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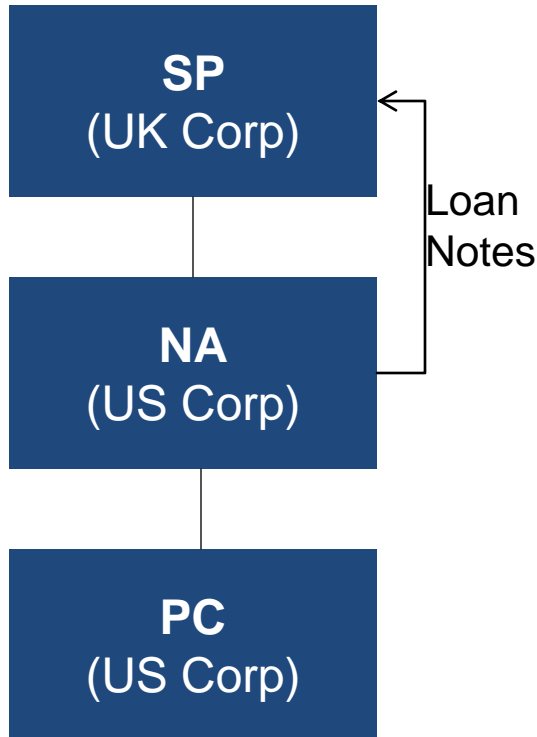
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Recent Debt vs. Equity Cases

Cases Discussed

- **NA General Partnership & Subsidiaries v. Comm’r, T.C. Memo 2012-172 (2012) (“ScottishPower”)**
 - Tax Court holds for taxpayer that instrument is debt.
 - **PepsiCo Puerto Rico v. Comm’r, T.C. Memo 2012-269 (2012)**
 - Tax Court holds for taxpayer that instrument is equity.
 - **Hewlett-Packard Inc. v. Comm’r, T.C. Memo 2012-135 (2012)**
 - Tax Court holds for IRS that instrument is debt.
 - **Historic Boardwalk Hall, LLC v. United States, No. 11-1832 (3d Cir. 2012)**
 - Third Circuit holds for IRS that instrument is effectively debt.
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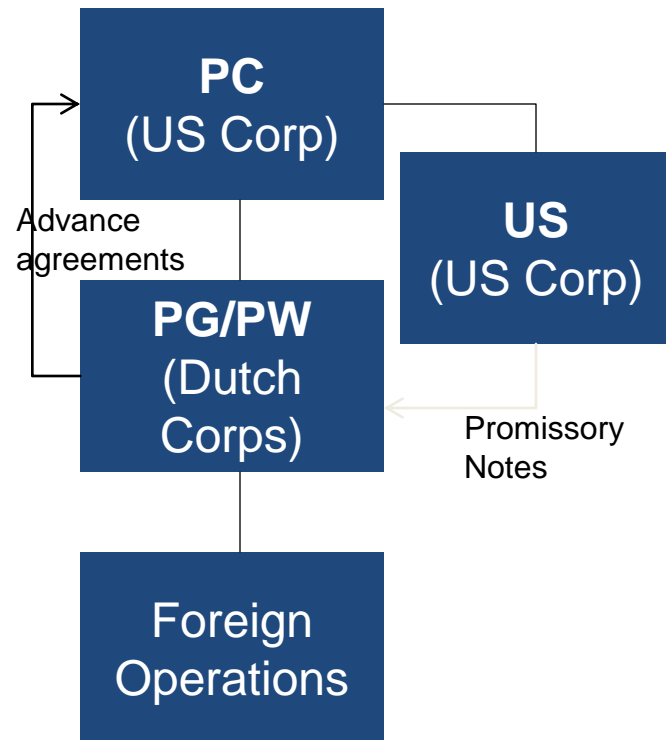
- **Facts (simplified)**

- SP effected a merger with PC through SP's US sub, NA. To compensate SP for issuing shares and ADSs to former PC shareholders, NA issued Loan Notes to SP.
- Notes provided for quarterly interest payments, were unsecured and unsubordinated and transferable. SP could accelerate payment upon default, and NA could redeem at the market rate.
- Interest expected to be paid out of PC dividends, which would derive partly from post-merger sale of PC's Australian business.
- Taxpayer argues debt/IRS argues equity

- **Holding: Loan notes are debt for U.S. tax purposes.**
 - **Court found typical debt characteristics:**
 - Expectation of repayment out of earnings;
 - Not subordinated to other creditors;
 - SP's right to enforce payment;
 - Parties' **intent** was to form debtor-creditor relationship, despite
 - NA's failure to make certain interest payments;
 - SP's funding of missed interest payments through short term loans;
 - NA and SP capitalizing some of the notes.
 - Tax motivation behind using debt was not a problem.
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ScottishPower(Cont'd)

- **NA (consolidated with PC) was adequately capitalized.**
 - IRS argued that NA would likely have been rated below investment grade (i.e., was thinly capitalized). Taxpayer and IRS experts opined BB+ and B rating, respectively.
 - Court held that even if B rating, NA could meet financial commitments under S&P rating system.
 - **Ability to Obtain Loans from Outside Lender.**
 - IRS argues: TP could not have obtained the same loan on the exact same terms.
 - Court holds: “The requirement of precise matching misses the mark.” “The lender in the related-party context may understandably offer more flexible terms than could be obtained elsewhere. ... We look to whether the terms of the purported debt were a patent distortion of what would normally have been available to the debtor in an arm’s length transaction.”
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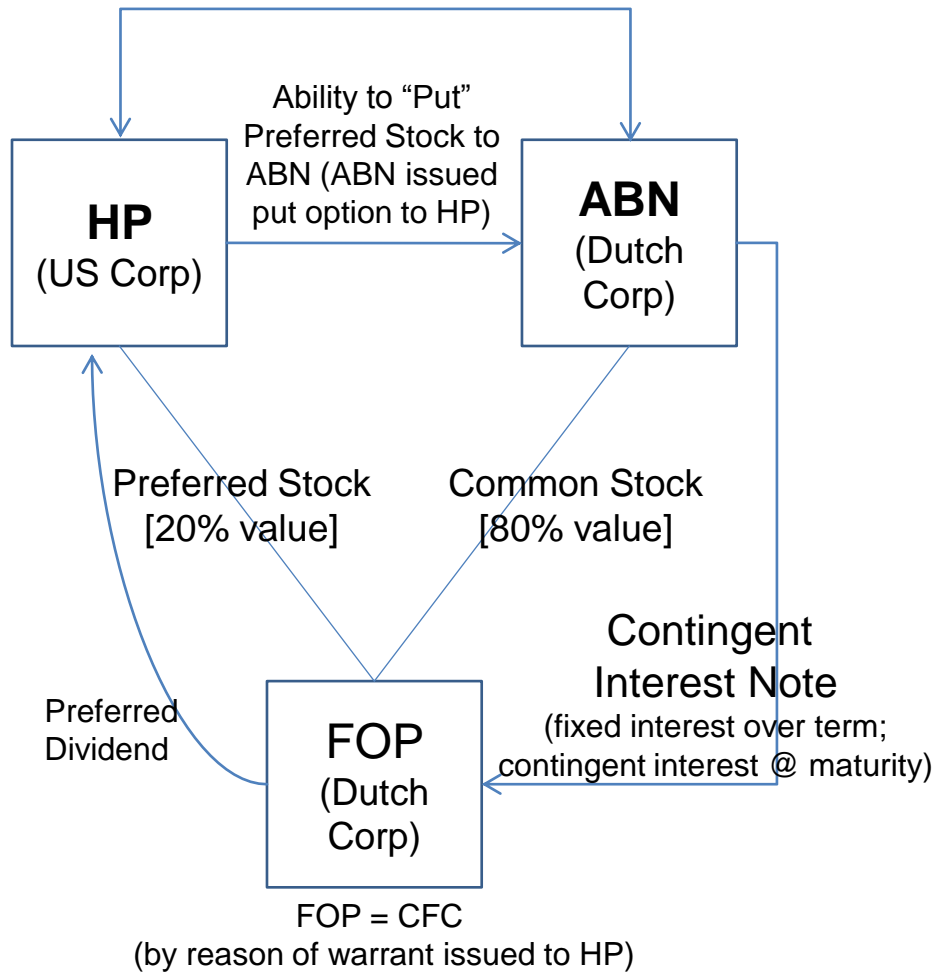


- **Facts (simplified)**

- PC's sub US transferred promissory notes to PG/PW in exchange for advance agreements to PC.
 - Intended treatment of advances was debt for Dutch purposes; equity for U.S. purposes.
- Term of 40 years. PG/PW could unilaterally renew for up to 15 years. Become perpetual if promissory notes default.
- Preferred return payable out of net cash flow of PG/PW.
- Obligation subordinated to all other debt of PG/PW.
- Dutch tax authority issued ruling that advances are debt, based in part on assumption that payments on promissory notes would "flow through" to fund preferred return of advances.
- Payments on advances not required/mandatory. PC's expectation of flow through from notes.

Holding: Advance agreements are equity for U.S. tax purposes.

- Court noted speculative nature of investment:
 - 40 year term, extendable for 15 years, and perpetual if promissory notes default;
 - Lack of traditional creditor remedies upon default;
 - Lack of sinking fund;
 - Thin capitalization of PG/PW.
 - Payments discretionary– PG/PW had no legal obligation to make payments.
 - Dutch ruling based on understanding that payments would “flow through”, but PG/PW free to deviate from the ruling.
 - Internal commitment to fund advance payments with interest from promissory notes is characteristic of debt.
 - But, PG/PW not bound to make such payments.
 - Could not have obtained such a loan from an outside third party.
 - Payments used to fund global expansion, not merely to reduce tax liability.
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FTC "generator" :

Assume: (i) Pref Shares issued for \$20; (ii) Common issued for 80; (iii) Loan of \$100 to ABN for contingent interest note (4% fixed per annum + contingent interest).

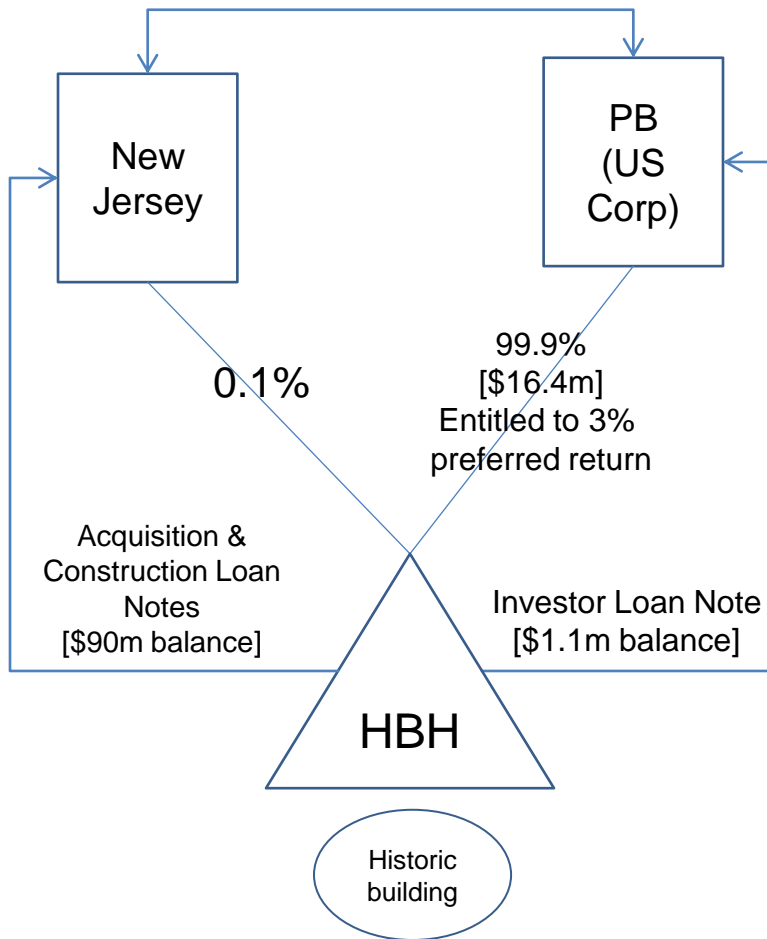
- ABN accrues \$10 interest deduction in Netherlands (which allows accrual for contingent interest). (CPDI rules did not apply.)
- FOP includes \$10 interest in income in Netherlands (but only receives \$4 of cash).
- FOP pays Dutch tax of \$3.00 (i.e., 30% * \$10).
- FOP has only \$1.00 of cash on hand (and \$1.00 of E&P).
- FOP distributes \$1.00 to HP as preferred dividend, carrying \$3.00 of tax credit.

Holding: Preferred shares are debt for tax purposes, so credits denied.

- Combination of HP's put right against ABN created a fixed term, the unconditional right to a dividend and rights to enforce payments that were thought to be akin to creditor rights.
 - HP's preferred stock had a fixed maturity date because, after seven years, HP would want to exit the investment based on expected negative E&P (eliminating further credits). Also, ABN indicated in obtaining a Dutch tax ruling that it would own the shares after seven years.
 - HP argued that the put was separate from the shares, but the court found that FOP was effectively a party because of the facilitation obligation.
 - The put agreement was "signed as a package at the FOP closing and is referenced in the shareholders agreement" (of which FOP was a party). As a party to the shareholders agreement, FOP "in effect ratified and became subject to the provisions of the agreement." The transaction was "meticulously structured" so that FOP could not "undermine the put agreement" – FOP was "inextricably connected" to the exercise of the put.
 - The put price was essentially fixed because of the rate reset. The put/redemption right, restrictions on what SPV could do and the change of control rights were thought to give HP "creditor rights."
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Historic Boardwalk

Series of Options (Consent Option, Put Option & Call Option)
Allowing NJ to buy back equity in HBH, so long as PB is made whole for its expected tax benefits and preferred return



• Simplified Facts and Holding:

- With respect to its equity, PB to receive: (i) 3% preferred return, (ii) 99.9% of *historic rehabilitation tax credits*, and (iii) 99.9% of net cash flows and proceeds from the sales of buildings, neither of which were expected to actually materialize.
- Question is whether PB is a bona fide partner and thus entitled to the tax credits. IRS says “no,” because interest looks too much like a financing.
- Third Circuit agrees with IRS – PB has no upside/downside in respect of HBH’s operations.

**Final Regulations –
Section 1.1273-2(f)
Publicly Traded
Property**

Publicly Traded Property

- Final regulations addressing when property is traded on an established market (publicly traded) to determine the issue price of a debt instrument, published Sept 12, 2012
 - Final Regs largely adopt 2011 Proposed Regs except:
 - No exchange-listed property
 - No de minimis trading exception
 - \$100,000 versus \$50,000 for small issuer exception
 - Issuer / Holder consistency
 - Additional anti-abuse rule
 - Final Regs apply to instruments issued on/after Nov 13, 2012.
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Publicly Traded Property

- Property is publicly traded if it falls into one of three categories anytime during the 31-day period ending 15 days after the issue date of the debt instrument (window period)
 - Property for Which There is an Executed Sales Price
 - Property for Which There is a Firm Price Quote
 - Property for Which There is a Indicative Price Quote
 - No category of exchange listed property included in Proposed Regs
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Publicly Traded Property

- **Property for Which There is an Executed Sales Price**
 - Property is traded on an established market if the price for an executed purchase or sale of property during the window period is reasonably available within a reasonable period of time after the sale
 - A price is reasonably available if the sales price (or information sufficient to calculate the sales price) appears in a medium that is made available to issuers of debt instruments, brokers in debt instruments, or persons that regularly purchase or sell debt instruments (including a price provided only to certain customers or to subscribers)
 - Taxpayers are only required to search for executed sales for a reasonable period of time after the issue date (including a significant modification), but that time need not be within the window period
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Publicly Traded Property

- **Property for Which There is a Firm Price Quote**

- Property is traded on an established market if a firm price quote to buy or sell the property is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or subscribers), and the quoted price is substantially the same as the price for which the property could be purchased or sold
 - A price quote is considered to be available whether the quote is initiated by a person providing the quote or provided at the request of the person receiving the quote.
 - Firm Quote
 - For a price quote to be considered “firm” for this purpose, the identity of the person providing the quote must be reasonably ascertainable
 - A quote is considered a firm quote if market participants typically purchase or sell at the quoted price even if the person providing the quote is not legally obligated to purchase or sell at that price
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Publicly Traded Property

- **Property for Which There is a Indicative Price Quote**
 - Property is traded on an established market if a “soft” or “indicative” price quote (a quote other than a firm quote) is available from at least one dealer, broker, or pricing service (including a price only available to certain subscribers or customers)
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Publicly Traded Property

- **Anti-Abuse Provisions**

- If there is a temporary restriction on trading a purpose of which is to avoid property from being publicly traded, then the property will be treated as publicly traded
- A sale or price quote will be disregarded if a principal purpose for the existence of the sale or price quote is to cause property to be publicly traded, or to materially misrepresent the value of the property for federal income tax purposes

- **Small Issuance Exception**

- A debt instrument is not publicly traded if the outstanding stated principal amount of the issue that includes the debt instrument does not exceed \$100 million
 - As defined in the Proposed Regulations, the small issuance exception would have applied to debt instruments with an original stated principal amount of \$50 million
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Publicly Traded Property

- **Establishing Fair Market Value**

- Presumed to be the trading price, sales price, or quoted price that establishes that it is publicly traded
 - If there is more than one price or quote available, a taxpayer is allowed to reconcile competing prices or quotes using any reasonable method, consistently applied, to the same or substantially similar facts.
 - The final regulations provide a non-exclusive list of factors a taxpayer may consider to establish FMV
 - the timing of the sale or quote relative to the issue date
 - whether the price is derived from a sale, firm quote, or indicative quote
 - the size of each relevant sale or quote
 - whether the price or quote corresponds to pricing information provided by an independent bond or loan pricing service
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Publicly Traded Property

- **Issuer / Holder Consistency and Reporting**

- The issuer of a debt instrument must determine whether property is traded on an established market and, if so, the FMV of the property.
 - If the issuer concludes that property is traded on an established market, the issuer must make this determination, along with its FMV determination, available to holders in a commercially reasonable manner (including by electronic publication) within 90 days of the debt instrument's issue date.
 - If the issuer fails to make the information reasonably available to the holder, then the holder must make its own determination regarding issue price and FMV.
 - If an issuer discloses its determination, then its determinations are binding on a holder unless the holder explicitly discloses that its determination is different than the issuers.
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Publicly Traded Property

- **Syndicated Loans – Effect on Borrowers**
 - Distressed borrowers restructuring their debt have a greater chance of recognizing COD income
 - Impact of any COD income may be mitigated by OID on “new” loan, but a timing mismatch
 - Borrower may face a permanent tax if the “new” loan is AHYDO or other limitations apply
 - Borrowers must use “reasonable diligence” to obtain pricing and trading information
 - This requirement could affect restructuring negotiations, since banks have this information, but may not want to share it with the borrower
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Publicly Traded Property

- **Middle Market Loans**

- \$100 million “small issuance exception” generally the avoids the COD income/deferred OID problem.
- For some investors, this may give rise to phantom gain.
 - “Self-help” is disallowed by changes to recent sales transaction rules.
 - Loss offsets the gain when the loan is sold, but:
 - Timing mismatch, if sale is in a later year;
 - Character mismatch, if some or all gain is ordinary income (market discount) while the loss is capital.
 - Investors that purchase securitized debt to work it out may be adversely affected if the debt comes under the “small issuance exception.”
 - The modification of the debt may be a deemed retirement/reissuance, with gain or loss determined by the difference between the investor’s basis in the debt and the par amount of the debt, regardless of its fair market value.

- **Corporate Bonds**

- Unlikely to change – nearly all bonds already qualified as “publicly traded”.
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