

Recent Developments

ABA Tax Section

Financial Transactions

May 10, 2013

Viva Hammer, Brandeis University

William Pomierski, McDermott Will & Emery LLP

Jo Lynn Ricks, Deloitte

Agenda

- ❑ **Obama Administration's fiscal 2014 revenue proposals relating to derivatives taxation**
- ❑ Inadvertent error exception to hedge identification rules
- ❑ Withholding tax considerations for cleared swaps under FIA/ISDA Cleared Derivatives Addendum
- ❑ Final basis reporting regulations

FY 2014 Revenue Proposals: Mark to Market Required for Derivatives

- The Administration's Fiscal Year 2014 Revenue Proposals released on April 10, 2013, include financial product reform rules similar to the proposal released on January 24, 2013, by House Ways & Means Committee Chairman David Camp (R-MI)
- The Administration's Proposal would, like the Camp proposal, seek uniformity for the tax treatment of derivatives by requiring all non-exempt derivative positions (as defined) to be marked to market
 - mark to market gains or losses would be uniformly treated as ordinary income or loss attributable to a trade or business of the taxpayer, allowing losses to be deducted against ordinary income

FY 2014 Revenue Proposals: Mark to Market Required for Derivatives

- The Administration's Proposal would define a derivative contract broadly to include (1) any contract the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property and (2) any contract with respect to a contract that is described in (1)
- A derivative contract that is embedded in another financial instrument or contract would also be subject to mark to market if the derivative by itself would be marked to market
 - "Consequently, the mark to market treatment would apply to contingent debt and structured notes linked to actively traded property."

FY 2014 Revenue Proposals: Mark to Market Required for Derivatives

- Businesses that enter into qualifying hedging transactions would be exempt from the mark to market rules
 - It is unclear whether the current definition of a qualifying business hedge in Code §1221(a)(7) would be altered
 - The Green Book references hedging of risk related to “creditworthiness” which is not currently included in Code §1221(a)(7)
- Under the Administration’s Proposal, taxpayers would be permitted to rely on hedge identifications made for financial accounting purposes, but only if the transaction otherwise qualifies as a tax hedge

FY 2014 Revenue Proposals: Impact on Straddle Positions

- The Administration's Proposal would require mark to market taxation for any non-derivative financial instrument (such as stock) that is part of a tax straddle with a non-exempt derivative
- Under this straddle rule, all positions in a straddle would be marked to market (presumably as ordinary income or loss)
 - pre-straddle built-in gains on non-derivative positions would be recognized at the time the straddle is entered into
 - pre-straddle built-in losses, however, would be deferred until the non-derivative position is disposed of in an otherwise taxable transaction

Agenda

- ❑ Obama Administration's fiscal 2014 revenue proposals relating to derivatives taxation
- ❑ **Inadvertent error exception to hedge identification rules**
- ❑ Withholding tax considerations for cleared swaps under FIA/ISDA Cleared Derivatives Addendum
- ❑ Final basis reporting regulations

Code §1221(a)(7) Hedging Transactions

- Extends ordinary gain/loss treatment to qualifying business hedging transactions
 - eliminates potential tax character mismatches
 - provides ordinary gains/losses for section 1256 contracts, interest rate swap early terminations, etc.
- Treas. Reg. § 1.446-4 generally applies to match the timing of the hedge and hedged item. See Rev. Rul. 2003-127.

Code §1221(a)(7) Hedging Transactions

□ § 1221 Capital Asset Defined.

(a) In general. For purposes of this subtitle, the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(7) any hedging transaction **which is clearly identified as such before the close of the day on which** it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe)

Code §1221(a)(7) Hedging Transactions

- Code §1221(b)(2) authorizes the Secretary to prescribe regulations to properly characterize any income, gain, expense, or loss arising from a transaction:
 - which is a hedging transaction but which was not identified as such in accordance with Code §1221(a)(7), or
 - which was so identified but is not a qualifying hedging transaction

Hedge Identification Requirements: Treas. Reg. §1.1221-2(f)

- Two independent identification rules:
 - same-day identification for the “hedging transaction”
 - substantially contemporaneous identification for the “hedged item(s)” (35 days)
- Identification must be clear and unambiguous
- Accounting and regulatory identifications are not determinative
- Bona fide hedge exception in Treas. Reg. §1.954-2 cross-references to Treas. Reg. §1.1221-2(f) hedge identification provisions

Hedge Identification Requirements: Treas. Reg. §1.1221-2(g)

- Failure to identify “qualifying” transactions
 - general rule: character of gains and losses will be based on general rules for the product
 - Exception #1: taxpayer may treat gains and losses as ordinary if:
 - transaction meets definition of a hedging transaction;
 - failure to identify was due to “inadvertent error”; and
 - all of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as hedging transactions

Hedge Identification Requirements: Treas. Reg. §1.1221-2(g)

- Failure to identify “qualifying” transactions
 - Exception #2: under an anti-abuse rule, the IRS may treat gains as ordinary
 - “no reasonable grounds” for treating transaction as other than hedging transaction
 - considers treatment for financial accounting purposes
 - does not extend to losses; character of losses is based on general rules for the product

Hedge Identification Requirements: Treas. Reg. §1.1221-2(g)

- Identification of non-qualifying transactions as tax hedges
 - ordinary gains by reason of the hedge identification
 - character of losses is based on general rules for the product
 - Exception from hedge character rules for gains if:
 - Transaction not a hedge;
 - identification due to “inadvertent error”; and
 - all of the taxpayer's hedging transactions in all open years are being treated in manner consistent with hedge rules.

Inadvertent Error Exception

- Inadvertent error is not defined in the Regulations

- PLR 200051035
 - Scope of inadvertent error exception is a “novel” issue

 - “In the absence of a specific definition in the regulations, the term ‘inadvertent error’ should be given its ordinary meaning. . . .”

 - “The ordinary meaning of the term ‘inadvertence’ is an accidental oversight; a result of carelessness.”

Inadvertent Error Exception

□ CCA 200851082

- Taxpayer should bear the burden of proving inadvertence, and its satisfaction should be judged on all surrounding facts and objective indicia of whether the claimed oversight was truly accidental.
- The size of the transaction, the treatment of the transaction as a hedge for financial accounting purposes, the sophistication of the taxpayer, its advisors, and counterparties, among other things, are all probative.

Inadvertent Error Exception

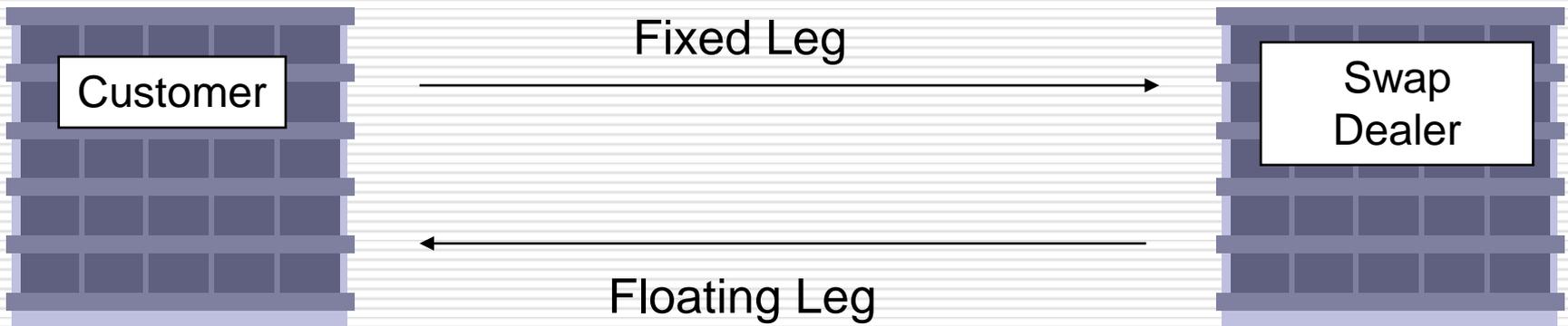
□ CCA 201046015

- “In our view, the inadvertent error rule is not intended to eviscerate the section 1221(a)(7) identification requirement”
- “Absent a change in the regulation, we see no compelling policy justification for reading the inadvertent error rule as an open-ended invitation for taxpayers to brush aside establishing hedge identification procedures, knowing that inattention to the rules or even unsound judgment (as seems to be the case here) can be fixed on an as needed basis.”
- “A system that operated as loosely as Taxpayer perhaps envisions would substantially undermine the section 1.1221-2(f)(2) requirement that taxpayers timely identify items hedged and the section 1.446-4 recordkeeping requirements.”

Agenda

- ❑ Obama Administration's fiscal 2014 revenue proposals relating to derivatives taxation
- ❑ Inadvertent error exception to hedge identification rules
- ❑ **Withholding tax considerations for cleared swaps under FIA/ISDA Cleared Derivatives Addendum**
- ❑ Final basis reporting regulations

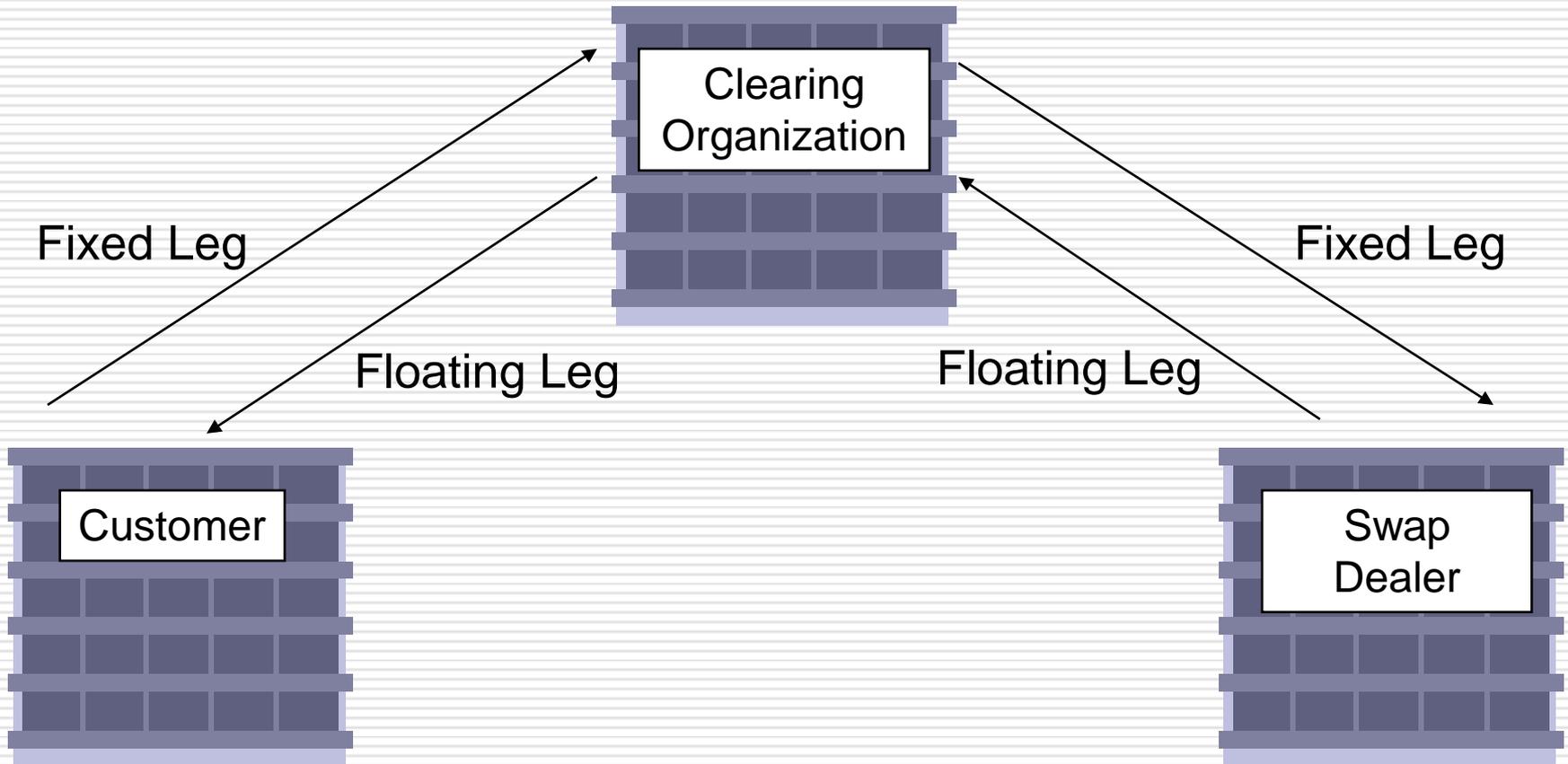
Bilateral Interest Rate Swap



ISDA Withholding Tax Considerations for Bi-lateral Transactions

- Basic Premise: All payments are made without any deduction or withholding of any Tax
 - Payee is made whole
 - Payer is responsible for Identifiable Taxes
- Identifiable Taxes – Section 14
 - Any tax other than:
 - a tax imposed due to payee's connection with the taxing jurisdiction (unrelated to Master Agreement)
 - stamp, registration, documentation or similar taxes
- In general payer grosses up payee, unless:
 - Non-indemnifiable taxes
 - Payee tax representation incorrect (unless due to changes in tax laws)
 - Payee failed to deliver correct forms (unless delivery would materially prejudice payee)

Cleared Interest Rate Swap



FIA/ISDA Cleared Derivatives Addendum Withholding Tax Provisions

- Basic Premise:
 - In the case of payments made by Customer to the Clearing Member (Section 8(a)(iii)), Customer is responsible (gross-up) for Taxes imposed:
 - on payments from Customer to Clearing Member, subject to exceptions for taxes that would not have been imposed but for
 - a present or former connection between the taxing jurisdiction and the Clearing Member
 - a Clearing Member Merger
 - failure of the Clearing Member to comply with its obligations under Sections 8(e)(i) and 2(a)(v) of the Addendum, or
 - Clearing Member FATCA noncompliance

FIA/ISDA Cleared Derivatives Addendum Withholding Tax Provisions

- Basic Premise:
 - In the case of payments made by Customer to the Clearing Member (Section 8(a)(iii)):
 - Customer is responsible (gross-up) for Taxes imposed on payments from Clearing Member to Clearing Organization, subject to exceptions for taxes that would not have been imposed but for
 - a Clearing Member Merger, or
 - failure of the Clearing Member to comply with its obligations under Section 8(e)(ii)(B) of the Addendum
 - In the event a payment made by Clearing Organization to the Clearing Member (Section 8(a)(iv)) is subject to a deduction or withholding of any tax:
 - Customer gets the after-tax amount received by Clearing Member net of any tax imposed on the payment from the Clearing Member to the Customer (i.e., no gross-up)
 - Subject to exceptions for taxes that would not have been imposed but for:
 - a Clearing Member merger
 - Clearing Member FATCA noncompliance, or
 - failure of the Clearing Member to comply with its obligations under Section 8(e)(ii)(A) of the Addendum

FIA/ISDA Cleared Derivatives Addendum Withholding Tax Provisions

- Identifiable Taxes – Section 8(a)(v)
 - Any tax for which a party is obligated to pay additional amounts under Section 8(a)(iii) or (iv)
- Tax Indemnity for non-Indemnifiable Taxes (Section 8(b))
- FATCA taxes are excluded from definition of “Tax”
- Tax documentation requirements
- “Other Taxes” (stamp, registration, documentation or similar taxes) are the responsibility of the Customer

Agenda

- ❑ Obama Administration's fiscal 2014 revenue proposals relating to derivatives taxation
- ❑ Inadvertent error exception to hedge identification rules
- ❑ Withholding tax considerations for cleared swaps under FIA/ISDA Cleared Derivatives Addendum
- ❑ **Final basis reporting regulations**

Highlights of Final and Temp. Basis Reporting Regulations

- April 17, 2013: Final regulations issued on broker reporting of basis for debt instruments and options
- Temporary regulations issued generally requiring broker reporting of bond premium and acquisition discount

Background: Effective dates

- ❑ Proposed regs, issued in 2011, were effective for covered debt instruments and options acquired on or after Jan. 1, 2013
- ❑ Notice 2012-34, delayed effective dates to Jan. 1, 2014
- ❑ Final regs implement basis reporting for debt instruments in phases

Final Regs.: Debt Reporting: Effective dates

- Final regs kept 1/1/2014 effective date for reporting debt with less complex features
 - E.g., most fixed-rate debt, including debt with embedded puts and calls, certain demand loans
- Final regs defer effective date to 1/1/2016 for more complex debt instruments
 - E.g., stepped-rate instruments, convertible debt, CPDIs, VRDIs, PIK debt, foreign issuer/FX debt, stripped bonds or coupons, debt issued as part of an investment unit

Final Regs.: Transfer Statement Reporting: Effective Dates

- ❑ Effective dates extended for transfer reporting requirements
- ❑ For less complex debt instruments, options, and securities futures contracts, transfer reporting begins on or after 1/1/2015
- ❑ For more complex debt instruments, transfer reporting is effective 1/1/2017

Final Regs.: Debt: Exemptions from Basis Reporting

- ❑ Proposed regs required basis reporting for all debt instruments, except for debt subject to section 1272(a)(6)
- ❑ Final regs kept exemption from basis reporting for 1272(a)(6) debt
- ❑ Final regs added new exemption from basis reporting for short-term debt, i.e., debt with a fixed maturity date not more than 1 year from issue

Final Regs.: Debt: Transfer Statement Reporting

- Final regs further expand the information brokers must provide on a transfer statement when transferring covered debt
- Proposed regs included:
 - Description of the payment terms; issue price and issue date; customer's initial basis; yield to maturity; adjusted issue price, amortized bond premium or accrued market discount as of transfer date
- Final regs expand list to include whether customer elections were applied to compute basis
- Transferring broker can supply the CUSIP number as a substitute for some required information

Final Regs: Debt Reporting: Customer Elections

- ❑ Final regs require brokers to reflect certain customer elections when computing cost basis of debt
- ❑ This is a reversal from the proposed regs, that did not allow brokers to support customer elections
- ❑ Proposed regs required brokers to use default assumptions in statute and regs for computing OID, market discount, bond premium, and acquisition premium

Final Regs.: Debt Reporting: Customer Elections

- Customer elections permitted
 - Election to not amortize bond premium
 - Election to include market discount in income currently
 - Election to accrue market discount using a constant yield
 - Election to treat all interest on a taxable debt as OID
 - Election to translate interest at spot rate on FX debt

Final Regs.: Debt Reporting: Customer Elections

- ❑ Customer must notify the broker in writing to have basis reflect the election or to revoke the election
- ❑ If no notifications received, broker assumes that the customer has elected to amortize bond premium when reporting basis, and that no other elections are made
- ❑ Customer can generally apply own elections when reporting basis
- ❑ A notification to a broker of an election is not treated as an affirmative election for tax purposes

Temp. Regs.: Premium Amortization

- ❑ Temp. regs conform rules for reporting interest (OID) on a premium bond to rules for basis reporting for these instruments
- ❑ Generally requires brokers to report interest (OID) income to reflect bond premium or acquisition premium for covered debt
- ❑ Previously, brokers reported interest income without these adjustments
- ❑ Broker will assume that the customer has made an election to amortize bond premium unless notified otherwise
- ❑ Effective for debt acquired on or after 1/1/2014

Final Regs.: Debt: Form 8281 Filing

- ❑ Final regs expand the scope of debt instruments for which issuers must file a Form 8281 -- to those sold in a private placement but registered with the SEC after the issue date.
- ❑ Previously, only debt instruments issued with OID and registered with the SEC at issuance had this requirement.
- ❑ Form needs to be filed within 30 days of date the offering is registered with the SEC.

Final Regs: Option Reporting

- Final regs generally apply basis reporting to:
 - An option on one or more specified securities, including index options on specified securities
 - An option on financial attributes of specified securities, e.g., interest rates or dividend yield
 - Warrants or stock rights on specified securities
- Final regs exclude compensatory options

Final Regs.: Option Reporting

- ❑ Retained reporting for OTC options and nonequity options subject to section 1256
- ❑ For options subject to section 1256, brokers apply the reporting rules for regulated futures contracts.
- ❑ For OTC options, broker reports gross proceeds and basis following the final regs.
- ❑ Because of difficulty determining section 1256 status, final regs grant relief if broker made a wrong determination in good faith

Final Regs: Stock acquired through a Compensatory Option

- ❑ Final regs prohibit brokers from increasing a customer's initial basis in stock for income recognized upon exercise of a compensatory option granted or acquired on or after 1/1/2014.
- ❑ This rule reverses the position in the proposed regs, which permitted the increase.
- ❑ Basis of stock will only reflect strike price paid for stock
- ❑ Employee may need to make additional basis adjustment to reflect full amount paid by employee

Final Regs: Stock Rights and Warrants

- Final regs permit, but do not require, brokers to apply the basis allocation rules in section 305 and 307 when reporting the basis of a stock right, warrant, or related stock
 - These rules may require basis to be allocated from previously owned stock to the stock rights or warrants.
- This rule departs from the rule in the proposed regs, which required the application of sections 305 and 307

Concluding Remarks

Contact Information

Viva Hammer

vhammer@brandeis.edu

202-412-9798

William R. Pomierski

wpomierski@mwe.com

312-984-7531

Jo Lynn Ricks

jricks@deloitte.com

202-220-2032

Disclaimer

IRS Circular 230 Disclosure: To comply with requirements imposed by the IRS, any U.S. Federal tax advice contained herein (including any attachments), unless specifically stated otherwise, is not intended or written to be used, and cannot be used, for the purposes of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter herein.