SPECIAL REPORT

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The Taxation of Dodd-Frank, Part 2

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One page of the behemoth Dodd-Frank Wall Street Reform and Consumer Protection Act is devoted to tax, but the legislation's tax implications extend far beyond that page. In this report, the authors discuss the tax aspects of seven parts of the new law: (1) bank capital and liquidity, (2) "living wills," (3) the Volcker rule, (4) banks as dealers in derivatives, (5) securitization, (6) derivatives, and (7) executive compensation.

This report is published in two parts. The first part, published in *Tax Notes* on July 11, 2011, provided an introduction and discussed bank capital and liquidity, living wills, the Volcker rule, and banks as dealers in derivatives. This second part will discuss securitization, derivatives, and executive compensation. It will also provide three appendices: (A) Living Wills — Tax Issues Checklist, (B) Index to Provisions of the Dodd-Frank Act Having Tax Significance, and (C) Glossary of Terms.

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The authors welcome any comments at vhammer@kpmg.com.

The information in this report is general in nature and based on authorities that are subject to change. Its applicability to specific situations is to be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG.

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V. Securitization

The Act imposes new risk retention requirements on "securitizers" in securitization transactions. On March 28, 2011, a joint notice of proposed rulemaking

on the risk retention rules was released.[100] The goal of the proposed regulations is to align the sponsor's and investors' incentives by ensuring that the sponsor retains meaningful exposure to the same credit risk that is borne by the investors in all classes of securities issued by a special purpose vehicle (SPV).

Final risk retention regulations applicable to residential mortgage-backed securities will take effect one year after their publication, and regulations applicable to other asset-backed securities (ABS) will take effect two years after publication of final regulations.

A. Background

Securitization facilitates the monetization of future cash flows from financial assets. In general, a securitization program intended to raise cash from unrelated investors involves successive transfers of financial assets among related entities, with the assets ultimately being placed in a bankruptcy-remote SPV that issues securities to investors.[101] The legal structure of a securitization is intended to isolate the securitized assets for two purposes. The first is to ensure that the SPV's assets will not be subject to the claims of any other entity's creditors. The second is to ensure that investors in the securities issued by the SPV will be unable to look to any assets other than the securitized ones as a source of payment on their securities.

Because holders of securities issued by an SPV can look only to the securitized assets as a source of payment, holders are exposed to the credit risk of the securitized assets. Generally, the capital structure of the SPV will contain several classes of securities, each of which exposes the holder to a different degree of credit risk on the underlying assets.[102] Under the SPV's hierarchy for distributing cash received on the securitized assets, senior classes of notes generally have first priority in receiving distributions of cash, followed by any junior (subordinated) classes of notes, followed by preferred or senior equity securities (if any), with the final claim to cash flow (the first loss position) belonging to the common or residual equity interest in the SPV. The junior note and equity classes act as a structural credit enhancement for the senior securities by absorbing losses before the senior.

The payment hierarchy described above would provide little protection from loss to the senior note classes if there is a high probability that losses on the securitized assets would exceed the principal entitlement of the subordinate classes. Consequently, securitizations are typically structured with other features intended to ensure that, except when losses on the securitized assets are much higher than expected, the senior note classes are paid out in full. These additional features may include overcollateralization (the excess of the initial face amount of the securitized assets over the initial face amount of the note classes issued by the SPV), excess spread (the excess of the interest received on the securitized assets over the rate of interest paid on the notes), and a cash collateral or reserve account.[103]

Many securitizations are static — that is, the pool of securitized assets generally is fixed at the time the SPV is formed. In static securitizations, principal receipts on the assets typically are not reinvested in similar assets but are paid shortly after receipt to investors as distributions on their securities, and new assets are not added to the pool. However, there are several common types of securitizations in which new assets are added to the collateral pool during the term of the transaction, either through reinvestment of principal receipts on existing assets or through the issuance of new interests in the SPV (or both). In a securitization done through a revolving asset master trust (RAMT), there typically is an initial period (the revolving period) during which principal receipts are reinvested in new assets rather than used to pay down the SPV's liabilities. For a securitization done through an asset-backed commercial paper (ABCP) conduit, the SPV is engaged in an ongoing program of purchasing receivables from one or more originators, which may be funded both by reinvesting principal receipts and by periodic issuances of commercial paper. The proposed regulations define special risk-retention methods adapted to both RAMTs and ABCP conduits.

In many securitizations, the senior note classes are publicly offered, while the subordinated notes and the formal equity classes are privately placed or

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[100]As required by section 941(b) of the Act, the joint notice containing the proposed risk retention rules (the proposed regulations) was released by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the FDIC, the SEC, the Federal Housing Finance Agency, and the Department of Housing and Urban Development.

[101]For general background on the legal, financial accounting, and tax issues raised by securitizations, see James Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitizations* (4th ed. 2011).

[102]The securities may take the form of ownership interests in the SPV (for example, trust certificates, membership interests, or stock) or creditor interests (notes). As discussed in more detail below, the legal form of the security does not necessarily determine its tax classification.

[103]In some securitizations, excess spread is monetized through the issuance and sale of interest-only securities or premium bonds. The proposed regulations contain a special rule under which amounts received from monetizing excess spread must be held as a reserve.

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retained by the sponsoring entity or an affiliate. Even before Dodd-Frank, it was typical for the sponsor to retain some kind of interest in the SPV or the securitized assets. However, the sponsor generally was not prevented from hedging any retained credit risk, and the degree of any retained credit risk may have been significantly lower than what the Act will require.

B. The Proposed Regulations

1. Scope of the proposed regulations. The proposed regulations would apply generally to transactions involving the issuance and sale of ABS by an issuing entity.[104] For a securitization transaction, an issuing entity is defined to mean the trust or other entity created at the direction of the sponsor that owns or holds the pool of assets to be securitized and in whose name the ABS are issued. An ABS is defined generally to mean a fixed-income or other security collateralized by any type of self-liquidating financial asset that allows the holder of the security to receive payments that depend primarily on cash flow from the financial assets.

The proposed regulations also separately define a broader category of financial interests called an ABS interest, which refers to all types of interests or obligations from an issuing entity, the payments on which primarily depend on the cash flows on the collateral held by the issuing entity. An ABS interest does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that is issued primarily to evidence ownership of the issuing entity, and any payments with respect to which are not primarily dependent on the cash flows of the collateral held by the issuing entity. The risk retention requirements will apply not only to ABS that are issued and sold to investors, but also to all ABS interests in the issuing entity.

Dodd-Frank provides that the risk retention rules apply to any securitizer. Under the proposed regulations, a securitizer to which the risk retention requirements apply is a person who organizes and initiates a securitization transaction by selling or transferring assets to the issuing entity.[105] When there are multiple sponsors, each sponsor is responsible for ensuring that at least one complies with the risk retention requirements.

The proposed regulations would allow a sponsor to shift some or all of the risk retention requirements to an originator of the securitized assets if conditions are met. An originator is defined as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an ABS and then sells the asset to a securitizer.

2. Permitted methods of risk retention. The proposed regulations define four general methods for satisfying the risk retention requirement (vertical, horizontal, L-shaped, and representative sample), as well as several special risk retention methods adapted to specific types of issuing entities (revolving asset master trusts, ABCP conduits, and issuers of commercial mortgage-backed securities (CMBS)). The sponsor can generally choose the method it intends to follow. In addition to the basic risk retention requirement, the proposed regulations would impose an independent requirement that the sponsor fund and maintain a premium capture cash reserve account for any securitization that is not exempt from the risk retention requirements and results in an issuance of ABS interests at a premium.[106]

a. Vertical risk retention. Under this method, the sponsor must retain at least 5 percent of each class of ABS interest issued in the securitization. The retention requirement applies regardless of the nature of the class of ABS interest (for example, senior or subordinated).

b. Horizontal risk retention. The proposed regulations describe two allowable methods of horizontal risk retention. Under the first method, the sponsor may retain an eligible horizontal residual interest in the issuing entity in an amount that is equal to at least 5 percent of the par value of all ABS interests issued in the securitization. An eligible horizontal residual interest is defined to be an ABS interest in the issuing entity that:

1. is allocated all losses on the securitized assets (other than losses that are first absorbed through the release of funds from a premium capture cash reserve account, if such an account is required to be established) until the par value is reduced to zero;

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[104]According to the preamble, the risk retention requirements of the proposed regulations would apply to securitizers of ABS offerings whether or not the offering is registered with the SEC under the Securities Act of 1933.

[105]The preamble to the proposed regulations notes that the definition of sponsor is substantially identical to the definition in the SEC's Regulation AB. It also notes that in the context of collateralized loan obligations (CLOs), the CLO manager generally acts as the sponsor by selecting the loans to be purchased for inclusion in the collateral pool and then managing the securitized assets once they have been deposited in the CLO structure. Presumably, then, a CLO manager could be subject to the risk retention requirements of the proposed regulations.

(Footnote continued in next column.)

[106]The following summaries of the risk retention methods have been adapted from the explanations in the preamble to the proposed regulations. The risk retention methods themselves are defined in subpart B of the proposed regulations.

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2. has the most subordinated claim to payments of both principal and interest by the issuing entity; and

3. until all other ABS interests in the issuing entity are paid in full, is not entitled to receive any payments of principal made on a securitized asset (except for the interest's current proportionate share of scheduled payments of principal received on the securitized assets in accordance with the transaction documents).

Alternatively, the sponsor can retain horizontal risk by establishing and funding in cash a reserve account at closing (a horizontal cash reserve account) in an amount equal to at least 5 percent of the par value of all the ABS interest issued in the securitization. The horizontal cash reserve account must be held by the trustee (or other person performing functions similar to a trustee) in the name, and for the benefit, of the issuing entity.

c. L-shaped risk retention. The proposed regulations allow the sponsor to use a combination of horizontal and vertical risk retention (hence, L-shaped risk retention) if the issuing entity retains (i) a vertical component containing at least 2.5 percent of each class of ABS interest issued in the securitization, and (ii) a horizontal component consisting of an eligible horizontal residual interest in the issuing entity in an amount equal to at least 2.564 percent of the par value of all ABS interest issued in the securitization, other than the interest required to be retained in the vertical component.[107] As under the horizontal risk retention method, the sponsor would have the option of replacing the eligible horizontal residual interest with a horizontal cash reserve account funded at closing.

3. Representative sample. Under this method, the sponsor must retain a random sample from a pool of assets identified for a securitization equal to 5 percent of the credit risk in the pool, according to a process described in the proposed regulations. The sampling method is intended to ensure that the sample retained by the sponsor is equivalent in all material respects to the assets in the pool that are transferred to the issuing entity and securitized. Under this method, the sponsor does not retain an interest in the issuing entity but separately holds the representative sample of assets.

4. Revolving asset master trust. Securitizations backed by revolving lines of credit, such as credit card accounts or dealer floor plan loans, often are structured using an RAMT. An RAMT allows the trust to issue more than one series of ABS backed by a single pool of revolving assets. In these transactions, the sponsor typically holds an interest known as the seller's interest. This interest is *pari passu* with the investors' interest in the receivables backing the ABS interest of the issuing entity until the occurrence of an early amortization event. Because the seller's interest is a direct, shared interest with all the investors in the performance of the underlying assets, the proposed regulations would allow the sponsor of an RAMT that is collateralized by loans or other extensions of credit under revolving accounts to meet the risk retention requirement by retaining a seller's interest in an amount not less than 5 percent of the unpaid principal balance of all the assets held by the trust (that is, the issuing entity).[108]

5. Asset-backed commercial paper conduit. The proposed regulations contain a special risk retention option designed for ABCP conduits used to securitize receivables or loans that are supported by a liquidity facility with a regulated institution. An ABCP program typically involves one or more originator-sellers, usually clients of the sponsoring financial institution, each of which sells eligible loans or receivables to an intermediate, bankruptcy-remote SPV established by the originator-seller. The ABCP conduit itself is a means for these originator-sellers to jointly monetize their financial assets. The ABCP conduit issues short-term ABCP to fund the purchase of the senior interests in the intermediate SPVs while the first-loss positions (represented by the residual interests in the SPVs) typically are retained by the originator-sellers. Under the proposed regulations, the sponsor of an eligible ABCP conduit[109] would be deemed to meet its risk retention requirement if each originator-seller who transfers assets to collateralize the ABCP issued by the conduit retains the same amount and type of credit risk in the assets transferred to its intermediate SPV as would be required under the horizontal risk retention option if the originator-seller were treated as the only sponsor of its intermediate SPV. In effect, if each intermediate SPV is treated as an issuing entity and each originator-seller (treated as the sole sponsor) meets the horizontal risk retention requirement for its intermediate SPV, the sponsor of the ABCP conduit is deemed to meet its risk retention requirement for the ABCP conduit.

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[107]According to the preamble, the size of the horizontal component is calculated to avoid double counting the portion of an eligible horizontal residual interest that the sponsor is required to hold as part of the vertical component.

[108]As noted in the preamble, the size of the seller's interest typically adjusts to account for fluctuations in the outstanding principal balances of the securitized assets.

[109]According to the preamble, the definition is intended to ensure that this risk retention method is not available to entities or ABCP programs that operate as securities or arbitrage programs (*e.g.*, a structured investment vehicle).

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6. CMBS. According to the preamble to the proposed regulations, the allocation of a first-loss position to a third-party purchaser (the so-called B-piece buyer) has been common practice in CMBS transactions for several years. To manage its risk, the B-piece buyer often is involved in the selection of pool assets, is designated as the controlling class under the pooling and servicing agreement or other operative document governing the transaction, and typically names itself or an affiliate as the special servicer in the transaction. Dodd-Frank itself acknowledges this market practice by providing that the agencies may allow sponsors of CMBS transactions to satisfy the risk retention requirement if third-party purchasers meeting specified requirements hold the first-loss position. One of the conditions required by the proposed regulations is that the B-piece buyer retain an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option. In addition, the B-piece buyer must comply with the same hedging, transfer, and other restrictions that would apply to a sponsor that had acquired an eligible horizontal residual interest.

7. Premium capture cash reserve account. As noted earlier, some securitizations are designed to allow the sponsor to monetize the excess spread that is expected to be generated by the securitized assets over the term of the transaction. The monetization is typically accomplished by the issuance of interest-only (IO) securities or premium bonds. The preamble expresses the agencies' belief that monetization of excess spread before the performance of the securitized assets can be observed allows sponsors to reduce the impact of any economic interest they may have retained in the securitized assets and thus frustrates the intent of Dodd-Frank's risk retention requirements. Consequently, the proposed regulations require that the sponsor of a securitization in which excess spread has been monetized fund a premium capture cash reserve account with an amount of cash determined by the amount of premium or purchase price, as applicable, received on the sale of the ABS interests that monetize the excess spread.

The amount of cash the sponsor is required to put into this reserve account is calculated under a formula that depends on the risk retention option chosen by the sponsor. Like a horizontal cash reserve account, a premium capture cash reserve account must be held by the trustee in the name, and for the benefit, of the issuing entity. The funds in a premium capture reserve account are to be used to cover losses before any other interest in or account of the issuing entity, including an eligible horizontal residual interest or a horizontal cash reserve account.

8. Hedging, transfer, and financing restrictions.[110] Dodd-Frank states that the risk retention regulations shall ''prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset.'' Consistent with that intent, the proposed regulations would prohibit a sponsor from transferring any interest or assets that it must retain to any person other than an affiliate whose financial statements are consolidated with those of the sponsor (a consolidated affiliate).

However, the proposed regulations would allow a sponsor that chooses the vertical risk retention option or the eligible horizontal residual interest version of the horizontal risk retention option to allocate a portion of its risk retention obligation under that option to any originator of the securitized assets that contributed at least 20 percent of the assets in the pool. The amount of the retention interest held by each originator must be at least 20 percent but cannot exceed the percentage of the securitized assets it originated. The originator would have to hold its allocated share of the risk retention obligation in the same manner, and under the same restrictions, as would have been required of the sponsor.

The proposed regulations would prohibit the sponsor or any consolidated affiliate (whether or not an ABS interest or asset has been transferred to any affiliate) from hedging in any fashion the credit risk of one or more ABS that the sponsor is required to retain. However, hedging transactions that are not materially related to the credit risk of the ABS that must be retained would not be prohibited. For example, the sponsor or its affiliates would be permitted to enter into positions related to overall market movements, such as movements of market interest rates, currency exchange rates, home prices, or the overall value of a broad category of ABS.

9. Exemptions from the risk retention requirements. Dodd-Frank requires that the regulations prescribed by the agencies provide for ''a total or partial exemption [from the risk retention requirements] of any securitization, as may be appropriate in the public interest and for the protection of investors.'' The Act exempts securitizations of qualified residential mortgages (QRMs) from the risk retention requirements and also specifies that the regulations must provide for a total or partial exemption for securitizations of assets issued or

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[110]The rules defining the restrictions on hedging, transfer, and financing are in subpart C of the proposed regulations.

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guaranteed by the United States, any state or political subdivision, or an agency of the United States (the Federal National Mortgage Association and Federal Home Loan Mortgage Corp. are not to be treated as agencies of the United States), as well as for securitizations of qualified scholarship funding bonds. Also, the Act specifies that the agencies must prescribe regulations defining underwriting standards, and allowing reduced risk retention requirements, for securitizers of asset classes such as residential mortgages, commercial mortgages, commercial loans, auto loans, and ''any other class of assets that the Federal banking agencies and the [SEC] deem appropriate.'' Accordingly, the proposed regulations provide a definition of QRM for purposes of the statutory exemption and also provide exemptions for securitizations of commercial mortgages, commercial loans, and auto loans that meet specified underwriting standards.

If the sponsor of a securitization transaction is exempt from the basic 5 percent risk retention requirement, it also is exempt from the requirement to establish a premium capture cash reserve account for that transaction.[111]

10. When are equity interests ABS interests? The definition of ABS interest in the proposed regulations makes it clear that there may be equity or residual interest in the issuing entity that isn't treated as an ABS interest. The distinction is important under the proposed regulations because non-ABS interest does not count toward meeting the 5 percent risk retention requirement and correspondingly need not be retained by the sponsor.

Although an equity interest such as a trust certificate, limited liability company interest, or share of stock demonstrates ownership of the issuing entity and thus will satisfy the first prong of the definition of an ABS interest, any payments regarding the interest may not be ''primarily dependent on the cash flows of the collateral held by the issuing entity.''[112] If they aren't dependent, the second prong of the test would not be satisfied, and the equity interest may not be an ABS interest. The agencies may need to clarify when an equity interest constitutes an ABS interest. As a practical matter, however, sponsors may be able to avoid the issue by defining a capital structure with a clear division between ABS interests and non-ABS interests.

11. Cash reserve accounts. The proposed regulations would require that horizontal and premium capture cash reserve accounts be held in the name, and for the benefit, of the issuing entity. That language raises the question as to whether the issuing entity must have both legal and beneficial ownership of the assets in the reserve account or only a security interest in the assets.[113] While not certain, it seems that the assets in the reserve accounts are intended to serve as collateral and that legal title to the assets need not be transferred to the issuing entity. If the sponsor conveys only a security interest to the issuing entity, the sponsor likely will be treated as the tax owner of the assets, and the sponsor may be treated as if it entered into a guarantee or indemnity arrangement with the issuing entity. If the arrangement is treated as a guarantee, the sponsor's tax treatment of any payments made under the guarantee may be governed by reg. section 1.166-9. However, at least one commentator has noted that there is some uncertainty regarding the timing and character of deductions or losses from payments made by a guarantor.[114]

C. Tax Effects of the Proposed Regulations[115]

In any securitization, two basic tax questions concern the tax characterization of the issuing entity and the tax characterization of the securities issued by the issuing entity. For tax purposes, the issuing entity generally will be a disregarded entity

[111]The requirement to establish a premium capture cash reserve account is in subpart B of the proposed regulations, along with the general 5 percent risk retention requirement. Subpart D, which defines the categories of exempt securitization transactions, states that for each type of exempt securitization, the ''sponsor shall be exempt from the risk retention requirements in subpart B of this part.''

[112]One type of interest that almost certainly should not be treated as an ABS interest is that of a so-called special member in a single-member Delaware LLC. A special membership interest is a springing membership interest that arises automatically on the termination of membership, or dissociation, of the sole member, in order to prevent the LLC from dissolving because it has no members. Although the special member is treated as a member of the LLC under Delaware law, the special member has no economic rights to distributions from the LLC and generally no control rights either.

(Footnote continued in next column.)

[113]*See, e.g., Wells Fargo & Co. v. United States*, No. 2010-5108 (Fed. Cir. Apr. 15, 2011), *Doc 2011-8274, 2011 TNT 74-13* (regarding what constitutes tax ownership, ''Ownership for tax purposes is not determined by legal title. Instead, in order to qualify as an 'owner' for tax purposes, the taxpayer must bear the benefits and burdens of property ownership,'' citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-573 (1978); and *Corliss v. Bowers*, 281 U.S. 376, 378 (1930)).

[114]*See, e.g.*, David Miller, ''Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis,'' 48 *Tax Law*. 103 (1994).

[115]In the discussion that follows, we will continue to use the terminology of the proposed regulations and refer to the SPV that issues securities to investors as the ''issuing entity.'' This discussion does not purport to be a complete discussion of all federal income tax issues that might arise from the application of the proposed regulations to securitizations.

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(DRE),[116] a grantor trust,[117] a corporation, a partnership, or a real estate mortgage investment conduit.[118] The securities issued by the issuing entity generally will be characterized as debt secured by the assets, a direct ownership interest in the assets (perhaps as a senior or subordinate ownership interest in the assets), or equity in a non-DRE (a corporation or partnership) that owns the assets.[119]

The two basic tax questions for a securitization are not independent; often, the tax characterization of the issuing entity will depend on the tax characterization of the securities issued by the issuing entity and the identity of the owners of those securities. Because the proposed regulations would not mandate any particular legal form or tax characterization for the issuing entity, the sponsor will be free to choose the tax characterization of the issuing entity. However, by requiring that a specified interest in the issuing entity be retained and by placing restrictions on which entities may hold the retained interest, the proposed regulations might affect both the tax characterization of the securities issued by the issuing entity and the tax characterization of the issuing entity itself.

1. Issuing entity treated as a grantor trust. If an investment trust is treated as a grantor trust for tax purposes, ownership of a trust certificate represents beneficial ownership of an interest in the trust assets. The beneficial interest owned by a certificate holder generally will represent a pro rata interest in the securitized assets. For a grantor trust with a single class of certificates, each certificate holder owns the same type of pro rata interest in all the trust assets. However, a grantor trust can have multiple classes of certificates. In some cases the certificate classes represent substantially similar economic interests in the trust assets, although there will be one or more junior classes of subordinated certificates whose holders are deemed for tax purposes to have granted an implicit guarantee in favor of the holders of the senior certificate class or classes.[120] The regulations would also allow an investment trust with certificate classes representing different economic interests in the trust assets to be treated as a grantor trust if the multiple classes of trust interests ''merely facilitate direct investment in the assets held by the trust.''[121] From the perspective of the taxpayer who originally places the assets in the grantor trust, the sale of trust certificates is treated for tax purposes as the sale of a portion of the assets in the trust.

Assuming that the issuing entity otherwise satisfies the necessary conditions, the risk retention requirements in the proposed regulations should not prevent a sponsor from treating an issuing entity as a grantor trust. Regardless of how many certificate classes were issued, the sponsor could follow the vertical risk retention method and retain 5 percent of each class. If there is a subordinate certificate class that satisfies the requirements for being treated as an eligible horizontal residual interest, the sponsor could retain that class under the horizontal risk retention method. Similarly, if there is a subordinate certificate class that satisfies the requirements for an eligible horizontal residual interest, the sponsor could follow the L-shaped risk retention method. Assets retained by the sponsor under the representative sample method need not have any legal or economic relation to the issuing entity at all and thus should not affect the tax treatment of the issuing entity as a grantor trust.

If the sponsor of a securitization effected as a grantor trust chooses to establish a horizontal reserve account or is required to establish a premium capture cash reserve account,[122] it seems likely that the sponsor would be able to establish the account apart from the issuing entity and contribute a security interest and guarantee to the issuing entity.

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[116]The legal entity that issues securities to investors may be (and typically is) a single-member or single-owner entity treated as a DRE for tax purposes under the entity classification rules of reg. section 301.7701-3. In that case, the issuer of the securities for tax purposes generally will be the first non-disregarded entity in the chain of ownership beginning with the entity that formally issues the securities.

[117]In the context of a securitization, a grantor trust usually refers to an investment trust as defined in reg. section 301.7701-4(c). Investment trusts are treated as grantor trusts subject to the rules of subpart E of the code even though holders of beneficial interests in the trust might not be the original grantors that created the trust. The IRS has issued regulations and numerous rulings stating or agreeing that ownership of grantor trust certificates, whether in the hands of the original grantor or a subsequent purchaser, represents beneficial ownership of the trust assets. *See, e.g.*, reg. sections 1.671-2(e) and 1.671-5(b)(22); prop. reg. section 1.671-2(f); Rev. Rul. 70-544, 1970-2 C.B. 6, and Rev. Rul. 70-545, 1970-2 C.B. 7, *both modified by* Rev. Rul. 74-169, 1974-1 C.B. 147, *and clarified by* Rev. Rul. 84-10, 1984-1 C.B. 155.

[118]A REMIC is purely a creature of statute that ''shall not be treated as a corporation, partnership, or trust for purposes of'' subtitle A of the Internal Revenue Code. Section 860A.

[119]Occasionally, an investor will hold an investment unit consisting of one of the three types of securities just described plus a derivative (*e.g.*, an NPC; *see* the example in reg. section 1.860G-2(i) of a REMIC regular interest that is bundled with an interest rate cap in a grantor trust), but we ignore this complication.

[120]*See* reg. section 301.7701-4(c)(2), Example 2.

[121]*See, e.g.*, reg. section 301.7701-4(c)(2), Example 4 (investment trust formed to facilitate a coupon strip of bonds under section 1286 is treated as a grantor trust); *cf.* Example 3 (investment trust formed to strip dividends from publicly traded stock is not treated as a grantor trust).

[122]Premium could be created if, for example, the sponsor sells a certificate class that is an IO strip (see reg. section 301.7701-4(c)(2), Example 4).

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A guarantee should not endanger the issuer's status as a grantor trust.[123] Some authorities support the position that the reserve assets could be contributed to the issuing entity.[124] However, any power to reinvest reserve assets held by an issuing entity would need to be analyzed to determine whether such power constitutes a prohibited power to vary the assets of the trust.

2. Issuing entity treated as a disregarded entity. Many securitizations are executed through an issuing entity that is intended to be a DRE for federal income tax purposes. To achieve that tax treatment, the equity of the issuing entity must be held by a single taxable owner, and the issuing entity must be an eligible entity that does not elect to be treated as a corporation.[125] Because a DRE must have only one owner, securities issued to a person other than the tax owner of the issuing entity cannot represent ownership interests and must be respected as debt for tax purposes. For tax purposes, then, the securitization is intended to be treated as a secured borrowing, with the equity of the issuing entity representing the borrower's residual economic interest in the securitized assets.

For the ABS interests (generally in the form of notes) issued to investors by a DRE to be treated as debt for tax purposes, the owner of the DRE must retain most of the benefits and burdens of ownership of the assets (or at least not transfer them to the note holders).[126] Exposure to the credit risk of the obligors on the securitized assets is a key burden of ownership that generally cannot be passed to an investor intended to be treated as a lender. If too much credit risk is transferred to a class of note holders, those holders might be treated as owning an equity interest in the issuing entity for tax purposes, and the issuing entity would no longer be treated as a DRE for tax purposes.[127]

The level of retained equity in an issuing entity treated as a DRE will depend on the risk retention method chosen by the sponsor. The sponsor should be able to choose any of the horizontal, L-shaped, or vertical risk retention methods and have the issuing entity treated as a DRE. If the sponsor chooses to retain an eligible horizontal residual interest under the horizontal method, the 5 percent retained exposure required by the proposed regulations might be higher than the level of equity otherwise required for the sponsor to be confident that the notes issued to investors are properly treated as debt for tax purposes. However, if the sponsor chooses the L-shaped risk retention method, the required 2.564 percent horizontal credit risk exposure arguably is in line with current market standards, and if the sponsor chooses to use the vertical risk retention method, the proposed regulations would not impose any lower boundary on how thin the sponsor's residual economic interest in the securitized assets may be. Consequently, it seems likely that the 5 percent risk retention standard imposed by the proposed regulations would not cause a general increase in the market standard for retained equity in a securitization done through a DRE.

Any ABS interests treated as debt in the hands of unrelated third parties but initially retained by the sponsor under the L-shaped or vertical risk retention methods would be disregarded for tax purposes so long as they are held by the sponsor,[128] and they would be treated as intercompany debt if later transferred to a tax-consolidated affiliate or originator.[129] If notes initially retained by the sponsor are later transferred to an affiliate (whether or not tax consolidated) or are transferred from a tax-consolidated affiliate to a non-consolidated affiliate, the notes would be treated as newly issued (in the first case) or as retired and reissued (in the second case).[130] Because of changes in market conditions between the date the original notes were issued and

[123]There are several rulings in which the IRS has taken the position that mortgage passthrough certificates guaranteed by federal housing agencies are grantor trust certificates. *See, e.g.*, Rev. Rul. 84-10, 1984-1 C.B. 155 (Fannie Mae guarantee); Rev. Rul. 71-399, 1971-2 C.B. 433, *amplified by* Rev. Rul. 81-203, 1981-2 C.B. 137 (Freddie Mac guarantee); Rev. Rul. 70-544, 1970-2 C.B. 6, *modified by* Rev. Rul. 74-169, 1974-1 C.B. 147 (Ginnie Mae guarantee).

[124]*See*, *e.g.*, Rev. Rul. 90-7, 1990-1 C.B. 153 (investment trust holding a reserve for administrative expenses); Rev. Rul. 73-460, 1973-2 C.B. 424 (reserve to cover taxes or other governmental charges).

[125]*See* reg. section 301.7701-3(a) and (b) for definitions of domestic and foreign eligible entity, and reg. section 301.7701-3(c) for election to be treated as a corporation.

[126]Securitizers could transfer some or all of the retained credit risk to a party other than the note holders by means of a credit derivative. The rules to be promulgated under the Act are supposed to impose restrictions on a securitizer's ability to hedge retained credit risk that way.

[127]For a general discussion of the tax authorities on whether a monetization transaction should be treated for tax purposes as a secured loan or a sale of assets, see Peaslee and Nirenberg, *supra* note 101, ch. 3.

[128]Notes issued by a DRE and held by the owner of the DRE would not be treated as debt, because the owner is the obligor on the notes for tax purposes, and a taxpayer cannot issue debt to itself (*see*, *e.g.*, LTR 200046015, *Doc 2000-29555*, *2000 TNT 224-24*).

[129]*See* reg. section 1.1502-13(b)(1)(i)(C) (''intercompany transaction'' includes the loan of money by one member of a consolidated group to another member).

[130]*See* reg. section 1.502-13(g)(7), Example 2 (deemed reissuance when intercompany obligation becomes a non-intercompany obligation by sale to a nonmember).

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the date the deemed newly issued notes are issued, the new notes conceivably could be treated as having a different amount of original issue discount than the originally issued notes.[131] In an extreme case, if the issuer's credit was significantly downgraded during the interim period, the new notes might even be viewed as equity.[132]

A sponsor also should be able to choose the representative sample risk retention method without endangering the status of the issuing entity as a DRE. Instead of requiring the sponsor to follow the statistical procedure described in the proposed regulations to pick a ''representative'' sample of assets, it seems much simpler to permit the sponsor to contribute the entire pool of assets to a single-class grantor trust, contribute 95 percent of the trust certificates to the issuing entity, and retain 5 percent of the certificates. Under that method, the sponsor would retain the requisite amount of credit risk for all the securitized assets, and there would be no uncertainty about whether the sample retained by the sponsor was truly representative of the pool. Given that the definition of collateral in the proposed regulations includes ''fractional undivided property interests in the assets or other property of the issuing entity,'' this suggested method seems to be in the spirit of the proposed regulations. However, neither the proposed regulations nor the preamble appear to contemplate such a method of retaining an ownership interest in the securitized assets.

An RAMT could be treated as a DRE if the sponsor holds all of the interests treated as equity for tax purposes. Even though a seller's interest is initially *pari passu* with the investor interests in its entitlement to principal receipts, tax practitioners have become confident that other features of the seller's interest (for example, subordination to the investor interests after an early amortization event, and fluctuation of the size of the seller's interest along with fluctuation in the size of the asset pool) support the position that it is properly treated as equity in the trust and that the investor interests are properly treated as debt.[133] Assuming that the seller's interests are the only interests in the RAMT that are properly treated as equity for tax purposes, a sponsor that chooses the special risk retention option for RAMTs should be able to treat the issuing entity as a DRE.[134]

The special risk retention option for ABCP conduits could also apply to issuing entities treated as DREs. Although ABCP conduits traditionally were organized as corporations, more recently the issuers are often organized as LLCs. Consequently, if an ABCP conduit organized as an LLC has a single member, it can be a DRE. However, for the ABCP conduit to be treated as a DRE, the commercial paper issued by the conduit would need to be respected as debt for tax purposes. ABCP conduits typically are thinly capitalized, and this feature emphasizes the question of whether the paper issued by the conduit is debt, an equity interest in the conduit, or perhaps an ownership interest in the intermediate SPVs formed by the originator-sellers. Assuming that the commercial paper issued by the ABCP conduit is respected as debt, the sponsor's use of the special ABCP conduit risk retention method should not endanger the conduit's status as a DRE.

Although all the foregoing risk retention methods appear to be compatible with the treatment of the issuing entity as a DRE, there are many thorny problems in attempting to treat the issuing entity in a CMBS securitization as a DRE, including, most notably, trying to fit the B piece into the risk retention rules while treating a CMBS as a DRE. Accordingly, it seems unlikely that a sponsor would pursue this course for a CMBS.

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[131]Even if the two sets of notes have different amounts of OID, they could still be treated as part of the same issue of debt for tax purposes if the requirements of reg. section 1.1275-1(f) are met or if the requirements for a reopening in reg. section 1.1275-2(k) are met. However, it seems unlikely that the conditions of reg. section 1.1275-1(f) could be met under the assumed facts, since one of the requirements is that all the notes be issued within a period of 13 days beginning with the date on which the first note that would be part of the issue is sold to a person other than a broker, underwriter, placement agent, or wholesaler.

[132]*Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), is a well-known case in which it was determined that the portion of a non-recourse note in excess of the value of the property securing the note did not represent valid indebtedness for tax purposes. Cases like this raise the question whether notes issued by SPVs in securitizations are recourse or non-recourse for purposes of these authorities. The Tax Court addressed a similar question in *Great Plains Gasification Assoc. v. Commissioner*, T.C. Memo. 2006-276, *Doc 2006-25732*, *2006 TNT 249-4*, concluding that a loan from the Department of Energy (DOE) to a special purpose partnership formed for the sole purpose of developing, constructing, owning, and operating a project to produce natural gas from coal, and which was secured by all the assets of the partnership, was nonrecourse debt when determining the tax consequences to the partnership of the DOE's foreclosure on the loan and subsequent conveyance of the assets.

[133]For a discussion of the features of a master trust that support the treatment of the investor interests as debt, see Peaslee and Nirenberg, *supra* note 101, ch. 3, sections D and E.

[134]That multiple securitizations are done using a single master trust suggests that the trust might consist of multiple partnerships for tax purposes if the seller's interests are held by different taxpayers. However, this question is moot if the seller's interests are the only equity interests in the trust and all of those interests are held by the sponsor.

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3. Issuing entity treated as a partnership. The use of an issuing entity intended to be a partnership for tax purposes is unusual. Nevertheless, a sponsor that intends to treat the issuing entity as a partnership generally should be able to comply with the risk retention requirements by using any of the horizontal, vertical, L-shaped, or representative sample methods.

4. Issuing entity treated as a corporation. As for an issuing entity treated as a partnership, an issuing entity treated as a corporation will be a taxable entity separate from the sponsor. Consequently, any ABS interests retained by the sponsor are not ignored for tax purposes.

Once the sponsor has determined whether any of the equity interests in the issuing entity are non-ABS interests, the sponsor generally should be able to use any of the horizontal, vertical, or L-shaped risk retention methods, as desired. Because many ABCP conduits have been formed as corporations, the special ABCP conduit risk retention method might be available to the sponsor. An RAMT could also be a corporation (for example, if the sponsor elected to have the trust treated as a corporation for tax purposes), and the special RAMT risk retention method likewise could be available to the sponsor.

Because the proposed regulations generally contemplate that an issuance of ABS will be supported by collateral consisting of self-liquidating financial assets, most issuances of securities by regulated investment companies or real estate investment trusts probably will not be subject to the proposed regulations. However, sponsors of so-called mortgage REITs may need to take a careful look at whether securities issued by their REITs are subject to the risk retention requirements of the proposed regulations. A mortgage REIT or a portion of a mortgage REIT might be treated as a REIT/taxable mortgage pool under the rules of section 7701(i)(3). The securities issued by the REIT that are subject to those rules could fit the definition of ABS interests and thus be subject to the risk retention requirements of the proposed regulations.

5. Issuing entity treated as a REMIC. A REMIC is a creature of statute and regulation that is not (unless explicitly stated otherwise in the code) treated as a corporation, partnership, or trust under subtitle A of the code. Congress intended REMICs to be the exclusive (or at least preferred) SPV for financing pools of real estate mortgage loans through securitizations issuing multiple maturities of debt (the REMIC regular interests).

A sponsor[135] forms a REMIC by contributing allowable assets to a qualified entity[136] and taking back securities issued by the REMIC (the residual interest and one or more classes of regular interests). As of the close of the third month beginning after the REMIC's startup day and at all times thereafter, substantially all of the REMIC's assets must consist of qualified mortgages and specified other permitted investments (the REMIC asset test).[137] A REMIC may treat a regular interest issued by another REMIC as a qualified mortgage.[138]

As noted earlier, Dodd-Frank requires that regulations be issued to exempt sponsors of QRM securitizations from the risk retention requirements. Under the proposed regulations, the sponsor of a securitization would be exempt from the risk retention requirements if (i) all the securitized assets that collateralize the ABS are QRMs, (ii) none of the securitized assets that collateralize the ABS are other ABS, (iii) each QRM is currently performing as of the closing of the securitization, and (iv) specified other conditions are met. The regulations similarly provide an exemption for some securitizations of commercial mortgages. However, it seems likely that many REMICs will not qualify for either exemption.

First, it is common for REMICs to hold regular interests issued by other REMICs. Because a regular interest is an ABS, not a mortgage loan, a REMIC that holds a REMIC regular interest will not qualify for the QRM exemption and likely not for the qualifying commercial mortgage loan exemption, either.[139] Second, even if the only assets held by a REMIC (apart from cash or cash equivalents) are qualifying mortgages under the REMIC rules, those

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[135]According to reg. section 1.860F-2(b)(1), a sponsor is a person who directly or indirectly exchanges qualified mortgages and related assets for regular and residual interest in a REMIC. This REMIC-specific definition is sufficiently close to the definition of sponsor in the proposed regulations that we will assume a sponsor under the REMIC regulations is a sponsor under the proposed regulations.

[136]A qualified entity includes an entity or a segregated pool of assets within an entity. Reg. section 1.860D-1(c)(3). A qualified entity elects to be treated as a REMIC by timely filing an initial Form 1066 for its first tax year of existence. Reg. section 1.860D-1(d).

[137]Section 860D(a)(4); reg. section 1.860D-1(b)(3).

[138]Section 860G(3)(C).

[139]The proposed regulations state that the securitization transaction must be collateralized "solely (excluding cash and cash equivalents)" by one or more commercial real estate loans, each of which meets the specified underwriting standards. Consequently, a REMIC holding a regular interest issued by another REMIC apparently would not satisfy the conditions for the exemption.

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mortgages might not be treated as QRMs or qualifying commercial mortgage loans under the proposed regulations. In fact, the preamble to the proposed regulations notes that ''many prudently underwritten'' mortgage loans will not be treated as QRMs or qualifying commercial mortgage loans and that sponsors of ABS backed by those mortgages will be subject to the risk retention requirements (unless another exemption is available). Consequently, the risk retention rules likely will have broad application to both residential and commercial REMICs.

The special tax rules for REMICs will cause any REMIC residual or regular interests that are retained by the sponsor in compliance with the proposed regulations' risk retention requirements to be treated differently for tax purposes than ABS interests issued by DREs, partnerships, or corporations that are retained by the sponsor. The retained regular or residual interests are not ignored; instead, the sponsor takes non-recognized gain or loss on the retained interests into account during the period the sponsor holds those interests.[140] The non-recognized gain or loss taken into income by the sponsor also should not be treated as an intercompany item, because the REMIC is not a corporation and thus cannot be a member of a consolidated group.

Whether the security evidencing tax ownership of the issuing entity is an ABS interest under the proposed regulations may have particular importance for sponsors of REMICs. Unlike sponsors of other types of securitizations, who generally retain tax ownership of the issuing entity (this is required if the issuing entity is to be treated as a DRE), sponsors of REMICs commonly dispose of the residual interest. The market that developed for trading in noneconomic residual interests (NERDs) apparently was sizable enough that the IRS issued regulations prescribing the tax accounting for so-called inducement fees received by transferees of NERDs.[141]

A NERD that does not entitle the holder to any distributions probably should not be treated as an ABS interest and consequently can be freely disposed of by the sponsor. For a residual interest that is not a NERD, the holder anticipates receiving sufficient distributions that the residual interest will be a net tax asset. That is why any residual interest that is not a NERD probably should be treated as an ABS interest and, as a result, will be subject to the risk retention requirements. Nevertheless, there is some uncertainty as to whether a NERD entitling the holder to some cash flow from the REMIC should be treated as an ABS interest. This uncertainty could complicate the sponsor's choice of which risk retention method to use.

For example, if the residual interest is an ABS interest but does not satisfy the requirements for being treated as an eligible horizontal residual interest, none of the regular interests may qualify as eligible horizontal residual interests, either, and the sponsor would likely be unable to use the horizontal or special CMBS risk retention methods. However, the REMIC regulations contemplate that a REMIC residual interest might be senior to a class of regular interests regarding allocation of cash flow shortfalls resulting from defaults or delinquencies on the REMIC assets. A sponsor of a CMBS transaction having a residual interest that is an ABS interest might be able to use this rule to create a B piece that is subordinate to the residual interest and satisfies the requirements for an eligible horizontal residual interest. Consequently, the sponsor might be able to dispose of the residual interest and comply with the special CMBS risk retention rule by having an appropriate third party own the B piece.

Finally, if the sponsor intends to maintain a horizontal cash reserve account or is required to establish a premium capture cash reserve account, the sponsor may have the choice of treating the account as an asset of the REMIC (a reasonably required reserve[142]) or as an asset kept outside the REMIC (an outside reserve fund[143]).

6. Effect of proposed regulations regarding hedging. The proposed regulations would allow the sponsor to hedge the interest rate or currency risk but not the credit risk of the retained ABS interests or representative sample of assets.

For tax purposes, a hedging transaction is any transaction that a taxpayer enters into in the normal course of its trade or business primarily (1) to manage the risk of price changes or currency fluctuations for ordinary property that is held or to be held by the taxpayer; or (2) to manage interest rate, price change, or currency risk for borrowings made

[140]The non-recognized gain or loss arises when the sponsor transfers mortgages to the REMIC in exchange for the REMIC's regular and residual interests. That transfer is a nonrecognition transfer, and the sponsor allocates its basis in the mortgages among the regular and residual interests. Some of the gain or loss thus transferred to REMIC regular interests will be recognized on a sale of those interests to investors. The balance is taken into account as described in section 860F(b)(1)(C) and (D).

[141]Reg. section 1.446-6. Because a NERD is a tax liability (on a net present value basis) to the holder, a transferor typically must make a payment to the transferee to cause the transferee to become or make the transferee become the tax owner of the NERD.

[142]Section 860G(a)(1)(B)(7)(B); reg. section 1.860G-2(g)(2) and (3).

[143]Reg. section 1.860G-2(h).

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or ordinary obligations incurred by the taxpayer.[144] Under that definition, only three types of risk may be hedged for tax purposes: interest rate, price change, and currency risk. The proposed regulations would allow the sponsor to hedge the interest rate or currency risk of retained ABS interests or the representative sample of assets. Consequently, the proposed regulations do not restrict the sponsor's ability to hedge those risks for tax purposes.

However, the proposed regulations might restrict a sponsor's ability to hedge the risk of price changes. In many cases, hedging the price risk of ABS will entail hedging both market risk (interest rate risk) and credit risk. For example, a dealer in securities subject to section 475 or a bank holding debt instruments subject to section 582 might hedge those positions against adverse movements in their price. Since the price of those positions could be influenced both by the issuer's creditworthiness and the movement of interest rates, a hedge that reduces both interest rate risk and issuer-specific credit risk likely will be viewed as violating the rule against hedging the credit risk of retained interests in ABS. However, the proposed regulations would allow hedges against the overall value of a particular broad category of ABS. For example, a sponsor might be able to take a position in a derivative based on a broad index of ABS that offers some protection against the risk of price decline in retained ABS positions without violating the risk retention requirement. Accordingly, while the proposed regulations would allow securitizers to enter into specific hedging transactions involving price risk, care will need to be exercised in choosing the hedges.

Dodd-Frank's effects on securitization cannot be known with certainty until final regulations in this area are published. However, based on the proposed regulations, it seems likely that:

- sponsors will not be constrained in their choice of legal form for a securitization;
- whatever legal form is chosen by the sponsor, the sponsor generally will be required to retain a minimum 5 percent interest in the securitized assets or 5 percent of each class of ABS interests issued by the SPV;
- sponsors generally will not be permitted to transfer or hedge the credit risk of the retained interests;
- sponsors will need to consider how the retention of ABS interests issued by the SPV will affect the tax characterization of the SPV and the retained ABS interests; and
- sponsors will need to consider whether the prohibition against hedging credit risk will affect the sponsor's ability to hedge price risk for tax purposes.

VI. Derivatives

A single page of Dodd-Frank is devoted to U.S. tax issues — the final one. That page purports to address one aspect of the tax consequences of comprehensive derivatives regulation introduced by the Act. It is curious that of all the potential tax issues raised by Dodd-Frank, of which this report describes only some, Congress chose to address only the derivatives issues. In this section we offer some explanation for the special treatment of the taxation of derivatives in the development of financial reform.

A. Early Warnings of Derivative Regulation

Financial reform arose out of a widespread need to affix blame for the global financial crisis, to punish the wrongdoing, and to ensure the culprits were prevented from doing the offending deeds again. Over-the-counter (OTC) derivatives were considered to be among the central precipitants of the crisis. So as Congress was first considering a legislative response to the financial crisis, it turned its attention to increasing control over the OTC derivatives markets, by using familiar mechanisms: clearing, execution, and reporting of derivative trades.

Reports of Congress's intentions for OTC derivatives were widely disseminated, and tax practitioners began discussing the tax implications of extending clearing and execution of OTC derivatives, focusing on section 1256 and its definition of regulated futures contracts (RFCs).

B. Derivatives Before Dodd-Frank

Immediately before the enactment of Dodd-Frank, most derivative contracts were negotiated privately between parties in what became known as the OTC derivative market. Pre-Act OTC derivative contracts were negotiated and concluded at market, so there was generally no cash payment at their inception, and no exchange, clearinghouse, or government agency came between the parties to the contracts or regulated them after the contracts were executed.

The tax rules governing the treatment of OTC derivatives are as diverse as life forms along the Amazon. Evolving ad hoc to address new financial transactions or to combat abuses, they combine an

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[144] Section 1221(a) (defining capital asset to generally mean "property held by the taxpayer (whether or not connected with his trade or business)," but providing exceptions for specific types of property); reg. section 1.1221-2(c)(2) (defining ordinary property and ordinary obligations under the hedging rules).

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analysis of a contract's form (for example, an option, a forward, or a swap), its purpose (for example, for investment or for hedging), and its ability to do mischief (for example, being part of a straddle). Yet, despite an abundance of laws, uncertainty is the dominant characteristic in the taxation of financial transactions.

Exchange-traded derivatives, in contrast, mostly developed along a consistent path following the enactment of section 1256 in 1981.

C. Section 1256

Section 1256 was a part of the phalanx of laws enacted to eliminate the tax straddle shelters popular in the 1970s.[145] The shelters used futures contracts traded on U.S. exchanges to create commodity straddles,[146] which deferred capital gains and converted short-term capital gains into long-term capital gains, and U.S. Treasury bill straddles,[147] which sheltered ordinary income. The straddle shelters wreaked havoc on the U.S. Treasury and futures markets, and Congress devised a multi-pronged attack to eradicate them.

One prong of the attack was the loss deferral straddle rule now found in section 1092. Treasury believed the loss deferral rule might be impractical, so it suggested an alternative rule for taxpayers with many commodities transactions:

> We propose that these persons be subject to a mandatory mark to market rule for their positions in futures contracts traded on an organized futures exchange. Because futures positions are marked to market on a daily basis under the normal operating rules of the exchange, with actual cash settlements on a daily basis, this rule does no more than make the tax laws reflective of the underlying market transactions.[148]

Congress and Treasury knew that taxing futures contracts under a mark-to-market system would be challenged under the principle articulated in *Eisner v. Macomber.*[149] In that case, the Supreme Court said that a receipt could be taxed only if it represented "a gain, a profit, something of exchangeable value proceeding from property, severed from the capital however invested or employed, and coming in being 'derived' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal."[150] Further, in *Commissioner v. Glenshaw Glass Co.*,[151] the Court said that to be taxed, income must be "undeniable accessions to wealth, clearly realized, and [something] over which the taxpayers have complete dominion."[152]

Anticipating a constitutional challenge to mark-to-market taxation, the Joint Committee on Taxation conducted research on the commodities futures markets.[153] The JCT report defines a commodities futures contract as a "standardized agreement either to buy or to sell a fixed quantity of a commodity to be delivered at a particular location in a specified month in the future."[154] The report describes several unique features of exchange-traded contracts: (1) all trading in futures contracts must be transacted through an exchange by exchange members; (2) a clearing association guarantees performance on all contracts traded through an exchange by interposing itself as a counterparty to every contract after the trade is made; and (3) all futures contracts are standardized as to size, location of delivery, and dates of delivery.[155]

The JCT report highlights one feature of the futures markets: the use of margin deposits. For an exchange to guarantee all contracts, it must limit risk in any open positions. The exchange reduces that risk by demanding a deposit upfront for each contract entered into on the exchange. The amount

[145]For more discussion of the history of section 1256, see Viva Hammer, "US Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty," 64 *Bull. Int'l Tax.* 176 (2010).

[146]In a commodity straddle, a taxpayer entered into two commodity futures contracts — a contract to buy the commodity and a contract to sell the commodity. The contracts had different delivery months. After some time to allow the underlying commodity price to move, one of the contracts would have decreased in value and the other would have increased in value, usually by nearly the same amount. The taxpayer then sold the loss contract and entered into an identical futures contract with a different delivery date, deducting the loss in the year of the sale. The following tax year, the taxpayer would sell the two remaining futures contracts, usually for a gain. That combination of transactions resulted in short-term capital loss in the first year, which can offset short-term capital gain, and long-term capital gain in the second year, which is taxed at a lower rate. The taxpayer effectively deferred capital gains and converted short-term capital gains into long-term capital gains.

[147]In a Treasury bill straddle, a taxpayer entered into long and short futures contracts on Treasury bills with delivery months at the end of the tax year. At the time, futures contracts were characterized as capital assets, while Treasury bills were ordinary property. At year-end, the taxpayer would close the loss contract by taking delivery of the Treasury bills and would recognize an ordinary loss. Then the taxpayer would replace the futures contract with an identical contract, but with a later delivery date. In the following year, the taxpayer would recognize a long-term capital gain on the futures contract that had been held for the necessary long-term holding period.

[148]"Commodity 'Tax Straddles': Hearing Before the H. Comm. on Ways & Means," 97th Cong. 63 (1981).

[149]252 U.S. 189 (1920).

[150]*Id.* at 207.

[151]348 U.S. 426 (1955).

[152]*Id.* at 431.

[153]JCT, "Background on Commodity Tax Straddles and Explanation of S. 626," (June 12, 1981).

[154]*Id.* at 3.

[155]*Id.*

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of that deposit is usually a percentage of the value of the contract, depending on the riskiness of the contract and other positions traded on the exchange by the taxpayer. The most important aspect of the margining system is that the amount of margin held by the exchange changes daily. If the value of a taxpayer's position declines because the market has moved against her, the taxpayer will owe money to the exchange; if the value of the taxpayer's position increases because the market has moved in her favor, the taxpayer will be entitled to withdraw money from her account. This system of daily margin adjustments is called marking to market.[156]

Daily cash movements reflecting changes in the values of the contracts held by taxpayers — the margin system — provided Congress with the justification for mark-to-market taxation. Those cash movements came to be viewed as "undeniable accessions to wealth, clearly realized, and something over which the taxpayers have complete dominion."

The futures industry strongly objected to being required to mark its positions to market for tax purposes, so lawmakers offered a sweetener: 60 percent of all gains and losses on exchange-traded positions would be taxed at a long-term capital gains rate, and the remaining 40 percent would be taxed at a short-term capital gains rate (60/40 treatment). At a time when long-term capital gains were taxed at 20 percent and the top rate for ordinary income was 50 percent, this offer was sweet indeed because it resulted in a considerable rate advantage, even for positions held only momentarily.[157]

Thus, section 1256 was born, eliminating straddle shelters through marking to market, but at the cost to the government of 60/40 treatment.

As it turned out, 60/40 treatment was so favorable that immediately after it was enacted, other taxpayers clamored to bring their contracts within section 1256. Many more contracts have been brought under section 1256's purview since 1981.[158]

D. Section 1256 and the Act

Although the constitutionality of section 1256 was initially the subject of controversy,[159] its scope was not. As the particulars of derivatives reform became a reality in 2009, however, the meaning of one provision within section 1256 defining an RFC was suddenly the subject of debate.

Section 1256(g)(1) defines an RFC as a contract:

> A. for which the amount required to be deposited and the amount that may be withdrawn depends on a system of marking to market;
>
> B. that is traded on or subject to the rules of a qualified board or exchange.[160]

The term "qualified board or exchange" is defined as:

> A. a national securities exchange that is registered with the SEC;
>
> B. a domestic board of trade designated as a contract market by the CFTC; or
>
> C. any other exchange, board of trade, or other market which Treasury determines has rules adequate to carry out the purposes of section 1256.[161]

When section 1256 was enacted, nothing in the predecessor to this definition caused uncertainty. It clearly intended to refer to futures contracts traded on U.S. exchanges or boards of trade. Derivatives reform muddied the waters, however, by proposing to impose onto OTC derivatives some of the requirements that exchanges impose on their members and on the contracts they trade, such as clearing, margining, and trading on an established exchange or some alternative swap execution facility.

Would derivatives reform force a large percentage of OTC derivatives to become RFCs because they would now be traded on or subject to the rules of a qualified board or exchange?

Financial reform did not have a tax bill associated with it, and congressional staffers did not expect that financial reform would raise tax issues directly. But tax practitioners understood that if OTC derivatives came within section 1256 as a result of financial reform, it could substantially alter the tax — and economic — consequences of entering into derivative transactions.

[156] *Id.* at 7-8.

[157] The 1981 act reduced the top tax rate from 70 percent to 50 percent and the top tax rate on long-term capital gains from 28 percent to 20 percent (as the result of a 60 percent exclusion for long-term capital gains).

[158] Congress later added other types of section 1256 contracts, including foreign currency contracts, non-equity options, dealer equity options, and dealer securities futures contracts. *See* section 1256(b)(1).

[159] *See Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993), *Doc 93-5499, 93 TNT 103-17*.

[160] Section 1256(g)(1).

[161] Section 1256(g)(7). The IRS has recognized several qualified boards or exchanges. *See, e.g.*, Rev. Rul. 2010-3, 1 C.B. 272, *Doc 2009-28256*, *2009 TNT 246-10* (London International Financial Futures and Options Exchange); Rev. Rul. 2009-24, 2 C.B. 306, *Doc 2009-19825*, *2009 TNT 171-28* (ICE Futures Canada); Rev. Rul. 2009-4, 1 C.B. 408, *Doc 2009-1114*, *2009 TNT 11-21* (Dubai Mercantile Exchange); Rev. Rul. 2007-26, 1 C.B. 970, *Doc 2007-7984*, *2007 TNT 62-12* (ICE Futures, a U.K. Recognized Investment Exchange).

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Taxpayers are in two major camps in their attitude toward section 1256. For individuals, 60/40 treatment is a significant benefit, especially when the tax rates for short-term and long-term capital gain diverge as much as they do today. This benefit eliminates the inconvenience of marking contracts to market. For corporations, there is no reduced rate for capital gains, and there is a substantial detriment in generating capital losses. Marking to market can add to a corporation's woes if it holds derivatives that experience great swings in value over their lifetimes, which is common.

If these two camps dueled it out in the halls of Longworth and Dirksen, we have no record of the battles. Dodd-Frank caused such seismic changes in the financial world that the taxation of derivatives hardly warranted an audience. One public statement emerged. Alan Fu of Prudential Financial Inc. wrote to Treasury outlining the problems for insurance companies if OTC derivatives were included in section 1256:

> 1. Ordinary gains/losses on derivatives used to manage interest rate and foreign currency risks in insurance businesses now become capital. Capital is less favorable for corporations because: (a) capital loss can only be offset against capital gain, not operating income; (b) capital loss has a shorter carryforward period than ordinary loss; and (c) corporations do not enjoy a lower capital gains tax rate.
>
> 2. Marking to market means there is a mismatch in recognizing taxable gain/loss on the derivatives and the economic reality. An interest rate swap that converts a fixed rate bond to floating rate would have to recognize phantom mark-to-market taxable capital gains/losses annually without the benefit of offsetting gains/losses on the bond.
>
> 3. Because of great volatility in derivatives markets, marking contracts to market makes forecasting taxable income difficult, which in turn hinders rational business decision-making that depends on such forecasts.[162]

Prudential's objections to section 1256 treatment were fairly idiosyncratic to the insurance industry, because many other types of corporations could obtain hedging treatment under section 1221(a)(7) and reg. section 1.446-4 for the transactions Fu described, and they would therefore avoid both mark-to-market and 60/40 treatment.[163] Also, a large group of corporations — not including insurance companies — would have fallen under an "end user" exemption from the derivatives provisions in the precursors to, and the enacted version of, Dodd-Frank.[164]

Nevertheless, it was the view presented in Fu's letter that prevailed in the final drafting of the Act. Congressional budget economists believed that forcing OTC derivatives into section 1256 would be a boon to individuals and detrimental to the fisc.[165] And because of this budget issue, in the final half-hour of drafting of the Act, staffers hastily added a "clarifying" provision drafted by Treasury, stating that some contracts do not become section 1256 contracts because of any provisions of the Act.

E. Regulation of Derivatives in Dodd-Frank

Dodd-Frank affected OTC derivatives as expected: it defined very broadly the derivatives population over which the regulatory institutions have jurisdiction, and it required the CFTC and the SEC to write rules safeguarding the derivatives markets. The possible tax consequences of the new rules are addressed in the last page of the Act, which provides a list of derivatives that Congress did not intend to be governed by section 1256. Practitioners are confused by the scope of the tax provision in Dodd-Frank for reasons described more fully below.

1. Swaps defined broadly for regulatory purposes. The Act regulates the derivatives markets by empowering the CFTC and the SEC to regulate swaps, security-based swaps, and mixed swaps. The definition of swaps is so broad that almost all imaginable derivative instruments are covered.

The definition of swap includes:

- options (including puts, calls, caps, floors, collars, and similar options);
- event contracts, which provide for purchase, sale, payment, or delivery that depends on the occurrence, nonoccurrence, or extent of occurrence of an event (other than a dividend on an equity security);
- derivative contracts commonly known as swap contracts (specifically including interest rate

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[162]Comments of Alan Fu of Prudential Financial Inc. (Apr. 23, 2010), *Doc 2010-9908*, *2010 TNT 86-22*.

[163]Section 1256(e)(1).

[164]The end user exemption offers a way for corporations that use OTC derivatives solely for hedging purposes to continue using OTC derivatives that are not subject to central clearing. But a corporation may opt to reap some of the benefits of central clearing and the associated regulatory structure, which could include enhanced security and liquidity. In that case, it would share the concern that section 1256 might apply.

[165]*See* Congressional Budget Office, "Cost Estimate, H.R. 4173, Restoring American Financial Stability Act of 2010," (June 9, 2010), at 7, *available at* http://www.cbo.gov/ftpdocs/115xx/doc11560/hr4173senatepassed.pdf (estimating revenue loss of $1.3 billion over 10 years).

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swaps, rate floors, rate caps, rate collars, cross-currency swaps, basis swaps, currency swaps, foreign exchange swaps, total return swaps, equity index swaps, equity swaps, debt index swaps, debt swaps, credit spreads, credit default swaps, credit swaps, weather swaps, energy swaps, metal swaps, agricultural swaps, emissions swaps, and commodity swaps)[166] and any executory contract (1) that provides for an exchange of a fixed or contingent payment or payments based on interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof; and (2) that transfers the financial risk associated with a future change in such value or level without conveying a current or future direct or indirect ownership interest in an asset or liability;

- any agreement, contract, or transaction that later becomes commonly known as a swap;
- security-based swap agreements; and
- any combination of any of the above or an option on any of the above.[167]

Unless exempted by Treasury, swaps include foreign exchange forwards, but Treasury has proposed exempting foreign exchange swaps and forwards from the definition of swaps for most purposes of the Act, including the clearing and trading requirements.[168]

The Act excludes the following from the definition of swap:

- futures contracts, options on futures, leverage contracts, security futures products, retail spot foreign exchange transactions described in Commodity Exchange Act (CEA) section 2(c)(2)(C)(i), and retail commodity transactions described in CEA section 2(c)(2)(D)(i) that are already regulated by the CEA;
- any sale of a nonfinancial commodity or security for deferred shipment or delivery, if the contract is intended to be physically settled;
- options on securities, straddles, certificates of deposit, or groups or indexes of securities subject to the Securities Act of 1933 and the Securities Exchange Act of 1934;
- foreign currency options listed on a national securities exchange;
- securities-based contracts (i) involving the purchase or sale on a contingent basis of one or more securities that are subject to the Securities Act of 1933 and the Securities Exchange Act of 1934, (ii) any debt that is a security under section 2(a)(1) of the Securities Act of 1933, and (iii) any contract that is based on a security and entered into by the issuer of the security to raise capital except when the contract is entered into to manage risk associated with raising capital;
- contracts with the Federal Reserve, the federal government, or any federal agency backed by the full faith and credit of the U.S. government; and
- security-based swaps other than mixed swaps.[169]

2. Regulation of OTC derivatives. The Act transforms the OTC derivatives markets in several ways by requiring:

- registration and satisfaction of specific other requirements for participants in swaps markets;[170]
- clearing of specified swaps;
- trading of specified swaps; and
- reporting of specified swaps.

Of particular relevance to the applicability of section 1256 are the clearing and trading requirements for specified swaps.

3. Compulsory swap clearing. Under the Act, it is unlawful for a party to enter into a swap unless it is entered into by, or subject to the rules of, a board of trade designated as a contract market under the CEA, or unless the party is exempt from clearing as an ''eligible contract participant.''[171]

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[166]Hereinafter referred to as traditional swaps.

[167]Section 721(a)(21) of the Act. On April 27, 2011, the CFTC and the SEC proposed rules for further defining swaps. They proposed that foreign exchange forwards, foreign exchange swaps, foreign currency options not traded on a national securities exchange, non-deliverable forward contracts involving a foreign exchange, currency and cross-currency swaps, and forward rate agreements be included in the definition of swap under the Act. *See* SEC press release, ''SEC Proposes Product Definitions for Swaps'' (Apr. 27, 2011), *available at* http://www.sec.gov/news/press/2011/2011-99.htm.

[168]Section 722(h) of the Act. On April 29, 2011, under its authority under the Act, Treasury issued a proposed determination that would exempt foreign exchange swaps and forwards from the definition of swap for most purposes of the Act, including registration, clearing, and trade execution. 76 *Fed. Reg.* 25774 (May 5, 2011).

[169]Section 721(a)(21) of the Act.

[170]The Act requires swap dealers and major swap participants to adhere to specified minimum requirements regarding capital, initial margin, and variation margin. On April 11, 2011, five federal agencies, including the Federal Reserve and the FDIC, issued proposed rules on those minimum capital and margin requirements. On April 14, 2011, the CFTC also issued proposed rules on those requirements.

[171]Section 2(e)(7)(C) of the CEA, added by section 723(a)(2) of the Act. An eligible contract participant includes financial

(Footnote continued on next page.)

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A swap that is required to be cleared must be submitted for clearing to a derivatives clearing organization (DCO). The CFTC or SEC must continually consider whether to require specific swaps to be cleared, and a DCO may propose to the CFTC or SEC that specific swaps be required to be cleared.[172] Under the Act, all economically equivalent swaps submitted for clearing to a DCO must be able to be offset against each other.

Every DCO must limit its exposure to potential losses from defaults by members and other participants in the DCO through the use of margin requirements and other risk control mechanisms.[173]

Under the end user exemption, the clearing requirement does not apply to a swap if one of the counterparties to the swap is not a financial entity,[174] is using the swap to hedge or mitigate financial risk, and notifies the CFTC of how it meets its financial obligations associated with entering into the swap. This exemption is an option, but not a requirement, of the nonfinancial counterparty to the swap.[175]

4. Trading. If a swap is required to be cleared, parties must execute its trade on a national securities exchange, a board of trade designated as a contract market, or a swap execution facility,[176] unless none of these institutions agree to trade the swap.[177]

The end user exemption described above applies to exempt some nonfinancial entities from the trading requirement as well.

F. Applicability of Section 1256

Although practitioners had considered OTC derivatives generally to be outside the purview of section 1256, the new clearing and trading requirements described above led many to reconsider whether traditional swaps would now be ''traded on or subject to the rules of a qualified board or exchange'' and therefore be within the definition of an RFC. That uncertainty caused Congress to add a list of exclusions from the definition of section 1256 contracts.[178]

The Act provides that section 1256 contracts do not include:

> Any 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.[179]

The list is odd. Although this tax provision is incorporated into the Act, the list of swaps covered on the tax page is utterly unconnected to the list of swaps in the main regulatory body of Dodd-Frank. For example, the regulatory definition of swap in Dodd-Frank is extremely broad, covering every type of contract imaginable. The tax definition is short and appears to be based on the list of contracts within the definition of NPC in reg. section 1.446-3(c)(1)(i), with the addition of credit default swaps.

Several questions are raised by the disconnection between the definition of swap for regulatory purposes and tax purposes. Why did the tax definition not simply refer to the regulatory definition of swap? And assuming the differences were intentional, what interpretive value should we draw from them? Several of the terms in the Dodd-Frank addition to section 1256 are new to the Internal Revenue Code, including the term ''swap.''

A tax professional might interpret the new 1256 list in Dodd-Frank any number of ways. We examine two here: (1) only NPCs and credit default swaps are excluded from section 1256 (whatever the term ''credit default swap'' means); and (2) all swaps are excluded (whatever the term ''swap'' means), because of the ''or similar agreement''

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institutions, insurance companies, investment companies, some corporations, partnerships, and other entities with more than $10 billion in assets, some commodity pools, employee benefit plans, governmental entities, and broker dealers, all acting for their own accounts. Section 1a(12) of the CEA.

[172]Section 2(h) of the CEA, added by section 723(a) of the Act.

[173]Section 5(b)(c) of the CEA, added by section 725(c) of the Act. The CFTC has issued proposed rules on the clearing requirements and risk management requirements for DCOs. *See* 76 *Fed. Reg*. 13101 (Mar. 10, 2011); 76 *Fed. Reg*. 3698 (Jan. 20, 2011).

[174]The term ''financial entity'' generally means a swap dealer, a major swap participant, a commodity pool, a private fund, an employee benefit plan, or a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature. Some exemptions apply for institutions with total assets under $10 billion. Section 2(e) of the CEA, added by section 723(a) of the Act.

[175]Section 2(h)(7) of the CEA, added by section 723(a)(3) of the Act.

[176]A swap execution facility is a trading system or platform in which multiple participants can execute or trade swaps by accepting bids and offers made by multiple participants in the facility. Section 1a(50) of the CEA, added by section 721 of the Act.

[177]Section 2(h)(8) of the CEA, added by section 723(a)(3) of the Act. Since the exchanges and swap execution facilities will set their own standards for which swaps they will execute, swaps with particularly risky counterparties or swaps with exotic or hard-to-value terms might not be accepted by any exchange or swap execution facility.

[178]Before the Act, some taxpayers and advisers had maintained that their traditional swap contracts were RFCs and therefore section 1256 contracts. Because of the Act's section 1256 exclusion and the lack of a transition rule, those taxpayers may have little alternative but to request the IRS commissioner's consent to change their method of accounting for their existing and future swaps.

[179]Section 1601(a)(3) of the Act.

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language at the end of the provision. One immediate question that comes to mind is whether ''swap'' include a bullet swap that has only one payment at maturity and therefore is excluded from the definition of an NPC?

These interpretive problems are not merely academic; energy and weather derivatives are two common types of derivatives whose status is uncertain under the newly amended section 1256. Under interpretation (1), energy and weather derivatives now potentially fall within section 1256 because they are not specifically enumerated in the exclusion to that section. But under interpretation (2), they are excluded from section 1256 because of the ''similar agreement'' language in the amendment.

At a recent American Bar Association webinar, Patrick McCarty, principal drafter of the Act, said, ''This is how I view it: No swap gets 1256 treatment, period.''[180] He added that the language ''or similar agreement'' is not meant to describe agreements similar to the listed ones only, but any swap under the Act.[181] Of course, McCarty's statements have no legal weight, but they may be helpful to the IRS and practitioners as they struggle to understand Congress's intent.

Legislative history, another source of potential help to taxpayers, says that the amendment to section 1256 is ''a provision to address the recharacterization of income as a result of increased exchange-trading of derivatives contracts by clarifying that [section 1256] does not apply to certain derivatives contracts transacted on exchanges.''[182] That language does not appear consistent with McCarty's interpretation that all swaps should be excluded from section 1256. Some interest rate derivatives, for example, are traded on the Chicago Mercantile Exchange (CME) and could be characterized either as futures contracts subject to section 1256 or as interest rate swaps. McCarty would exclude these from section 1256, but it doesn't appear that the legislative history would.

McCarty's view that all swaps should be excluded from section 1256 also presents difficulties for some energy swaps. For instance, CME ClearPort provides clearing services in which OTC energy swaps are converted into futures contracts. The resulting contracts probably fell within section 1256 before the enactment of Dodd-Frank. Since these contracts generally provide for a single payment, they are not NPCs. In all likelihood, they would not be excluded under a reading of the section 1256 amendment that limits exclusions to NPCs, credit default swaps, and agreements similar to NPCs and credit default swaps. However, if the list is read to include the broad definition of swaps under the Act, a definition that includes energy swaps, these contracts might be taken out of section 1256.

Another contract with uncertain status is the interest rate swap cleared on the International Derivatives Clearing House (IDCH). The IDCH offers to clear the interest rate swaps by exchanging each interest rate swap position for a futures contract with equivalent payment terms. After clearing, each party transacting with the IDCH has a futures contract as a regulatory matter with payment terms equivalent to an interest rate swap. These contracts were certainly not contemplated by Congress when it enacted section 1256, which leaves questions about how periodic payments under the contracts would be taxed. Although Dodd-Frank specifically excludes interest rate swaps from section 1256, it is still unclear whether after clearing, this contract is best characterized as an interest rate swap (outside section 1256) or as a futures contract (within section 1256).

Treasury and IRS guidance is needed.[183] Scholars of tax policy offering advice to the government on the section 1256 dilemma raised by Dodd-Frank would begin with the tax policy ideals of efficiency, equity, and administrability. But neither equity nor efficiency will ever be optimized while we labor under the current Internal Revenue Code. Whether a specific contract is within or outside section 1256 will not improve the efficiency of the financial markets when there is already such diversity of tax treatment between economically similar contracts. To fix that problem, we would need a tax reform as comprehensive as the regulatory reform implemented by Dodd-Frank.

The only tax policy ideal Treasury and the IRS can fully uphold today is administrability, giving taxpayers a clear message on which instruments are within and which are outside section 1256. Commentators overwhelmingly support mark-to-market treatment for financial instruments,[184] and they equally despair at the nonsensicalness of 60/40 treatment. If the government must choose which

[180]Marie Sapirie, ''Mark-to-Market Exception Covers All Swaps, Former Staffer Says,'' *Tax Notes*, Mar. 7, 2011, p. 1121, *Doc 2011-4585*, *2011 TNT 43-4*.

[181]*Id.*

[182]H.R. Rep. No. 111-517, at 879 (2010).

[183]*See* Sapirie, ''Dodd-Frank Clouds Foreign Currency Swap Issues,'' *Tax Notes*, Apr. 18, 2011, p. 237 *Doc 2011-7732*, or *2011 TNT 70-2* (''An expected announcement by Treasury Secretary Timothy Geithner regarding the regulation of foreign exchange swaps may add another layer of uncertainty to the question whether those swaps must be marked to market'').

[184]*See, e.g.*, Yoram Keinan, ''Mark-to-Market for Derivatives,'' *Tax Notes*, Sept. 20, 2010, p. 1269, *Doc 2010-18356*, or *2010 TNT*

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transactions fall under section 1256, both it and taxpayers will win some and lose some. The government alone can decide who falls on which side and when. We eagerly await its decision.

VII. Executive Compensation & Corporate Governance

The Act contains several provisions regarding executive compensation and corporate governance.[185] Below we discuss the provisions with a tax impact.

A. Shareholder Approvals and Disclosures

1. The Act's provisions.

a. Shareholder approval of executive compensation ('say on pay'). The Act requires that at least once every three years, the issuer include in its proxy statement a resolution giving shareholders a nonbinding vote to approve the compensation of the issuer's executives. Also, at least every six years, shareholders must vote on a separate resolution regarding whether the shareholder vote is to occur every one, two, or three years.[186]

b. Shareholder approval of golden parachutes. The issuer's proxy statement must disclose any agreements with specified executive officers (currently the CEO and the three most highly paid officers) that concern any compensation based on an acquisition, merger, consolidation, sale, or other disposition of substantially all of the issuer's assets, unless the agreement is already disclosed and voted on under the say-on-pay provision. Shareholders must have a nonbinding vote to approve that compensation.[187]

c. Disclosure of executive pay vs. performance. The proxy statement must disclose the relationship between executive compensation actually paid and the issuer's financial performance, taking into account changes in share value, dividends, and other distributions. Also, the issuer must disclose (i) the median of the annual total compensation of all of the issuer's employees other than the CEO, (ii) the annual total compensation of the CEO, and (iii) the ratio of the amount in (i) to the amount in (ii).[188]

d. Disclosure of employee and director hedging. The proxy statement must disclose whether any employee or member of the board is permitted to purchase financial instruments for the purpose of hedging any decrease in the market value of securities that are paid in compensation or otherwise held by those individuals.[189]

2. Effective dates. The say-on-pay provision and the golden parachute provisions are effective at a company's first shareholder meeting or proxy solicitation occurring after January 21, 2011. The effective date of the pay-versus-performance and hedging provisions will be in rules the SEC intends to issue by mid-2011.

3. Tax issues. The Act's rules regarding executive compensation revisit policies Congress has already considered in the tax law. Section 162(m) generally disallows a public company from deducting compensation that is paid to each named executive officer in excess of $1 million per tax year. Performance-based compensation that is subject to goals established by a compensation committee comprising at least two outside directors is exempt from that rule. Section 280G provides an intricate set of rules that, if violated, would disallow a deduction for excess parachute payments made to executives in connection with the change in ownership or control of a corporation or a substantial portion of its assets. Executives receiving those excess payments are subject to a 20 percent excise tax under section 4999. The Act's provisions supplement these provisions by requiring public disclosure of much of the same information that is needed in analyzing the application of the tax provisions.

B. Recovery of Compensation

1. The Act's provision. The SEC is required to write rules for the recovery of incentive-based compensation from current or former executive officers of a publicly traded corporation that is determined to exceed what should have been paid, based on revised figures in an accounting restatement of the corporation's financial statements.[190] For example, bonuses that are based on the reported income of a corporation would have to be recovered at least in part if that income was reduced by an accounting restatement. This clawback provision applies to compensation paid during the three-year period preceding the date of any accounting restatement.

184-10; David S. Miller, ''A Progressive System of Mark-to-Market Taxation,'' *Tax Notes*, Oct. 13, 2008, p. 213, *Doc 2008-20805*, or *2008 TNT 200-48*; David A. Weisbach, ''Colloqium on Financial Instruments: Tax Responses to Financial Contract Innovation,'' 50 *Tax L. Rev*. 491 (1995).

[185]Subtitles E and G of Title IX of the Act contain the sections regarding corporate governance and executive compensation.

[186]Section 951 of the Act. On April 4, 2011, the SEC issued a final rule on the say-on-pay provision. *See* SEC Rule 14a-21. SEC, ''Shareholder Approval of Executive Compensation and Golden Parachute Compensation'' (Apr. 4, 2011).

[187]*Id.* On April 4, 2011, as part of the say-on-pay rules that were issued, the SEC also addressed the golden parachute provisions of the Act.

[188]Section 953 of the Act.

[189]Section 955 of the Act.

[190]Section 954 of the Act.

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2. Effective date. The effective date of the clawback provision will be included in rules the SEC intends to issue by mid-2011.

3. Tax issues. When amounts paid by the issuer are subject to reporting and wage withholding in one year and later required to be paid back in a following year by the executive, there is no general relief or adjustment available for the withholding and reporting in the prior year of payment. Rather, each executive must approach the IRS with her own theory on why a refund of the prior-period withholding should be made. The most logical approach would appear to apply a claim of right theory under section 1341. The Act does not appear to prohibit indemnifying the executive for any unreimbursed taxes, but any such payment will be compensation subject to reporting and wage withholding.

C. Independence

1. The Act's provisions. Compensation of executive officers of a public company is deliberated on and determined by the board's compensation committee. Those committee members must be independent members of the board. Determination of the member's independence takes into account the source of the member's compensation, including any consulting, advisory, or other fees paid by the issuer to the member, and whether the member is affiliated with the issuer. The Act also requires the issuer's compensation committee to take into account several factors (such as the level of work otherwise done for the company) in selecting compensation consultants and advisers to ensure their independence.[191]

2. Tax issues. Section 162(m) disallows a deduction for publicly traded corporations of compensation exceeding $1 million paid to the CEO and the four other highest-paid officers of the corporation unless that compensation is approved by a compensation committee of the board consisting of two or more outside directors.[192] Also, the compensation exceeding $1 million must be based on performance goals that have been disclosed to, and approved by, a majority of the corporation's shareholders. While the independence provisions in the Act still await clarification from the SEC, the tax rules and the Act's rules ultimately may not match, and care should be taken not to confuse them.

VIII. Conclusion

The seven provisions of Dodd-Frank discussed in this report are those most likely to significantly affect the corporate world from a tax perspective. These rules will affect many institutions, and as they work toward complying with the new rules, many tax issues could appear.

As the new provisions of the Act become effective, companies and their advisers should take particular care in navigating them and assessing the tax consequences of complying with them. Different roads to compliance will lead to different tax consequences, but careful planning can help reduce the adverse tax consequences and may even create valuable tax opportunities.

Appendix A: Living Wills — Tax Issues Checklist

The following checklist highlights many of the tax issues that should be considered in connection with disposition and internal restructuring transactions provided for in a living will. While this list focuses only on U.S. federal income tax matters, foreign, state, and local tax issues should also be considered. The list is for general information only and is not a substitute for careful, individualized tax advice and analysis.

Planning for Dispositions

1. Will the disposition be structured as an asset or stock sale (or perhaps in some other manner, such as a transfer to a joint venture)?

2. Is the disposition expected to result in gain or loss, and should the transaction be structured to be taxable or tax free?

3. If a tax-free spinoff is desired, will all the requirements under section 355 be satisfied?[193]

4. Can transactions be structured in a way that will maximize the use of (or minimize any limitations on) net operating losses and other tax attributes?[194]

5. Will the transaction trigger the recapture of credits or other items?[195]

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[191]Section 951 of the Act. On March 30, 2011, the SEC issued proposed rules regarding the different independence provisions of the Act. SEC, "Listing Standards for Compensation Committees" (Mar. 30, 2011).

[192]Reg. section 1.162-27(e)(3) contains detailed rules on the independence required of outside directors that is needed to satisfy the statutory exception to the $1 million cap on the deduction of executive compensation.

[193]*See* Thomas F. Wessel et al., "Corporate Distributions Under Section 355" (PLI 2009).

[194]*See generally* Thomas Avent and John Simon, "Preserving Tax Benefits in Troubled Companies — Navigating Mostly Unchartered Waters" (PLI 2009); Deanna Walton Harris and Mark Hoffenberg, "Be Careful What You Wish For: Is Section 382's Treasure Section 384's Trash?" (PLI 2009).

[195]*See, e.g.*, sections 42(j) (low-income housing credit), 45D(g) (new markets credit), and 48(d)(2) (energy credit); *see also* sections 1245 and 1250.

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6. If a controlled foreign corporation is involved, will gain be triggered under a gain recognition agreement?[196]

7. Will recognition of deferred intercompany items, excess loss accounts, or various recapture provisions be triggered?[197]

8. Will the unified loss rule or other limitations on the recognition of losses be brought into play?[198]

9. If a joint venture is involved, have the relevant partnership tax provisions been considered (including, for example, the rules on hot assets, section 704(c) property, and technical terminations)?[199]

10. Will the disposition of the business cause a significant modification to third-party or related-party debt, generating cancellation of indebtedness income or other tax consequences?[200]

11. Will the disposition of the business cause an exchange of derivative positions (or other financial instruments other than debt instruments) to one or both counterparties?[201]

12. Will significant transfer taxes be incurred?

Other Internal Restructuring and Capital-Raising Transactions (in Addition to the Above Issues)

1. Will the raising of new capital create problems regarding a change of ownership under section 382, affect tax attribute use, or raise concerns about the anti-stuffing rules?[202]

2. Will the transfer of businesses or assets between members of a consolidated group create deferred intercompany items?[203]

3. Will items that are deferred for U.S. federal income tax purposes have immediate state or local tax consequences?[204]

4. Could restructuring transactions (individually or together with other transactions) be re-characterized for tax purposes in possibly overlapping ways to result in unexpected tax consequences?[205]

5. In a cross-chain sale of assets, could unintended tax consequences arise from the potential issuance of a nominal share of acquirer stock under the stockless D reorganization regulations?[206]

6. In a taxable transaction, what assets will receive a stepped-up basis for tax purposes, and will the potential step-up be caught by the anti-churning rules?[207]

7. On loss transactions, will section 267 defer or deny the use of any losses?

8. For transactions involving CFCs, will the transactions create subpart F income?[208]

9. Will foreign transactions be treated as covered asset acquisitions or be subject to the anti-splitter rules?[209]

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[196]Reg. section 1.367(a)-3(b) through (e) and (a)-8.

[197]Reg. sections 1.1502-13; 1.1502-19; 1.1503(d); 1.367(a)-6T; and 1.904(f)-2.

[198]Reg. section 1.1502-35 and -36; *see also* section 382(h)(1)(B).

[199]*See* sections 704(c), 708(b)(1)(B), and 751; *see generally* William S. McKee et al., *Federal Taxation of Partnerships and Partners*, ch. 16 (''Sales, Exchanges, and Other Transfers of Partnership Interests''). For a particular rule when an existing partner acquires all the interests in a partnership, see Rev. Rul. 99-6, 1999-1 C.B. 432, *Doc 1999-2092*, *1999 TNT 10-7* (purchaser treated as acquiring all the partnership assets directly by purchase).

[200]Reg. section 1.1001-3; section 108(e)(10) (issuer recognizes cancellation of indebtedness income if the issue price of the new modified instrument is less than the adjusted issue price of the old unmodified instrument). A significant modification may also give rise to OID. Some debt-for-debt exchanges may be treated as recapitalizations under section 368(a)(1)(E).

[201]*See* preamble to debt modification regulations under reg. section 1.1001-3; T.D. 8675, *Doc 96-18674*, *96 TNT 128-90*; Rev. Rul. 90-109, 1990-2 C.B. 191; James M. Peaslee, ''Modifications of Nondebt Financial Instruments as Deemed Exchanges,'' *Tax Notes*, Apr. 29, 2002, p. 737, *Doc 2002-10327*, or *2002 TNT 83-25*; reg. section 1.446-3(h), -3(f), and -3(g)(4) (treatment of termination payments on NPCs); reg. section 1.1001-4 (exception to gain for non-assigning counterparties for swaps novated between dealers under agreements permitting that novation).

[202]Sections 382(g) and (l)(1); 336(d)(2); *see also* Avent and Simon, *supra* note 194.

[203]Reg. section 1.1502-13.

[204]*See, e.g.*, Cal. Rev. and Tax. Code section 23362; N.Y. reg. section 3-9.4; *see generally* Thomas W. Giegerich, ''Selected Tax Considerations in Corporate Restructurings'' (PLI 2009).

[205]*See generally* Bernita L. Thigpen et al., ''The Direction of a Merger — Federal Income Tax Consequences'' (PLI 2009).

[206]Reg. section 1.368-2(l).

[207]Section 197(f)(9).

[208]Under the subpart F rules, the transferring CFC will not be subject to an immediate tax, assuming it qualifies for the active financing exception under section 954(c)(2)(C) or (h). There is an exception from foreign personal holding company income in section 954(c)(1)(B) for income from the sale of section 954(h) property. That exception covers sales of assets by CFCs that fall within the ambit of section 954(h). Also, reg. section 1.954-2(e)(1) and (3) generally should provide protection from foreign personal holding company income treatment for gains from the sale of dealer property and intangible assets (including goodwill and going concern), respectively, used in an active trade or business.

[209]Sections 901(m) (covered asset acquisitions) and 909 (FTC splitter transactions); Notice 2010-92 (setting out rules for pre-2011 splitter transactions).

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10. Could the tax-free treatment of a reorganization, liquidation, or contribution be jeopardized by the questionable solvency of an entity?[210]

11. Could the potential re-characterization of intercompany debt as equity in a distressed entity alter the intended tax consequences of a restructuring transaction?

12. If an entity is insolvent, when and how should a worthless stock deduction be claimed, and can plans be made to take the loss as an ordinary or capital loss?[211]

13. If intercompany debt is partially or wholly worthless, what loss on the debt can be claimed?[212]

14. If distressed assets are being sold, how should the buying entity treat the market discount arising on the sale?[213]

Side Effects

1. Will customers recognize gain or loss on derivative positions that are novated in a restructuring, and will the restructuring give rise to changes in withholding tax rates on financial instruments or create other tax issues?[214]

2. Will any restructuring change the tax residence of a company for state and local tax purposes?[215]

3. Will restructuring give rise to a new permanent establishment offshore or otherwise affect tax treaty positions?[216]

4. Will the movement of assets or entire business units shift the entities in which some important functions are performed, necessitating changes in existing transfer pricing policies and service level agreements?[217]

5. Will the change in an entity's business profile caused by a restructuring change the analysis of uncertain tax positions?

6. If assets are moved or disposed of, what will be the effect on hedging positions?[218]

7. For transactions affecting CFCs having a functional currency other than the U.S. dollar, will the transaction generate a foreign currency gain or loss?[219]

8. What will be the effect on GAAP accounting for income taxes of any disposition of a business or the movement of assets? Will the change affect an Accounting Principles Board No. 23 assertion made by a foreign subsidiary?[220]

9. Will the change in how a business is structured trigger or require a change in accounting method?

Other Considerations for Living Wills

1. When inventorying legal entities for the living will, has the company's organization chart been reviewed and updated, and has the tax department been apprised of all changes?

2. If the tax department chooses to conduct a general tax planning review when reviewing the organization chart and living will, are there stale tax planning structures that should be removed or new tax planning opportunities that should be created?

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[210]Reg. section 1.332-2(b); *see also* prop. reg. sections 1.351-1(a)(1)(iii) and 1.368-1(f) and the preamble to the proposed "no net value" regulations at 2005-1 C.B. 835; *but see Scott v. Commissioner*, 48 T.C. 598 (1967); *see also* Thomas Avent, "Liquidations, Reorganizations and Contributions Involving Insolvent Corporations" (PLI 2009).

[211]Worthless stock deductions are covered by section 165(g). Worthless stock of an affiliate will give rise to an ordinary loss under section 165(g)(3). However, a liquidation of a company whose stock has no value may fall under section 331 and be treated as a sale or exchange giving rise to a capital loss. Reg. section 1.332-2(b); *Commissioner v. Spaulding Bakeries*, 252 F.2d 693 (2d Cir. 1958). Section 267 does not apply to losses on a distribution in liquidation. Section 267(a)(1).

[212]Worthless debt constituting a security is treated under section 165(g); other bad debts are covered by section 166.

[213]Literally, the market discount rules in sections 1276-1278 would appear to apply to distressed debt bought at a deep discount. However, the legislation does not seem to target that situation, and these rules may not apply to those transactions.

[214]*See* reg. section 1.1001-3; T.D. 8675.

[215]The restructuring may result in an entity having a physical presence in a new state. Equally important, it may affect economic nexus considerations. Megan A. Stombock, "Economic Nexus and Nonresident Corporate Taxpayers: How Far Will It Go?" 61 *Tax Law.* 1225 (2008); Andrew W. Swain and John D. Snethen, "Economic Nexus: Past, Present, and Future," *State Tax Notes*, Apr. 23, 2007, p. 243.

[216]In general, a PE is a fixed place of business through which the business of an enterprise is carried on in whole or in part. 2006 U.S. Model Income Tax Convention, art. 5(1). A similar definition is in article 5 of the OECD Model Tax Convention on Income and on Capital.

[217]Reg. section 1.482-1(d)(3)(i); *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, ch. 1, C(b)(2).

[218]For the effect of terminating hedges, see reg. section 1.446-4(e)(6) and sections 475(b)(1)(C) and (b)(2).

[219]For a thorough discussion of this topic, see the preamble to the proposed section 987 regulations, 2006-2 C.B. 698.

[220]Under APB 23, a U.S. tax accrual is not imposed on the foreign earnings of a CFC if the foreign earnings are indefinitely invested overseas.

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3. Are there opportunities for eliminating or consolidating entities in isolated circumstances or as part of a full-scale legal entity rationalization project?

4. Are any valuations or tax studies needed (including, for example, basis studies, earnings and profits studies, or section 382 ownership change and net unrealized built-in loss/net unrealized built-in gain determinations)?

5. Should the organization implement or update any tax allocation agreements?

Establishing New Hedge Funds and Private Equity Funds[221]

1. What form should the new fund take?

- Will a new hedge fund take the common form of a master-feeder structure with a master fund established offshore and treated as a partnership for U.S. tax purposes, a domestic feeder LLC for U.S. investors, and a foreign corporation for non-U.S. and tax-exempt investors?
- For private equity funds, will a simpler Delaware limited partnership structure be established?

2. What tax year and accounting methods should the new fund elect?

3. Will a new hedge fund elect trader status under section 475(f)?

4. How will the partners' distributive share of income, gain, loss, deductions, and credits be allocated to give them substantial economic effect?

5. Will the partnership make a reverse section 704(c) election to allow historic partners who have terminated their investments to realize their share of unrealized appreciation or depreciation once those amounts have been realized?

6. Will the partnership make a section 754 election to account for retired and new investors in the fund? How will the decision on making a trader election affect the section 754 election?

7. How will the fund managers be compensated? Should they be given carried interest?

8. How should the fund deal with the rules in section 409A on deferred compensation under non-qualified deferred compensation plans?

9. How will the fund deal with withholding taxes on investments made by foreign investors?

10. How will the fund handle information reporting and the Foreign Account Tax Compliance Act requirements?

Appendix B: Index to Provisions of the Dodd-Frank Act Having Tax Significance

Bank Capital and Liquidity

Title I — Financial Stability

Subtitle C — Additional Board of Governors Authority for Some Non-Bank Financial Companies and Bank Holding Companies

- Section 165 — Enhanced supervision and prudential standards for non-bank financial companies supervised by the Federal Reserve Board of Governors and some bank holding companies.
- Section 165(c) — Authorizes the Federal Reserve to require bank and nonfinancial holding companies to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.
- Section 171 — Leverage and risk-based capital requirements. Imposes risk-based and leverage capital standards currently applicable to U.S. banks on U.S. bank holding companies and on non-bank financial companies supervised by the Federal Reserve.

Living Wills

Title I — Financial Stability

Subtitle C — Additional Board of Governors Authority for Some Non-Bank Financial Companies and Bank Holding Companies

- Section 165 — Enhanced supervision and prudential standards for non-bank financial companies supervised by the Federal Reserve Board of Governors and some bank holding companies.
- Section 165(b)(1)(A)(iv) and (d)(1) — Requires covered institutions to prepare resolution plans.
- Section 166 — Early remediation requirements. Requires regulators to adopt rules dealing with the early remediation steps regulators should take with troubled institutions.

Volcker Rule

Title VI — Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions

[221]For a general discussion of hedge fund and private equity fund tax issues, see Richard Lipton and John Soave III, "U.S. Taxation of Private Equity and Hedge Funds," 919 PLI/Tax 193-1 (Mar./Apr. 2008); Jerald August and Lawrence Cohen, "Hedge Funds — Structure, Regulation and Tax Implications," 919 PLI/Tax 192-1 (2010).

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- Section 619 — Prohibitions on proprietary trading and specified relationships with hedge funds and private equity funds. Amends the Bank Holding Company Act of 1956 to prohibit banking entities and their affiliates from (i) engaging in proprietary trading or (ii) sponsoring or investing in hedge funds and private equity funds, subject to a de minimis exception.

Derivatives

Title VII — Wall Street Transparency and Accountability

Subtitle A — Regulation of Over-the-Counter Swaps Markets

Part I — Regulatory Authority

- Section 716 — Prohibition against federal government bailouts of swaps entities. Requires swap dealers that are banks or other entities having access to Federal Reserve credit or FDIC assistance to limit their swap dealings to specified permitted activities.

Part II — Regulation of Swaps Markets

- Section 723 — Clearing. Requires mandatory clearing of affected swaps through a derivatives clearing agency.

Several sections of the Act also impose new reporting and record-keeping requirements, including:

- Section 727 — Public reporting of swap transaction data.
- Section 728 — Swap data repositories.
- Section 729 — Reporting and record keeping.

Title XVI — Section 1256 Contracts

- Section 1601 — Certain swaps, etc., not treated as section 1256 contracts. Provides that section 1256 contracts do not include specified swaps or similar agreements.

Securitization

Title IX — Investor Protection and Improvements to the Regulation of Securities

Subtitle D — Improvements to the Asset-Backed Securitization Process

- Section 941 — Regulation of credit risk retention. Imposes new risk retention requirements on securitizers, who in general must retain a minimum of 5 percent of the credit risk in the assets it sells into a securitization.

Executive Compensation and Corporate Governance

Title IX — Investor Protection and Improvements to the Regulation of Securities

Subtitle E — Accountability and Executive Compensation

- Section 951 — Shareholder vote on executive compensation disclosures. Periodically requires a resolution to be included in the issuer's proxy statement on which shareholders must have a nonbinding vote to approve the compensation of executives.
- Section 952 — Compensation Committee Independence. Members of an issuer's compensation committee must be independent members of the issuer's board of directors.
- Section 953 — Executive Compensation Disclosures. The proxy statement must disclose the relationship between executive compensation actually paid and the financial performance of the issuer.
- Section 954 — Recovery of erroneously awarded compensation. Issuers must develop and implement a policy that provides for (i) disclosure of the issuer's policy on incentive-based compensation, and (ii) clawback of incentive-based compensation from current or former executive officers based on revised figures in an accounting restatement.
- Section 955 — Disclosure regarding employee and director hedging. The proxy statement must disclose whether any employee or member of the board is permitted under company policy to hedge securities that are paid in compensation or otherwise held by those individuals.

Appendix C: Glossary of Terms

Basel III — The rules issued by the Basel Committee requiring banks to have specified levels of minimum common share equity, Tier 1 equity, and total capital. Basel III also introduced a requirement for a capital conservation buffer of common share equity of at least 2.5 percent of risk-weighted assets.

Basel committee — The Basel Committee on Banking Supervision comprises senior representatives of bank supervisory authorities and central banks from the member countries of Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, Switzerland, where its permanent secretariat is located.

Collins amendment — Provision of the Act that imposes on U.S. bank holding companies and nonbank financial companies supervised by the Federal Reserve the risk-based and leverage-capital standards previously applicable only to U.S. banks. These standards will also be applied to U.S. bank holding company subsidiaries of foreign banks.

Contingent capital — Debt convertible into capital of the issuer in times of financial distress. Basel III

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requires contingent capital to be converted into common equity of the issuer if the local banking regulator determines the bank would otherwise become nonviable.

Contingent convertible bonds or **CoCos** — New financial instruments that are issued as debt, but on the occurrence of specified events, will convert automatically into common equity of the issuing bank or bank holding company.

Lincoln amendment — Provision of the Act that establishes the derivatives push-out rule prohibiting FDIC-insured entities and other entities having access to Federal Reserve credit facilities from being dealers in almost all derivative instruments.

Living wills — Recovery plans providing for remediation steps if an institution encounters financially difficulty, and resolution plans that provide for the windup of a financially distressed institution.

Push-out rule — This provision of the Act, established by the Lincoln amendment, prohibits FDIC-insured entities and other entities having access to Federal Reserve credit facilities from being dealers in almost all derivative instruments. The rule is subject to several broad exemptions.

Say on pay — Provision of the Act that requires, at least once every three years, a resolution to be included in the issuer's proxy statement in which shareholders must be given a nonbinding vote to approve the compensation of the issuer's executives.

Trust-preferred securities — Also known as TRUPs, these hybrid securities have characteristics of both subordinated debt and preferred stock. The issuer generally forms a trust that issues securities in a public underwriting. The trust uses the proceeds received from the underwriting to acquire specified junior subordinated notes from the issuer. Before the enactment of Dodd-Frank, TRUPs were includable in the Tier 1 regulatory capital of banks, but the Act excludes them from the Tier 1 regulatory capital of banks beginning in 2013.

Volcker rule — Provision of the Act that prohibits banking entities from proprietary trading and from sponsoring and investing in hedge funds and private equity funds. The Volcker rule also authorizes U.S. regulators to impose capital requirements and quantitative limits on the investment activities of non-bank financial companies subject to supervision by the Federal Reserve.

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