taxanalysts®
The experts' experts.™
Tax Notes Today

DECEMBER 8, 2014

# Tax Reform a Chance to Rethink Swap Withholding, JCT Counsel Says

**William R. Davis and Amy S. Elliott**

Summary by taxanalysts

Tax reform is an opportunity for Congress to rethink withholding policy on swaps, rather than reacting to tax shelters, as lawmakers did with section871(m), Joint Committee on Taxation Legislative Counsel Viva Hammer said December 5.

Full Text Published by taxanalysts®

Tax reform is an opportunity for Congress to rethink withholding policy on swaps, rather than reacting to tax shelters, as lawmakers did with section 871(m), Joint Committee on Taxation Legislative Counsel Viva Hammer said December 5.

"Maybe we need to think about why we withhold on certain flows of income," Hammer said.

Under current rules, swap payments are sourced to the recipient, and there's never any withholding on swaps, Hammer said at a Practising Law Institute conference on corporate tax strategies in Los Angeles. "Even when the swap mimics a flow that would attract withholding -- like dividends -- there is no withholding on the swap outflow," she said. Hammer noted that the tax reform discussion draft of House Ways and Means Committee Chair Dave Camp, R-Mich., says nothing about the treatment of derivatives that cross borders. (Prior coverage.)

"Perhaps we should be thinking about swaps entirely differently, as a transaction like other types of financial transactions, but without any investment component," Hammer said. "Should the U.S. be treating swaps favorably like investments in equity or debt? Or should they be treated like other kinds of business activity, taxed on a net basis with the ability to rely on treaty relief?"

## Mark-to-Market

Practitioners at the same conference said that if Congress mandates the marking of derivatives to market, the law should affect only instruments based on actively traded property. It's easier to determine whether property is actively traded than it is to assess the value of untraded property or to structure the law to carve out specific types of contracts, they said.

Camp's tax reform draft, released February 26, included a proposal to mark most derivatives to market, whether the underlying property is actively traded or not. (Prior coverage.)

Then in March, President Obama included a similar proposal in his fiscal 2015 budget plan, except his applied only to derivatives for which the underlying property is actively traded.

Hammer said that because active trading is defined so broadly and because most derivatives are based on interest rates or major currencies, the practical difference between the proposals is small.

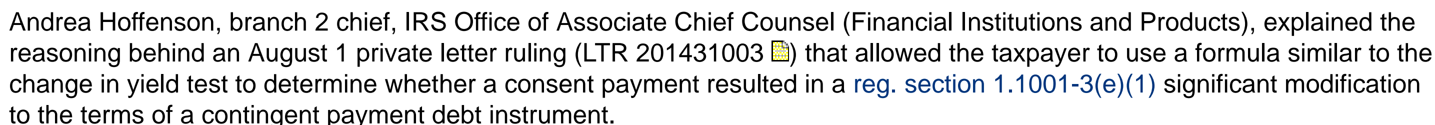
But Erika W. Nijenhuis of Cleary Gottlieb Steen & Hamilton LLP took issue with Hammer's comment, saying the difference between derivatives with traded and untraded underlying positions may not always be so small. She offered an example in which a taxpayer enters into a contract that extends into the next calendar year to buy some stock of a closely held subsidiary. Under Camp's draft, the contract could be marked to market, while under Obama's proposal, it wouldn't be subject to the mark-to-market rules because the underlying property isn't actively traded.

Hammer acknowledged that Nijenhuis presented "a fairly clear case for exception," but she said policymakers believe that if Congress starts excepting some non-actively traded property, there would be potential for abuse.

Nijenhuis countered that any mark-to-market regime would present new complications and that officials need to choose whether they want to answer the question whether an asset is actively traded, or face the enormous task of calculating the value of untraded property or carving out transactions "that nobody thinks of as derivatives."

Matthew Stevens of EY agreed with Nijenhuis, saying any test should focus on distinguishing between actively traded and non-traded property. "I think we have a lot of experience in the tax system with making that distinction over the last 30 or 40 years," he said.

### Contingent Payment Debt Instruments

Andrea Hoffenson, branch 2 chief, IRS Office of Associate Chief Counsel (Financial Institutions and Products), explained the reasoning behind an August 1 private letter ruling (LTR 201431003 ) that allowed the taxpayer to use a formula similar to the change in yield test to determine whether a consent payment resulted in a reg. section 1.1001-3(e)(1) significant modification to the terms of a contingent payment debt instrument.

Because the bright-line change in yield test doesn't apply to contingent payment debt instruments, "we had to look at the general facts and circumstances," Hoffenson said.

Hoffenson added that the Service has a general policy of not ruling on whether something is significantly modified using a section 1001 facts and circumstances analysis. "But in this case, we felt like we should give [taxpayers] a little guidance," she said.

Stevens and Nijenhuis praised the ruling, and Nijenhuis asked whether the Service might publish similar, more broadly applicable guidance in a revenue ruling. Hoffenson replied that the case involved specific facts and circumstances that might not be suitable for a revenue ruling, but she added that Service officials would look into the matter.

### REIT Income Guidance

Hoffenson said policymakers are leaning toward issuing regulations clarifying the definition of good real estate investment trust income in section 856(c)(3). The IRS and Treasury added a project to develop guidance on the issue to their 2014-2015 priority guidance plan .

"We think it's good tax policy to give a comprehensive update," Hoffenson said. She added that the regulations now in effect are so old that they predate the use of taxable REIT subsidiaries.

---

## Tax Analysts Information

**Jurisdiction:** United States
**Subject Area:** Financial products and banking
**Author:** William R. Davis; Amy S. Elliott
**Institutional Author:** Tax Analysts
**Tax Analysts Document Number:** Doc 2014-28821
**Tax Analysts Electronic Citation:** 2014 TNT 235-4

---

© Tax Analysts (2014)