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News Analysis: High Finance and High Fashion: Essential Questions Addressed

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Around here, we are obliged to address matters of pressing national concern. We confess that we have been negligent in the past in our failure to discuss the important question of red-carpet gowns.

Now, evening gowns are an anachronism. But like debutante balls and children's beauty pageants, they live on in some parts of the country. They're big in Texas, in both senses of the word. In the old Confederacy, where social class is everything, gowns are purchased for occasions beyond just weddings. So when stylists stuff actresses into borrowed gowns for awards shows, designers will sell dresses in addition to perfume and bags.

At the recent Golden Globes, there were more than the usual number of stylistic disasters. Many of the mistakes can be blamed on the failure to understand what the L.A. sunlight, the television cameras, and the red rug do to dresses that looked great in dressing room snapshots. Herewith, our rules for the red carpet:

1. Don't wear black or black lace unless you appeared in a Tim Burton feature. Yes, black makes you look slimmer and sexier. But in the L.A. afternoon sunlight when awards shows are taped, you look like a wayward goth. Several actresses successfully pulled off burgundy.

2. Go easy on the sparkle. The television camera magnifies every sequin. Julianne Hough's gold-spangled ball gown looked like it belonged on the Rockettes, while Isla Fisher's pale beaded Reem Acra number worked.

3. Pastel colors work best on television camera. Anyone who ever studied soap opera costumes knows that flesh tone and hyacinth (like Cody Horn's Vionnet dress) are in heavy rotation. Don't wear white or ivory -- you're not getting married (again).

4. Don't go too sexy unless the occasion is the Adult Video Awards. Let's not make it too obvious which skill set you used to get that part.

5. The dress should not have too much volume. You didn't sweat it out in boot camp with your trainer three days a week to don a 19th-century poufy ballskirt. Even if you're chubby, opt for something more slimming, like the maroon dress Lena Dunham of *Girls* wore.

6. Keep your hair off your face, and don't wear dark lipstick. It's middle-class American television, not a Green Day gig.

7. Don't wear haute couture. Many of the Golden Globes disasters came straight from the Paris runways, where they're trying desperately for something new. Elizabeth Taylor always managed to look good at these gigs because she used costume designer Nolan Miller of *Dynasty*, who knew better than anyone what works on camera. Miller is gone, but Jenny Packham designed several successful outfits.

8. Don't wear prints. They look better on bedroom windows. The camera fights prints, and they distract from your face.

Of course, another matter of pressing national concern is how Treasury will use its power under section 871(m)(3)(B) to excuse some derivatives from dividend equivalent withholding. There is no good answer to that just yet, but the drafters are under the gun because withholding agents are reluctant to program for the proposed regulations, and Sen. Carl Levin, D-Mich., chair of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, is unlikely to permit the IRS to extend the effective date further.

Mark Perwien, IRS special counsel to the associate chief counsel (financial institutions and products), and Peter Merkel, branch 5 attorney-adviser, IRS Office of Associate Chief Counsel (International), were on hand at the Practising Law Institute taxation of financial products seminar in New York on January 16 to address important financial tax questions. Perwien did not address section 871(m), but Merkel responded to practical questions about withholding on derivatives.

Dividend Equivalent Withholding

Section 871(m) was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010. The statute requires withholding on dividend equivalents, a key definition. It does not require Delta One replication of risk. But Delta One may become highly relevant. Perwien's recent remarks have moved the focus of discussion from control of the contract to replication of total return risk. (Prior coverage.)

The key words of the dividend equivalent definition in section 871(m)(2)(B) are "determined by reference to" a dividend. The transition period part, section 871(m)(3)(A), dealt with affirmative acts of control by the customer. (The transition has been extended to 2014.)

But the rule that goes into effect after the transition, section 871(m)(3)(B), requires a Treasury determination that there is no tax avoidance potential to excuse a contract from withholding. The government appears to have changed its collective mind about the criteria for differentiating contracts since it issued proposed section 871(m) regulations (REG-120282-10).

Merkel told the audience that the final regulations will flesh out the words "in connection with" in section 871(m)(3)(A). He anticipated that guidance would be inspired by the industry issue directive on indirect transactions. Merkel expressed a desire to have objective rules, noting that the words "tax avoidance" in section 871(m)(3)(B) do not require bad intent.

Laurence Salva, a managing director of Citigroup Global Markets, peppered Merkel with detailed questions about problems faced by withholding agents, of which Citi is obviously one. The principal problem is that existing withholding systems focus on accounts, while section 871(m) focuses on products. "We're working on making it workable," said Merkel.

Well, gee, didn't the hedge funds and the banks agree to handle section 871(m) through a recent International Swaps and Derivatives Association protocol? The banks want this language in the contracts, but the hedge funds not only refuse to oblige, they also want to bilaterally renegotiate the terms of each swap. "It's frustrating when protocols don't launch successfully," said Salva, who wanted the government to resolve the dispute.

Merkel demurred. "We are concerned about the race to the bottom, but I don't know whether it is appropriate for the IRS to act as transaction counsel," he said. Salva asked for the IRS to say what representations withholding agents should ask for to be able to apply the "know or reason to know" standard.

What if a hedge fund with a long position had a short position with another dealer, or a fund related to the hedge fund had a short position with another dealer? How would the first dealer, a withholding agent, know what its client was up to? Merkel responded that the IRS understood that there would be abusive situations that a withholding agent couldn't see. "It's something we hope to address," he said.

Some equity derivatives, structured notes, and options are cleared, Salva explained. That means that the clearinghouse steps into the shoes of the original counterparty -- the one with relevant knowledge for withholding, which may in fact be a withholding agent. The last in line before the payment goes offshore is the withholding agent, roughly speaking.

If the derivative concerns a narrow index -- which is common for structured notes -- and one issue in the index declares a dividend, withholding could be required on only a portion of the interest payment, Salva noted. Merkel acknowledged the complexity but worried about the "substantially similar" language in section 871(m)(2)(C).

Salva made the radical suggestion -- often made by bank personnel in private -- that banks just be allowed to withhold 30 percent on every payment, leaving it to U.S. residents to file for refunds. This would move the compliance burden from banks to the IRS, he noted. There were no volunteers.

What about cascading withholding? Merkel responded that the IRS is thinking about it but is afraid to permit arrangements that resemble the ones condemned by Levin's subcommittee. It is difficult to differentiate legitimate back-to-back and chain arrangements from tax avoidance deals, he added.

Master Limited Partnerships

Swaps over interests in publicly traded partnerships (sometimes called master limited partnerships or MLPs) are a popular way of obtaining equity exposure to these vehicles, which can be engaged in mineral extraction and asset management. Section 871(m) does not cover derivatives on MLPs, even though they trade on equity exchanges.

Although MLP units look a lot like stock, section 871(m) by its terms applies only to swaps over stock or dividends, said Stuart E. Leblang of Akin Gump Strauss Hauer & Feld LLP. "MLPs are not subject to any tax at the entity level, so if a foreign person owns an MLP through a swap and it's respected, arguably there's no tax in the U.S. tax system at all," he said. (Prior coverage.)

Perwien concurred with this view. "You have neither stock nor dividends," he said, so section 871(m) would be difficult to assert.

Leblang pointed out that holding interests in MLPs in derivative form not only to avoid withholding tax on dividends but also to avoid the recognition of effectively connected income, unrelated business taxable income, and some state tax reporting requirements "is a big business of the investment banks." If the swap is over less than 5 percent of the MLP, the taxpayer would also be exempt from the Foreign Investment in Real Property Tax Act.

Leblang said that if the section 871(m) regulations are finalized as proposed, making it more difficult to use a swap over a stock to avoid withholding tax on dividend equivalents, swaps over MLPs would benefit. That's the case "even though maybe the quote abuse or the benefits from a tax perspective would be even more significant when you own it over an MLP," he said.

Nevertheless, Perwien cautioned that the common law constructive ownership doctrine would apply to MLPs, which tend to be thinly traded, so that the dealer would be required to hedge a swap with the physical. "The common law survives the enactment of section 871(m)," he said, adding that the common law standard "is easier for the Service to assert in the MLP context."

"If you deal in a security where the dealer is always hedged physically and the dealer had to be hedged physically because there was not enough of a derivative market, I think the Service always had a common law argument. . . . You have to be very careful and just be very sure of yourself on a common law basis that you have a real derivative," said Perwien.

Some judges will look at swaps over MLP interests in light of a report issued by Levin's subcommittee identifying what it considered to be an abusive dividend tax transaction. "For the reasons you stated, this arguably is more abusive than that," Perwien said.

When pressed by Jeffrey Maddrey of PricewaterhouseCoopers LLP about what constitutes a "real" derivative, Perwien agreed that problems arise when a hedge fund owned the physical and replaces that position with a swap. Often the MLP interest is sold to a bank that then writes a swap for the seller. Perwien said that "if you have a cross on one side, the Service has all of the agency arguments available to it on the other side."

Levin's subcommittee studied a securities lending transaction that was the subject of a generic legal advice memorandum (AM 2012-009) issued November 5. Leblang said the scope of the guidance is potentially too broad because it "implies that if you take a position that you held physically and then change it into a derivative form for tax purposes," the position could be deemed to have incurred no material change on economic substance grounds.

"Yes, to put it bluntly in this instance, if you want to get smarter you actually have to sell and be out of the market for a while," Perwien said, declining to specify how long "a while" is.

Maddrey said that although there is language in the guidance "that if applied in other situations could be a little bit broad," he reads it more narrowly as simply an effort to address only the specific securities lending transaction identified in the subcommittee report.

Of course, the same investors who use swaps to gain exposure to MLPs also like to short them when their investment view changes. A loan of an MLP interest to close a short sale is ineligible for section 1058, but Perwien averred that taxpayers might argue for open transaction treatment despite what the tax law considers an exchange.

Because these hedge funds claim foreign residence, ECI questions also arise. Rev. Rul. 91-32, 1991-1 C.B. 107, states that gain on the sale of an interest in a business producing ECI is also ECI. The Obama administration in its fiscal 2013 budget proposed to codify this controversial ruling. It proposed to treat gain or loss from the sale or exchange of a partnership interest as ECI to the extent it is attributable to the transferor's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property.

If the holding in Rev. Rul. 91-32 is correct, there is a question whether gain on a short sale of an MLP should be ECI. "I think there are people out there who are worried about it," Maddrey said. "Whatever logic Rev. Rul. 91-32 has, the partner is basically carrying on the activities of the partnership. When you're short selling, you're betting against the partnership. There's just no look-through concept that fits there."

Speaking on his own behalf, Perwien said, "It's very difficult to argue that when you get negative, that that negative is connected income to a U.S. trade or business." He added that he doesn't think the IRS National Office has discussed it.

Foreign Currency

Chip Harter of PwC, Viva Hammer of Brandeis University, and Doug Chestnut of Ernst & Young LLP discussed foreign currency hedging issues. In the cases discussed, financial accounting or transactional practicalities require that foreign exchange exposure be hedged, but the IRS may or may not recognize the hedge on audit. Even though the foreign currency area has pretty good hedge integration rules, they are not perfect.

Often a U.S. multinational wants to acquire the shares of a foreign corporation for cash. The foreign owners want to be paid in their own currency, so the U.S. acquirer puts on a currency hedge to offset its exposure between the acquisition agreement and closing. The hedged executory contract rule of reg. section 1.988-5(b) permits integration of the hedge into the cost of the acquired shares if it is identified and put on after the executory contract becomes binding.

But the hedge must be in the same entity that is making the acquisition, which is usually a special-purpose acquisition company. Banks prefer hedges to be at the parent level. Groups often put hedges in their group finance subsidiaries, then create mirror hedges between the latter and the acquisition companies. These arrangements are not eligible for identification as hedges under reg. section 1.988-5(b).

So planners often write a memo to the file and wing it. Or they tell the IRS and ask it to use its discretion under reg. section 1.988-5(b) to integrate the hedge. Some taxpayers choose not to integrate hedges in situations when financial accounting would not permit it.

So what's the problem? The IRS examiners appear to be in the habit of forcing integration of hedges that produce losses to prevent taxpayers from separately recognizing a loss. Harter reported that one taxpayer settled for 50 cents on the dollar rather than fight about an abuse of discretion. The IRS audit practice is "very asymmetrical," said Harter.

Brian Jenn, attorney-adviser in Treasury's Office of International Tax Counsel, empathized but noted that clear reflection of income often dictates integration of the hedge even if the taxpayer is ineligible for the hedge executory contract rule.

"There's some awkwardness or tension within this rule," he said. "Taxpayers should be aware that the IRS views the grant of discretion very broadly and should be prepared that the IRS will integrate." He recommended that taxpayers give the IRS a heads up before entering a hedge in these situations.

Another common situation is somewhat less sympathetic. The check-the-box rules permit multinationals to strip income out of high-tax countries where it is earned by having checked entities within those countries make actual interest and royalty payments to their controlled foreign corporation subparents. There is no subpart F income because U.S. law does not see the payments or the licenses or the notes.

But the checked entities are making payments in their own functional foreign currencies. If the CFC recipient uses the dollar, it has a foreign currency exposure that it must hedge as a practical matter. So the CFC asks the U.S. system to recognize a hedge of a payment that does not exist under that same system. You read that right. If the U.S. system does not recognize a hedge, the CFC would have subpart F income in the form of foreign exchange gain under section 954(c)(1)(D).

The business needs exception of reg. section 1.954-2(g)(2)(ii) would arguably recognize the hedge. But this rule requires that the hedge be a section 988 item, whereas it is reported on the group's return as a section 987 translation item, Harter explained. However, he does not expect the IRS to litigate this matter.

"There's some discomfort on our part that the CFC could hedge a disregarded note," said Jenn. Nonetheless, Treasury is sympathetic to the problem, and Jenn asked for comments on the business needs exception.