

Financial Products

Institute of International Bankers

***ANNUAL SEMINAR ON U.S. TAXATION OF
INTERNATIONAL BANKS***

Beatrice Montaudy, Moderator
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June 17, 2014

Topics to Be Covered

- Internal Revenue Code Section 871(m) – Withholding on Cross-Border Dividend Equivalents
- Internal Revenue Code Section 1234A – Current Developments
- Taxation of Virtual Currency Transactions
- Issues Affecting Dealers in Notional Principal Contracts

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•Practices

•Tax

•Derivatives and Commodities

•Energy and Project Finance

•Structured Finance

•Micah Bloomfield is a tax lawyer whose practice emphasizes the taxation of financial products, including asset-backed securities transactions, life settlement transactions and structured notes. Mr. Bloomfield has extensive experience with tax issues relating to hedge fund and private equity funds, XXX transactions (a type of capital market transaction used by life insurance companies), bankruptcy reorganizations and tax incentives for renewable energy projects. He has also advised dealers and other participants in numerous swap and other derivatives transactions. He has drafted model tax modules in connection with cross-border swap transactions for use in negotiating ISDA tax representations and related tax forms. Mr. Bloomfield is an active member of ISDA's tax committee and frequently comments on proposed Treasury regulations.

•Representative Matters

- Tax work setting up real estate funds to invest in India for a major bank
- Tax work setting up commodity funds for a major bank
- Advising clients concerning FATCA compliance
- Structuring a large potential securitization transaction as debt for tax (\$3+ billion)
- Advising clients in negotiating tax provisions in documentation for letters of credit, loans and derivatives
- Advising regarding the use of favorable treaty provisions for investing in life settlements

• Honors and Awards

- Mr. Bloomfield is listed in *New York Super Lawyers* and *The Best Lawyers in America*.

• Memberships

- Executive Committee, Business Law Section, New York State Bar Association (NYSBA)
- Financial Transactions Committee, American Bar Association (ABA)
- Tax Committee and Accounting Committee, American Securitization Forum (ASF)

- North America Tax Committee and Equity Swaps Working Group, International Swaps and Derivatives Association (ISDA)
- Tax Committee, Managed Funds Association (MFA)
- Government Relations Committee, National Association of Real Estate Investment Trusts (NAREIT)
- The New York Tax Study Group
- Wall Street Tax Association
- Institute of International Bankers

• Selected Activities

• Speeches and Events

- Panelist, "The Foreign Account Tax Compliance Act: The Impact on Life Settlements," DealFlow Media's Life Settlements Conference, September 2012
- Panelist, "What's a Bank, as a Withholding Agent, To Do? Section 871(m) and Withholding," ABA Tax Section Annual Meeting, May 2012
- Panelist/Instructor "Income Tax Aspects of Real Estate Transactions," Real Estate Board of New York Education Classes, 2011, 2012
- Panelist, "Hot Topics in Taxation of Financial Products: Cross-border Life Settlement Transactions – Tax Issues," BNA/SFI Conference, December, 2011

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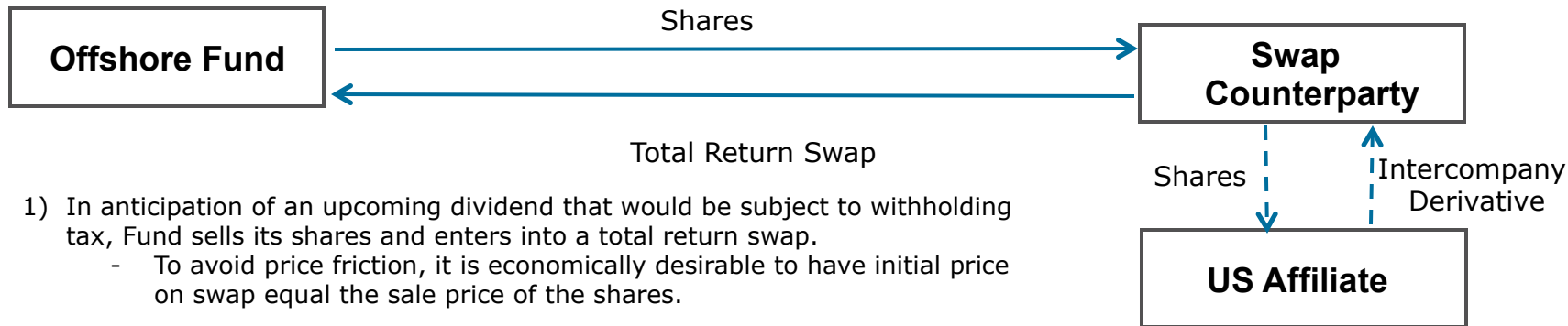
Ms. Farr is a member of Davis Polk's Tax Department. She concentrates in the taxation of corporate finance, derivatives and structured finance and on domestic and international tax planning for financial institutions. She has advised financial institutions and issuers in the development and execution of complex public and private financial products designed to achieve capital raising, hedging or other objectives. Ms. Farr has also done significant work representing investment funds and insurance companies.



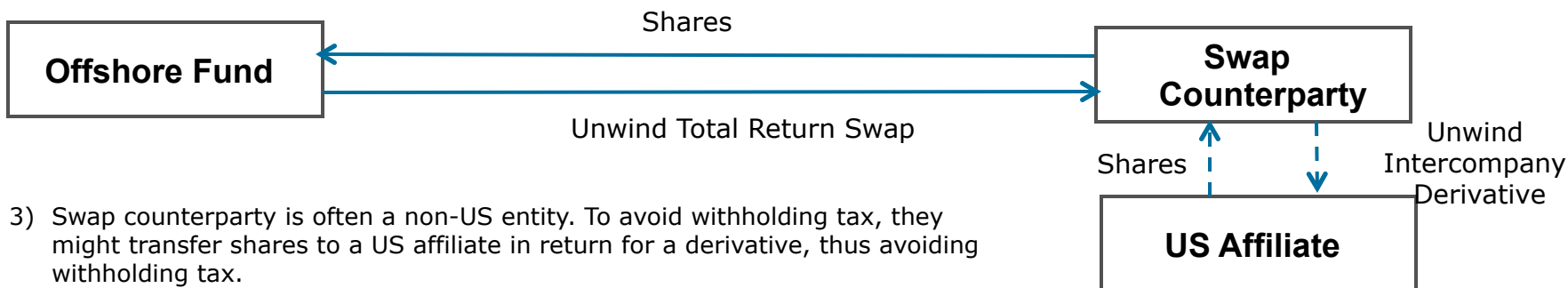
Mark H Leeds (212) 506-2499 (mleeds@mayerbrown.com) is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and strategies for efficient utilization of tax attributes, such as net operating losses. Mark is also the editor-in-chief of *Derivatives: Financial Products Report*, a Thomson/RIA monthly publication. Prior to joining Greenberg, Mark 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 & Touche, where he led the Capital Markets Tax Practice.

The Revised Rules on Dividend Equivalents

The Trade That started it all



- 1) In anticipation of an upcoming dividend that would be subject to withholding tax, Fund sells its shares and enters into a total return swap.
 - To avoid price friction, it is economically desirable to have initial price on swap equal the sale price of the shares.
- 2) Swap counterparty, needing shares as a hedge of its swap obligation, is in the market to purchase shares.
 - This may result in a "cross" trade.



- 3) Swap counterparty is often a non-US entity. To avoid withholding tax, they might transfer shares to a US affiliate in return for a derivative, thus avoiding withholding tax.
- 4) Some period of time after the dividend, the derivative is unwound and the Fund re-establishes its long position by repurchasing shares.
 - To avoid price friction, it is economically desirable to have final price on swap equal the repurchase price of the shares.
- 5) Swap counterparty, needing to dispose of its hedge, is in the market to sell shares.
 - This may result in a "cross" trade.
- 6) This may be repeated as subsequent dividend dates approach.

Dividend Equivalent Proposed Regs

- 4 rules currently effective for payments through 2015 with swaps
 - Cross in
 - Cross out
 - Not readily tradable on established security market
 - Long party has the underlying stock as collateral
- The rules for substitute dividends and the equivalent for repos

New Proposed Rules

Effective for payments on or after January 1, 2016 in the case of swaps (notional principal contracts).

Effective for payments on or after January 1, 2016 for equity linked instruments if the ELI is issued on or after 90 following publication of the final regs in the federal register. Notice 2014-14.

Not all references to dividends will make payments “specified” NPCs or “specified” ELIs.

- Two requirements to be “specified” NPC or ELI.
 - Payment determined by an underlying security (namely something that could generate US source dividends)
 - Delta at time of acquisition of 0.70 or more. Delta is, roughly, defined as the change in value of the NPC or ELI, divided by the change in value of the reference shares, resulting from a tiny (say 1¢) change in value of one share.

Proposed Regulations: The Delta Standard

- Effective Dates -- proposed to be effective for payments made on or after January 1, 2016 (no grandfathering)
 - Special effective date for equity-linked instruments (“ELIs”) -- proposed to apply only to payments made on ELIs that are acquired by a non-US person on or after the date that is 90 days after final regulations are issued
- Delta-based standard applies to swaps and ELIs – a Specified NPC or specified ELI is any NPC or ELI that has a delta of 0.70 or greater when acquired by the client
 - The “delta” of an NPC or ELI is the ratio of the change in the FMV of the NPC or ELI to the change in the FMV of the property referenced, determined in a commercially reasonable manner
 - The delta calculated for non-tax business purposes ordinarily is treated as the delta for § 871(m) purposes
 - A delta not reasonably expected to vary during the term of the transaction is treated as a delta of 1.0
 - Delta is tested on the date of acquisition by a non-US person
 - Note that an instrument, such as an option, may have a delta of less than 0.70 when issued, but if it has a delta of greater than 0.70 when acquired by a non-US person, the exchange or counterparty could have a withholding obligation when making payments to the non-US person.

Amount of Dividend Equivalent

- Retest delta on date dividend fixed
 - Earlier of
 - Record date
 - Ex dividend date
 - Multiply dividend on the number of referenced shares by the delta
- Withholding only done on the payment date, which is the date fixed
 - For example, if determined by dividend paid before the date of the ELI, withholding would be on the purchase of the ELI

The Amount of the Dividend Equivalent

- Securities lending or sale-repurchase -- the actual dividend paid on the underlying security multiplied by the number of shares transferred pursuant to the transaction
- Specified NPC or Specified ELI – the dividend with respect to the underlying security multiplied by the number of shares referenced (subject to adjustment) multiplied by the corresponding delta at the time that the amount of the dividend equivalent is determined (which may be 1 if > 0.70 & is constant)
- Note the delta used to calculate the amount of Dividend Equivalent Payments may differ from the delta used to determine whether a transaction is a Specified NPC or Specified ELI

The Amount of the Dividend Equivalent

- For a payment based on an estimated dividend, the actual dividend is used to calculate the Dividend Equivalent Payments amount unless the dealer identifies a reasonable estimated dividend amount in writing at inception of the transaction, in which case the per share dividend is the lesser of the estimated dividend or the actual dividend
- Calculated by reference to the earlier of the ex-dividend date or the record date
- For short-term transactions (≤ 1 year), the amount of Dividend Equivalent Payments is determined when the client disposes of the transaction
- A client that acquires an option with a term of one year or less that is a Specified ELI will not incur a withholding tax if the option lapses

Dividend Equivalent Payments

- Dividend Equivalent Payments include any payment that references (i.e., is directly or indirectly contingent upon or determined by reference to) a U.S. source dividend payment that is a (a) substitute dividend made pursuant to a securities lending or sale-repurchase, (b) a payment pursuant to an SNPC, (c) a payment pursuant to an Specified ELI, or (d) any other substantially similar payment
- A Dividend Equivalent Payment includes any gross amount that references a U.S. source dividend and is used to compute any net amount transferred to or from the client even if the client makes a net payment to the dealer or the net payment is zero
- Payment is treated as made on the date the amount of the Dividend Equivalent Payments is fixed
- Explicitly treats estimated dividend payments as Dividend Equivalent Payments, eliminating the exception for expected dividend payments in the 2012 proposed regulations
- Includes implicit dividends such as contractual terms that are calculated based on an actual or estimated dividend (e.g., single stock futures)

Exclusions

- Qualified Dealer Rule
- Major Acquisition
- Lapsing Option
 - Short term npc?

Proposed Regs: Delta Combinations

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

- Combined positions can only increase delta, no negative adjustments
 - Butterfly options (long 1 ITM call; short 2 ATM calls; long 1 OTM call)
 - 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
- 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.

Netting and Withholding

- Dividend equivalent payments are to be computed on a gross basis.
- The fact that a dividend equivalent is subsumed or reduced by a funding payment made by the long party to the swap does not reduce or alleviate the obligation of the short party to withhold against the full amount of the dividend equivalent.
- “Non-US payers” of dividend equivalents are required to withhold & remit tax to the Internal Revenue Service in the same manner as US payers of dividend equivalents.
 - The rules cannot be skirted by having a non-US branch or party as the short swap party.
- ISDA had prepared a “HIRE Act Protocol” pursuant to which dividend withholding taxes would not be treated as a Indemnifiable Tax under a swap.
- ISDA Tax Representations had been amended to ask long party to represent that it would not sell referenced stock on the date of the swap opening or buy referenced stock on date of stock closing.

Reporting and Withholding

- Broker party to NPC or ELI or the short party required to determine delta.
- Broker party or short party has to supply information to brokers.
- Broker party or short party liable for the withholding amount if it gives incorrect information.

Open Issues or Controversies

- How to determine number of shares in the denominator of the delta fraction.
- Broad definition of “payment” can include initial purchase price of an ELI (in addition to the expected inclusion of gross payments on a swap, even when no net payment).
- Inclusion in ELI of convertible debt
- With new long position, must determine whether delta for the combo is greater than 0.70 (if done in connection with first transaction). Does not cause first transaction to lose specified NPC taint.

What is an Equity-linked Instrument?

- Equity Linked Instruments -- defined broadly to include any financial transaction that references the value of one or more underlying securities, including forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments with payments linked to underlying securities
- Equity linked debt instruments with a delta > 0.7 are not treated as passing through dividend equivalents but contingent interest may still be subject to withholding because interest linked to dividends on US stocks will no longer qualify for the portfolio interest exemption

What is an Equity-linked Instrument?

- Bifurcation Rule -- a transaction referencing more than one underlying security must be evaluated with respect to each underlying security without taking into account the other underlying securities, and may be a § 871(m) transaction with respect to one or more underlying securities referenced (except in the case of a qualified index)
- Combination Rule -- where client enters into two or more transactions that reference the same underlying security in connection with each other (even if months apart), the transactions may be treated as a single transaction for purposes of § 871(m) (*e.g.*, put/call combinations)
 - A withholding agent is not required to withhold in this case unless the withholding agent knows that the counterparty entered into the transactions in connection with each other

Qualified Indices

- Where a transaction references more than one entity (including a non-qualified index) or different interests in the same entity, each security is treated as a separate underlying security
- Qualified Indices are treated as a single security that is not an underlying security, and include any indices that satisfy the following six conditions as of the acquisition date:
 - References 25 or more underlying securities;
 - References only long positions in underlying securities;
 - Contains no underlying security that represents more than 10% of the index's weighting;
 - Rebalances based on objective rules at set intervals. As currently written, S&P 500 index would not qualify;*
 - Does not provide for a high dividend yield (defined generally as > 1.5 times the current yield of the S&P 500 index); and
 - Is referenced by futures or option contracts that trade on a national securities exchanged or a domestic board of trade

More on Multiple Exposures in a Specified NPC or ELI

- If a transaction references a qualified index and another position, the index may lose its qualified status if the other position (or a separate transaction acquired by the client or a party related to the client) reduces exposure on a portion, but not all, of the qualified index
- A transaction that references an interest in an entity that is not a C corporation is treated as referencing the allocable portion of any underlying securities and potential § 871(m) contracts held directly or indirectly by that entity.
- Look-thru rule does not apply if the underlying securities and potential § 871(m) transactions represent, in the aggregate, 10% or less of the value of the interest in the referenced entity at the time the transaction is entered into

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

Special Rules Affecting Dealers

- Qualified dealer exception -- a transaction is not a § 871(m) transaction where a qualified dealer, acting in its capacity as such, enters into it as the long party (1.871-15(j)) – SG in its capacity as a dealer
 - A qualified dealer is any dealer in securities under § 475 that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized
 - Dealer must certify in writing to the client that it is a qualified dealer acting in its capacity as such and that it will withhold any tax imposed by § 871(m) when it is a short counterparty acting as a dealer
 - Does not apply with respect to Proprietary Trading of Dealer
 - Withholding exception where no money or property is paid -- a withholding agent is obligated to withhold on Dividend Equivalent Payments until the later of:
 - The time when the amount of DEPs is determined; or
 - The time at which (i) money or other property is paid, (ii) the withholding agent has custody or control of money or other property of the client on or after the Dividend Equivalent Payments is determined, or (iii) there is an upfront payment or a prepayment of the purchase price

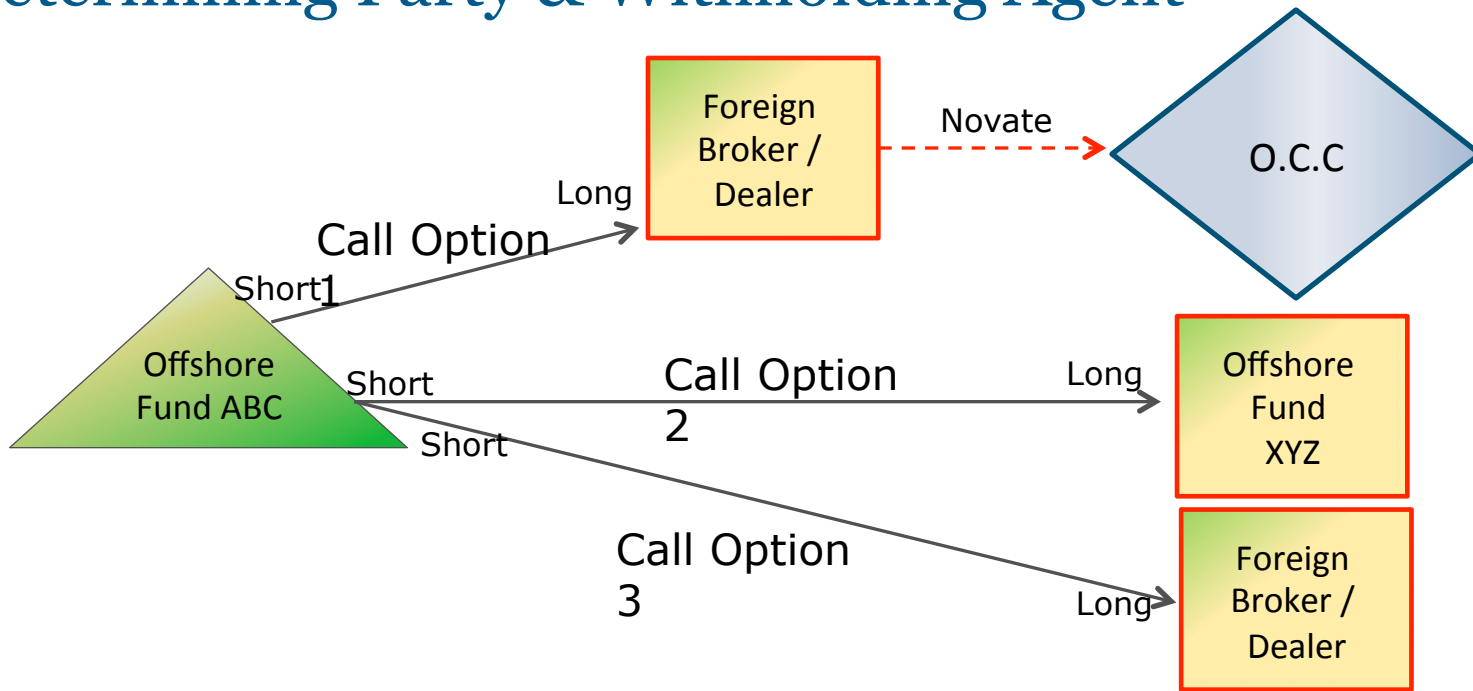
Special Rules Affecting Dealers

- A dealer is required to determine whether a transaction is a Section 871(m) transaction if the counterparty is not a dealer.
- If both (or neither) parties are dealers, the short party must determine whether the transaction is a Section 871(m) transaction

More on Dealer Responsibilities

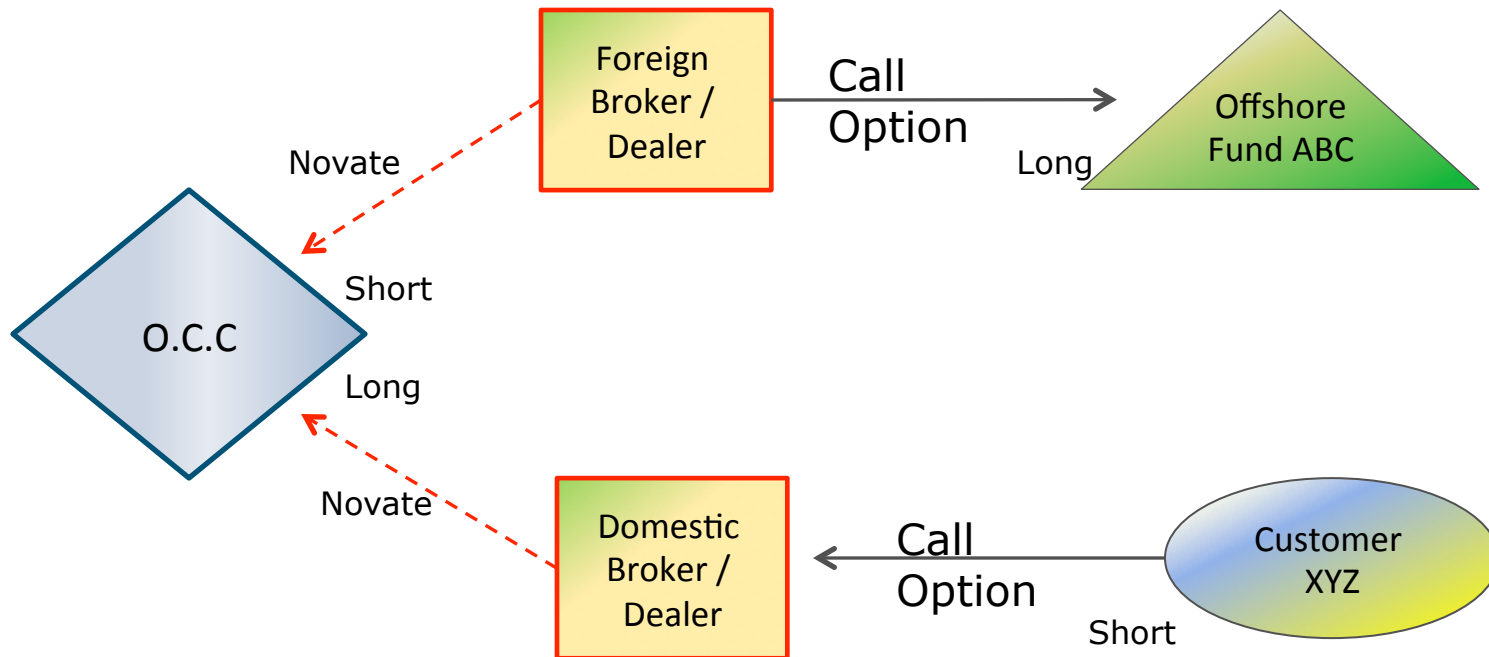
- The party required to determine whether a transaction is a Section 871(m) transaction has reporting responsibilities.
- Dealers must keep and provide the following information
 - The delta of the transaction
 - The amount of tax withheld and deposited
 - The estimated dividend amount (if applicable)
 - Other information necessary to enable compliance with rules
- Dealers are treated as withholding agents on information required to be provided. If the dealer fails to provide information or provides inaccurate information and the person required to withhold fails to do so or withholds too little, the IRS may collect the tax from the dealer that was required to provide the information.
- Dealers must provide this information to:
 - Brokers who hold Section 871(m) transactions
 - Any person required to file an information return
 - Any person who is a party to the transaction

Determining Party & Withholding Agent



- Assuming all call options are 871(m) transaction
 - Option 1: Fund ABC is not the determining party on the listed call option but is presumably a withholding agent that must obtain a Qualified Dealer rep
 - Option 2: Fund ABC is the determining party and withholding agent
 - Option 3: Fund ABC is not the determining party on the OTC call option but is a withholding agent (assuming prop position of foreign b/d)

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 a party to the 871(m) transaction but becomes merely a agent / nominee after novation.

Issues Affecting Dealers in Notional Principal Contracts

Section 1234A

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

(1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or

(2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer

shall be treated as gain or loss from the sale of a capital asset....

Background of Section 1234A

- Enacted in 1981 in conjunction with straddle rules
 - Stated purpose to avoid electivity and tax similar transactions similarly (i.e., settlements of contracts vs. sale/exchange)
 - Applied only to actively traded personal property
- Expanded in 1997 to include non-actively traded personal property

Compare Section 1234, Section 1234B

- Section 1234(a)(1):
 - Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him). [Property = stocks, securities, commodities and commodity futures]
- Section 1234B(a)(1):
 - Gain or loss attributable to the sale, exchange, or termination of a securities futures contract shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by the taxpayer).

Pilgrim's Pride Corp. v. Comm'r, 141 T.C. No. 17 (2013)

- Facts

- Taxpayer held preferred stock and trust preferred securities as capital assets
- Issuer offered to redeem the securities, but the taxpayer decided to abandon the securities (to the issuer) and claim an ordinary loss
- IRS claimed the loss was capital, and the court raised the question of whether Section 1234A applied

Pilgrim's Pride (cont.)

- Question presented: Does Section 1234A apply to a taxpayer's rights that are inherent in the ownership of property that is a capital asset (in this case stock and securities)? Or does it apply only to a contractual or other derivative right to property that is a capital asset?

Pilgrim's Pride (cont.)

- The court reached the former conclusion, stating that “[s]hares of stock are intangible interests or rights that the owner has in the management, profits, and assets of a corporation, while a certificate of stock is tangible evidence of the stock ownership of the person designated therein and of the rights and liabilities resulting from such ownership.”
 - In support of its conclusion, the court cited legislative history that used the redemption of a bond as an example
 - Court deemed irrelevant 2008 amendments to the Section 165 regulations clarifying that abandonment of securities held as capital assets generates capital loss
- Court also stated that the property itself, not the “right or obligation” with respect to the property, must be a capital asset

Open Issues Under Section 1234A

- Does Section 1234A apply where there is no clear underlying asset?
 - E.g., interest rate swaps, weather derivatives
- What about derivatives that are capital assets on ordinary property (e.g., “store on the board”)
- Are there business transactions where Section 1234A simply doesn’t apply?
 - Rev. Rul. 2009-12 (surrender of life insurance contract); *see also* TAM 200452033
 - PLR 200823012 (termination fee under merger agreement)
- How does Section 1234A apply to positions that are obligations of the taxpayer?

**What Financial
Instruments Does
Dodd-Frank Subject
to Code § 1256?**

Code §1256

- Certain derivatives are classified as Section 1256 Contracts and are subject to special character and timing rules
- Derivatives that are not classified as Section 1256 Contracts are generally taxed as open transactions and subject to the tax character principles of Code §§ 1234 or 1234A
 - special accrual accounting and tax character rules are provided for “notional principal contracts”
 - special tax character rules are provided for derivatives classified as Section 988 Transactions under Code §988

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 dealer equity options (single stock and narrow-based stock indices)
 - Dealer 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 and
 - 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 Securities and Exchange Commission
 - 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

Section 1256 Contract Classification and Transition Issues

- Intercontinental Exchange (“ICE”)
 - effective October 15, 2012, transitioned energy contracts from its CFTC designated “exempt commercial market” to either ICE Futures US or ICE Futures UK (each of which is a CFTC “designated contract market”)
 - open contracts were transferred
- Nodal Exchange
 - effective September 30, 2013, Nodal’s CFTC designation changed from an “exempt commercial market” to a “designated contract market”
 - extended to all Open Interests

Section 1256 Contract Classification Issues: “Swaps” Distinguished

- Many swaps are taxed as “notional principal contracts,” defined in Reg. §1.446-3(c) 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 an index based on objective financial information

Dodd-Frank Wall Street Reform and Consumer Protection Act

- Dodd–Frank, when fully implemented, will require that certain “swaps” be cleared and potentially traded on a registered exchange
- An *end-user* exception from exchange clearing and trading is provided in limited cases
- How will Dodd-Frank impact tax classification?
 - 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.

Cleared Swaps

- When a swap is cleared:
 - A central counterparty becomes the legal counterparty to both sides of the transaction
 - Both parties must provide “initial” margin
 - The parties also pay or receive daily “variation margin” (collateral for the in-the-money value of the NPC)

Dodd-Frank Act “Swaps” Exclusion

- New Code §1256(b)(2) 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 Section 1256 Contract Regulations

- 2011 proposed regulations relating to Code §1256(b)(2) and Treas. Reg. §1.446-3
 - interprets the Dodd-Frank swaps carve out as applying only to NPCs and options on NPCs
 - application to traditional options remains unclear
 - would narrow number of contracts considered Section 1256 Contracts if a “deemed payment rule” is adopted
 - includes an ordering rule providing that if a derivative is both a futures contract and an NPC, NPC classification prevails

Section 1256 Contract Classification Uncertainty

- Cleared swaps
- Swap futures

Bitcoin Notice

- What Bitcoins or other digital currency are
- Notice 2014-21
 - Basically treat like any other property. Not like a currency.
 - Pay tax if paid in bitcoins
 - Pay tax is sell a bitcoin for more than basis
 - Semi-exception: if mine bitcoins, treated as being paid then even though similar to creating value by your own work (when generally no income till transfer to someone else)

Swap Assignment Regulations and Upfront Payment Classification Issues

Notional Principal Contracts: Three Categories of Payments

- NPCs are not taxed as Section 1256 Contracts, meaning Mark to Market and 60/40 Rules do not apply
- Under the NPC regulations, different tax character and timing results for:
 - Periodic payments
 - Nonperiodic payments
 - Termination payments

Notional Principal Contracts: Nonperiodic Payments

- Nonperiodic payments: any NPC payment that is not a periodic payment or termination payment
 - Includes upfront premiums for off-market swaps, premiums for caps/floors, payments at irregular intervals, and end of term payments (total return or “bullet” swaps)
- General timing rule: amortize upfront nonperiodic payments over life of contract
- General character rule: ordinary income and deductions
- Potential embedded loan treatment for “significant” nonperiodic payments

NPC Timing Rules -- Assignments

- Special issues for assignments under Code §1001
 - Proposed NPC regulations (1991) originally said non-assigning party had a taxable exchange
 - Final NPC regulations left issue to Code §1001 regulations
 - Dodd-Frank and changes to bank regulatory rules meant that many customer transactions would be novated (assigned) from one legal entity to another

NPC Assignment Transactions

- Possible assignment transactions include:
 - Assignment to central clearing organization, so swap becomes cleared
 - Assignment to affiliate of dealer
- Assignments require consent of counterparty
- Reg. § 1.1001-4 (obsolete) addressed assignments only in certain circumstances
 - Dealer-to-dealer assignments
 - “the terms of the contract permit the” assignment

NPC Assignment Tax Consequences

- Application of prior Reg. § 1.1001-4 was not certain:
 - Is a clearinghouse a “dealer”?
 - Does the consent requirement mean that an assignment is not “permitted” under the terms of the contract?
- If assignment were taxable, taxpayers might refuse to move their derivatives positions:
 - Gain would be taxable
 - Loss might not be deductible
 - Integration elections would be terminated

New Regulations for NPC Assignments

- Under Reg. §1.1001-4 (2013), an assignment is not treated as a deemed exchange by the non-assigning party if:
 - Both assignor and assignee are either a dealer or a clearinghouse;
 - The terms of the derivative contract permit the assignment of the contract, whether or not the consent of the non-assigning counterparty is required; and
 - The terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange under Code §1001.

NPCs: “Significant” Nonperiodic Payments

- If there is a “significant” nonperiodic payment, under 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 section 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

NPCs: When Would A Taxpayer Make A Nonperiodic Payment?

- A nonperiodic payment may be made in many situations:
 - Taxpayer wants to match the terms of an asset or obligation that it is hedging
 - NPC is of a type that has coupons that are not market-level coupons (examples: credit default swaps, MAC swaps)
 - Taxpayer takes delivery of swap in settlement of a futures contract
 - Taxpayer assigns NPC in taxable transaction

NPCs: When Is A Nonperiodic Payment “Significant”?

- We don't know.
- Regulations give examples that indicate:
 - Nonperiodic payment that is <10% of at-market fixed-rate payments is not “significant”
 - Nonperiodic payment that is >40% of at-market fixed-rate payments is significant
 - But these are only examples
 - And there is a big gap between 10% and 40%

Cleared Swaps with Nonperiodic Payments

- When a swap with an upfront nonperiodic payment is cleared:
 - One party (Party A) makes the upfront payment to the other (Party B), through the clearinghouse
 - Party B pays the same amount to Party A as variation margin, through the clearinghouse
- Is there a deemed loan here? Should there be?

Section 956: Cleared Swaps with Nonperiodic Payments

- If Party A is a CFC, and Party B is a US affiliate, does an upfront payment paid by Party A on a cleared swap give rise to a deemed loan?
- Under Temp. Reg. §1.956-2T, the answer is no, provided that:
 - Party A is a dealer
 - The swap is cleared by a clearinghouse that is a US-regulated entity
 - Party A makes the nonperiodic payment to Party B and Party B makes the offsetting variation margin payment to Party A, as specified in the regulations