
  - The challenge will be to implement ordering rules that prevent double-taxation. The draft indicates that there should be a "primary rule" as well a "defensive rule" that comes into effect only when the primary rule is not implemented in the counterparty jurisdiction.
  - For example, for structures that create double deductions (deductions for both the investor and its subsidiary), the draft proposes that the primary response should be to deny the deduction in the investor jurisdiction, and the defensive rule should be to deny the deduction in the subsidiary jurisdiction. (see table on page 18 of the domestic law draft)
- The second draft discusses changes to the OECD Model Tax Convention
  - One proposal is to eliminate the ability of dual resident entities to obtain treaty benefits by examining dual residents on a multi-factor, case-by-case basis rather than applying the current rule based on place of effective management.
  - Another significant proposal is to broaden the application of partnership rules to all transparent entities.

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This presentation may not be used to avoid tax penalties under U.S. law.

This presentation does not render tax advice, which can be given only after considering all relevant facts about a specific transaction. Consult a professional tax adviser for tax advice.

Appendix – Comparison of Select Traditional and Non-Traditional Debt-Equity Cases

Comparison of Traditional and Non-Traditional Cases

	Taxpayer Arguing Debt		Taxpayer Arguing Equity	
Factor	***Laidlaw*** T.C. Memo. 1998-232	***Scottish Power*** T.C. Memo. 2012-172	***Hewlett-Packard*** T.C. Memo. 2012-135	***PepsiCo*** T.C. Memo. 2012-269
Ability to Obtain Third-Party Loans	**Equity:** The Court concluded that even if the borrower could have borrowed the same amount, it could not have done so on similar terms. Instead, lenders would have required additional security and far less favorable terms. Slip op. at 78–79.	The Court rejected the IRS expert's analysis because it focused on **precise** matching of terms and price. Slip op. at 35–38. **Debt:** The Court accepted the taxpayer expert's testimony that the terms of one set of notes were not a "patent distortion" of what was available in the market. **Neutral**: Because the Court concluded that third parties might have required subordination of part of another set of notes, this factor was neutral for those notes.	**Neutral**: The Court concluded that no third party would lend at a 1.5–1.9% pre-tax return at a time when the rate on U.S. bonds of the same duration was 6.4%. But the Court held that the factor was neutral because "[p]lacing significant emphasis on this factor would allow taxpayers' tax advantaged investments to elude debt characterization." Slip op. at 76–78.	**Equity:** The Court concluded that the terms could not be replicated "in any reasonably similar manner, by independent debt financing" because of (i) long, perhaps perpetual, terms, (ii) subordination, (iii) lack of acceleration rights on default, and (iv) restrictions on payments. Slip Op. at 93–95.
Source of Payments	**Equity**: The Court concluded that the borrower generated insufficient cash flow (EBITDA-CAPEX) to repay and found that Laidlaw failed to prove it could have refinanced at maturity. The Court rejected the possibility of selling other assets. Slip Op. at 60–63.	**Debt**: The Court accepted the taxpayer expert's testimony that, based on contemporaneous management forecasts, the borrower would generate enough cash flow and would be able to refinance at maturity. The Court also considered the proceeds of an asset sale because the sale was contemplated at the time of the loans. Slip op. at 18–21.	**Debt.** Although the agreements conditioned payment on earnings, the Court concluded that the structure of the transaction eliminated risk and made the earnings "predetermined," causing this factor to support debt characterization. Slip op. at 66–69.	**Debt.** Based on Pepsi's statements to the Dutch tax service and its actual practice of using interest received on other notes to pay the interest on the advance agreements, the Court concluded that this factor supported debt characterization. Slip Op. at 67–77.

Comparison of Traditional and Non-Traditional Cases

	Taxpayer Arguing Debt		*Taxpayer Arguing Equity*	
Factor	***Laidlaw*** T.C. Memo. 1998-232	***Scottish Power*** T.C. Memo. 2012-172	***Hewlett-Packard*** T.C. Memo. 2012-135	***PepsiCo*** T.C. Memo. 2012-269
Capitalization	**Equity:** The Court rejected Laidlaw's argument that it should use market value in determining ratios because the agreements at issue relied on book value. Slip op. at 68–72. Note, however, that the Court concluded that the same result occurred with market value. Slip op. at 70.	**Debt:** The Court evaluated the capital ratio based on similar companies in the industry and on business risk. In evaluating the S&P rating, the Court rejected the IRS expert's testimony for failing to consider business risk. The Court also stated, in dicta, that a B rating under the S&P system indicated debt. Slip op. at 31–34.	**Debt:** Although the parties didn't address this factor, the Court concluded that it favored debt characterization because the common shares exceeded the preferred shares at issue by four to one. Slip op. at 75.	**Equity:** The IRS failed to contest the taxpayer expert's conclusion that third parties would not extend similar loans to borrowers in similar industries with the same debt-to-equity ratios. Slip op. at 91–93. The Court also rejected the Fifth Circuit approach, used in *Laidlaw*, that also looks to whether the parties expected the ratio to increase and to whether the borrower used the funds to buy capital assets and to meet start-up expenses. Slip op. at 92, n. 75.
Subordination	**Equity:** Although a postponement agreement was not a subordination agreement, it indicated equity because, by delaying payment, it effectively subordinated repayment to other creditors, increasing the borrower's risk. Slip op. at 64–66.	**Debt:** The Court rejected the IRS's argument that failure to include a covenant against taking on senior debt indicated equity. The Court also rejected the IRS's argument that subordination of holding company debt to debt of the operating companies indicated equity. Slip op. at 22–24.	**Debt:** Despite the parties stipulation that the agreements ranked junior to all indebtedness, the Court concluded that this factor favored equity because other agreements prohibited the "borrower" from incurring significant debt or having general creditors. Slip op. at 72.	**Equity:** The Court concluded that a subordination provision in the agreements supported debt characterization because the "borrower" had substantial related- and unrelated-party debts. The Court did not, however, consider subordination to a credit facility guaranteed by the "borrower's" far-more-solvent parent corporation. Slip op. 83–88.

Comparison of Traditional and Non-Traditional Cases

	Taxpayer Arguing Debt		*Taxpayer Arguing Equity*	
Factor	***Laidlaw*** T.C. Memo. 1998-232	***Scottish Power*** T.C. Memo. 2012-172	***Hewlett-Packard*** T.C. Memo. 2012-135	***PepsiCo*** T.C. Memo. 2012-269
Maturity Dates	**Equity:** Although the agreements had fixed maturity dates, the parties agreed to postpone repayment indefinitely indicating equity. The Court distinguished refinance cases because of the circular flow of funds. Slip op. at 58–60.	**Debt:** Because the agreements contained fixed maturity dates, this factor supported equity. Slip op. at 18. Regarding this factor, the Court did not address the fact that some notes were later recapitalized into equity. *See* slip op. at 13–14.	**Debt:** The Court concluded that because HP would lose the tax benefits of the transaction after 7 years and because HP held an option to put its shares to the other shareholder at that time, the shares had an effective 7-year maturity date. Slip op. at 61–65.	**Equity:** The Court distinguished *Monon R.R.* and concluded that the 55-year maturity dates were not consistent with debt characterization because the agreements lacked other debt-like characteristics and the borrower never established a reserve or sinking fund for principal repayment. Slip op. at 57–66.
Enforceability	**Equity**: Although the agreements provided the lenders with the right to enforce payments, the Courts concluded that because of their failure to do so and because of the parties understanding that they would not , this factor indicated equity. Slip Op. at 63.	**Debt:** Because the agreements provided for enforcement, this factor indicated debt. Slip op. at 22. Although the Court also cited the borrower's pledge of stock as security, the Court noted that the pledge was of minimal importance because the lender effectively controlled the borrower's shares that it held through a partnership. Slip op. at 22, n. 11.	**Debt:** The Court concluded the shareholder's agreement gave HP the right to take over and possibly liquidate the "borrower" if it failed to pay dividends. The Court concluded that this possibility gave the "borrower" and its controlling shareholder an economic compulsion to assure repayment. As a result, this factor indicated debt. Slip op. at 61–65.	**Equity:** The Court concluded that the U.S. subsidiary could not enforce payment because the agreements had a net-cash-flow restriction and because, unlike in *Hewlett-Packard*, the IRS was unable to show that the structure generated an economic compulsion requiring the "borrower" to repay regardless of other events. Slip op. at 77–83.

Comparison of Traditional and Non-Traditional Cases

	Taxpayer Arguing Debt		*Taxpayer Arguing Equity*	
Factor	***Laidlaw*** T.C. Memo. 1998-232	***Scottish Power*** T.C. Memo. 2012-172	***Hewlett-Packard*** T.C. Memo. 2012-135	***PepsiCo*** T.C. Memo. 2012-269
Intent of the Parties	**Equity:** The Court distinguished between intending for advances *to be treated* as loans and intending for advances *to be* loans. Slip op. at 67. The Court concluded Laidlaw intended the advances to be equity because (i) despite the borrowers' worsening financial conditions, the lender extended repayment terms without additional security, (ii) the lender advanced funds whenever interest was due, and (iii) Laidlaw represented to Canadian tax officials that the loans were "in the nature of capital contributions." Slip op. at 66–67.	**Debt:** The Court found that the desire to obtain interest expense deductions implied, if anything, the intent to create *bona fide* debt. Slip op. at 26. The Court concluded that Scottish Power intended the advances to be equity because (i) the notes were in the form of debt, (ii) the taxpayer recorded the notes as debt on their books and records, (iii) the parties' correspondence treated the notes as debt, and (iv) the parties represented to the SEC that the notes were debt. The Court concluded that later failures to make timely payments and the later recapitalization of the notes did not indicate an intent to create equity because those events were caused by changed circumstances. Slip op. at 25–31.	**Debt:** HP argued that the parties intended for it to receive preferred stock and to be treated as an equity holder for tax purposes. The Court held that the relevant question was the parties' intent regarding their actual rights and obligations under the transaction. Slip op. at 74. The Court concluded that the parties intended the advances to be debt because (i) statements by the parties indicated that they intended a definite seven-year term, (ii) the "borrower" was restricted from meaningful business other than holding notes with predetermined interest payments, and (iii) the agreements provided HP with creditor-like rights. Slip op. at 73–74.	**Equity:** The Court concluded that Pepsi intended the advances to be debt because (i) despite representing to the Dutch Tax Authority that the borrower would make payments from interest received on other notes, Pepsi was "uncompromising" in refusing to add terms to the agreements requiring it to do so, (ii) the agreements had long and possibly perpetual terms showing that Pepsi did not intend to create an instrument with traditional debt characteristics and obligations, and (iii) at the time of issuance, repayment was uncertain. Slip op. at 88–91.

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The Camp Proposals Addressing the Taxation of Financial Products

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April 2014

Financial Instruments & Strategies

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Today's agenda

- Legislative overview
- Mark-to-market
- Hedge identification
- Debt proposals
- Proposals Affecting Securities
- Wrap-up

Tax Reform – Overview - Congress

- December 6, 2011- Joint Ways & Means Committee & Senate Finance Committee hearing
  - Economically similar instruments are taxed differently
- January 24, 2013 - Rep. Dave Camp [R- Mich.] (Ways & Means Committee chair) discussion draft on financial products (the "Camp Proposals")
  - "Provide more uniform tax treatment of financial products"
- February 13, 2013 to May 6, 2013 Rep. Camp and Rep. Levin [D- Mich.] Tax Reform Working Groups
  - 177 submissions to Debt, Equity, and Capital or Financial Services Groups

Tax Reform – Overview – Congress (cont.)

- Rep. Camp (R – Mich.) has issued 4 proposals
  - International Tax Reform (October 2011), Financial Products (January 2013), and Small Business (March 2013) and Comprehensive Proposal (March 2014)
- Sen. Baucus (D – Mont.) (chair of the Senate Finance Committee) has issued 4 proposals
  - International Tax Reform (November 2013), Tax Administration (November 2013), Cost Recovery (November 2013), and Energy Taxes (December 2013)

Tax Reform – Overview – Congress (cont.)

- Rep. Camp's tenure as Ways & Means Committee chair will expire at the end of 2014 and he is retiring from Congress
- Sen. Baucus had previously announced his retirement when his term ends at the end of 2014
- The Obama Administration named Sen. Baucus US Ambassador to China, so he has already left the Congress
- Rep. Ron Wyden (D – Oregon) is the new chair of the Senate Finance Committee

Tax Reform – Overview – Congress (cont.)

- Sen. Wyden has a pending tax reform proposal
- Wyden-Coats Bipartisan Tax Fairness and Simplification Act (April 2011)
  - 24% corporate tax rate
  - Limits interest deductibility
  - Repeals tax deferral of active foreign earnings
  - Reinstitutes per-country foreign tax credit
- Senate Finance Committee has marked up an extenders package.
- Ways & Means Committee has also recently held hearing on extenders.

Tax Reform – Overview – Congress (cont.)

- 2014 Congressional Elections
  - There will definitely be a new chairman of Ways and Means Committee due to Camp's retirement.
  - There may be a new chairman of Senate Finance Committee depending on whether the Republicans win the Senate.

Tax Reform – Overview – Obama Administration

- March 2014 - Administration's Fiscal Year 2015 Revenue Proposals
- Mark-to-market derivatives
  - Derivatives include only contracts where the underlying is actively-traded property.
  - Ordinary gain/loss
- Tax hedge identification – GAAP ID is okay

Today's agenda

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2014 Camp Derivatives Proposal
Mark-to-market - General rules

- All derivatives marked-to-market (MTM).
- Income, deduction, gain, or loss treated as ordinary.
- MTM and ordinary rules do not apply to:
  - Hedging transactions
  - Commodities transactions in normal course of trade or business
  - The right to return of the same or substantially identical securities in a securities lending, sale-repurchase, and similar financing transactions
  - Options received in connection with performance of services
  - Insurance contracts, annuities, and endowments
  - Derivatives with respect to stock of affiliated group members
  - ADR’s with respect to foreign stock

2014 Camp Derivatives Proposal
Mark-to-market - Straddles

- Definition and consequences of “straddles” expanded
  - If straddle includes any derivative subject to MTM, all positions in straddle are MTM and ordinary
  - Any built-in gain position that becomes part of a straddle is treated as sold at the time the straddle is established, but gain generally is capital.
  - Built-in loss on a position that becomes part of a straddle is deferred.

2014 Camp Derivatives Proposal
Mark-to-market - Definition of “derivative”

- A contract with respect to underlying property--
  - Any share of stock in a corporation
  - Any partnership or beneficial ownership interest in a partnership or trust
  - Any note, bond, debenture, or other evidence of indebtedness
  - Generally, any real property
  - Any commodity that is actively traded
  - Any currency
  - Any rate, price, amount, index, formula, or algorithm AND
  - Any other item prescribed by the Secretary

2014 Camp Derivatives Proposal
Mark-to-market - Embedded derivatives

- The term “derivative” includes an embedded derivative component.
- If a contract has derivative and non-derivative components, then each derivative component is treated as a derivative.

2014 Camp Derivatives Proposal
Mark-to-market - Embedded derivatives

- But a debt instrument is not treated as having an embedded derivative component merely because
  - The debt instrument is denominated in or payments are determined by reference to a nonfunctional currency, or
  - The debt instrument is a convertible debt, contingent payment debt instrument, integrated debt instrument, variable rate debt instrument, investment unit, a debt instrument with alternative payment schedules, or a debt instrument to which the regulations under section 1275(d) apply.
  - Would instruct Treasury to write regulations to treat convertible debt as CPDI's. Rev. Rul. 2002-31.

Today’s agenda

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- ► Hedge identification
- ► Debt proposals
- ► Proposals affecting securities
- ► Wrap-up

2014 Camp Hedge Proposal
Hedge identification (ID)

- Would institute a limited financial accounting hedge ID conformity rule
  - Tax hedge ID requirement deemed satisfied if a transaction is
    - Properly identified as a hedge for tax purposes, or
    - Treated as a financial accounting hedging transaction on an audited financial statement.
    - For purposes of an audited financial statement
      - Certified as in accordance with GAAP, and
      - Used for enumerated purpose(s) (e.g., a report to shareholders)
  - *Proposal would not change the definition of "hedging transaction" for tax purposes*
  - *Bonds held by an insurance company are treated as ordinary property solely for purposes of hedge qualification-gap hedges*

Today’s agenda

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2014 Camp Debt Proposals
Debt modifications

- Issue price of a debt instrument in a debt modification defined as the lesser of the adjusted issue price of the existing debt or the issue price of the new debt (determined under section 1274).
  - Under current law, if the debt is publicly traded, its issue price would be its fair market value.
- This means if a debt is modified, the issuer will not have cancellation of indebtedness (COD) income (even if the debt is publicly traded at a discount), so long as the principal amount is not reduced and the modified debt calls for interest at a rate no lower than the applicable federal rate (AFR).
- An actual or deemed debt for debt exchange would be treated for the holder as a non-taxable transaction with carryover basis.

2014 Camp Debt Proposals
Current Inclusion of Market Discount

- Current inclusion on a constant yield basis extended to market discount.
- Limitation on the amount of the accrual to the greater of original yield plus 5% or AFR as of the date of the subsequent acquisition plus 10%.
- Rate would accrue on the actual purchase price.
- Loss on the sale of a market discount bond would be ordinary to the extent of previously accrued market discount.
- Retains same exceptions from treatment as interest (section 103, 871(m), 881, 1441, 1442 and 6049).
- Repeals special rules for short-term non-governmental obligations.
- Modification of section 1277 (deduction for interest to carry market discount bond).

2014 Camp Debt Proposals - Inclusion of OID No Later than for Financial Statement Purposes

- Requires taxpayers to apply the revenue recognition rules under Section 451 before applying the OID rules under Section 1272.
- The proposal would prevent credit card issuers and other financial institutions from treating credit card fees as interest to be deferred under the OID rules.
- This proposal would essentially overrule the *Capital One* case.

2014 Camp Debt Proposals - Changes to Section 265 Interest Expense Disallowance Rules

- Would provide a proportional disallowance rule to all corporations. Interest expense would be disallowed based on the proportion of tax exempt obligations to total assets.
- Would repeal the qualified small issuer exception.
- Would repeal the 2% de minimis rule.
- For individuals, investment interest expense would be disallowed to the extent of tax-exempt interest before application of the net investment income limitations on interest expense deductions.

2014 Camp Debt Proposal – Corporate Acquisition Indebtedness

- Section 279 denying a corporation's interest deduction for certain debt issued as consideration for the acquisition of stock in another corporation or for the acquisition of assets of another corporation would be repealed in its entirety.
- Welcome relief
  - Since with appropriate planning the section rarely applied, it was not a large revenue raiser.
  - Largely a trap for the unwary.

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2014 Camp Proposals re: Gain/Loss Determination – Basis calculation for sales of securities

- Taxpayers would be required to determine basis and holding period of securities on a FIFO basis.
- Securities include shares of stock of a corporation, evidence of indebtedness or a commodity or contract or derivative with respect to such commodity.
- The 2013 proposal has a similar rule, but used average cost basis which made the calculation of holding periods very complex.
- Requiring use of FIFO is simpler, but eliminates a planning opportunity used by taxpayers who could use the specific identification method.

2014 Camp Proposals re: Gain/Loss Determination – Expansion of wash sale rules

- The proposal would modify section 1091 to treat a sale and subsequent repurchase as a wash sale when a related party reacquires the stock or securities sold.
- A related party for this purpose is the taxpayer's spouse, the taxpayer's dependent, or any party for whom the taxpayer is a dependent, an individual, corporation, partnership, trust, or estate that controls or is controlled by the taxpayers or a related individual, or any IRA, qualified tuition program, employee benefit plan or deferred compensation plan with respect to the taxpayer or related individuals.
- Any disallowed loss would not increase the basis of the related party other than a spouse.

2014 Camp Proposals re: Gain/Loss Determination – Derivatives in Corporation’s Own Stock

- Section 1032 would be expanded to cover rights or obligations (i.e., derivatives) with respect to a corporation’s stock except certain forward contracts.
- Income recognition on certain forward contracts as if the includible amounts were OID.
- Contributions to capital on the other hand would be includible in gross income to the extent the amount contributed exceeds the FMV of any stock issued in exchange.

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Notional Principal Contract Update

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April 2014

Financial Instruments & Strategies

Agenda

- **Notional Principal Contract Overview**
- Special Considerations
  - Credit Default Swaps
  - Withholding Tax Considerations
  - Swap Assignments Safe Harbor
- Proposed NPC Regulations
  - Section 1256 Contracts and Dodd-Frank Act Considerations
  - 2011 Proposed Regulations

How are Derivatives Taxed?

- Under current law, there is not a uniform set of tax rules for derivatives
- Tax character and timing depends—in part—on the type of derivative
  - futures contracts
  - forward contracts
  - options
  - swaps, caps or floors ("notional principal contracts")

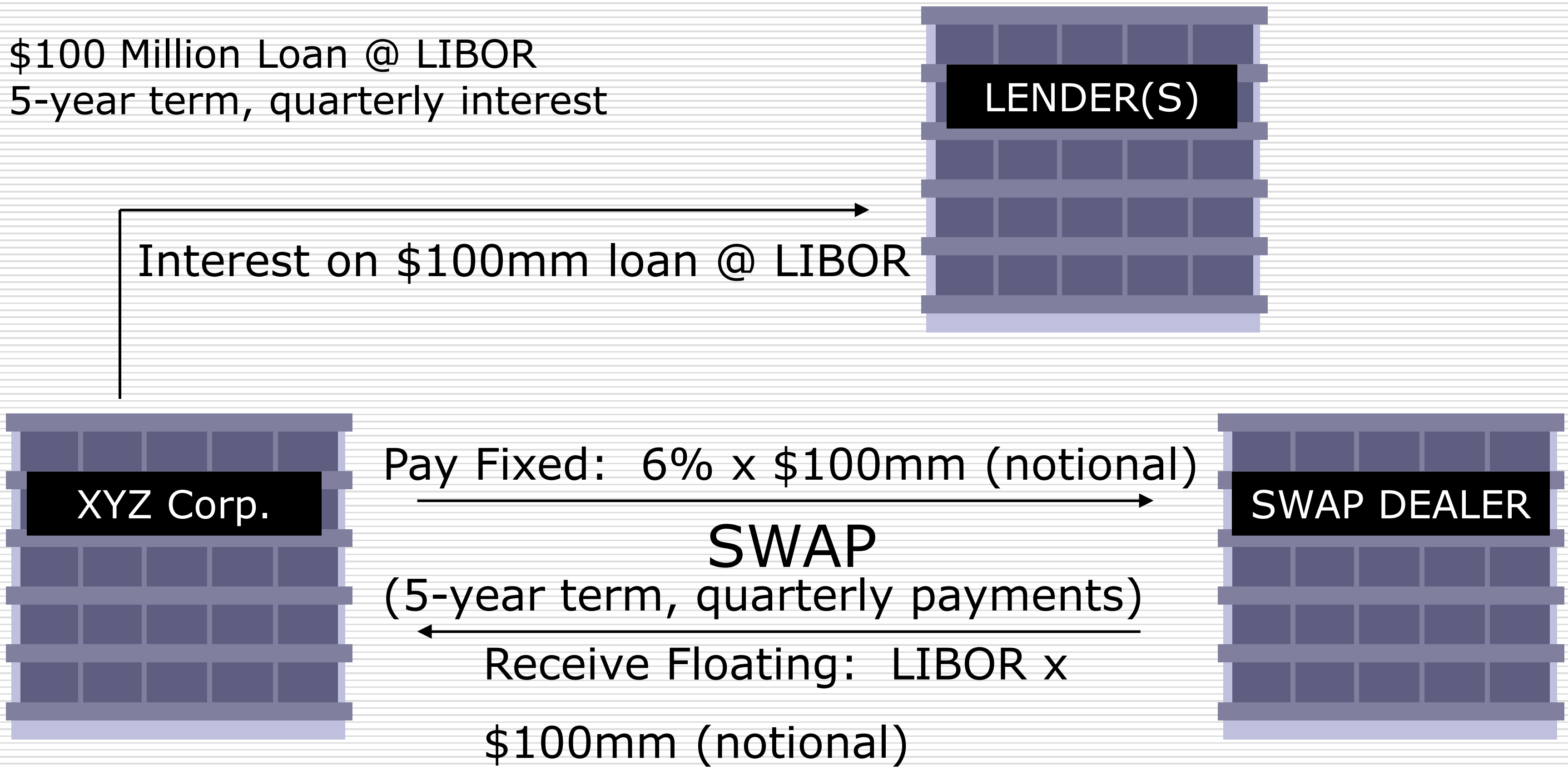
Swaps

- One transaction with multiple payments
- Economically equivalent to a series of cash-settled forward contracts
- Taxed differently from forwards, futures or options
- Swaps traditionally have not been exchange-traded, but the product offerings are changing due to Dodd-Frank and other market considerations

How are “Swaps” Taxed?

- Many—but not all—swaps are taxed as “notional principal contracts,” defined in Reg. §1.446-3 as:
  - a *financial instrument* providing for *two or more* payments by one party to the other at specified intervals based on a notional (hypothetical) principal amount multiplied by a specified index (an index based on objective financial information)
- Includes interest rate swaps, currency swaps, commodity swaps, equity swaps, and similar agreements
  - Classification of certain swaps, such as credit default swaps and weather swaps, is unclear

Floating for Fixed Interest Rate Swap



How are "Swaps" Taxed? (*Cont.*)

- Includes option-like products (caps and floors) with multiple payments
- Under current regulations, <u>excludes</u> contracts calling for a single settlement payment, such as futures, options, forwards, and bullet swaps
  - Swaps that are not classified as NPCs are generally classified as cash-settled forward contracts for tax purposes
  - Need to consider combination products, such as swaptions and forward starting swaps

Notional Principal Contracts: Three Categories of Payments

- Different tax character and timing results for:
  - periodic payments
  - nonperiodic payments
  - termination payments
- This analysis ignores other rules that can apply depending on the type of taxpayer (dealer, trader or hedger) and whether the NPC is part of a risk management transaction (i.e., straddle rules, hedge timing and character rules)

Periodic Payments

- Periodic payments: payments required to be made at periodic intervals of one year or less throughout the entire term of the contract
- General Timing Rule: amortize pro rata (daily) portion of periodic payments (year-end accrual)
  - This accrual method of accounting applies to all taxpayers
  - Accruals will approximate annual cash flows, but is not exact
  - This is not mark to market taxation

Periodic Payments (*Cont.*)

- General Character Rule: ordinary income and deductions
  - Potential Code §212 treatment for individual taxpayers
- Periodic payments are not “interest”
  - But consider Reg. §1.861-9T for FTC purposes

Nonperiodic Payments

- Nonperiodic payments: any NPC payment that is not a periodic payment or a termination payment
  - includes upfront premiums for off-market swaps, premiums for caps/floors, payments at irregular intervals, and end of term payments (total return swaps)
- General Timing Rule: amortize nonperiodic payments over life of contract
  - Special amortization rules were proposed for contingent nonperiodic payments pursuant to 2004 proposed regulations

Why Make a Nonperiodic Payment?

- Nonperiodic payments are made to compensate one party to a swap for off-market payments
- Example: Assume that an at-the-market interest rate swap would require Party A to pay 5% x notional principal amount and that Party B would pay LIBOR x the same notional principal amount, for 5 years
  - But Party A wants to pay 4%
  - Party B will not enter into the swap unless Party A makes an upfront payment to B to compensate B for receiving 4% instead of 5%

Nonperiodic Payments

- General Character Rule: ordinary income and deductions
- Potential embedded loan treatment for "significant" upfront payments (Reg. §1.446-3(g)(4))
  - The payment is treated as a loan by the payor to the payee
  - The loan is treated as paid back by the payee to the payor in installments (with interest) over the term of the swap
  - The swap is restated as a swap with at-market payments (including amounts equal and offsetting to the deemed loan payments)

NPCs: Why Deemed Loans Matter

- A deemed loan could give rise to one or more of the following:
  - Complex calculations that do not correspond to financial accounting treatment
  - Withholding tax
  - Information reporting
  - UBTI (for tax-exempt counterparties)
  - Interest expense allocation/FTC issues
  - Special rule for Code §956
    - IRS may treat any nonperiodic swap payment as a loan
    - A deemed loan from a CFC to a US affiliate gives rise to an investment in United States property and a potential deemed dividend from the CFC

Termination Payments

- Termination payments: payments made to assign or early terminate a NPC
- General Timing Rule: termination payments are generally recognized only upon assignment/termination (not subject to accrual principles)
- General Character Rule: depends on tax character of underlying asset (Code §1234A)
  - exceptions:
    - qualified hedging transactions
    - currency transactions

How are Forward Contracts Taxed?

- Forwards are bi-lateral (not exchange traded) agreements relating to the future sale or purchase of property
  - Can be physically or financially-settled
- For all forwards outside of Code §1256:
  - Generally timing is on a "when realized" basis (i.e., no tax consequences until settlement)
  - Physical settlement: purchase or sale of underlying property
  - Cash settlement: ordinary character under executory contract case law; capital under Code §1234A <u>if</u> underlying property is capital
    - Code §988 override for FX forwards

Agenda

- Notional Principal Contract Overview
- **Special Considerations**
  - **Credit Default Swaps**
  - **Withholding Tax Considerations**
  - **Swap Assignments Safe Harbor**
- Proposed NPC Regulations
  - Section 1256 Contracts and Dodd-Frank Act Considerations
  - 2011 Proposed Regulations

Credit Default Swaps

- Alternative Characterizations – IRS Notice 2004-52
  - Notional Principal Contract
  - Contingent Option
  - Guarantee Contract
  - Insurance
- Proposed Regulations – 2011 Clarify that CDS can be NPC

Withholding Tax Considerations

- Withholding under Code §§1441 and 1442 applies to payments of U.S. source FDAP to foreign persons.
- Generally FDAP withholding will not apply to swap payments because they are sourced according to location of recipient. Reg. §1.863-7.
- Payments of interest on swap not covered by §863 regulations. Have to rely on portfolio interest or treaty.
- Equity Swaps potentially subject to withholding under Code §871(m).

Swap Assignments

- Original Treatment Under 1991 Proposed Regulations: Because assignment modified terms of swap, the assignment would result in a deemed exchange
- 1994 Regulations: Assignment would result in deemed exchange only if assignment results in Code §1001 exchange
- Safe Harbor of Temp. Reg. §1.1001-4T. Substitution of new counterparty not a deemed exchange if:
  - The party assigning its rights and obligations and the assignee are dealers in NPCs
  - Terms of Swap must permit substitution of parties

Swap Assignments

- Modified safe harbor language of Reg. §1.1001-4T regulations. Substitution of new counterparty not a deemed exchange if:
  - The party assigning its rights and obligations and the assignee are dealers in NPCs or clearinghouse;
  - Terms of Swap permit substitution of parties (although does not require consent); and
  - The terms of the Swap are not otherwise modified for Code §1001 purposes (the "Cottage Savings" analysis).

Agenda

- Notional Principal Contract Overview
- Special Considerations
  - Credit Default Swaps
  - Withholding Tax Considerations
  - Swap Assignments Safe Harbor
- **Proposed NPC Regulations**
  - **Section 1256 Contracts and Dodd-Frank Act Considerations**
  - **2011 Proposed Regulations**

Code §1256

- Code §1256 applies only to derivatives classified as Section 1256 Contracts and imposes two special rules:
  - the 60/40 Rule (capital gain or loss)
  - the Mark-to-Market Rule
- Exceptions to the 60/40 Rule include:
  - tax hedges under Code §1221(a)(7)
  - certain FX transactions considered "section 988 transactions"
- Exceptions to the Mark-to-Market Rule include:
  - tax hedges under Code §1221(a)(7)

What are Section 1256 Contracts?

- Section 1256 Contracts are limited to five types of derivatives:
  - Regulated futures contracts
  - Listed nonequity options
  - Foreign currency contracts
  - Listed <u>dealer</u> equity options (single stock and narrow-based stock indices)
  - <u>Dealer</u> securities futures contracts (single stock and narrow-based stock indices)

Regulated Futures Contracts Defined

- Regulated Futures Contracts are limited to *contracts* that are:
  - traded on or subject to rules of a qualified board or exchange <u>and</u>
  - subject to a system of daily mark-to-market (variation margin requirement)

What is a Qualified Board or Exchange?

- A qualified board or exchange is limited to:
  - a national securities exchange registered with the SEC
  - a domestic board of trade designated as a contract market by the CFTC
  - any other exchange, board of trade, or other market the Secretary determines has rules adequate to carry out the purposes of Code §1256
    - there are currently a limited number of foreign exchanges designated as QBEs under this category, the recent additions of EUREX, LIFFE, ICE Futures Canada, Dubai Mercantile, and ICE Futures UK

Dodd-Frank Wall Street Reform and Consumer Protection Act

- Dodd–Frank requires that certain "swaps" be cleared and potentially traded on a registered exchange
  - Clearing for certain interest rate swaps has commenced
- An *end-user* exception from exchange clearing and trading is provided in limited cases
- The Congressional Budget Office scored the derivatives part of the Senate version of the bill as losing over $1 billion because taxpayers were expected to take the position Code §1256 is applicable

Dodd-Frank Act "Swaps" Exclusion

- New Code §1256(b)(2) was added at the last minute
  - Applies for tax years beginning after 2010
  - Excludes the following from Section 1256 Contract classification: interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement

Proposed NPC Regulations

- Proposed NPC regulations were issued in September, 2011, that if adopted would:
  - change the definition of a "payment" to include an amount that is fixed on one date and paid or otherwise taken into account on a later date (the "deemed payment rule")
  - distinguish between swaps with an explicit cost of capital leg (NPC) versus a forward contract/bullet swap with an implicit cost of capital (not an NPC)
  - potentially include credit default swaps
  - options and forward contracts are still carved out

Proposed NPC Regulations *(Cont'd)*

- Includes weather-related swaps as NPCs
  - based on nonfinancial indices that are comprised of any objectively determinable information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances, and that cannot be reasonably expected to front-load or back-load payments accruing under the contract
- Timing regulations requiring amortization or mark to market tax accounting for contingent nonperiodic NPC payments, as well as for prepaid forward contracts, are expected next

Proposed NPC Regulations

- 2011 proposed regulations also address the Section 1256 Contract “swaps” exclusion
  - Interprets the Dodd-Frank swaps carve out as applying to NPCs and options on NPCs
  - Includes an ordering rule is included providing that if a derivative is both a futures contract and an NPC, NPC classification prevails
  - Could narrow number of contracts considered Section 1256 Contracts if the NPC “deemed payment rule” is adopted

Concluding Remarks/Questions

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Hedges, Straddles and Integration Transactions

Avoiding Tax Pitfalls in Treasury Operations

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Financial Instruments & Strategies

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The Tax Straddle Rules

What Is a Tax Straddle?

- A straddle exists when a taxpayer has "offsetting positions" with respect to "personal property."
- Offsetting positions exist when "there is a substantial diminution of risk of loss" from holding one position by reason of holding one or more other positions.
- No specific level of risk reduction is specified by the statute.
- In contrast to the wash sale rules, the 2 positions do not have to be substantial identical.
- Straddles can arise from inventory hedging transactions, managing interest rate risk from Treasury operations & defeasing risk from supplies

What Are the Consequences of a Straddle?

If the capital gain long-term holding period for a position that is included in a straddle is not met, the holding period is reset to zero.

Losses on a leg of a straddle are deferred to the extent of unrecognized gain in the other leg of the straddle.

At the end of each succeeding taxable year, the unrecognized gain is recomputed. To the extent that the unrecognized gain is less than the unallowed loss, the loss is recognized.

Net interest and carrying charges incurred with respect to a straddle are capitalized. The amount subject to capitalization is reduced by current income on the straddle positions. These amounts are referred to "qualified income offsets."

What Is Personal Property?

Personal property means property that is actively traded. There must be an "established financial market" for the property. This includes CFTC contract markets.

An interest in personal property includes a forwards, futures contracts and positions in swaps

Stock is personal property only if it is a type that is publicly-traded and the offsetting position is the same stock or is "substantially similar."

Stock in a private company can be part of a straddle if it is formed or availed of to offset positions in publicly-traded stock.

Positions held by related persons are taken into account. Look-thru rules apply to pass-thru entities.

Actively-Traded Is Broadly Defined

Property is considered to be actively-traded if it is traded:

1. On a national securities exchange
2. On an interdealer quotation system under the SEA of 1934
3. On a domestic board of trade maintained by the CFTC
4. On a foreign securities exchange (the IRS intermittently releases notices stating whether a foreign exchange qualifies)
5. In an interbank market
6. In an interdealer market
7. For debt instruments, a debt market.

Debt Is Traded in a Debt Market

A debt market exists if price quotations are readily available from brokers, dealers or traders.

Debt is not considered to trade in a debt market:

1. No debt of the issuer in 1-6 on preceding slide
2. Original stated principal amount is equal to or less than $25 million
3. The restrictions placed on the issuer are materially less restrictive than the covenants imposed on traded debt or
4. The maturity date is more than 3 years greater than the issuer’s other traded debt.

A "Position" in Personal Property Is Broadly Defined

The so-called debt straddle rules treat a position embedded in a debt instrument issued by a taxpayer as part of a straddle.

Under Prop. Treasury Regulation § 1.263(g)-2(c)(3), indebtedness "the payments on which are determined by reference to payments with respect to personal property or the value of, change in value" are treated as a position for purposes of the straddle rules.

For example, if the taxpayer has a long position in gold and issues a bond, the interest or principal on which varies inversely with the price of gold, the taxpayer has a straddle.

The Identified Straddle Rules

A taxpayer may make an identified straddle election by the close of the day that the straddle is entered into.

Requirements for an identified straddle:

1. The value of each position is at least equal to basis (no built-in loss positions)
2. The straddle is not part of a larger straddle.

If an identified straddle election is made, then the positions in the identified straddle are ring-fenced & other positions will not be taken into account in determining if a straddle exists.

For identified straddles, recognized loss in excess of unrecognized gain is added to the basis of the offsetting position.

The Mixed Straddle Rules

A mixed straddle consists of identified offsetting positions where one position is in a Section 1256 contract and the other position is not subject to the mark-to-market rules.

Regulations permit the establishment of a mixed straddle account in which all positions placed into the account will be treated as part of a straddle.

Treasury Regulation § 1.1092(b)-3T(b)(6) requires the recognition of all gain or loss inherent in any position that is placed in a mixed straddle account.

Gain or loss from a mixed straddle account depends upon the positions that gave rise to the gain or loss.

The Mixed Straddle Rule Kerfluffle

Indentified straddles provide tax planning opportunities to convert unrealized losses into current losses

When the transaction is identified as a straddle, unrecognized gain or loss is unlocked

On Aug 2, 2013, the IRS issued Temp. Treas. Reg. § 1.1092(b)-6T. The temporary regulations provided that when a taxpayer enters into a mixed straddle after Aug. 1, 2013, gain or loss is not recognized. Instead, it is taken into account at the time it would under other Code sections.

The Temporary Regulation effectively required gain recognition under the constructive sale rules, but denied current loss recognition.

In a correction, the new Temp. Regs. will not be effective until finalized.

The Qualified Covered Call Rules

A QCC exists when the taxpayer is long a stock and has written a call option on such stock.

A QCC is an option:

1. That is traded on a national securities exchange
2. Is granted more than 30 days prior to expiration
3. Is not deep-in-the-money &
4. Is not granted by an options dealer in connection with the options dealing business

Whether an option is deep in the money depends upon the trading price of the stock.

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Hedges are a Special Type Of Straddle

The Concept of Hedging

- "The term 'hedging transaction' means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks as the Secretary may prescribe in regulations." Section 1221(b)(2).

Significance of the Tax Hedging Rules

- The <u>character</u> of the recognized gain or loss.
  - Matching ordinary gains with ordinary losses.
  - Avoid matching ordinary gains with capital losses.
    - Corporations: capital losses only deductible against capital gains.
    - Individuals: capital losses only deductible against ordinary income up to $3,000.
- The <u>timing</u> of gain or loss recognition.
  - Matching hedging gains and losses to gains and losses on hedged items.

Tax Hedging Standards

- A transaction can be treated as a tax hedge if it is entered into to *manage* risk. There is no requirement of a showing that the transaction *reduces* risk.
- Hedging transactions must manage price or currency fluctuations with respect to "ordinary property or
- The hedge must manage interest rate or price changes on borrowings of ordinary obligations.

Ordinary Property & Obligations

- Property is ordinary property if it cannot produce capital or loss under any circumstances.
- Obligations are ordinary obligations if performance or termination could not produce capital gain or loss.
- Capital assets cannot be hedged within the meaning of the tax law.

The Risk Management Standard

- Whether a transaction manages risk is based on all facts & circumstances. There is no correlation requirement.
- Risk management can be undertaken on business unit basis or an enterprise-wide basis
- Whether a transaction manages risk is determined on an enterprise wide basis, not on a company-by-company basis. A contrary election is provided.

The Risk Management Standard

- A transaction that reduces risk on a group of assets or liabilities can be a hedging transaction, provided it is reasonable to assume that it will "reduce the overall risk of a taxpayer's operations."
- No requirement to demonstrate that a particular transaction undertaken as part of a macro hedging program reduces risk.
- Per se rule that the holding of a debt instrument, equity security or annuity contract cannot be a hedging transaction. Hedging deferred compensation plans requires the use of derivatives.

Hedge Documentation Requirements

- A hedge must be identified as such on the date that it is entered into.
- Identification must specify items being hedged or the aggregate risk being hedged. The item being hedged may be identified within 35 days of the hedge.
- Aggregate hedging programs may be adopted. If so, then each transaction entered into pursuant to the program can be specified as one of transactions entered into pursuant to the program.

Failure to Document a Hedging Transaction

- Treas. Reg. § 1.1221-2(g)(2) excuses inadvertent failures to identify hedges
  - Failure to indentify hedge was inadvertent
  - Transaction is a hedging transaction
  - All hedges in open years have been treated as hedges
- If an unidentified transaction is not identified as a hedge, but can only be a hedge, all gain is ordinary, but loss remains capital.

Federal Income Tax Accounting Rules For Hedges

Overriding Principle: Matching

- Treasury Reg. § 1.446-4(b) Rule: Tax accounting for a hedge must clearly reflect income.
- Object is match income, gain, deduction and loss from hedging transaction with such items from hedged item.
- Aggregate hedging is subject to matching rule even if hedge cannot be matched to a particular hedged item.

The Mark & Spread Method

- The mark & spread method requires that the hedges be marked to market at periodic intervals.
- Gain or loss from marking to market is then taken into account over the period during which the hedging transactions are intended to manage risk.
- Inventory hedges are accounted for as an element of cost of goods sold.
- Debt hedges are accounted for by reference to the terms of the debt instrument and the period during which the hedge manages risk.

Use of NPCs for Hedging

- If an NPC is used as a hedge, the timing of gain or loss from such a hedge is governed by the <u>NPC timing rules</u> (Treas. Reg. 1.446-3), unless applying these rules would not result in a clear reflection of income.
- If the NPC timing rules do not apply to a certain hedging transaction, the hedge timing rules would apply to it.

The Treatment of Hedging Transactions Under the Camp Discussion Draft

Hedging Transactions Would Be Carved Out From Mark-to-Market Treatment

- Derivatives held in hedging transactions would not be subject to mark-to-market rules.
- Straddle rules would be made inapplicable to hedging transactions.
- Code § 263(g) disallowance rules for net interest & carrying charges would be made inapplicable to hedging transactions.

Disparate Treatment for Capital Asset Hedges

- A derivative acquired to hedge risk in a capital asset would be subject to mark-to-market & ordinary treatment.
- If the hedged asset is a capital asset, gain or loss on the hedged item remains capital.

Bootstrapping Financial Accounting Hedge Designations

- The Treasury Regulation § 1.1221-2(b) definition of a hedge would be codified (a promotion that would come without a raise).
- Hedges could be identified by same day ID as a tax hedge; same as current rule –OR—
- If a taxpayer designates a transaction as a hedge on its audited financial statements, the transaction would be automatically treated as a hedge for tax purposes.
  - BUT a transaction designated as a book hedge would be treated as a tax hedge ONLY if treated as a hedge for some tax purpose.
- Trap for the unwary: many transactions qualify as tax hedges, but do not qualify as financial accounting hedges.

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The Integration Elections Are Surrogates for Hedge Treatment

The Integration Elections

- Integration elections allow taxpayers to ignore derivatives
- Instead, the combined cash flows the derivative and the hedged item are accounted for on a net basis
- The integration elections are beneficial because they eliminate the need for separate tax accounting & potential character mismatches
- No requirement that position be an ordinary obligation or an ordinary asset

Integrating a Debt Instrument & a Hedge

- Debt instrument integration rules apply to debt issued or debt held by a taxpayer
- The integration election has no effect on other parties (that is, the person to whom the debt instrument was issued or the person who holds the debt, as the case may be)
- The integration election was the basis of a favorable IRS ruling on so-called “call spread convertibles” (AM 2007-0014)

Treas. Reg. § 1.1275-6 Requirements

- Any “financial instrument” may be integrated with a “qualifying debt instrument.”
- A financial instrument is a spot contract, forward, future contract, option, swap or a debt instrument (but a debt issued by a taxpayer may not be integrated with a debt instrument held by the taxpayer)
- Qualifying debt is any debt other than a tax-exempt instrument, a REMIC regular interest or a contingent payment debt issued for property

Treas. Reg. § 1.1275-6 Requirements

- Requirements for integrated debt instrument & hedge
  - Combined cash flows must permit the calculation of a yield to maturity (or a qualified floating rate)
  - Integrated debt must have the same term to maturity as the stand alone debt instrument
  - Currency hedges are not eligible for Treas. Reg. § 1.1275-6 integration

Treas. Reg. § 1.1275-6 Granular Requirements

- Taxpayer must satisfy same day identification requirement (no IRS filing; books & records designation is sufficient)
- None of the parties to the hedge are related unless party selling hedge uses mark-to-market accounting
- Same person enters into the debt transaction as enters into the hedge
- If taxpayer is foreign, all items of income & expense on hedge & debt instrument must be effectively connected to a US trade or business

Treas. Reg. § 1.1275-6 Granular Requirements (cont.)

- Neither qualifying debt instrument nor financial instrument was part of another integrated transaction that was legged out of within 30 days
- Debt instrument must be issued or acquired before any payment is made or received on hedge
- Neither hedge nor debt instrument was part of a straddle transaction

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Legging Into & Out of an Integrated Transaction

- Treas. Reg. § 1.1275-6(d) permits integration treatment for already issued or acquired debt instruments (legging in)
- Election to leg in causes then current accrual period to end.
- Leg out occurs when financial instrument or debt instrument is disposed of. Leg outs do not include nonrecognition transactions
- Immediately before leg out transaction, integrated position is marked to market and gain or loss is taken into account.

Foreign Currency Integration Election

- Treas. Reg. § 1.988-5 allows taxpayers to integrate a foreign currency-denominated debt instrument with a "§ 1.988-5 hedge" to create a functional currency (US$ denominated debt instrument
- Integration election eliminates the need to separately report FX gain or loss by creating a synthetic US$ denominated asset or liability
- § 1.988-5 hedge includes most derivatives: spot contracts, futures, forwards, options, swaps, and combinations of such instruments

Requirements for FX Integration Election

- **Derivative, when combined with debt instrument, must permit the calculation of a yield to maturity.**
- **All payments must be fully hedged and any contingencies must be fully offset by the hedge**
- **The hedge must be identified as a § 1.988-5 hedge on or before the date that the hedge is closed.**
- **None of the parties to the hedge can be related**
- **If transaction involves a QBU outside of the US, both of the debt & the hedge must be refleced on the books of the QBU**

Requirements for FX Integration Election (cont.)

- Both of the debt instrument and the hedge must be entered into by the same taxpayer
- If taxpayer is foreign engaged in a US trade or business, all income and loss associated with the debt & the hedge must be effectively connected income
- Legging into an integrated transaction is permitted, but all FX gain or loss is realized immediately prior to leg in transaction, but such gain or loss is not recognized until debt instrument is disposed of
- If taxpayer legs out of an integrated transaction, the debt instrument is treated as though it was disposed of and gain or loss is realized & recognized

Identification Rules for FX Integrations

- **Same day identification must specify:**
  - The date that the hedge & debt instrument were entered into
  - The date that the hedge and the debt instrument are integrated
  - Any leg in gain or loss that is deferred
  - A description of the debt instrument and the hedge
  - A summary of the resulting cash flows

Other Foreign Exchange Integration Elections

- Executory contracts denominated in FX may be integrated with a currency hedge to become a US$ receivable or contract.
- Eligible contracts include contract for services or goods sold in the ordinary course of business
- Proposed regulations would extend integration treatment to "qualified payments"
- Qualified payments include declared but unpaid dividends, rents and royalties

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Foreign Currency Developments

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Financial Instruments & Strategies

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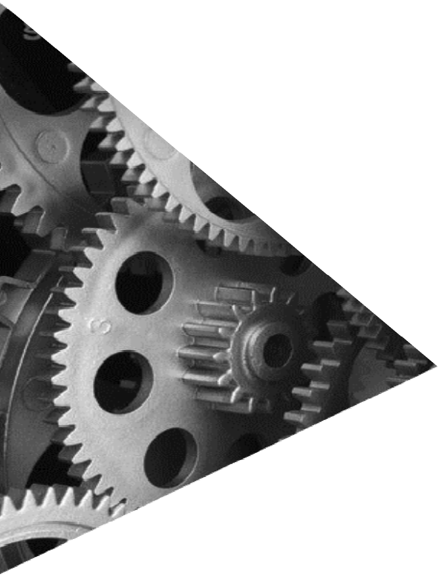
- This presentation is an overview, not a comprehensive course on the accounting and taxation of foreign currency

Contents

- Background
- Overview of Foreign Currency Transactions Under Section 988
- Overview of Subpart F Treatment of Foreign Currency Transactions
- Overview of Foreign Branch Currency Translation Under Section 987
- Examples

Background



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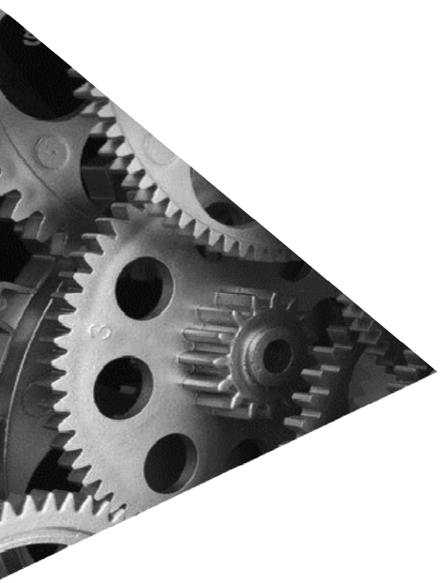
Foreign Currency Key Concepts

- Qualified business unit under section 989(a)
- Functional currency under section 985(b)
- Translational exchange gain/loss under section 987
- Transactional exchange gain/loss under section 988

Overview of Foreign Currency Transactions Under Section 988



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Section 988 – In General

- Section 988 transactions may give rise to foreign currency gain or loss
- Section 988 transactions include:
  - Disposition of nonfunctional currency
  - Acquiring or becoming an obligor under a nonfunctional currency-denominated (or determined) debt instrument
  - Accruing a nonfunctional currency-denominated (or determined) item of income or expense
  - Entering into a nonfunctional currency-denominated (or determined) forward contract, futures contract, option, or similar financial instrument (e.g., a currency swap)
    - Does not include any regulated futures contract or nonequity option that would be marked-to-market under section 1256, absent election to apply section 988

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Section 988 – In General (cont.)

- Section 988 transactions do not include:
  - Foreign currency-denominated equity transactions
  - Foreign currency-denominated equity or commodity swaps
  - Any other foreign-currency denominated derivative instrument where underlying position is not a §988 transaction (for example, forward contract to purchase commodity denominated in nonfunctional currency)
- Gain or loss generally sourced to residence of taxpayer (or qualified business unit) on whose books the item is properly reflected
- Gain or loss generally treated as ordinary income or loss
- Reportable loss transaction disclosure requirement

Section 988 Hedging Transactions

- Section 988(d) grants regulatory authority for IRS to treat all transactions that are part of a "§988 hedging transaction" as a single integrated transaction
  - Regulations apply only to debt instruments, executory contracts and purchases or sales of publicly traded stock
  - Example: Treat FX hedge of FX debt collectively as a single synthetic debt instrument denominated in the currency into which the debt instrument is hedged
    - Neither hedge nor debt instrument subject to mark-to-market or straddle rules (unless qualified hedging transaction is part of a straddle)
    - Interest expense on synthetic borrowings allocated as interest
    - Qualifying debt instrument and hedge are treated separately if U.S.-source and non-effectively connected for purposes of §§871(a), 881, 1441, 1442, and 6049

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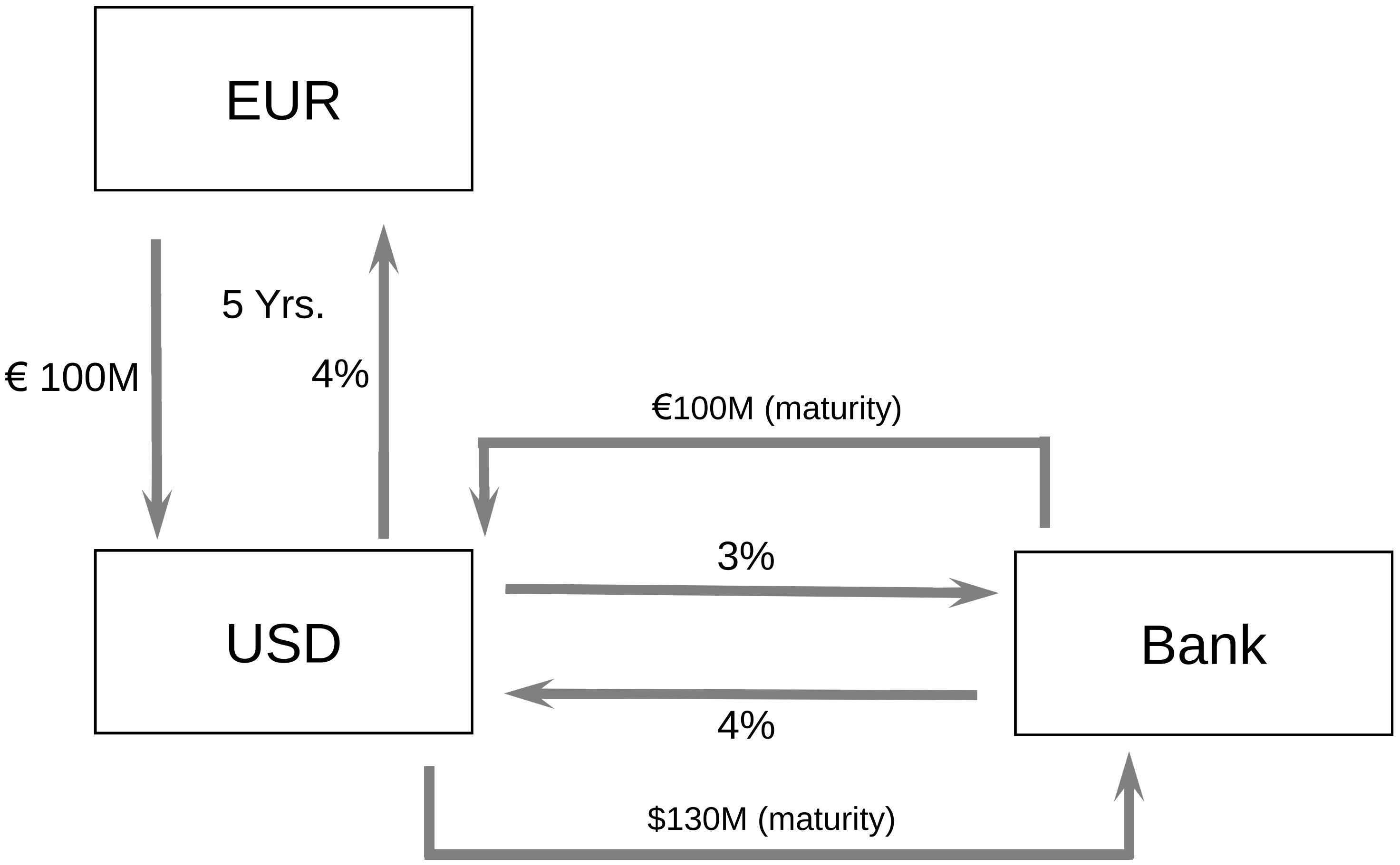
Qualified Hedging Transactions

- Qualified Hedging Transaction (QHT) is defined as an "integrated economic transaction" consisting of:
  - Qualifying debt instrument
    - Debt instrument regardless of whether denominated in (or determined by reference to) nonfunctional currency
    - Does not include accounts payable, accounts receivable, or similar items of expense or income
  - Reg. §1.988-5(a) hedge:
    - Spot contract
    - Futures contract
    - Forward contract
    - Option contract
    - Swap contract
    - Similar financial instrument

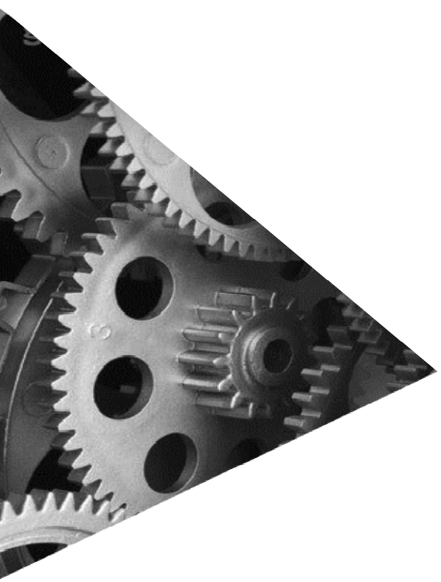
Qualified Hedging Transactions – Requirements

- All payments to be made or received under the qualifying debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged on the date the taxpayer identifies the transaction as a QHT
- Hedge is properly identified on or before the date the hedge is entered into
  - Specific identification and recordkeeping requirements in Reg. § 1.988-5(a)(8)
- None of the parties to the hedge are related under §§ 267(b) or 707(b)
- For a QBU outside the US, both qualifying debt instrument and hedge must be properly reflected on the books of the QBU throughout the term of the QHT
- Both the qualifying debt instrument and the hedge are entered into by the same taxpayer

Example of Integrated Borrowing



Overview of Subpart F Treatment of Foreign Currency Transactions



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Subpart F Treatment of Foreign Currency Transactions – In General

- Net foreign currency gain is generally foreign personal holding company income ("FPHCI")
  - Net foreign currency loss generally cannot reduce other Subpart F income, but see Section 952(c)(1) and Reg. § § 1.954-2(g)(3) and (g)(4)
- FPHCI does not include foreign currency gain or loss directly related to the business needs of the CFC (the "business needs exception")
  - Including a bona fide hedging transaction
- Special rule for foreign currency gain or loss from an interest bearing liability
  - Characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under Temp. Treas. Reg. § § 1.861-9T and 1.861-12T

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Subpart F Treatment of Foreign Currency Transactions – Business Needs Exception

- Foreign currency gain or loss is directly related to the business needs of a CFC if it:
  - Arises from a transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the CFC's trade or business, other than the business of trading foreign currency;
  - Arises from a transaction or property that does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign currency gain or loss;
  - Does not arise from a foreign currency denominated forward contract, futures contract, option or similar financial instrument; and
  - Is clearly determinable from the records of the CFC as being derived from such transaction or property

Subpart F Treatment of Foreign Currency Transactions – Bona Fide Hedging Transaction

- Foreign currency gain or loss is directly related to the business needs of a CFC if it:
  - Arises from a bona fide hedging transaction with respect to a transaction or property that satisfies the first three requirements described in the prior slide, provided that any gain or loss arising from such transaction or property is clearly determinable from the records of the CFC
    - Hedging transaction must meet the requirements of Reg. § 1.1221-2(a) through (d) and the identification requirements of Reg. § 1.954-2(a)(4)(ii)(B), except that the risk being hedged may be with respect to ordinary property, section 1231 property or a section 988 transaction

Section 1221 Hedging Transactions and Identification Requirements

- Transactions entered into by the taxpayer in the normal course of business primarily to
  - Manage risk of price changes or currency fluctuations with respect to “ordinary” property held or to be held; or
  - Manage risk of interest rate, price changes, or currency fluctuations on borrowings or “ordinary obligations” incurred or to be incurred
- Not available for hedges of ordinary income streams from capital assets
- Risk hedged must be taxpayer’s own
- Unambiguous tax identification required
  - Same-day identification of hedge
  - “Contemporaneous” (35-day) identification of hedged risk and accounting methods

Subpart F Treatment of Foreign Currency Transactions – Loss Limitation Rules

- A loss in the foreign currency FPHCI category may not reduce any other category of FPHCI or foreign base company income (“FBCI”), except by operation of the E&P limitation under section 952(c)(1) (i.e., current E&P)
- Relief from loss limitation rule
  - Treas. Reg. § 1.954-2(g)(3) provides an election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category (i.e., another category of FPHCI or, if applicable, another category of FBCI)
  - Treas. Reg. § 1.954-2(g)(4) provides an election to treat all foreign currency gains or losses as FPHCI
    - If such an election is made, foreign currency losses over foreign currency gains may be apportioned to, and offset, other categories of FPHCI

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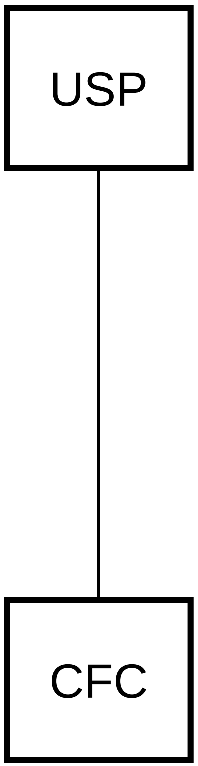
Subpart F Foreign Currency Gains and Losses



- CFC serves as the finance and currency coordination center for the US multinational group.
- Year 1: CFC has net FX gain of $100. USP must include $100 of Subpart F income on its US return.
- Year 2: CFC has net FX loss of $(100). The loss generally does not reduce USP's inclusion from CFC's other Subpart F income.

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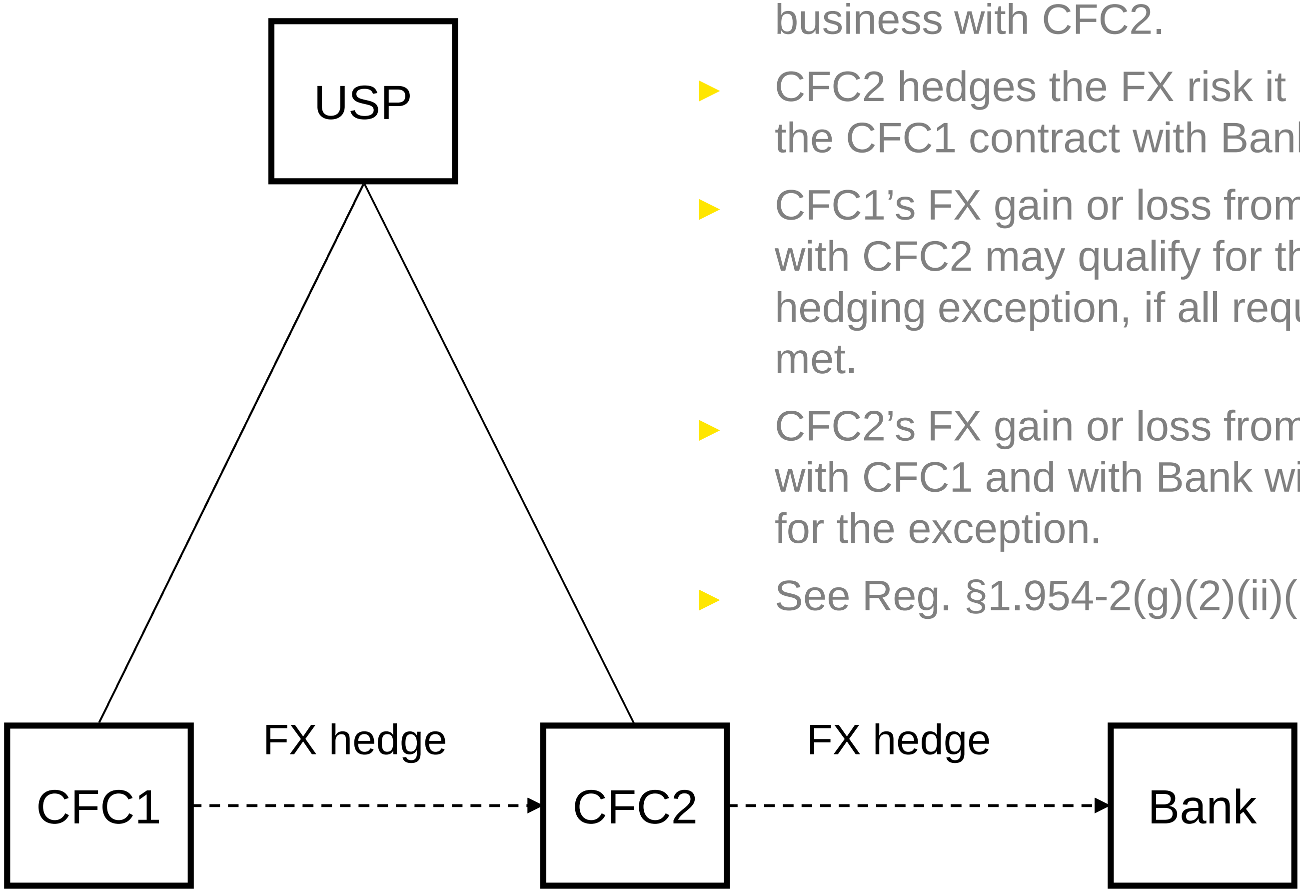
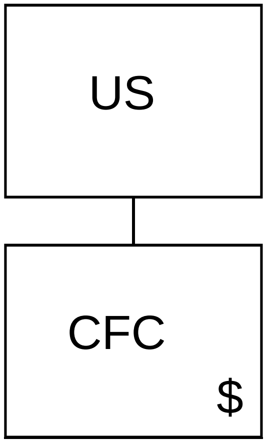
Business Needs Exception – Bona Fide Hedging Transactions



- CFC1 hedges the FX risk arising from its business with CFC2.
- CFC2 hedges the FX risk it incurs from the CFC1 contract with Bank.
- CFC1's FX gain or loss from the contract with CFC2 may qualify for the bona fide hedging exception, if all requirements are met.
- CFC2's FX gain or loss from the contract with CFC1 and with Bank will not qualify for the exception.
- See Reg. §1.954-2(g)(2)(ii)(D).

Reg. §1.954-2(g)(3) Election – Example



Facts

1. CFC earns and accrues FBCSI under §954(d)(1) of GBP 100 when the exchange rate is GBP 1:USD 2
2. CFC receives payment on such accrual when the exchange rate is GBP 1:USD 1.5
3. Thus, CFC has an exchange loss of $50

Results without Reg. §1.954-2(g)(3) Election

- CFC has $200 of FBCSI
- CFC has $50 exchange loss in the §954(c)(1)(D) FPHCI category that generally cannot reduce other FPHCI or FBCI

Results with Reg. §1.954-2(g)(3) Election

- CFC has $150 of FBCSI
  - ($200 FBCSI) less ($50 exchange loss)

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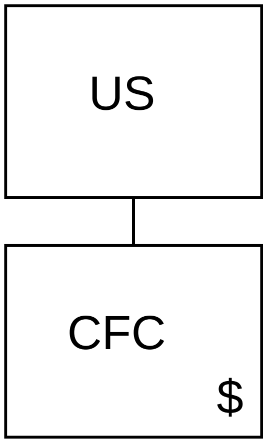
Reg. §1.954-2(g)(4) Election – Example



Facts

1. CFC earns $200 of FPHCI interest under §954(c)(1)(A)
2. CFC has an unrelated FPHCI exchange loss of $50 under §954(c)(1)(D)
3. CFC has "business needs" exchange gain of $20 under Reg. §1.954-2(g)(2)(ii) (i.e., non-FPHCI)
4. CFC has other non-FPHCI of $100

Results without Reg. §1.954-2(g)(4) Election

- CFC has $200 of FPHCI
- CFC has $70 of non-subpart F general limitation E&P
  - $50 exchange loss offsets $120 non-FPHCI general limitation E&P (See Reg. §1.954-1(c)(1)(ii))

Results with Reg. §1.954-2(g)(4) Election

- CFC has $170 of FPHCI (and $100 of non-FPHCI)
  - ($200 FPHCI interest) less (($50 exchange loss) plus ($20 business needs exchange gain))

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Overview of Foreign Branch Currency Translation Under Section 987

Building a better working world

When Does Section 987 Apply?

- Section 987 applies when a taxpayer owns a QBU that uses a different functional currency
- Examples:
  - US Corp owns UK branch that uses pound sterling as its functional currency
  - Swiss CFC owns German manufacturing branch, and Swiss CFC's functional currency is Swiss franc while German branch uses the euro
  - Swiss CFCs are partners in an Italian partnership, where Swiss CFCs use Swiss franc as their functional currency and Italian partnership uses the euro

What Does Section 987 Require?

- Accounting for the taxable income or loss of a branch by its owner
  - Translated from the branch's functional currency into the owner's functional currency at the average rate for the taxable year
- Recognition of gain or loss on remittances from a QBU branch
  - When a branch actually distributes property to its owner, the owner may realize more or less in its own functional currency than its basis in the property

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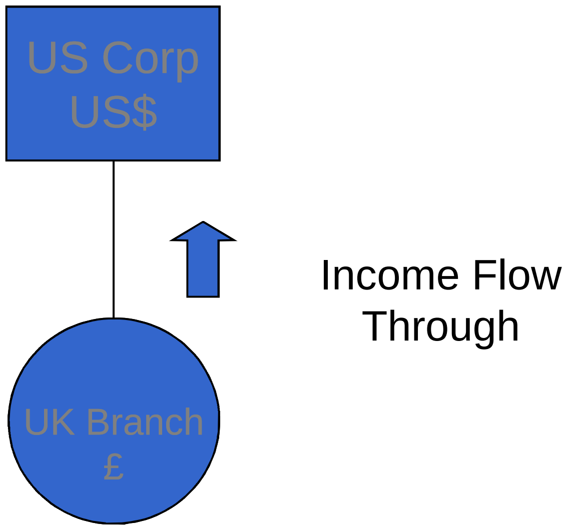
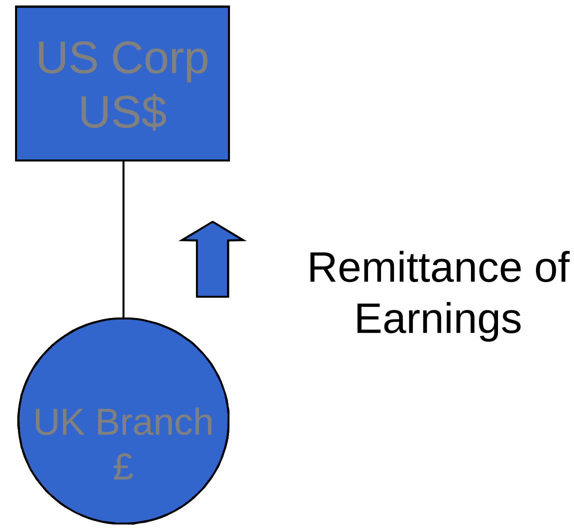
Section 987 Gain or Loss Example





In Year 1, the UK Branch earns £100 when the exchange rate is $2 = £1. US Corp includes $200 of branch income in its U.S. income tax return.

In Year 2, the UK Branch distributes the prior year's branch income of £100 to US Corp when the exchange rate is $1.5 = £1. US Corp receives $150 of previously taxed income and recognizes a $50 §987 loss.

Section 987 History

- 1991 Final Regulations (apply to pre-1987 branches)
- 1991 Proposed Regulations
  - Never finalized and generated many unanswered questions
  - Some taxpayers have applied the regs. or a hybrid of the regs.; others have done something else or nothing at all
- Notice 2000-20
  - Indicated IRS intention to rework the regulations and noted several issues to be addressed
  - Seen as a repudiation of some or all of 1991 regulations
- 2006 Proposed Regulations
  - Withdrew the 1991 Proposed Regulations
  - Eliminate "non-financial assets" from pools and calculation
  - Two transition rules (depending on use of a "reasonable method")

Section 987 – Final regulations?

- Government Officials have indicated final regulations are close…
  - Has been said for the last 28 years
  - Recent developments lend some credence
- What does this mean for taxpayers who:
  - Have not reasonably complied with §987
  - Have reasonably complied with §987
  - Have early adopted the 2006 Prop. Regs.
- *See* “How I Learned to Stop Worrying and Love Section 987: From Marks to Marked Items: Tax Notes International, 29 April 2013

2006 Prop. Regulations – Foreign Exchange Exposure Method

- Adopt a foreign exchange exposure pool ("FEEP") method to calculate net unrecognized section 987 gain or loss
  - Balance sheet approach to determine exchange gain or loss
  - Exchange gain or loss arises from "marked items" (monetary assets and liabilities that would be §988 transactions to the owner)
  - Exchange gain or loss identified annually but pooled and deferred until remittance
  - Exchange gain or loss taken into account upon a remittance equals the owner's portion of the QBU's net unrecognized section 987 gain or loss, multiplied by the owner's "remittance proportion"
  - Draws from both the "net worth" and "profit and loss" methods
- Effective date
  - One year after the first day of the first taxable year following the date the regulations are finalized
  - For calendar year companies: 2016 if finalized in 2014

2006 Prop. Regulations – Summary of Changes

- CTB holding branch generally not a QBU - head office deemed to own stock and partnership interests actually held by its branch
- A corporation or partnership itself is not an eligible QBU (even though a corporation or a partnership may have activities that qualify as an eligible QBU)
- Flat structure approach
- Unrecognized section 987 gain/loss determined based only on monetary assets/liabilities (i.e., “marked items”)
- Remittances determined on annual rather than daily basis
- Branch income
  - Requires translation of inventory, depreciation, and amortization using historical rates
    - May change taxable income significantly compared to the 1991 proposed regulations—depends on currency fluctuations
    - Significant additional compliance burden

2006 Prop. Regulations – Summary of Changes (Cont.)

- Inter-branch transactions
  - Can elect to combine branches of the same owner that have the same functional currency
  - Otherwise, rules similar to 1991 proposed regulations – all inter-branch transactions deemed remittances and contributions
- Terminations
  - Section 987 gain/loss recognized on all contributions of a section 987 QBU to a corporation under section 351
  - Under the aggregate approach, a partnership termination may not necessarily result in section 987 gain/loss
  - Other rules similar to those in 1991 proposed regulations
- Section 987 gain can be subpart F income
  - Authority based on section 989(c)(5)
  - Apportioned based on the asset method for interest expense apportionment purposes

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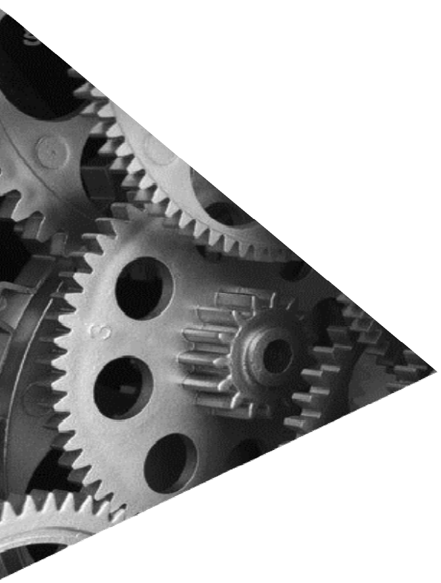
2006 Prop. Regulations – What Does It Mean in Practical Terms?

- Smaller amounts of section 987 gain/loss
- Greater fluctuations in branch income/loss
- Significant change in compliance burden
  - Decreased burden: Remittances computed on an annual basis rather than a daily basis
  - Increased burden: Tracking historical rates for non-current assets to compute branch income
- The proposed regulations do not adopt the approach that only capital transactions, not ordinary business transactions, should be subject to section 987
  - Issues mitigated by election to combine branches with the same functional currency

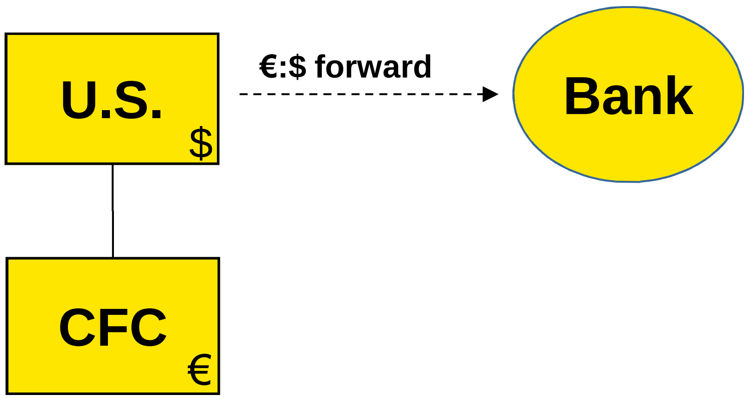
What To Do Now?

- Section 987 is in the Code and should not be ignored
- Identify current section 987 QBUs
- Verify current method of accounting for section 987 gain or loss upon remittances
- Determine operational and structural objectives
- Develop process to gather data and perform computations
- Determine historic translation rates for balance sheet items (determine reasonable allocation methods as necessary)
- Model effect of transition rules

Examples

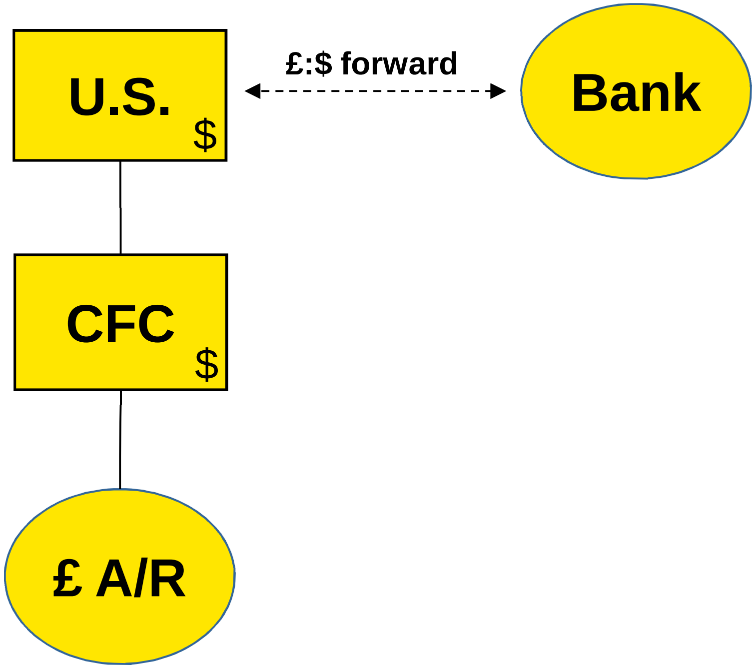


U.S. Hedge of Net Investment in CFC



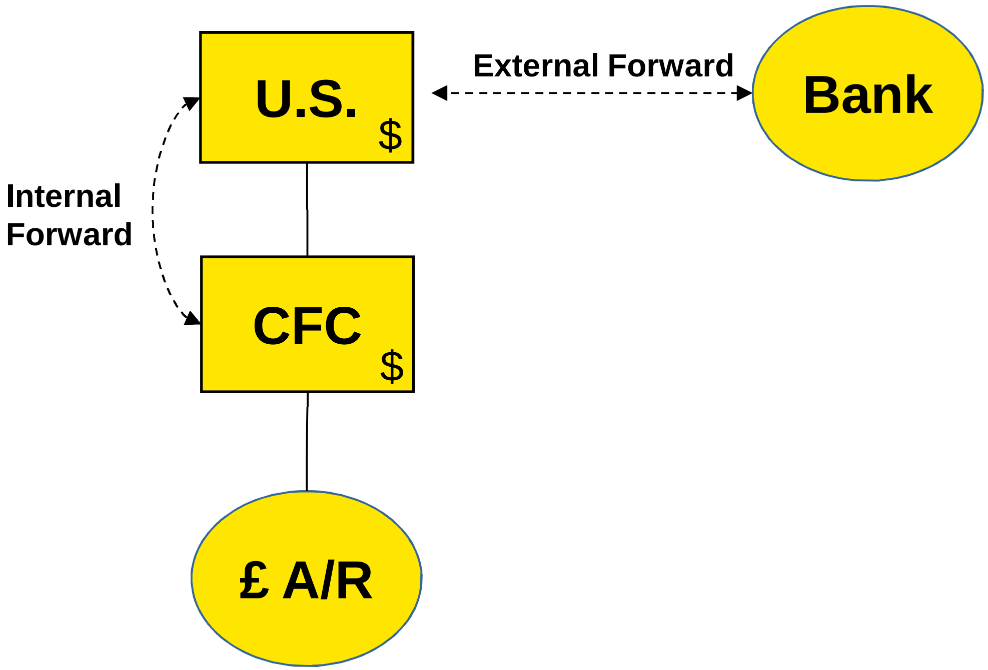
- Generally, ineligible for tax hedging treatment (not ordinary property)
- Forward may be marked-to-market under Section 1256, accelerating gains
- Section 1092 straddle provisions may defer losses to the extent of any unrecognized gain in offsetting positions
- Character, if derivative is not FX
- Realization upon actual or deemed payments if a debt instrument is used

U.S. Hedge of Foreign Receivables



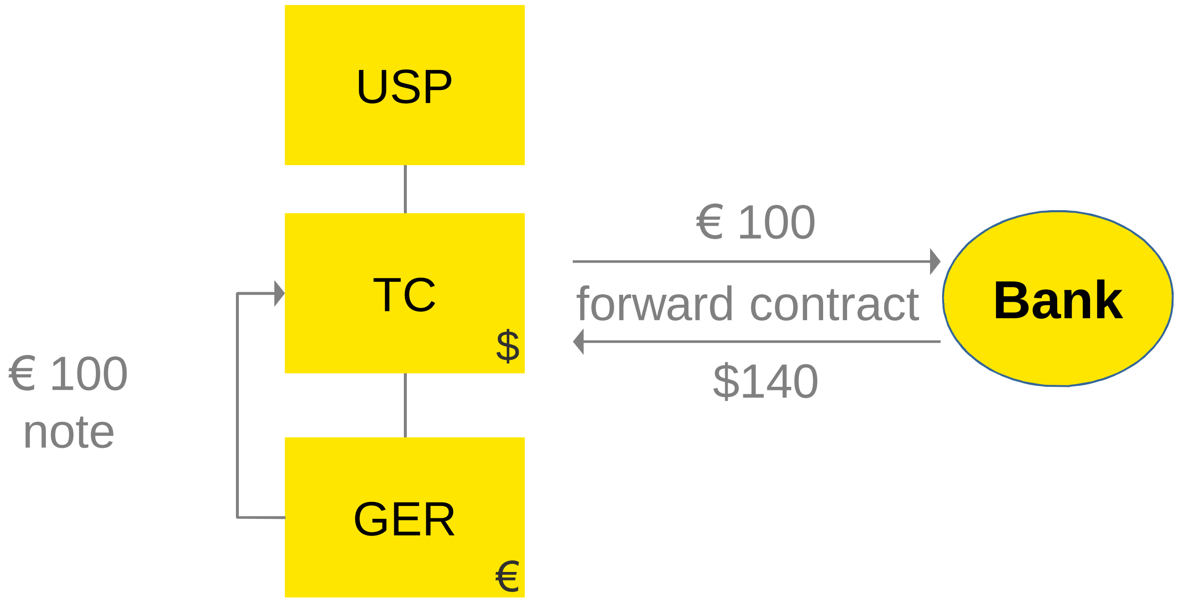
- Generally, ineligible for hedging treatment (not a risk of the taxpayer)
- Forward may be marked-to-market under Section 1256, accelerating gains
- Section 1092 straddle provisions may defer losses to the extent of any unrecognized gain in any offsetting positions
- Character, if derivative is not FX

U.S. Hedge of Foreign Receivables with Back-to-Back Hedge



- US level
  - Potential timing mismatch: External Forward generally marked-to market under Section 1256; Internal Forward generally not marked-to market under Section 1256
  - Section 1092 straddle provisions may defer losses to the extent of any unrecognized gain in offsetting positions
  - Is US a dealer in securities under Section 475(a)?
  - Can External Forward be a Section 1221 hedging transaction?
  - Are forwards entered into in the normal course of US's business?
- CFC level
  - Exchange gains and losses generally FPHCI, unless business needs exception applies

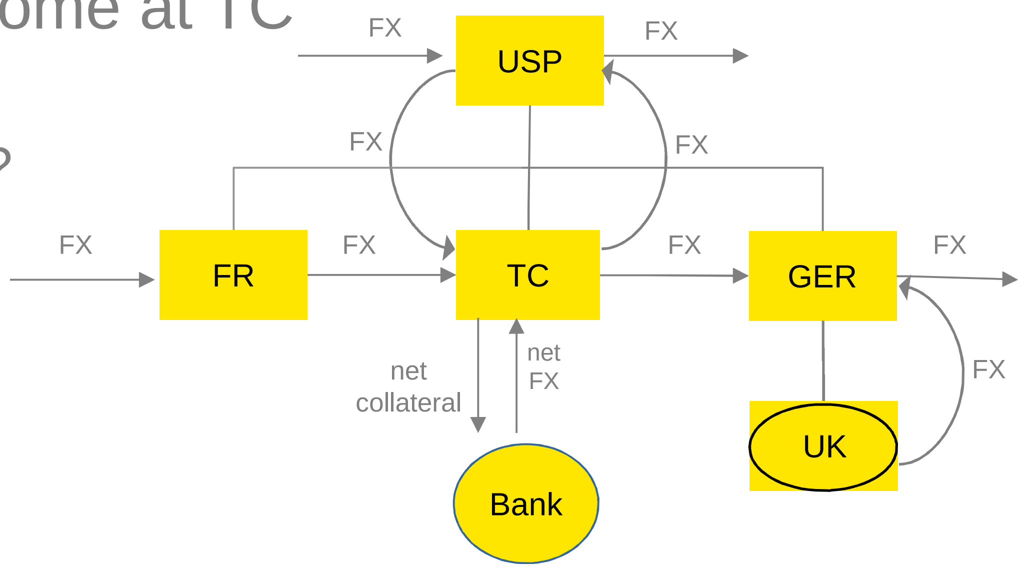
Hedging 'Impermissible' Exposures



- Net FX gains on forward and note are FPHCI
  - Beware of timing whipsaws under §§1256 and 1092
- Bona fide hedging exception -
  - If € note reasonably expected to give rise to subpart F income, fails as hedge
- What if note and hedge are in US?

Centralized FX Hedging

- Intercompany derivatives can qualify as bona fide hedges
  - Regarded exposures/entities
  - Disregarded exposures/entities
- TC nets intercompanies, enters into net hedges with bank
- Manage subpart F income at TC
  - Section 475(a)
  - Reg. §1.954-2(g)(2)(ii)?



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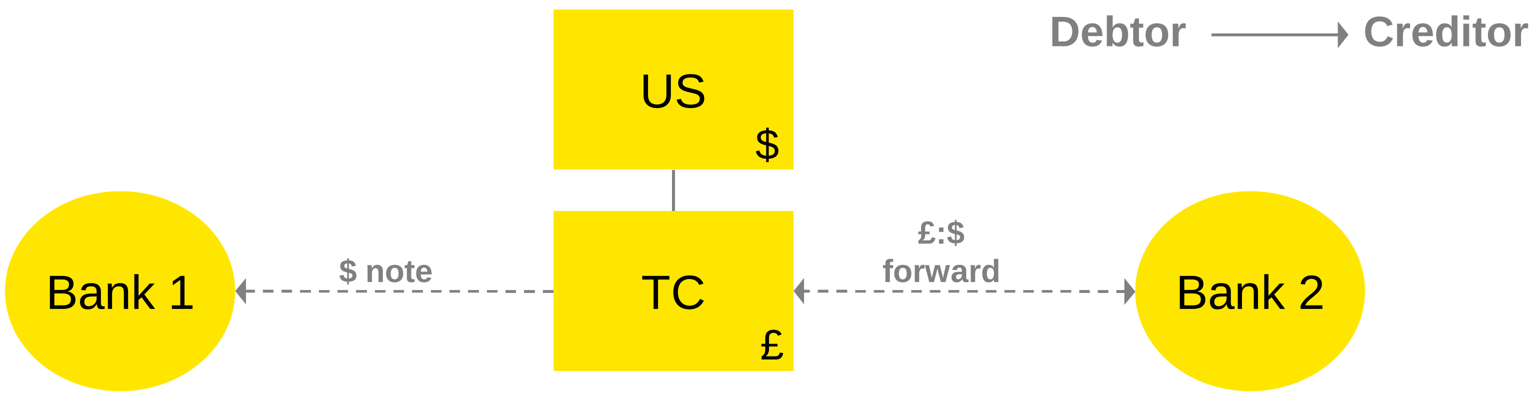
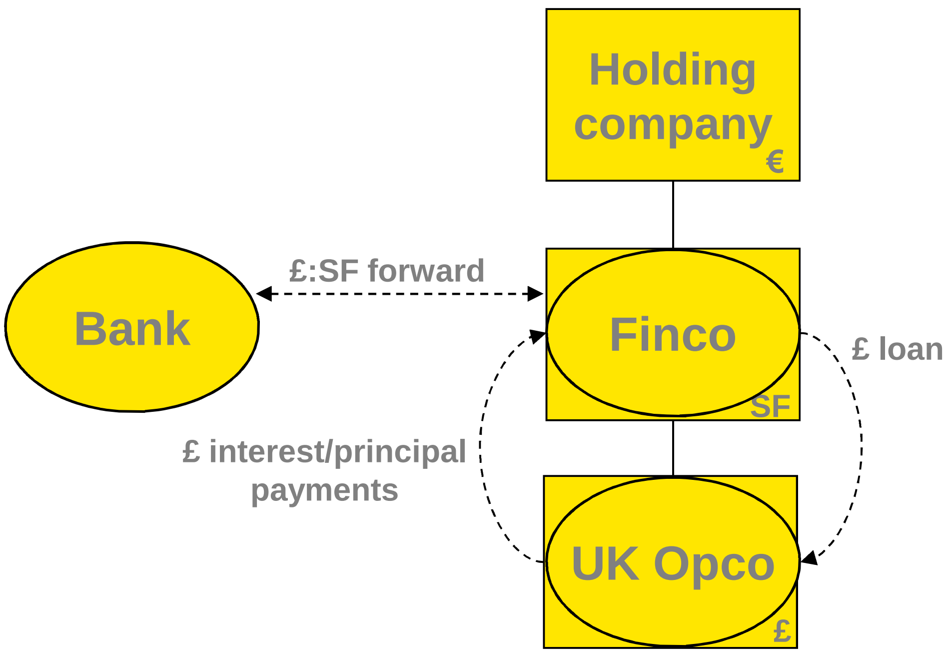
CFC Hedge of Nonfunctional Currency Borrowing



- Potential subpart F income exposure
  - Exchange gain or loss on borrowing is apportioned between subpart F and non-subpart F
  - Exchange gain or loss on hedge may be wholly subpart F or non-subpart F income or apportioned
- Options
  - Integrate debt with hedge under Reg. § 1.988-5
  - Temp. Reg. § 1.861-9T(b)(1) and (6) whipsaw
- Potential passive basket income
  - Identify as a bona fide hedging transaction under Reg. § 1.954-2(a)(4)(ii)(B)

CFC Hedge of Intra-taxpayer Transaction



- Disregarded interest and loan
- "Interest" and "principal" payments may result in Section 987 gain or loss
  - Section 987 method
  - Tiered vs. flat structure
- Forward contract is not disregarded ("naked hedge")
- Forward contract may be marked-to-market under Section 1256
- Potential subpart F income exposure

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