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Derivatives Taxation – Current Developments for Financial Institutions

Key Issues for Financial Institutions and Their Clients

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Today's Speaker

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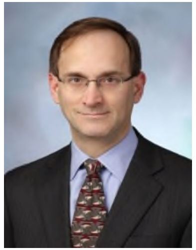
Mark is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and working with credit funds, offshore insurance companies and hedge funds. Prior to joining Mayer Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice. Mark began his legal practice at Skadden Arps and then at Weil Gotshal.

Today's Speaker



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Matthew Stevens is a principal in the Capital Markets group at EY. He handles planning and controversy matters regarding the U.S. federal income tax consequences of transactions, specializing in the design, structuring and implementation of domestic and international financial transactions, including cryptocurrency. He advises hedge funds, private equity funds, financial institutions, high net worth individuals (both U.S. and non-U.S.) and foreign and domestic multinational corporations.

Matthew serves as chair of the annual Practicing Law Institute program "Taxation of Financial Products and Transactions." He has served as chair of the Financial Transactions Committee of the Tax Section of the District of Columbia Bar, and as the chair of the Financial Transactions Committee of the Tax Section of the American Bar Association. He has co-taught the Georgetown University Law Center class entitled "United States Taxation of International Income – II." He has published a number of articles dealing with international aspects of U.S. income tax and with the taxation of financial products and transactions. Matthew is listed in Chambers USA: America's Leading Lawyers for Business. From 2002 to 2004, Matthew served as special counsel to the Chief Counsel for the Internal Revenue Service. There, he advised the Chief Counsel regarding published guidance on a wide range of tax issues involving financial products and cross border transactions.

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Topics to Be Covered

- **Inflation Reduction Act Minimum Tax**
- **Base Erosion Anti-Avoidance Tax Issues Faced by Financial Institutions**
- **Tax Reporting for Cryptocurrencies**
- **Litigation Finance Transactions – New(ish) Asset Class Ready for Securitization**

The Inflation Reduction Act Book Income Minimum Tax

The Inflation Reduction Act Added an Alternative Minimum Tax (Book Min Tax)

- **Tax only applies to corporations with average financial statement income (called Adjusted Financial Statement Income or AFSI) in excess of $1 billion for any 3-year period ending prior to the current year and after 2021. Tax begins in 2023.**
  - **For 2023, average income will be determined from 2020-2022**
- **Starting point is Form 10-K financial statement.**
  - **Income in any year is not reduced by NOL carryovers**
- **Aggregate members of consolidated group to determine if $1 billion threshold is exceeded.**
- **Once a corporation is in the new corporate AMT, it remains there until a change of ownership or IRS determines that its income has remained below the $1 billion threshold for a period of time.**
  - **Private equity funds are excluded from aggregation of corporate subsidiaries**

More on the New Book Minimum Tax

- Foreign-parented corporations have a lower threshold of $100 million – provided that worldwide group income is at least $1 billion.
- US branches of foreign banks are treated as a separate US corporation.
- AFSI may reduced by NOLs incurred in 2020 and after but NOLs are capped at 80% of AFSI.
- AMT Foreign Tax Credit can be taken only if taxes are taken into account on an applicable financial statement and is limited to the 15% rate times foreign subsidiary's income included in AFSI.
- Other tax credits can reduce AMTI by up to 25%.
- AMT can be applied as a regular tax credit in future years to the extent that the corporation's regular tax liability exceeds the BMT.

More on the New Book Minimum Tax

- **Income from CFCs is added to book income.**
- **Taxes do not reduce AFSI, so are add-backs in determining AFSI.**
- **BMT rate is 15%.**
- **Tax only applies to the extent that AFSI times the 15% rate exceeds the amount of regular tax imposed at the corporate rate of 21% plus BEAT.**
  - **15% tax is reduced by the corporate AMT foreign tax credit**
  - **Foreign taxes imposed on CFCs may also be credited**
- **BMT is not compliant with OECD proposed global minimum tax (Pillar 2).**
- **GILTI tax (10.5%) could result in application of BMT.**

Base Erosion Anti-Abuse Tax and Financial Institutions

US Base Erosion And Anti-Abuse Tax (BEAT) – Background

- Congress believed that base erosion structures enabled US corporations and US branches to strip earnings from the US tax net to lower tax jurisdictions
  - Common deductions included interest, royalties, management fees, and derivative payments
  - Funding US sub (or branch) with debt vs. funding US sub with equity
- Pre-2018 US rules did not prevent base erosion structures to the satisfaction of the US Congress
  - IRC § 163(j) (only applicable to interest)
  - § 163(j) allows netting of interest before limitation applies
- US has been reluctant to sign on to European BEPS initiatives

US Base Erosion And Anti-Abuse Tax (BEAT) – Who's Affected?

- Taxpayer must be taxable as a corporation in the US
  - All banks & insurance companies are taxable as corporations (including those operating through US branches)
- Average annual gross receipts for prior 3 years must exceed $500 million
  - US branch: Gross receipts test only looks to US branch transactions
  - All income of US subs is counted (even if not earned within the US)
  - Each company is attributed the gross receipts of its affiliates
- Base erosion percentage must exceed 2% (3% for non-financial business)
  - Percentage generally means ratio between the base erosion payment deductions and taxpayer's total deductions (including base erosion payments)
  - Not clear whether intercompany transactions must be considered on a gross or net basis

Base Erosion and Anti-Abuse Tax Overview

- **BEAT compares taxpayers' modified taxable income (MTI) to their ordinary income tax liability (reduced by certain tax credits)**
  - **MTI is the taxpayer's taxable income determined without regard to (i) certain deductible "base erosion payments" and (ii) the "base erosion percentage" of any NOL deduction**
- **If the taxpayer's tax liability on MTI (computed at 10% rate) is greater than its ordinary income tax liability, the excess represents an additional tax (BEAT).**
  - **12.5% beginning in 2026**
- **BEAT tax rate is 11% for financial institutions (13.5% beginning in 2026)**

Steps in Computing BEAT Tax

Determine if BEAT applies for the year, if so:

- Determine "modified taxable income" by adding back base erosion payments for such year, and base erosion payments in NOLs being used in such year.
- Modified taxable income means taxable income before credits without regard to (i) any base erosion tax benefit with respect to any base erosion payment or (ii) the base erosion percentage of any NOL deduction for the taxable year
- Multiply modified taxable income by 10%
  - Rate 12.5% after 2025
- Subtract regular tax liability from the result
  - Regular tax liability is pre-credit tax liability reduced (but not below zero) by credits other than R&D credits and 80% of certain other Section 38 credits (only), until 2026

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Base Erosion Payments Must Exceed Threshold

- **Base Erosion Percentage must be 3% or higher (2% for banks and securities dealers)**
- **Base erosion percentage equals**
  - **the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year divided by**
  - **the taxpayer's tax deductions for the taxable year (not including deductions for NOLs, participation exemption on foreign dividends, GILTI, FDII, certain payments w/r/t services, and deductions for certain qualified derivative payments)**
- **How are related party transactions taken into account? Statute would disregard all payments to foreign related parties.**
- **How are swaps and other derivatives treated?**
  - **Is a swap book treated on a gross basis, so that every transaction is separately considered or is netting taken into account?**
  - **IRS is reported to be interested in taxpayer comments on netting issue.**
  - **When a swap book is treated on a gross basis, a dealer is less likely to exceed base erosion percentage.**

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Base Erosion Payments

- “Base erosion payment” generally means any amount paid or accrued to a related foreign party that generates a deduction or is used to acquire depreciable/amortizable property (including also premiums and reinsurance payments)
- Payments that qualify as FDAP income and are subject to 30% WHT in the US are excepted. But if the WHT rate is lower because of a tax treaty, then only a corresponding portion of the payment is excluded from the MTI calculation.
- A significant risk exists that payments by a US sub to a US branch be treated as a base erosion payment, even if the branch picks up the payment as US income.
- Payments by one US branch to another could be base erosion payments if they are respected for federal income tax purposes
  - Treaty Method vs. Treas. Reg. § 1.882-5 Method (interbranch payments not recognized)

Excess Interest Payments by Branches

- **Taxpayers that operate through branches do not determine their interest expense solely be reference to US booked liabilities.**
- **Branch interest expense is determined by the amount of US assets, using a 3-part calculation that determines US connected liabilities.**
- **US connected liabilities are notional and the notional liabilities can give rise to notional interest deductions. The notional interest deduction can be subject to US withholding tax under Code § 884(f). Under Code § 884(f), the notional interest is considered to be paid to a non-US parent for purposes of Code § 881.**

Qualified Derivative Payment Exception

Determining a taxpayer's MTI – "Base Erosion Payments:"

- **Qualified derivative payments (QDP) made by the US branch or US subs are not treated as base erosion payments**
  - **QDP (i) must be accounted for on the mark-to-market method of accounting, (ii) must result in ordinary gain or loss, and (iii) all items in connection with the payment must be treated as ordinary. QDP do not include any non-derivative component**
  - **Mark-to-market transactions (IRC § 475) with affiliates give rise to base erosion payments even though income is not recognized through counterparty payments**
  - **Time value of money element inherent in any QDP must be stripped out and treated as base erosion payment**
  - **Does this rule require imputing a cost of funds on all amounts funded by non-US branches and non-US affiliates?**

The BEAT Eats Most Tax Credits

Base Erosion Minimum Tax Amount =

10% of Modified Taxable Income

−

Regular Tax Liability
(21% of Taxable Income)

−

Chapter 1 Credits
(includes Research Credit*, WOTC foreign tax credits, etc.)

−

Research Credit* + 80% of Applicable Sec. 38 Credits

*While regular tax liability is decreased by all Chapter 1 credits, only the Research Credit and specified Sec. 38 credits (low-income housing credit, renewable electricity production credit, and investment credits allocable to the energy credit) are added back in such that they do not reduce the regular tax liability. All other credits are lost, including foreign tax credits.

Foreign Related Parties

- A foreign related party can include US branches of non-US taxpayers, but this does not seem to be a base erosion payment situation.
- Similarly, a foreign related party can include a controlled foreign corporation (a CFC) even if the US owner is including the payment as subpart F income of GILTI. Again, this should not be a base erosion payment situation but the final regulations do so.
- Generally, a foreign related party includes:
  - Any 25% owner (by vote or value) (with modified § 318 attribution)
  - Any person related to the taxpayer or a 25% owner, within the meaning of § 267(b) or § 707(b)(1) (with modified § 318 attribution)
  - Any person related to the taxpayer for purposes of § 482

Cryptocurrency Tax Reporting

The US Tax Code Now Has Rules for Reporting Cryptocurrency Transactions

- Code § 6045 (broker reporting rules) now specifically requires “any person” who for consideration provides “any service” effectuating the transfer of digital assets.
- Rule is effective beginning in 2023, unless the IRS enacts a deferral.
- Digital assets include “any digital representation of value” that is recorded on a cryptographically secured distributed ledger or similar technology.
- Form 1099-B will be required to report sales of cryptocurrencies and NFTs.
  - New Tax Form 1099-DA is on the way
- The definition of broker is extremely wide. Definition could be read to include validators, miners stakers, wallet provider and software providers.
- Application to decentralized exchanges is unclear.

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Cryptocurrency Information Reporting

- Information to be reported will include holding period and basis.
- A broker-to-broker transfer must be accompanied by relevant information.
- Unclear what information must be reported when crypto is transferred from an exchange to a wallet.
- The receipt of $10,000 or more (in one transaction or 2 or more related transactions occurring within 1 year) must be reported with information about the payer. Code § 6045I.
  - Criminal penalties exist for deliberately avoiding reporting.
  - Trade or business threshold for reporting
- Anonymity of crypto transactions provides a headwind to reporting.

Litigation Financing: Ready for Securitization?

How are attorneys and plaintiffs taxed now?

- **Under current law, lawyers working on contingency-fee cases generally cannot deduct expenses incurred for depositions, expert testimony and discovery until the conclusion of the case.**
- **Current law suspends deductions for these expenses until the lawyer receives the corresponding income at the conclusion of the case or the case otherwise concludes.**
- **Upfront payments received by the plaintiff or the law firm from a litigation funder for the sale of the underlying legal claim are immediately taxable to the party being funded as income.**

Novoselsky v. Commissioner

- In *Novoselsky v. Commissioner*, TC Memo 2020-68, the IRS successfully challenged a litigation finance transaction structured as a loan.
- The facts of that case are as follows:
  - During 2009 through 2011, the taxpayer, an attorney, executed "litigation support agreements" with various individuals and entities. Under those agreements, the individuals and entities made upfront payments to the taxpayer to support the costs of litigation.
  - If the litigation was successful, the taxpayer was obligated to pay the counterparty, from his award of attorney's fees and costs, the initial payment advanced to the taxpayer, plus a premium. However, if the litigation was not successful, the taxpayer had no obligation to return any funds to the counterparty.
  - The taxpayer did not report any of the funds advanced to him pursuant to the agreements in which he had no obligation to repay the counterparty on his tax returns. The IRS audited his returns and found that the payments were not loans and that he was required to include them in gross income.

Novoselsky v. Commissioner (continued)

- **The Tax Court held for the IRS that the payments the taxpayer received from the third parties constituted gross income to the taxpayer and not loans. Specifically, the payments were not loans because any obligation for the taxpayer to repay was contingent on future events, and therefore did not constitute debt for federal income tax purposes.**
- **In addition, the Tax Court held that the payments under the litigation support agreements did not represent bona fide loans under factors used by federal courts to distinguish between debt and other payments because: (i) the taxpayer did not execute a formal promissory note; (ii) no fixed schedule for repayments was established; (iii) the taxpayer provided no collateral or security; and (iv) no payments of principal or interest were ever made.**

The use of forward contracts

- In order to address the immediate taxability of upfront payments where the transaction is structured as a sale, many litigation financings are structured as forward contracts.
- Forward contracts must be over "property."
- Under this structure, the litigation funder makes an upfront payment for a payment determined with reference to portion of the plaintiff's case or a portion of the law firm's contingent fee when the lawsuit is resolved.
- The litigation funder is treated as having made a financial wager, in which it makes the upfront payment, and in return receives the right to receive an uncertain amount if there is a recovery.

The use of forward contracts (continued)

- **By structuring the litigation financing as a forward contract, the party being funded would not be taxed on the upfront payment and the parties would be taxed on their net recoveries at the end of the transaction.**
- **In order to receive the advantage of no immediate tax on the upfront payment under a forward contract structure, it is critical that the transaction properly be treated as a forward contract (i.e., reflects that recovery is subject to variation and not guaranteed).**
- **If the litigation financing is treated as a sale of the underlying claim, the upfront payment will be immediately taxable to the party being funded.**

Thank You!

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