

2014 Institute of International Bankers Annual Tax Seminar

# *Tax Regulatory, Legal and Other Updates*



Melissa A. Heise, Moderator  
SVP and Tax Counsel  
HSBC Securities (USA) Inc.

Roger Brown, Principal  
Ernst and Young

Rob Culbertson, Partner  
Covington & Burlington LLP

Susan Grbic, Partner  
WeiserMazars LLP

Izabel Peros  
PriceWaterhouse Coopers

# Capital Planning Issues

# Overview to Capital Planning

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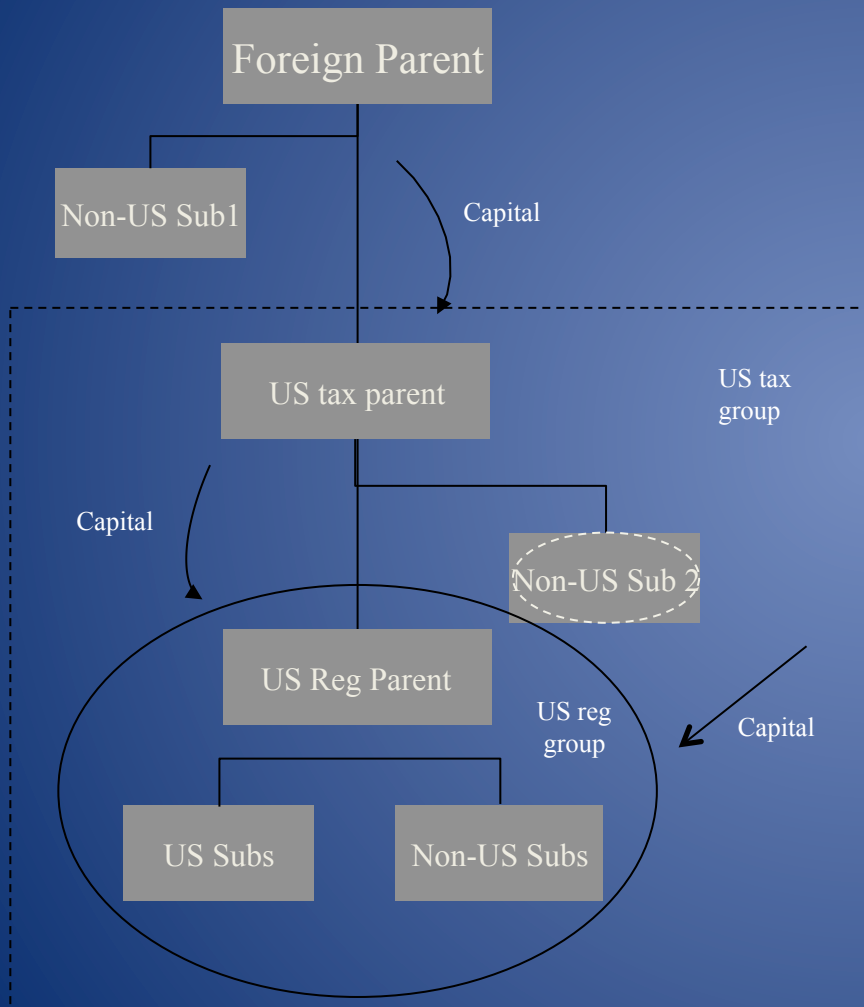
- ▶ Regulatory capital is the lifeblood of any / most regulated entities
- ▶ Few enterprises have so much capital that they don't explore enhance capital efficiency
- ▶ All three areas of the balance sheet offer opportunities:
  - ▶ Assets,
  - ▶ Liabilities, and
  - ▶ Equity
- ▶ There is little business activity that does not present the ability to optimize one's capital position by planning in at least one of these buckets
- ▶ Approaches may also differ with respect to structural, transactional, and operational solutions

# Capital & Structural Planning

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- ▶ Capital planning can be broken down between
  - ▶ Removing adverse drivers of regulatory capital
    - ▶ High risk weights
    - ▶ Capital write offs (attribute DTAs, goodwill, etc.)
  - ▶ Reducing balance sheet usage on trading
  - ▶ Tax – deductible Tier 1 capital
  - ▶ DTA planning
- ▶ The combination of the Dodd Frank Act and Basel 3 made it difficult to structure instruments that are Tier 1 capital, but debt from tax perspective in the US.
- ▶ Although a number of other countries have issued guidance granting tax deductions on Additional Tier 1 (AT1) Capital, the US has not.
  - ▶ Such instruments may be equity from a US tax perspective
  - ▶ The value of a US tax deduction on Tier 1 capital may be an annual \$30m - \$60m tax savings per billion of capital raised

# Structural Capital Efficiency



## Considerations:

- ▶ Different ways to establish US tax parent
- ▶ US consequences on transition
- ▶ Non-US consequences on transition
- ▶ Mixes of debt and equity at different levels
- ▶ Capital efficiencies achievable due to differences in tax and regulatory groupings

Alternative structures exist for entities below the US regulatory parent

# Asset Based Focus to Capital Planning

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- ▶ Variations in approaches
  - ▶ Limiting assets subject to regulatory capital measurement
  - ▶ DTA planning
- ▶ Asset base
  - ▶ Revisiting trading models
    - ▶ State and local considerations
  - ▶ De-risking assets
- ▶ DTA
  - ▶ Attribute absorption with built-in gains
  - ▶ Attribute absorption beyond existing built-in gains
  - ▶ Preventing additional attributes from arising
- ▶ Triggering existing gains / value
  - ▶ Traditional tools / well worn paths
  - ▶ Nontraditional tools

# Liability Based Focus to Capital Planning

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- ▶ Approaches vary between
  - ▶ Funding with liabilities that may count as regulatory capital
  - ▶ Using liabilities as a source of DTAs absorption
  - ▶ Potentially using DTA usage as collateral for borrowings
- ▶ Sample techniques
  - ▶ Proactive use of interest expense deferral rules
  - ▶ COD
  - ▶ DTA linked borrowings
    - ▶ *See Banks Target DTAs to Boost Capital (Feb. 21, 2014), reprinted at <http://www.reuters.com/article/2014/02/21/idUSL6N0LQ2YR20140221>*
    - ▶ “I fully expect some significant DTA-linked transactions to be closed this year.”
    - ▶ Balancing the tension points with such structures
- ▶ Instruments (or structures) that qualify as tax deductible equity (net income vs. gross income approach).

# Legislative and Regulatory Outlook

# Legislative and Regulatory Outlook

- Inversion madness – do the potential responses present concerns for IIB members?
- Tax reform – is it dead yet, or just sleeping?
- Specific legislative proposals of interest
- The regulatory pipeline

# Inversion Madness

- Many Fortune 100 companies are reported to be planning or considering an inversion
- Despite some media interest, legislative and administration response has thus far been muted
- Will that continue?
- If there is a legislative response, could it affect IIB members?

# Possible Effects of Anti-Inversion Legislation on IIB Members

- Collateral damage from changes to 7874
  - Under some current legislative proposals, a foreign group's routine acquisition of a US target could potentially result in treating the foreign parent as a US corporation
  - Presumably over breadth of proposal will be addressed
- The real concern: potential renewed focus on base erosion, and related earnings stripping, expense allocation, and transfer pricing rules

# Renewed Focus on Base Erosion?

- Much of the rhetoric on both sides currently focuses on using inversions to reduce US tax on international operations
- But for many potential US inverters, more tax benefits arise from domestic base erosion – deductible payments from US to foreign affiliates
- 163(j) tighteners have already been proposed
- Recall previous, much tougher 163(j) proposals (pre-7874) – renewed traction?

# Tax Reform

- It needs to happen – politically, morally, objectively
- Much serious work has been done, and the two sides are remarkably close in many respects
- But there are still important disagreements
- And neither side wants to let the other get any credit for having achieved it
- So it will remain frozen, like Sleeping Beauty, until a prince joins forces with the dwarves
  - But the two inhabit different fairy tales

# Tax Reform

- But in the meantime, revenue must still be raised
- And ideas proposed as part of tax reform packages may provide tempting sources of revenue
- And inversions or other tax issues may catch fire politically, setting a bill in motion
- So it's important to track the proposals, even while Sleeping Beauty snores
  - Chairman Camp's Tax Reform Act of 2014 Discussion Draft
  - Obama Administration's 2015 Budget

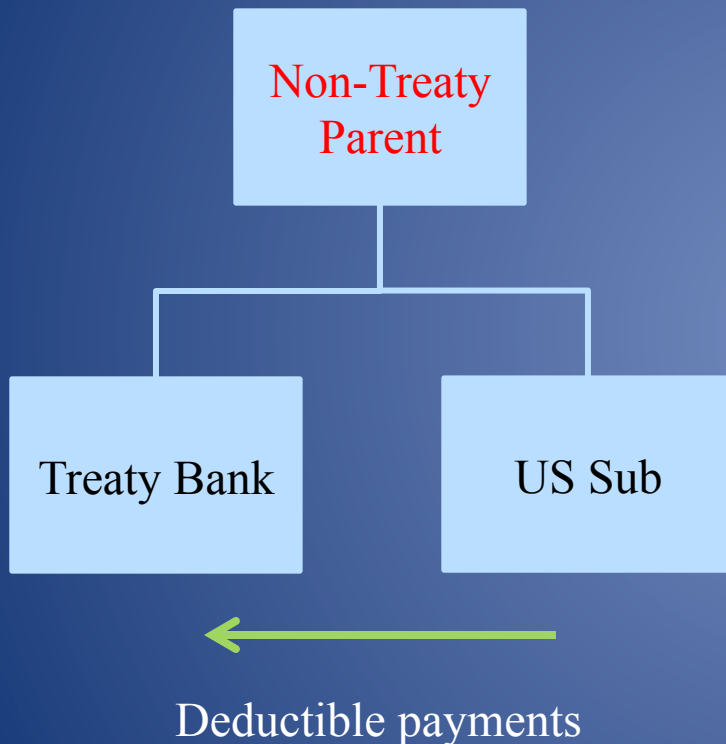
# 2014 Camp Discussion Draft

- Modification of 163(j) earnings stripping rule
  - Current law: deduction for related party interest expense may be denied if net interest expense exceeds 50% of adjusted taxable income (roughly, cash flow) and d/e ratio exceeds 1.5 to 1
  - Proposal: lower the excess interest threshold to 40% of ATI
  - No change to calculation based on net interest expense

# 2014 Camp Discussion Draft

- Override of treaty benefits for deductible related-party payments
  - Limitation on benefits provisions of US tax treaties generally limit benefits to treaty-country entities that are owned by treaty residents
    - But LOB rules typically contain several exceptions that preserve treaty benefits based on various factors
    - One important exception typically preserves treaty benefits when treaty entity has active business in treaty country

# Treaty LOB Rules



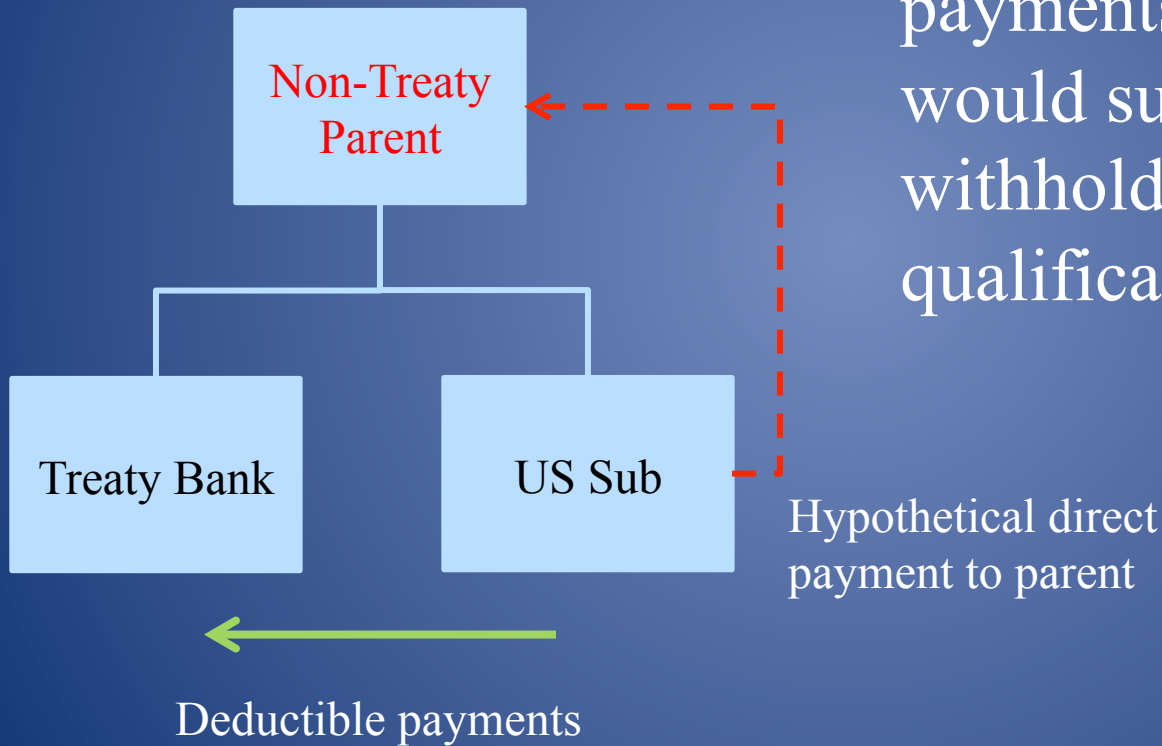
- Treaty Bank would not qualify under most treaty LOB rules looking to ownership or derivative benefits
- But if Treaty Bank meets active business test in applicable LOB rule, treaty benefits apply to reduce US withholding tax
  - In addition to requiring ATB, treaties require that Treaty Bank activity be substantial in relation to the US activity

# 2014 Camp Discussion Draft

- Camp draft would override treaty LOB rules by denying treaty benefits for deductible payments to a related treaty entity
  - Provision applies even if the treaty entity meets the treaty's active business rule (or otherwise qualifies for benefits)
- Treaty benefits would be preserved if a payment directly to the foreign parent would be eligible for benefits under its own treaty
  - Does not appear to require equivalent benefits, just some reduction of US withholding tax

# 2014 Camp Discussion Draft

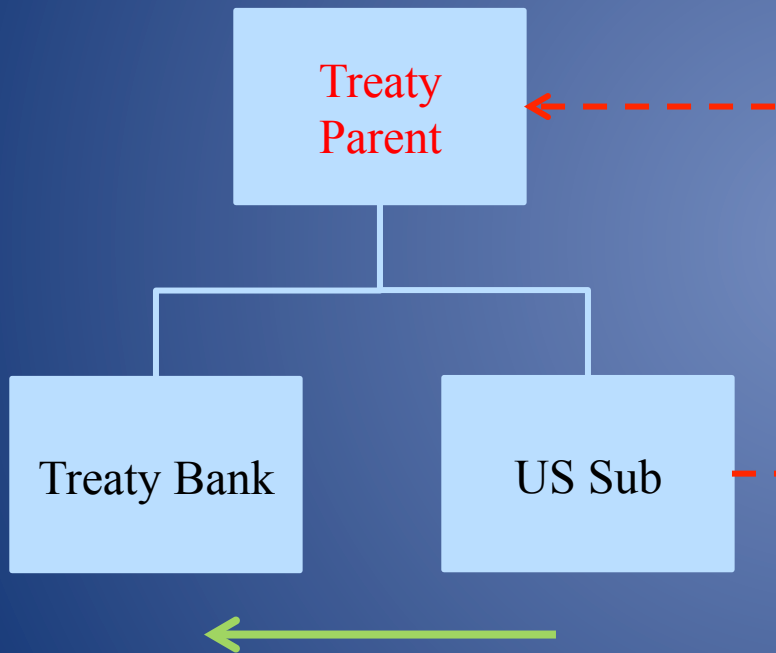
Under Camp proposal, payments to Treaty Bank would suffer 30 percent withholding, despite qualification under LOB



# 2014 Camp Discussion Draft

Effects of Camp rule would not be limited to non-treaty parents, however

- Rule could bite if a treaty-based parent had a narrower treaty that didn't cover particular payments



Hypothetical direct payment to parent

Deductible payments

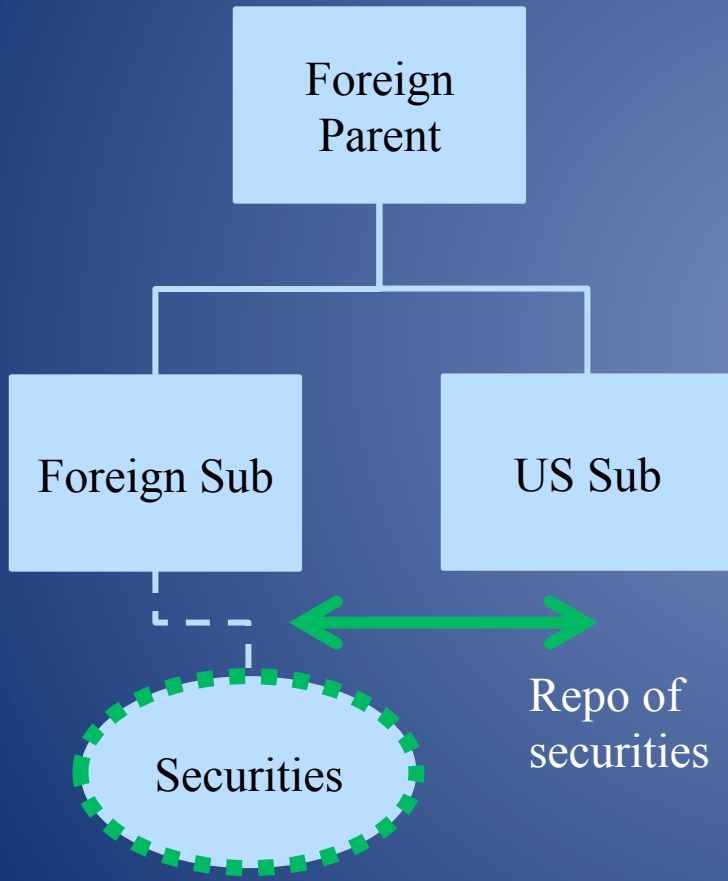
# Obama Administration's 2015 Budget

- New limitation, in lieu of section 163(j), on interest deductions of foreign-parented US groups
  - Applies a proportionate worldwide leverage test: US group can't be more heavily debt-financed than worldwide group (or limited to 10 percent of ATI)
  - But only applies to net interest expense
  - And excludes financial services entities
  - Reminiscent of Camp 2011 thin cap proposal
  - No apparent interest in revisiting 882-5 issues, NatWest, etc., despite analogous concerns?

# Obama Administration's 2015 Budget

- Deduction denied for related-party interest and royalty payments under hybrid arrangements if:
  - No corresponding income inclusion to recipient under foreign tax rules; or
  - Taxpayer receives additional deduction for same payment in another jurisdiction
- Additional reg authority to address:
  - Deduction denials for hybrid conduit arrangements
  - Unrelated party interest and royalty hybrids
  - Arrangements in which the recipient includes the payment in income, but at a preferential rate

# Hybrid Payment Proposal



- Repo of securities by US Sub to Foreign Sub
- Foreign Sub jurisdiction treats as sale
- US views as collateralized loan to US sub, giving rise to interest deductions
- Depending on foreign tax treatment of income on securities, hybrid payment proposal may deny US interest deduction

# Administrative Guidance Pipeline

- Potential expansion of 936(h)(3)(B) included intangibles
  - Although the main focus is 367(d), could restructuring activity of inbound multinationals be impacted (367(e))
- Section 987 regulations
- Global Dealing regulations

# Questions?

# Tax Regulatory and Legislative Developments

# Tax Transparency



# Tax Transparency

- How does an organization communicate its approach to taxes and how much does it pay?
- How do you provide clarity to the public and stakeholders on complex tax issues?
- How do you give stakeholders confidence that tax is being fairly calculated and paid?

# Push for Transparency

- Factors driving the debate:
  - Post financial crisis revenue
  - Rise of corporate responsibility
  - Media focus
  - Globalization of business
  - Value of intangibles
- The public and tax activists want to know that companies are paying their “fair” share.

# Changes to International Tax Framework

- Global Forum on Transparency
  - Created in 2000 under the auspices of the OECD to address money laundering, tax evasion, tax havens, and offshore financial centers.
  - 110 member jurisdictions including the European Union.
- Joint International Tax Shelter Information Center
  - Established in 2004 to identify and share expertise in combating abusive tax schemes
  - China and Korea recently joined representatives from 25 other nations

# Changes to International Tax Framework

- FATCA
  - Over 70 countries have signed, or are in discussion to sign, an IGA with the IRS.
  - Has become a new global standard for tax transparency
  - Model for future tax transparency initiatives

# Responses to Perceived Lack of Transparency

- Stop Corporate Inversions Act of 2014
  - Proposal to make it more difficult for U.S. corporations to expatriate through inversions
  - Tighten anti-inversion rules of Section 7874
- Information Sharing
  - U.S., U.K., and Australia have agreed to share information on offshore trusts and companies holding assets on behalf of U.S., U.K. and Australian residents
  - Information includes the owners of entities and advisors who structured the transactions
- European Commission
  - Announces investigation into transfer pricing agreements in Ireland, the Netherlands, and Luxembourg by Apple, Starbucks, and Fiat

# The Future of Transparency

- Country-by-Country Reporting
  - EU Parliament approved country-by-country reporting for European banks beginning in 2014
  - New SEC rules are to be issued requiring disclosure of country-by-country information in the oil, gas, and mining sectors.
- Automatic Information Sharing
  - Proposals for global system based on FATCA

# Conclusion

- How will financial institutions prepare for greater disclosure and transparency in the future?
- How to balance the public desire for information with the current system of limited disclosure?
- How will increasing transparency change the global tax system?

# Questions?

# Recent Trends and Hot Topics

# SEC footnote comments

- Recent history has shown increase footnote comments related to taxes
  - Assessment of Deferred tax assets
  - Rate Reconciliation
  - Uncertain tax positions
  - Indefinite Reinvestment

# Assessment of Deferred Tax Assets

- 1. We note you substantially reversed your valuation allowance for deferred tax assets in the fourth quarter of 2012.** It appears you did so based on your ability to generate pre-tax income in the five most recent fiscal quarters. Prior to that, we note the last fiscal year you generated pre-tax income was in 2006. **Given the modest level of pre-tax income you have recently generated and the relatively short duration of your return to profitability, coupled with the significant uncertainties associated with your industry, please provide us with a more comprehensive explanation of why you believe it was appropriate to substantially reverse your deferred tax asset valuation allowance in the fourth quarter of 2012.**

# Rate Reconciliation

- The effective tax rate (ETR) reconciliation is a primary area of focus
- Provides valuable insight into the business
- Increased scrutiny of certain reconciling items:
  - Disclosure of the relationship between the mix of foreign and domestic revenues
  - Items are not disaggregated to avoid 5 percent requirement
    - Reconciling items below this threshold are displayed in appropriate categories
  - Groupings should be consistent from year to year

# Uncertain Tax Positions

- Reference is made to your disclosure regarding certain transactions you refer to as Lease In/Lease Out (“LILO”) transactions. You disclose that in January 2013, the U.S. Court of Appeals for the Federal Circuit reversed an October 2009 trial court decision and disallowed tax deductions claimed by you relating to certain LILO transactions you entered into in 1997 and 1999, and that you expect to record an estimated charge of between \$150 million and \$170 million (after-tax) in the first quarter of 2013. Please provide all of the journal entries you anticipate recording in conjunction with this decision. **As this ruling appears to relate to events that occurred prior to the date of the financial statements and the information was available before the financial statements were issued, please explain to us in detail why you have not recorded this charge within the year ended December 31, 2012. Please also tell us what amounts, if any, you recorded as uncertain tax positions related to these transactions as of December 31, 2011 and 2012 and a detailed description of your assessment under ASC 740.**

# Indefinite Reinvestment

- Particular attention paid to the disclosure of the amount of tax that would be due upon repatriations
- Focus on the consistency between the permanent reinvestment disclosure and the liquidity discussion elsewhere in the financial statements
- Questions as a result of recent repatriations to ensure accounting impacts are recorded in the correct period
- Significant interest in partial permanent reinvestment assertions

# Section 162(f)

- Section 162(f) states “no deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law
- This is contrasted from payments for damages, restitution, etc. which are deductible as business expenses
- In the real world fines and penalties are often part of a broader settlement “package” between a taxpayer and the government.

# Fines/Penalties –recent examples

- In 2013 JPMC settled certain mortgage related matters with DOJ and state AGs for a total of \$13bn, which included a \$2bn penalty. The remaining \$11bn related to customer assistance, principal reductions, etc., and therefore deductible.
- Some member of Congress have criticized current law as “subsidizing wrong doing” and would support broader application against various payments.

# Fines/Penalties

- Responding to pressure some companies have agreed NOT to deduct payments that would otherwise be deductible
- Since more penalties can be expected for various matters-mortgage lending, money laundering, etc. the question of whether 162(f) should be amended will continue to be discussed.

# AD Investment v. IRS

- *AD Investment 2000 Fund LLC, et. al, v. Commissioner*, 142 T.C. No 13 (2014).
- Protection offered by attorney client privilege is eliminated by any disclosure of the information to a third party other than one with common legal interest
- Where an email is sent with privileged information the privilege is waived with respect to that email and all attachments
- The extrajudicial disclosure of a protected attorney-client communication waives the privilege with respect to any matters actually disclosed, but not with respect to other parts of the communication.

# AD Investment v. IRS

- An IRS motion to compel production of legal opinion letters was granted where attempts by a partnership to establish reasonable cause and good faith defenses to accuracy-related penalties put into dispute the state of mind of those who acted for P and P's good faith efforts to comply with the tax law. IRS had to be allowed to inquire into the content and formation of P's legal knowledge and beliefs. The court rejected the contention that P's agents relied on a generalized good faith defense unrelated to the advice of counsel and thus didn't waive privilege. Although P said it didn't rely on professional advice, P never claimed that those acting for it ignored the opinion letters. Thus, IRS was entitled to examine relevant communications forming the bases of P's legal knowledge including the opinion letters

# IRA Rollover Case

- A taxpayer's temporary withdrawal of funds from his IRA for his personal use could qualify for tax-free rollover treatment. The taxpayer is not taxed on the partial distribution where the funds are re-deposited into the same or another qualified IRA account within the 60-day rollover period
- This is described in Publication 590, Individual Retirement Arrangements (IRAs) and restricts this withdrawal to once a year per each IRA

# IRA Rollover Case

- Case involving taxpayer who staggered 3 IRA withdrawals with different IRA accounts owned by him and his wife to redeposit into the prior IRA account to meet the 60 day requirement
- The court ruled withdrawal from his second IRA could not qualify for rollover treatment because the “plain language” of the law makes it clear that the once a-year rollover restriction applies to all of a taxpayer’s IRAs combined
- It has been thought that this case undermines public confidence in the tax system as it is viewed that taxpayer who has followed the IRS guidance has made an error with potentially catastrophic financial consequences.

# Questions?