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US Taxation of Structured Notes

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History

- Common law: taxpayer's method of accounting
- Code section 1275(d)
- 1986 proposed OID regulations
- 1996 OID regulations

Dollar Bond Index Linked Securities ("Dollar BILS")

- Lehman Brothers Corporate Bond Index-Total Return (simplified example)
- 10 different 10% corporate bonds, all purchased on index start date for $100 each so initial index value= $1000
- Interest payments deemed reinvested in the index
- So, if all bonds paid 5% on the same first semi-annual interest payment date, and all bonds were still worth $100 each then $50 interest payment deemed reinvested in $5 par amount for each of the same 10 bonds
- Result: After 6 months, index value is $1050

Dollar BILS

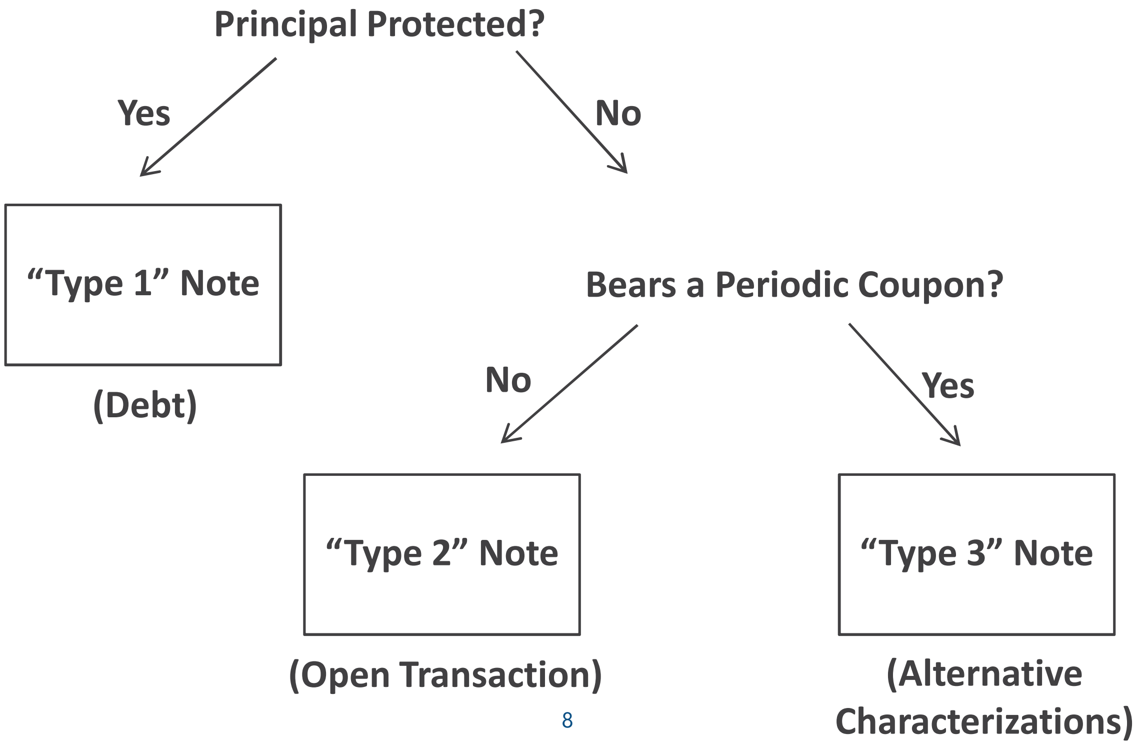
- Merrill Lynch issues $100 million Dollar BILS
- Senior debt
- Principal protected
- Due in 10 years
- No current interest payments
- Interest payment at maturity equal to increase, if any, in Lehman Corporate Bond Index-Total Return from start date to maturity date

Dollar BILS Common Law

- Cash method taxpayer: includes interest in gross income when the taxpayer actually (or constructively) receives the interest
- Accrual method taxpayer: "all events" test
- Result for Dollar BILS
  - Holder not required to include interest income before maturity
  - Sale before maturity: potential long-term capital gain

Structured Notes – Tax Classification

Tax Classification



Tax Classification (con't)

- Type 1 Notes
  - Fixed rate debt, variable rate debt, contingent payment debt
  - OID
- Type 2 Notes (non-principal protected with single payment at maturity)
  - Open transaction
  - Notice 2008-2
- Type 3 Notes (non-principal protected with periodic payments)
  - Unit consisting of components (debt/deposit plus a derivative)
  - Single instrument
- Special Considerations
  - Foreign currencies; Rev. Rul. 2008-1
  - Expectations vs. legal entitlements

Notice 2008-2

- Government requested comments
- Considering tax policy issues:
  - "In connection with certain financial transactions frequently referred to as prepaid forward contracts (or in certain circumstances as exchange traded notes)"
- Considering whether parties should be required to accrue income/expense during term
- Nothing has happened...
- Waiting for mark-to-market?

Select Tax Considerations

Constructive Ownership (Section 1260)

- Under Section 1260, if a taxpayer has gain from a “constructive ownership transaction” with respect to any “financial asset” (commonly referred to as a “1260 Asset”), then that gain is treated as ordinary income to the extent it exceeds the taxpayer’s “net underlying long-term capital gain”
  - “Constructive ownership transactions” generally include derivatives such as notional principal contracts, forward contracts, and certain pair option strategies
  - “Financial asset” includes interests in regulated investment companies, real estate investment trusts, S corporations, partnerships, trusts, common trust funds, PFICs, and REMICs
  - “Net underlying long-term capital gain” is generally the amount of gain the taxpayer would have had if it held the underlying directly. This is assumed to be zero unless established by clear and convincing evidence by the taxpayer
- In addition, Section 1260 imposes an interest charge on the deferral of gain recognition, requiring the taxpayer to allocate the recharacterized gain to each taxable year of the taxpayer’s holding period

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Constructive Ownership (Section 1260) (con't)

- Sample disclosure:

While the matter is not entirely clear, to the extent a Basket Component is the type of financial asset described under Section 1260 of the Code (including, among others, any equity interest in pass-thru entities such as regulated investment companies (including certain exchange-traded funds), real estate investment trusts, partnerships, trusts and passive foreign investment companies, each a "Section 1260 Financial Asset"), there exists a substantial risk that an investment in the notes is, in whole or in part, a "constructive ownership transaction" to which Section 1260 of the Code applies. If Section 1260 of the Code applies, all or a portion of any long-term capital gain recognized in respect of a note will be recharacterized as ordinary income (the "Excess Gain"). In addition, an interest charge will also apply to any deemed underpayment of tax in respect of any Excess Gain to the extent such gain would have resulted in a gross income inclusion in taxable years prior to the taxable year of the sale, exchange, or settlement (assuming such income accrued at a constant rate equal to the applicable federal rate as of the date of sale, exchange, or settlement).

If an investment in a note is treated as a constructive ownership transaction, it is not clear to what extent any long-term capital gain in respect of the note will be recharacterized as ordinary income. It is possible, for example, that the amount of the Excess Gain (if any) that would be recharacterized as ordinary income in respect of the note will equal the excess of (i) any long-term capital gain you recognized in respect of the note and attributable to Section 1260 Financial Assets, over (ii) the "net underlying long-term capital gain" (as defined in Section 1260 of the Code) you would have had if you had acquired an amount of the corresponding Section 1260 Financial Assets at fair market value on the original issue date for an amount equal to the portion of the issue price of the note attributable to the corresponding Section 1260 Financial Assets and sold such amount of Section 1260 Financial Assets upon the date of sale, exchange, or settlement of the note at fair market value (and appropriately taking into account any leveraged upside exposure). To the extent any gain is treated as long-term capital gain after application of the recharacterization rules of Section 1260 of the Code, such gain would be subject to U.S. federal income tax at the rates that would have been applicable to the net underlying long-term capital gain. However, unless otherwise established by clear and convincing evidence, the net underlying long-term capital gain is treated as zero. You should consult their tax advisors regarding the potential application of Section 1260 of the Code to an investment in the note.

PFIC and FIRPTA

- PFIC and FIRPTA typically carved out with disclosure such as:
  - We will not attempt to ascertain whether the Reference Asset or any of the entities whose stock is owned by the Reference Asset would be treated as a passive foreign investment company ("PFIC") or United States real property holding corporation ("USRPHC"), both as defined for U.S. federal income tax purposes. If the Reference Asset or one or more of the entities whose stock is owned by the Reference Asset were so treated, certain adverse U.S. federal income tax consequences might apply. You should refer to information filed with the SEC and other authorities by the Reference Asset or the entities whose stock is owned by the Reference Asset and consult your tax advisor regarding the possible consequences to you if the Reference Asset or one or more of the entities whose stock is owned by the Reference Asset is or becomes a PFIC or a USRPHC.
- Under FIRPTA, a U.S. real property interest generally does not include publicly traded stock in a corporation if the interest in such corporation is held by a person that owns five percent or less of the total fair market value of such corporation's publicly traded stock for the prescribed period
  - Structured notes do not generally reach notionals high enough to exceed this exception, although some uncertainty in regulations on how to apply the test.

Form 8281

- Issuer of a "publicly offered" debt instrument issued with OID generally required to file Form 8281 within 30 days of issue date
- Publicly offered if:
  - Registered with the SEC, or
  - Would be required to be registered under the Securities Act of 1933 but for an exempt from registration (a) under section 3 of the Securities Act of 1933, (b) under any law (other than the Securities Act of 1933) because of the identity of the issuer or the nature of the security, or (c) because the issue is intended for distribution to persons who are not US persons
- Both debt instruments issued at a discount and other principal protected notes treated as contingent payment debt instruments

Withholding Tax

- U.S. imposes a 30% withholding tax on payments of U.S. source "FDAP" income (interest, dividends, etc.) to foreign investors
  - Portfolio interest exception
  - Capital gains of foreign investors generally exempt
  - Impact of "dividend equivalents"
- Type 1 Notes – No withholding because the interest payment qualifies for the portfolio interest exemption (or because foreign source)
  - Potential exclusion from PIE under Code Section 871(h)(4)(A) for interest contingent on sales, receipts, income, profits, or change in value of property of debtor
- Type 2 Notes – No withholding because no FDAP, only capital gain
- Type 3 Notes – Unclear; source of payments?

Dividend Equivalents

- 30% U.S. withholding tax on U.S.-source “dividend equivalent” amounts – a dividend equivalent includes:
  - Any substitute dividend made pursuant to a securities-lending or “repo” transaction
  - Any amount paid pursuant to a “specified notional principal contract” and that is contingent on, or determined by reference to, the payment of a U.S.-source dividend
  - Any amount that the Treasury determines is substantially similar to the above items

Dividend Equivalents (con't)

- Regulations/Effective Dates
  - Final and temporary Section 871(m) regulations issued September 18, 2015
  - Applicable to instruments issued on or after January 1, 2019; prior to 2023, only "delta one" instruments covered
- Highlights
  - Simple vs. Complex instruments
  - Delta threshold of 0.80 for Simple instruments, "substantial equivalence test" for Complex instruments
  - Delta (or substantial equivalence test) determined once (at inception)
  - Estimated and implicit dividends taken into account
  - Qualified index exception
  - Combined transactions
  - Derivative within debt instruments (convertible debt or CPDI)
  - Withholding at the later of payment or when amount of dividend equivalent is determined

Potential Issue with Indices

- In 2015, IRS released Notices 2015-73 and 2015-74. The Notices are targeted at the perceived abuse of certain "basket option contracts."
  - Example of basket option transaction: Bank marketed to taxpayer seeking hedge fund exposure a two year call option written by the Bank. Contract designated a portfolio manager related to taxpayer. Over the course of two years, Manager would change out components to make basket performance more profitable. The contract was designed so that taxpayer would not recognize gain or loss currently, and would receive long term capital gain at maturity, thus converting ordinary income and short-term capital gain into long-term capital gain. CCA 201547004.
  - Notice 2015-73 targeted at these specific facts, characterizing such transactions as "listed transactions"
- Notice 2015-74 broader, characterizing transactions that are contracts based on the performance of a reference basket as "transactions of interest" if: (1) taxpayer (T) enters into a contract to receive a return based on the performance of the reference basket; (2) the basket contract has a stated term of more than one year or overlaps two of T's taxable years; (3) **T or T's designee** has exercised discretion to change (either directly or through a request to counterparty) the assets in the reference basket or the trading algorithm
- Certain exceptions for widely used or publicly quoted indices and changes to administer the index, provided such changes are not designed to improve index performance

Tax Considerations for COVID-19

- Plenty of legislative tax changes and IRS guidance – not much in the structured notes space
- Tax considerations?
- Issuers continue to issue structured notes
- At some point (but not this year) Congress may again turn to revenue raising

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