

June 18, 2014

Institute of International Bankers Annual Seminar on U.S. Taxation of International Banks

Tax Implications of Dodd Frank Act Section 165 (IHC Requirement) and the Volcker Rule

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DFA Section 165 Enhanced Prudential Standards

Statutory Requirements

“In order to prevent or mitigate risks to the financial stability of the United States” the Federal Reserve is directed to impose enhanced prudential standards (“EPS”) on bank holding companies – including FBOs with a U.S. branch or agency – with total consolidated assets of \$50 billion or more.

- Mandatory EPS
 - Risk-based capital and leverage limits
 - Liquidity requirements
 - Overall risk management requirements
 - Resolution plan requirements (“living wills”)
 - Concentration limits
 - Capital stress testing

DFA Section 165 Enhanced Prudential Standards

- The Federal Reserve may also establish additional prudential standards that it determines are appropriate.
- The Federal Reserve has statutory discretion to “tailor” the application of EPS based on a variety of factors, including a covered company’s size, complexity and financial activities.
- The Federal Reserve is directed to (i) give due regard to the principle of national treatment and equality of competitive opportunity and (ii) take into account the extent to which an FBO is subject on a consolidated basis to home country standards that are comparable to those applied to U.S. bank holding companies.

Federal Reserve Final Rules for FBOs

The Federal Reserve's Final Rules Implementing Section 165 for Large FBOs – A Fundamental Change in the Regulation of FBOs

Governor Tarullo's perspective:

“In sum, I would say that the most important contribution we can make to the global financial system is to ensure the stability of the U.S. financial system.”

- The Federal Reserve applies the statutory \$50 billion threshold on the basis of a covered company's global assets.
 - This results in extending EPS to more than 100 FBOs – i.e., more than 4 times the number of U.S.-headquartered bank holding companies that are subject to EPS
 - To mitigate the impact of EPS on FBOs, the Federal Reserve distinguishes among FBOs based on the size of their U.S. footprint and, for those with combined U.S. assets of \$50 billion or more, whether their U.S. non-branch operations in the aggregate have \$50 billion or more in assets

Smaller FBOs

- In general, EPS are applied to FBOs whose combined U.S. operations have less than \$50 billion in assets by reference to home country standards, but failure to meet the prescribed requirements can result in limits on U.S. operations.
 - Risk-based capital and leverage limits – certification and reporting requirements
 - U.S. risk committee – must meet requirements prescribed by the Federal Reserve
 - Liquidity risk management – annual reporting requirement
 - Capital stress testing

Larger FBOs – In General

- The approach to FBOs whose combined U.S. operations have greater than or equal to \$50 billion in assets is considerably more extensive and burdensome.
 - The FBO itself is subject to risk-based capital/leverage and capital stress testing requirements in a manner that generally is similar to those applicable to FBOs whose combined U.S. operations have < \$50 billion in assets).
 - The requirements for the U.S. risk committee are considerably more extensive and the FBO must appoint (e.g., review and approve risk management policies) a U.S. Chief Risk Officer who must exercise regulatorily-prescribed responsibilities.
 - There are extensive liquidity risk management requirements applicable to the combined U.S. operations (e.g., with respect to cash-flow projections and contingency funding planning).
 - The U.S. operations are subject to monthly liquidity stress testing requirements (conducted with respect to the combined U.S. operations and separately for U.S. branches) and U.S. branches must maintain a prescribed liquidity buffer.

Larger FBOs – IHC Requirement

- **FBOs with U.S. non-branch assets of \$50 billion or more must establish a U.S. intermediate holding company (IHC) that in general will be regulated the same as a U.S. bank holding company with \$50 billion dollars or more in consolidated assets regardless of whether the FBO in fact has a U.S. bank subsidiary.**
 - The Federal Reserve has adopted the IHC requirement as a “supplemental” enhanced standard.
 - The IHC provides a “consistent platform for the supervision, regulation and risk management” of an FBO’s U.S. non-branch operations.

Larger FBOs – IHC Requirement

- The IHC requirement entails restructuring the entirety of an FBO’s U.S. non-branch operations under a single U.S. holding company.
 - Specifically: an FBO that is required to establish an IHC “must hold its entire ownership interest in any U.S. subsidiary [with two very limited exceptions] through its U.S. intermediate holding company.”
 - Designation as a “subsidiary” is based on the definition of control under the Bank Holding Company Act (25% voting interest/majority of the board/exercise a “controlling influence”)
 - Exceptions to this general rule require the Federal Reserve’s express prior approval, which the Federal Reserve contemplates will be granted only in very narrow circumstances.
 - Home country law prohibits holding all U.S. subsidiaries under a single IHC.
 - The FBO controls lower-tier FBOs which conduct their own U.S. non-branch operations.

Larger FBOs – IHC Requirement

- FBOs have flexibility in choosing the organizational form of the IHC (e.g., a corporation or LLC), provided that (i) the IHC is not a foreign legal entity and (ii) the organizational form does not prevent the IHC from complying with the applicable regulatory requirements (described below).
 - Structural considerations and implications.
 - An existing subsidiary – such as a U.S. intermediate bank holding company subsidiary – may become the IHC, but the ownership interests in all other U.S. subsidiaries held outside such a bank holding company must be transferred to the bank holding company/IHC.
 - “U.S. subsidiaries” include those owned by non-U.S. affiliates of the FBO.
 - “Split” ownership of the majority and minority ownerships interests in a U.S. subsidiary must be combined under the IHC.
 - Questions regarding treatment of ABCP conduits and other securitization vehicles

Requirements Imposed on IHCs

- The IHC is subject to the following regulatory requirements as prescribed by the Federal Reserve:
 - U.S. risk-based bank capital and leverage requirements
 - IHCs are not subject to the U.S. advanced approaches, but can elect to apply them
 - Capital stress testing requirements
 - Capital planning requirements – the Comprehensive Capital Analysis and Review program (CCAR)
 - Overall risk management and risk committee requirements
 - Liquidity risk management, liquidity stress testing and liquidity buffer requirements
- NB: The prescribed liquidity buffer must be maintained separately from the liquidity buffer required for the U.S. branch network

Requirements Imposed on IHCs

– IHC phase-in provisions

- Establish the IHC – July 1, 2016
 - Implementation plans are due January 1, 2015
- CCAR – October 1, 2017
- Leverage ratio – January 1, 2018

– The IHC requirement will have the greatest impact on FBOs with proportionally large capital markets (broker-dealer) operations that do not own a U.S. bank subsidiary (or whose U.S. bank subsidiary is relatively small compared to the capital markets operations)

- Implications for transferring assets/activities from the IHC to either the U.S. branch network and/or outside the United States in order to (i) drop below the U.S. non-branch \$50 billion asset threshold or (ii) mitigate the impact of the regulatory requirements applicable to IHCs.

IHC – Tax Considerations

Tax Considerations

Establishing an IHC for all of an FBO's U.S. subsidiaries will necessitate an examination of the commercial objectives of the businesses and the effectiveness of a particular entity structure from a funding, capital, liquidity and tax perspective.

Entities generally being considered by FBOs to function as their IHC include:

- U.S. Limited Liability Company (LLC) taxed as a disregarded entity
- U.S. Corporation

IHC – Tax Considerations

LLC IHC Tax Considerations

Although the Federal Reserve has offered no specific guidance, an LLC structure may qualify as an IHC as long as the structure does not violate the prudential standards set forth in the guidance.

- Four traditional corporate characteristics needed for an LLC structure:
 - Centralized Management
 - Perpetual Succession
 - Free Transferability of Interests
 - Limited Liability

IHC – Tax Considerations

Potential Tax Advantages:

- Combine profits and losses with U.S. branch for U.S. tax purposes, assuming income of LLC can be treated as ECI
- May be able to achieve a single tax group in the U.S. This could simplify tax compliance and ETR management, and reduce number of potential income tax examinations.
- Minimize transfer pricing issues within the U.S.
- Transactions between U.S. branch and LLC treated as interbranch transactions and ignored for U.S. income tax purposes. (Though in some instances may be a disadvantage.)

Potential Tax Disadvantages:

- LLC may not be entitled to income tax treaty relief for cross border FDAP payments or BPT
- Potential interest expense disallowance per regulation section 1.882-5
- Could create additional state income tax exposures

IHC – Tax Considerations

US Corporation IHC Tax Considerations

- **Potential Advantages:**

- Blending of profits and losses allowed among U.S. subsidiaries
- Deferral of intercompany transactions (this could also be a disadvantage)
- Elimination of intercompany dividends from gross income
- Minimize transfer pricing issues on intercompany transactions occurring within the US
- Consolidating US subsidiaries may simplify tax compliance burden

- **Potential Disadvantages:**

- Holding company may be subject to tax on gains should it decide to sell one of its group and retain others
- Consider application of unified loss rules on dispositions of loss subsidiaries
- Consideration of the impact of consolidation on separate group attributes such as NOLs(SRLY), capital losses, general business credits, 163(j) capacity and FTC capacity
- Differences between state and federal reporting could result in additional complexity

IHC – Tax Considerations

- **Restructuring – General Considerations:**
 - Assets must be transferred at arm’s-length prices
 - Transactions between new/reorganized legal entities must be catalogued and priced at arm’s-length
 - Tax implications of U.S. restructuring in home country
 - US tax treatment of restructuring
 - Section 351/reorganization requirements
 - Deemed dividends/withholding tax risk (e.g., section 304)
 - Preservation of tax attributes
 - Consider new tax elections
 - Analyze impact of restructuring on existing tax structures and tax planning
 - Potential continuation/termination of existing consolidated groups (e.g., reverse acquisition rules)
 - Analyze impact of restructuring on tax sharing agreements
 - Analyze impact of restructuring on deferred tax assets and liabilities
 - Movement of employees between entities may trigger certain employment tax issues, including FICA tax restart issues and changes in unemployment tax experience rates

IHC – Tax Considerations

- **Other Tax Considerations:**
 - **Transfer Pricing:**
 - **Regulatory Requirements:**
 - Reg W. Section 23(b) governs transactions between member banks and their affiliates. Terms must be at least as favorable to regulated entity as those prevailing at the time for comparable transactions
 - Regulators are demanding to see not just arm’s-length policies, but detailed evidence of process, controls and governance around intercompany transactions
 - **Technology:**
 - Technology must be leveraged to handle regulatory/tax requirements and the potential for increased volumes of intercompany transactions
 - Many banks are investing in new technologies that are scalable, transparent and have the capability to meet new regulatory requirements both in the U.S. and abroad
 - **Associated Expenses:**
 - Expenses associated with restructuring and managing regulatory requirements can be significant, and must be allocated on an arm’s-length basis
 - **Dispute Resolution:**
 - Disparate tax and regulatory requirements are bringing a new focus to channels for global dispute resolution and an increased emphasis on strategic planning related to these options

IHC – Tax Considerations

- **State Tax Considerations:**
 - **Potential recognition of state gains and losses**
 - Proposed transactions involving the movement of assets or stock (e.g., sales, contributions, or distributions of assets and stock, movement of employees, etc.) should be analyzed to identify potential gains and losses that may be deferred for federal tax but recognized for state tax purposes in separate filing states.
 - State basis differences should also be considered.
 - **Indirect and/or state and local transfer tax liabilities**
 - Transactions between legal entities must be analyzed for potential sales and use tax liabilities, real estate transfer taxes, and other indirect transfer taxes
 - **Preservation of tax attributes**
 - Transactions should be structured to ensure preservation of state tax NOL and credit carryovers, if possible.
 - Mid-year reorganization transactions may trigger a short tax year and accelerate the expiration of any NOL, credit or other tax attributes or elections.
 - New elections may be available.
 - **Choice of entity/structural planning**
 - FBOs should consider alternative structures and choice of entities in forming the IHC structure to achieve a more efficient structure for state tax purposes.

IHC – Tax Considerations

– Combined filing methodologies

- FBOs should reconsider state tax combined filing requirements and options.
- Certain states may assert that the new IHC structure is a single unitary group and expect to see a combined return that includes the IHC and all affiliated unitary corporations.
- FBOs should analyze the potential impact of combined or separate filings and document facts to support their filing positions.

– Classification of subsidiaries as general or financial organizations

- A number of states provide for separate tax regimes for general taxpayers and financial organizations.
- Classification of an entity may depend upon the ownership structure and/or the classification of the parent IHC and may impact the entity's tax base, apportionment methodology, nexus rules, rate, and combined filing status.
- FBOs that restructure should review the filing status of their U.S. entities in jurisdictions with separate rules for financial organizations to preserve and take advantage of any favorable classifications

IHC – Tax Considerations

– Net worth and capital based taxes

- Certain structures could impact taxable net worth in certain jurisdictions.

– Impact on state effective tax rates, deferred taxes, and capital

- Changes to a new IHC structure will impact an FBOs state effective tax rate.
- FBOs should also consider the impact of any reorganization on existing state net operating loss and credit carryforwards.
- These changes may need to be reflected in the carrying values of the FBOs deferred tax assets and liabilities as well and any valuation allowances.

The Volcker Rule

Statutory Structure

- Codified as Section 13 of the Bank Holding Company Act
 - **Applies to the entirety of an FBO's global operations unless otherwise provided**
 - The key FBO exemption – proprietary trading and covered fund activities conducted “solely outside of the United States” (the “SOTUS” exemptions)
- In contrast to Section 165, there is no asset threshold with respect to the application of the Volcker Rule's prohibitions
 - Asset thresholds instead apply to the applicability of certain requirements (e.g., compliance program requirements and proprietary trading metrics reporting).

The Volcker Rule

- **The Statutory Prohibition**

- Section 13(a) (1) of the Bank Holding Company Act
- “Unless otherwise provided in this section, a banking entity shall not –
 - engage in proprietary trading; or
 - acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.”
- Full conformance with the statutory requirements is required by July 21, 2015.
 - Metrics reporting for those with \$50 billion or more in “trading assets and liabilities” takes effect on July 1, 2014 (first reports due September 2nd)
 - For FBOs, trading assets and liabilities are calculated on the basis of their combined U.S. operations
 - Banking entities with less than \$50 billion report on a phased-in basis
 - » Those with \geq \$25 billion and $<$ \$50 billion – May 2016
 - » Those with are \geq \$10 billion and $<$ \$25 billion – January 2017
 - » Those with $<$ \$10 billion – no metrics reporting

The Volcker Rule

- The Federal Reserve may grant two additional one-year extensions.
 - It has stated its intention to do so with respect to investments in CLOs.
 - An additional, one-time extension for not more than 5 years may be granted for investments in “illiquid” covered funds.

Volcker Rule: Proprietary Trading

- Defined
- **“Engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.”**
 - Activities that do not constitute proprietary trading include repos/reverse repos; securities lending/borrowing transactions; purchase and sale of securities in connection with “liquidity management” activities.
 - “Financial instrument” include securities, derivatives and commodity futures/options on futures.
 - Excluded items include loans and foreign exchange (but not fx swaps/forwards)

Volcker Rule: Proprietary Trading

- **The Volcker Rule requires a bank to demonstrate that all of its activities that fall within the definition of “proprietary trading” consist exclusively of permissible activities as prescribed by Section 13 and the implementing regulations. Those activities include:**
 - Underwriting
 - market making-related
 - risk-mitigating hedging
- Specifically: Risk mitigating hedging activities “in connection with and related to individual and aggregated positions, contracts, or other holdings of the banking entity and designed to reduce the specific risks in connection with and related to such positions, contracts, or other holdings.”

Volcker Rule: Proprietary Trading

- trading as principal in U.S. government securities, Agency securities and state and local/municipal securities (but not derivatives based on such securities)
- trading in foreign government obligations (but not derivatives based in such securities)
 - there are interpretive questions regarding the permissible scope of these activities
- trading activities conducted by foreign banking activities “solely outside of the United States” (“SOTUS”)

Volcker Rule: Proprietary Trading

- **Permissible activities are subject to conditions and restrictions, compliance with which is necessary to engage in the activity.**
 - Key SOTUS conditions/restrictions
 - the trade is conducted by the FBO or a non-U.S. affiliate
 - both the trade itself and any risk-mitigating hedging related to the trade are booked outside of the United States
 - the trade is not in any way financed by a U.S. branch/affiliate of the FBO
 - all relevant conduct by the banking entity occurs outside of the U.S.
 - the decision to trade is made outside of the U.S.
 - the trade is arranged, negotiated and executed exclusively by personnel outside of the U.S.

Volcker Rule: Proprietary Trading

- trades with or through any U.S. entity are prohibited other than:
 - trades with the “foreign operations” of a U.S. entity (as defined below), provided that no personnel of the U.S. entity involved in the arrangement, negotiation or execution of the trade are located in the U.S.
 - trades with an unaffiliated market intermediary acting as principal that are promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty
 - » as defined, “market intermediaries” is limited to securities broker-dealers, SDs, SBSDs and FCMs
- trades made through an unaffiliated market intermediary acting as agent, provided that the trade is
 - conducted anonymously on an exchange or similar trading facility and
 - promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty

Volcker Rule: Proprietary Trading

- Additional considerations regarding the “U.S. entity” restrictions
 - “U.S. entity” is defined to include non-U.S. affiliates of U.S. companies as well as any entity “acting on behalf of or at the direction of” a U.S. company
 - Impact on existing Rule 15a-6 trading relationships
 - Ability to rely on the SOTUS exemption for certain types of trades, such as direct trading of cleared products on exchanges or SEFs.

Volcker Rule: Proprietary Trading

- Key risk-mitigating hedging conditions/restrictions
 - At its inception, the hedge is
 - designed to reduce or otherwise mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, and
 - does not give rise to significant exposures that are not themselves hedged in a contemporaneous transaction.
 - Once established, a hedge must be subject to continuing review, monitoring, and management policies and procedures which include ongoing recalibration requirements to make sure that the hedge continues to comply with the risk-mitigating hedging requirements.
 - If a hedge is (a) established by a trading desk that is different from the trading desk that is responsible for the positions being hedged, or (b) effected through a financial instrument that is not identified as a hedging instrument in the relevant trading desk's policies; or (c) hedges across aggregate positions of two more trading desks, then the banking entity must document
 - the risks intended to be reduced;
 - the risk-mitigating strategy; and
 - the trading desk responsible for the hedge.

Volcker Rule: Proprietary Trading

- Alternative authority under the Volcker Rule must be found for “proprietary trading” activities that do not satisfy the SOTUS and risk-mitigating hedging activities exemptions.
 - A likely source of authority is the market making-related provisions, which are subject to their own extensive conditions and restrictions.

Volcker Rule: Proprietary Trading- Tax Considerations

- **Tax Considerations**

- Transfers of trading desks to take advantage of SOTUS exceptions:

- Transfer pricing issues – Was an intangible transferred from US operation to foreign operation? Need to consider other IP issues relating to US systems and software usage – licensing fees?
- Withholding tax issues – Will foreign trading desks be exempt from US withholding tax (consider dividends on equities, dividend equivalents on derivatives)

Volcker Rule: Proprietary Trading- Tax Considerations

- Effectively connected issues – Will transferred positions continue to be effectively connected under U.S. tax rules despite the transfer (once ECI, always ECI rule)? Effect of inter-branch transaction rules. Otherwise, for sales and other transfers from a US to a non-US entity, the transaction will generally transfer trigger gain (but not loss) recognition under Section 267(f) loss deferral rules.
- Unless the specific provisions of Treas. Regs Section 1.1001-4 apply, the change in counterparty to the position may result in income recognition to the counterparty. Requirements: (i) the transfer involve a derivative contract (broadly defined), (ii) the position is transferred from a dealer or clearinghouse to a dealer or clearinghouse, (iii) terms of the derivative permit the transfer (including a transfer where consent of the counterparty is required), and (iv) no other modification that would result in a taxable exchange.

Volcker Rule: Proprietary Trading- Tax Considerations

- Use of hedging exceptions – Will identification as hedges require a change in accounting from marked-to-market under IRC section 475 to hedge accounting under Section 446 regulations?

Volcker Rule: Covered Funds

Covered Funds – Hedge Funds and Private Equity Funds

- Identifying “covered funds”
 - Point of reference is the Investment Company Act of 1940 (the “40 Act”)
 - The fund would be subject to the 40 Act but for Section 3(c)(1) or 3(c)(7), which generally exclude from the definition of “investment company” under the 40 Act funds whose interests are not publicly offered and whose outstanding securities are owned (i) by not more than 100 persons or (ii) exclusively by “qualified purchasers”.
 - Key exclusions from the definition of “covered funds” for all banking entities
 - foreign public funds
 - foreign pension and retirement funds
 - loan securitizations – those whose portfolios consist exclusively of loans (cash equivalents and DPC securities are permitted, as are fx/interest rate derivatives used solely for risk-mitigating purposes)
 - impact on CLOs
 - qualifying ABCP conduits – those that hold only loans and other assets permissible for loan securitizations and ABS supported solely by such assets
 - mutual funds registered under the 40 Act

Volcker Rule: Covered Funds

- FBOs may exclude “foreign private funds” but their U.S. operations cannot
 - A foreign private fund that is not offered or sold to U.S. investors (and therefore need not rely on Sections 3(c)(1) or 3(c)(7)) and in which the FBO has an ownership interest or which the FBO sponsors
- Funds that are not “covered funds” may be “banking entities” if controlled by an FBO (applying the Bank Holding Company Act definition of “control”)
- “Super 23A prohibition” on affiliate transactions with covered funds (*e.g.*, extensions of credit).
 - Triggered where a banking entity is the investment manager, investment adviser or sponsor of a covered fund or a fund that the banking entity organizes and offers.

Volcker Rule: Covered Funds

- **Investments in covered funds are prohibited unless specifically authorized under the Volcker Rule**
 - Investments are permitted in funds that the bank organizes and sponsors only in connection with its provision of bona fide trust, fiduciary or investment advisory services.
 - Subject to post-“seeding period” limits on the amount of such investments individually and in the aggregate.

Volcker Rule: Covered Funds

- FBOs (but not their U.S. operations) may sponsor and invest in “SOTUS” funds
 - The activity or investment must be conducted “solely outside of the United States”.
 - decisions and booking occur outside of the U.S.
 - the FBO’s U.S. operations may not finance the investment

Volcker Rule: Covered Funds

- No ownership interest in the fund is “offered for sale or sold to a resident of the United States.”
 - “resident of the United States” as defined under SEC Reg S
 - » This permits offers and sales to foreign branches of U.S. banks, as well as to U.S. dealers and other professional fiduciaries acting on behalf of discretionary or similar accounts held for the benefit or account of non-U.S. residents.
 - within these parameters, U.S. personnel may be involved in the offer and sale of interests in the fund
 - an ownership interest is not “offered for sale or sold to a U.S. resident” if it is sold or has been sold pursuant to an offering that does not target a U.S. resident
 - A U.S. affiliate may be the fund’s investment adviser

Volcker Rule: Covered Funds

- Among the key challenges presented by the covered funds' provisions are:
 - Restructuring investments in non-conforming funds to conform to the Volcker Rule's requirements
 - Use of parallel or feeder funds
 - Consequences of having to divest an investment in a non-conforming fund
 - Relevance of the conformance period and additional extensions
 - Timing of extension requests

Volcker Rule: Covered Funds – Tax Considerations

- **Tax Considerations**

- Sale or transfer of existing investments in covered funds may give rise to taxable gains and, if sale or transfer is to an affiliated entity, deferred losses.
- SOTUS requirement with respect to decisions relating to investing in funds may give rise to same issues as proprietary trading limitations --
 - Transfer pricing issues – Was an intangible transferred from US operation to foreign operation? Need to consider other IP issues relating to US systems and software usage – licensing fees?
 - ECI / PE Issues – Will investment in SOTUS funds by non-US units create ECI or a PE for investor company?
 - Withholding tax issues – Will investment in funds be subject to US withholding tax under Sections 1441, 1445 or 1446?

DFA Title VII Swap Clearing Requirements

The Statutory Requirement

- The intention is to expand the central clearance of swaps and thereby reduce systemic risk.
- Section 2(h)(1) of the Commodity Exchange Act requires that any swap that the CFTC determines is required to be cleared must be cleared through a registered derivatives clearing organization (“DCO”) or a DCO that is exempt from registration.
 - Commercial end users are not subject to the swap clearing requirement but may opt into the requirement.
 - This “end user” exception does not apply to “financial entities” (e.g., swap dealers, commodity pools and pension funds).

DFA Title VII Swap Clearing Requirements

- Swaps that are subject to the clearing requirement must be executed on a designated contract market (DCM) or swap execution facility (SEF), unless no DCM or SEF has made the swap available to trade.
- To date, the CFTC has issued clearing mandates for four classes of currency and interest rate swaps and two classes of index CDS, and it is anticipated that it will issue mandates for other classes of swaps in the future.

DFA Title VII Swap Clearing Requirements

Treatment of Upfront Payments and Cleared Interest Rate Swaps

- Upfront payments are made in connection with swaps conducted on “off-market” terms and compensate the party receiving a below-market (or paying an above-market) rate.
- In the case of cleared swaps, the DCO becomes the counterparty on each side of the swap, and the upfront payment made on one side is immediately collected by the DCO as variation margin on the swap on the other side, which amount the DCO in turn remits as variation margin to the party to the swap that made the upfront payment.
- The party that is due the upfront payment under the terms of the swap thus does not receive any cash in connection with the payment, and the party obligated to make the payment will not actually have made any cash outlay.

DFA Title VII Swap Clearing Requirements

Uncleared Swaps

- Title VII directs the adoption of regulations establishing initial and variation margin requirements for uncleared swaps. These regulations have not been finalized but are expected to reflect the standards adopted by the Basel Committee and IOSCO in September 2013.
 - Under those standards, all financial firms and systemically important non-financial entities that engage in uncleared swap transactions will have to exchange initial and variation margin commensurate with the counterparty risks arising from such transactions. The standards are designed to reduce systemic risks related to OTC derivatives markets, as well as to provide firms with appropriate incentives for central clearing while managing the overall liquidity impact of the requirements.
- In the case of uncleared swaps involving full variation margin the same result is obtained as in the case of cleared swaps (albeit without the involvement of a DCO) – the recipient of the upfront payment is required to post the same amount with the payor as variation margin.

Swap Clearing Requirements: Tax Considerations

- Existing tax rules for the treatment of significant upfront payments (i.e., as deemed loans) did not contemplate either
 - the growth of such payments as a result of the DFA requirements for clearing (in part because termination of a swap will now be accomplished through the issuance by a counterparty of an offsetting swap to the clearing organization to replace the terminated transaction, with the new counterparty likely giving or receiving an upfront payment), or
 - the requirements of upfront and variation margin – which will generally require the entire upfront payment to be returned to the clearinghouse or counterparty as a margin payment.

Swap Clearing Requirements: Tax Considerations

- Treas. Regs 1.1001-4 and 1.956-2T(b)(2)(xi) address part of the problem –
 - The transfer of the swap to the clearing organization will not cause the non-assigning counterparty to recognize gain or loss under Section 1001 as a result of the change in counterparty from the dealer to the clearinghouse

Swap Clearing Requirements: Tax Considerations

- For purposes of Section 956 (investments in US property by a CFC), in connection with the transfer of a swap to a derivatives clearing organization or agency, the deemed loan resulting from an upfront payment will not be treated as an investment in US property by the CFC making the payment if
 - The CFC is a dealer in securities or commodities;
 - The upfront payment is required under a contract cleared by a registered derivatives clearing organization or agency (as defined under the CEA or '34 Act);
 - The CFC makes the upfront payment to or through a member of such clearing organization or agency, or directly to the clearing organization or agency (if the CFC is a member of the organization or agency);
 - The upfront payment is made by the organization or agency, directly or indirectly, to the original counterparty to the derivatives contract;
 - The original counterparty to the contract is required to make a payment of initial variation margin to the clearing organization or agency in an amount equal to the upfront payment; and
 - The initial variation margin is paid by the clearing organization or agency to the CFC.

Swap Clearing Requirements: Tax Considerations

- There are still considerable unresolved issues –
 - Treatment of the deemed loan as debt for cross-border interest reporting withholding purposes – will deemed interest on deemed loan be exempt as portfolio interest? Even if exempt, will reporting be required? Similarly, if US-source interest is deemed paid on the deemed loan, FATCA withholding may apply in circumstances where a derivatives payment (foreign sourced under the residence sourcing rule for derivatives) would be exempt.
 - Treatment of deemed loan on uncleared swaps may be subject to section 956 investment in US property rules even if the upfront payment is received back by the CFC as variation margin (inter-affiliate swaps may replicate swaps between US affiliate and clearing organization).

Swap Clearing Requirements: Tax Considerations

- Treatment of deemed loan may give rise to debt financed property for tax-exempts subject Section 514 tax on UBTI.
- Section 1.884-5 treatment of interest paid on deemed loans by US branches of FBOs.

Basel III Overview of U.S. Developments

Background

- The Basel Committee on Banking issued proposals on the quantity and quality of banks' regulatory capital in December 2010 (Basel III).
- On August 30, 2012, the Fed, the OCC, and the FDIC issued three related notices of proposed rulemaking (NPRs) to implement Basel III that substantially amended the risk-based capital rules for banks.
- A final rule ("Final Rule") to implement the Basel III capital guidelines in the United States was approved by the regulators in July 2013.

Basel III Final Rule Applied in the United States

Capital Ratio Requirements

- All banking organizations must meet these minimum capital requirements:
 - 4.5% common equity tier 1 (CET1) capital ratio;
 - 6.0% tier 1 capital ratio;
 - 8.0% total capital ratio;
 - 4.0% leverage ratio; and
 - Capital conservation buffer greater than 2.5%, to avoid restriction on capital distributions and discretionary bonus payments to executive officers.

Current Rules and Deferred Taxes

Background – Current U.S. bank regulatory rules for taxes

- The amount of DTAs that are recognized for book purposes as “good” assets for regulatory capital purposes is determined as follows:
 - DTAs are allowed to the extent they can be netted against DTLs
 - Net DTAs are allowed if they can be carried back against taxes previously paid
 - Remaining net DTAs are allowed if they can be absorbed against projected taxable income for the 12 months following the reporting date to the extent that they do not exceed 10% of a bank’s Tier 1 capital.
- DTAs exceeding these limits must be written off.
- Accumulated other comprehensive income (AOCI) items are reversed - i.e., gains or losses recognized on available for sale debt securities, gains from available for sale equity securities, actuarial gains or losses on pensions, and gains or losses on cash flow hedges
- Determined net of associated DTAs/DTLs, with option to also include or exclude from limitation calculation.

Current Rules – Example 1

Example 1 – Calculation of benefit from DTA based on carryback potential and projection of next 12 months taxable income

Facts

- ABC Bank has its head office in NY and branch operations throughout the United States. It has:
 - \$1,000 loan loss reserve
 - \$400 DTA relating to this loan loss reserve (an “LLR DTA”)
 - \$100 DTA related to federal LIHC credit (“Credit DTA”)
 - \$120 DTL relating to mortgage servicing asset (“MSA DTL”)
- In Year 1, ABC Bank had a tax liability of \$150, and in Year 2, it had a tax liability of \$75. In the current year (Year 3), as of the reporting date at the end of the calendar year, it has an anticipated tax liability of \$75. For the 12 months following the reporting date, it projects a tax liability of \$50.

Current Rules – Example 1

- **Analysis**

- Step 1: Net DTAs and DTLs, resulting in a net DTA position of \$380 ($\$500 - 120$).
- Step 2: Carryback the net DTA against prior year tax liability. $\$380$ net DTA - $\$300$ prior year taxes paid = $\$80$ DTA to carryforward.
- Step 3: Analyze taxes expected in the next 12 months. $\$80$ DTA carryforward - $\$50$ future tax liability = $\$30$ DTA to write off against T1 capital.

Basel III Final Rule – Summary

Deferred Taxes Guidelines

- DTLs are allocated pro-rata against all DTAs
 - DTAs can only be netted against DTLs levied by the same taxation authority and subject to the same character
- Net operating loss (NOL) or credit carry forward DTAs (net of pro-rata allocated DTLs) subtracted from CET1
- DTAs arising from temporary differences are treated as good assets if they:
 - Carried back against previously paid taxes on a jurisdictional basis
 - Do not exceed caps set in the Threshold Deductions calculations
- AOCI, except cash flow hedges, included in CET1, unless the institution “opts out”
- DTA/DTL netting is allowed against other regulatory adjustments subject to certain rules

Basel III Final Rule – Adjustments to Capital & Transition Rules

- Effective dates of Final Rule
 - 1/1/14 for Advanced Approaches Banks (Certain Large US Banking Institutions)
 - 1/1/15 for Non-AA Banks
- Adjustments to and deductions from GAAP equity to arrive at required capital under the Final Rule
 - The adoption of these adjustments and deductions are generally phased in over a five-year period.
 - All institutions (AA and Non-AA Banks) use same transition percentages in 2015 and following.

Basel III Final Rule – Adjustments to Capital & Transition Rules

	2014	2015	2016	2017	2018
CET1 Deduction	20%	40%	60%	80%	100%
Carryforward DTA – Tier 1	80%	60%	40%	20%	0%

Basel III Final Rule – Adjustments to Capital

- **Major deductions from common equity Tier 1 capital (CET1):**
 - Goodwill and other intangibles (other than mortgage servicing assets (MSAs))
 - Deferred tax assets (DTAs) arising from NOLs and tax credit carryforwards
 - Gain on sale associated with a securitization exposure
 - Defined benefit pension fund asset net of DTL held by a depository institution holding company that do not have unrestricted access to the fund assets
 - Not required for insured depository institutions
 - Certain investments in the bank's and other bank's capital instruments

Basel III Final Rule – Adjustments to Capital (continued)

- **Major regulatory adjustments to CET1:**
 - Unrealized gain/loss on certain cash flow hedges relating to items not recognized at FV
 - Banks making AOCI “opt out” subtract AOCI items
 - Changes in value of a bank’s liabilities resulting from changes in bank’s creditworthiness
 - Items subject to Threshold Deductions calculation

Basel III Final Rule – Adjustments to Capital (continued)

- **Threshold Deductions:**
 - **Three** items are treated as good assets to the extent:
 - Individually less than 10% of adjusted CET1
 - Collectively less than 15% of CET1
 - » DTAs
 - » Mortgage Servicing Assets (MSA)
 - » Significant Investments in Unconsolidated Financial Institution's common stock

Basel III Final Rule – State/Foreign Taxes

- Banking organizations must analyze DTAs and DTLs on a jurisdiction-by-jurisdiction basis.
- Applies in analyzing the ability to carry back state and foreign DTAs
- Utilize tax laws of the relevant state and local jurisdictions in calculating current and deferred taxes
- Consider character of DTAs and DTLs under relevant federal and state tax laws in determining the ability to offset DTAs and DTLs
 - For example, capital loss DTAs could only be offset against capital gain DTAs

Basel III Final Rule – Example 2

- **Example 2 – Calculation of realization for DTAs based on carryback potential assuming temporary differences reverse at report date with the carryback of DTAs on a gross basis**
- **Facts**
- As in Example 1, ABC Bank has:
 - \$1,000 loan loss reserve
 - \$400 DTA relating to this loan loss reserve (an “LLR DTA”)
 - \$100 DTA related to federal LIHC credit (“Credit DTA”)
 - \$120 DTL relating to mortgage servicing asset (“MSA DTL”)
- In Year 1, ABC Bank paid taxes of \$150.
In Year 2, it had a tax liability of \$75.
In the current year (Year 3), as of the reporting date at the end of the calendar year, it has an anticipated tax liability of \$75.
- Assume that ABC Bank calculates the realization of its DTA carryback on a gross basis.

Basel III Final Rule – Example 2 (continued)

- **Analysis**

- Step 1: Break out DTAs and DTLs.
 - Federal DTA = \$100 Credit DTA, \$400 LLR DTA, (\$120) MSA DTL
- Step 2: Analyze the carryback potential
 - \$400 LLR DTA is carried back before allocating DTLs against prior 3 years of taxes paid for a carryback of \$300 (Y1 – Y3). The remaining \$100 (\$400 - \$300) is carried forward to net with DTLs
- Step 3: Allocate DTL between Credit DTA and remaining LLR DTA.
 - $\$120 \text{ DTL} \times (100/200) = \60 DTL to Allocate against Credit DTA.
Net Credit DTA = \$40 (\$100 - \$60)
 - $\$120 \text{ DTL} \times (100/200) = \60 DTL to allocated against LLR DTA. Net LLR DTA = \$40 (\$100 - \$60)

Basel III Final Rule – Example 2 (continued)

- Step 4: Analyze the remaining DTA against the Threshold Deduction
 - Remaining \$40 net LLR DTA is analyzed as part of the 10%/15% threshold deduction
 - Remaining net Credit DTA of \$40 is disallowed

The “clarification” in the Preamble and amendment to section 22(d) appears intended to preclude this approach, but as section 22(e) was substantially unchanged there may still be a basis to take this approach.

Basel III Final Rule – Example 3

- **Example 3 – Calculation of realization for DTAs based on carryback potential assuming temporary differences reverse at report date with the carryback of DTAs on a net basis after allocation**
- **Facts**
- As in Example 1, ABC Bank has:
 - \$1,000 loan loss reserve
 - \$400 LLR DTA
 - \$100 Credit DTA
 - \$120 MSA DTL
- In Year 1, ABC Bank paid taxes of \$150.
In Year 2, it had a tax liability of \$75.
In the current year (Year 3), as of the reporting date at the end of the calendar year, it has an anticipated tax liability of \$75.
- Assume that ABC Bank calculates the realization of its DTA carryback on a net basis.

Basel III Final Rule – Example 3 (continued)

- **Analysis**

- Step 1: Break out DTAs and DTLs.
 - Federal net DTA = \$100 Credit DTA, \$400 LLR DTA, (\$120) MSA DTL
- Step 2: Allocate DTL between Credit DTA and LLR DTA.
 - $\$120 \text{ DTL} \times (100/500) = \24 DTL to Allocate against Credit DTA. Net Credit DTA = \$76 (\$100 - \$24)
 - $\$120 \text{ DTL} \times (400/500) = \96 DTL to allocated against LLR DTA. Net LLR DTA = \$304 (\$400 - \$96)
- Step 3: Analyze the carryback potential
 - \$76 Credit DTA cannot be carried back and is disallowed
 - \$304 LLR DTA is carried back against prior 3 years of federal taxes paid for a carryback of \$300 (Y1 – Y3). The remaining \$4 (\$304 - \$300) will be subject to the Threshold Deduction

Basel III Final Rule – Example 3 (continued)

- Step 4: Analyze the remaining DTA against the Threshold Deduction
 - Total \$4 DTA is analyzed as part of the 10%/15% threshold deduction
- This approach follows the “net of DTLs” language of section 22(d), while still applying the pro-rata allocation of section 22(e)(3).

Basel III Final Rule – AOCI Opt-Out

- Final Rule would require that most components of AOCI be included in calculating common equity Tier 1 capital
- Opt-Out Election
 - Available for Non-AA Banks
 - One-time election to “opt out” of the requirement to include certain AOCI items
 - Applies to all regulated subsidiaries of the banking organization making the election
 - Must be made on the first regulatory report filed after the date the organization is required to comply with the Final Rule
 - In certain merger, reorganization and acquisition situations there is a possibility of a change in election

Basel III Final Rule – Netting of Deferred Taxes Against Other Regulatory Adjustments

- **A Summary of Final Rule Sections relevant for netting:**
 - Section 22(b)* – “fair value measurements or similar adjustments”
 - Section 22(a) -- i.e., goodwill or other intangible assets
 - Section 22(c) and (d) – i.e., MSAs and significant investments in unconsolidated subsidiaries

*Note this table follows the Preamble with respect to 22(b)

	22(a) DTL	22(a) DTA	22(b) DTL	22(b) DTA	22(c)/(d) DTL	22(c)/(d) DTA
Net Against Associated Item	May Net OR	Cannot Net	Must Net AND	Must Net AND	May Net OR	Cannot Net
DTA/DTL Included in Threshold Calculation	May include/ exclude	Must Include	May include/ exclude	May include/ exclude	May include/ exclude	Must Include

Basel III Tax Planning Opportunities

- Tax planning may effectively manage a bank's Deferred Tax position to enhance regulatory capital.
 - Focus of planning:
 - An overall assessment of the bank's Deferred Tax position, and
 - A compliance review of the bank's accounting methods.
 - Opportunities to explore include:
 - Converting “bad” DTAs (i.e., NOL and credit carryforwards) into “good” DTAs by accelerating income recognition or deferring the tax recognition of an expense
 - Accelerating deductions to create DTLs
 - Analyzing the potential to file a carryback claim
- As part of M&A tax planning, deferred tax aspects of asset or stock acquisition vis-à-vis purchase accounting.