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How Should a Corporation Strategically Review Its Capital Markets and Financial Activities in the United States?

This article explores ways to avoid audit risk in connection with a company's financial activities, and will describe effective methods for dealing with the Internal Revenue Service when it begins examining financial transactions. As conflicts with the IRS can sometimes be prevented or curtailed through effective communications with the other institutions involved in the tax universe, the article also considers the workings of the IRS, the relationship between the IRS Chief Counsel, the Office of Tax Policy at the Department of the Treasury and various Congressional bodies creating the tax law.

1. Introduction

Much has been written about the theoretical interpretation of the complex laws governing the taxation in the United States of financial activity. Little has been written about the practical aspects of a taxpayer managing its tax risk in the finance arena – knowing which are the “danger” issues, advocating before governmental bodies to change the laws, and dealing with an audit as it looms before a taxpayer. Tax is a culture, and to practice effectively, the tax practitioner must understand the major institutions creating, interpreting and enforcing the laws. This article explores some of the cultural perspectives of financial product law.

This article pays attention to ways to avoid audit risk in connection with a company's financial activities, and will describe effective methods for dealing with the Internal Revenue Service (IRS) when it begins examining financial transactions. Sometimes conflicts with the IRS can be prevented or curtailed through effective communications with the other institutions involved in the tax universe. With this in mind, this article will shed light on the workings of the IRS, the relationship between the IRS Chief Counsel, the Office of Tax Policy at the Department of the Treasury and various Congressional bodies creating the tax law. Throughout, the discussion will be kept as current as possible, recognizing that financial activity of even non-financial firms has been targeted by the IRS as one of the areas of highest scrutiny.

2. Why Should the Tax Department of a Company Be Concerned about Financial Transactions?

2.1. Changes at the IRS

Mr Donald Korb, IRS Chief Counsel, has stated publicly that he has made financial transactions a priority for the

IRS and says that he “wants to get on top” of financial products much faster. He frequently reminds audiences of the many successes he has had in litigating tax cases involving financial transactions (such as *Chicago Tribune*, *Castle Harbour* and *Coltec*), and has indicated that he will use the tool of litigation more extensively in the future. Mr Korb has also established a new branch within the Financial Institutions and Products section of Chief Counsel that is directed to focus only on new financial products. This group is expected to be available for discussions with taxpayers with regard to transactions they are contemplating or having issue with and is authorized to issue timely guidance in various forms.

Consistent with this, the IRS has established a new form of guidance, namely the generic legal advice memorandum (GLAM). The purpose of such advice is to give agents a framework to understand the legal issues in a situation. The advice is public and is intended to be published soon after it is requested. The GLAM format was designed in response to the use by taxpayers of technical advice memoranda (TAMs) as a sword against the government, rather than as was intended by the IRS, i.e. as a mechanism for resolving a case to pre-empt litigation.

2.2. Aggressive tax shelter stance for derivatives

The IRS and Treasury view derivatives and financial engineering as an exceptionally productive tool in the development of tax shelter transactions. Because derivative contracts are so flexible, there are an unlimited number of possible economic outcomes that can be obtained using derivatives. In contrast, tax outcomes are limited by the “pigeonhole approach” the law has adopted for determining the tax treatment of a transaction. The principles of economic substance and business purpose do provide some boundaries on the possible tax manipulation that is possible, but there is still risk to the Treasury when taxpayers engage in financial engineering to minimize their tax liability.

While many of the tax shelter notices issued in the past several years have been targeted at derivative transactions, the one that has caused particular trouble for taxpayers is described in Notice 2002-35¹ and Notice

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1. 2002-1 CB 992.

2006-16.² In these Notices, the transaction described could include almost every swap in the marketplace, as well as other plain vanilla transactions. This outcome is unavoidable in the finance arena because an abstract description of one abusive transaction can be understood to apply to a wide range of benign transactions. The tax rules for derivatives are generally unconnected to the underlying economics of the transaction, and so the cause of the abuse is usually the application of the tax rules, rather than some characteristic of the transaction. Hence the difficulty the government has in describing "bad" derivatives. The difficulty the IRS has in distinguishing abusive from non-abusive transactions, as well as the difficulty in understanding financial transactions makes the IRS especially wary of any transaction that contains elements of financial engineering.

3. Avoiding Audit Risk in the Finance Arena

3.1. Understanding why simply following book is not appropriate

The tax department in a company is often unaware of the decisions and activities of the treasury department and financial advisors of the firm. Managing a firm's debt and equity issuances, hybrids and mezzanine debt, commercial paper, cash management programmes, interest rates, currency and policy regarding commodity derivatives is often set and implemented outside the purview of the tax professionals. This is despite the fact that all finance activity carries with it significant tax risk.

Some firms determine the tax consequences of financial transactions using outputs coming straight from their GAAP accounts. This almost invariably results in completely incorrect tax filings, as GAAP and tax have different rules for almost every type of financial transaction.

The following are some examples of common transactions that result in different outcomes for tax and GAAP purposes.

3.1.1. Hedging

The tax and accounting rules regarding hedging transactions almost invariably diverge. If a company engages in derivative transactions that do not constitute "hedges" for tax purposes, even if they are regarded as hedges for accounting purposes under the governing GAAP standard (SFAS 133), unexpected and unfortunate tax outcomes are almost inevitable. Differences between tax and accounting include:

- the definition of a hedge versus hedge effectiveness;
- what constitutes a hedge is entity-specific for tax purposes. The right entity must enter into the hedging transaction; and
- the type of transaction that is eligible for hedge treatment.

The tax impact of entering into derivatives regarded as hedges versus non-hedges flows into many parts of the tax return. Most importantly:

- character. In general, a derivative transaction is regarded as being capital in nature. If the derivative

is hedging an ordinary business risk, but is not regarded as a hedge for tax purposes, a substantial capital loss may be generated – unmatched by a capital gain on the hedged item. This result is aggravated if the IRS invokes the whipsaw rule that always favours itself;

- timing. Gain or loss on a hedge properly identified for tax purposes follows gain or loss on the underlying item. If not identified, the timing on the derivative will follow general tax rules, which may conflict with the timing of gain or loss on the item being hedged; and
- foreign tax credit, subpart F, etc. Whether a transaction is regarded as a tax hedge will determine the basketing of gain or loss for foreign tax credit purposes, as well as whether it is entitled to deferral under subpart F, and may have other international tax effects.

In order to avoid a whipsaw situation, unexpected capital loss, inconsistent timing, as well as other unexpected and significantly adverse outcomes on hedging transactions, the tax law requires compliance with a comprehensive set of hedging rules. These rules require a system for contemporaneous identification of hedges, as well as a description of the hedging programme that complies with tax definitions. Piggy-backing onto the company's accounting programme does not satisfy the tax law, and may even lead to worse results than doing nothing.

3.1.2. Debt versus equity

Treatment of company issuances on the debt-equity spectrum receive different treatment for tax, GAAP and rating agency purposes. Tax takes a binary view, such that an instrument is either debt or equity with highly significant ramifications with regard to e.g. interest deduction, dividends received deduction, interest netting, earnings stripping and withholding. GAAP and the rating agencies recognize that debt and equity can be viewed as two extremes of instruments on a spectrum. Bankers and lawyers devote significant effort to arbitraging the tax, GAAP and rating agency rules, particularly aiming to obtain a tax deduction with some equity "credit" from the rating agencies. Such hybrid instruments require higher than normal internal scrutiny and almost invariably a tax opinion.

3.1.3. Derivatives

GAAP and tax treat derivatives very differently. Contracts such as futures, forwards, options, caps, floors, swaps and swaptions are often required to be marked to market under GAAP rules (SFAS 133). Tax treatment generally follows the form, unless there is reason to think that the form may mask an inappropriate tax benefit. There are different rules for forwards, futures, options and swaps. Contracts with characteristics of more than one of these prototypes (called hybrids) are generally

treated for tax purposes like the contract which the hybrid most closely resembles. Bifurcation (dividing the contract up into its component parts) is very rare in tax law because there are no "lowest common denominators" in finance – any derivative contract can be carved up economically into any number of different combinations of other contracts. No one combination can be categorically regarded as more correct than any other. Hence, tax law resists dividing up contracts, unless to do so is necessary to prevent abuse.

3.2. Strategies for managing tax consequences of finance activity

3.2.1. Get to know the treasurer

It is vital for a company's tax director to have alliances throughout the corporate organization, no less so than with the treasurer. The hedging rules require same-day identification of hedging transactions – those transactions that manage certain financial risks, such as floating interest rates or fluctuating oil prices. In order to make same-day identifications, the tax department needs to secure cooperation from the company's treasury department to ensure that the tax department is informed when a hedging transaction is entered into. The tax department also needs to understand what risk is being hedged and over what time period. Communication can be systematized using computerized notations when hedges are entered into, or some other mechanism can be used to reduce the compliance burden. When hedges are not identified or are misidentified, the IRS can whipsaw the taxpayer – particularly by characterizing losses on the hedge as capital.

Derivatives that are not hedges are also important to be aware of. Many derivatives form parts of a straddle and require loss deferral. Changes in market conditions could result in significant capital losses, and so the tax department must be kept informed of the timing of sales or terminations of these contracts.

3.2.2. Develop procedures and follow them

Any interaction with the IRS is eased with the presentation of clear, easy to understand procedures for the treatment of a particular financial activity or transaction. Some examples include a file containing documentation of all hedge transactions attached to the contract creating the risk being hedged, or a schedule containing the algorithm for the accrual of swap transactions. Even if there are errors in implementation, for example one transaction of many failed to be identified as a hedge, the IRS is usually more lenient if there is a proper method that was bypassed in error. Under the hedge regulations, there is an exception for "inadvertent failure", but this exception does not extend to the failure by the tax department to know that there is a hedging programme being undertaken in the company.

3.2.3. Be aware that some financial transactions are reportable transactions

Corporate treasury departments often enter into complex derivative transactions with no tax motive in mind. However, because of the ability of derivatives to be used for both timing and character plays in the tax law, under Notice 2002-35³ and Notice 2006-16,⁴ a broad swath of derivatives may be regarded as substantially similar to a listed transaction so as to subject to mandatory disclosure on Form 8886 (Reportable Transaction Disclosure Statement). For that reason, it is important for the tax department to be aware of transactions being contemplated by their finance colleagues, even if there is no tax benefit intended.

4. Handling a Financial Transactions Audit

Auditors audit financial transactions under two principal mandates: following a directive to examine a tax-motivated product or transaction, or under more general guidelines to ensure that the rules are being adhered to, particularly anti-abuse rules.

4.1. Tax-motivated transactions

Tax-motivated transactions will originate with the tax department or those departments will be heavily involved. Aside from ensuring that high-level opinions are sought and GAAP requirements are fulfilled, the tax department must also ensure that all evidentiary materials are well preserved and in order. All cases turn on specific facts, and these must be asserted and proven. Many controversies are settled based on favourable factual findings.

4.2. Compliance with the law

Certain financial product problems are ubiquitous, such as the straddle rules. Straddles are offsetting positions in actively traded property, for example a company that has an account in a foreign currency and a forward contract to sell that foreign currency. The draconian tax rules governing straddles provide that any realized losses on one position in a straddle must be deferred to the extent there are gains in unrealized positions in that straddle. There are complicating rules for successor positions to offsetting positions. The IRS does not always audit for straddles, but when they do, it is very difficult to fight an adjustment. The rules are extremely anti-taxpayer and of broad application. However, IRS agents are not always familiar with the scope of the rules and exceptions, or with the latest guidance, and so it is important to review the issues and the taxpayer's specific facts carefully. Expertise by the taxpayer and its advisors can often defeat an initially problematic adjustment.

3. See note 1.

4. See note 2.

5. Utilizing the Various Branches of the Government to Obtain Outcomes Favourable to the Taxpayer

Taxpayers can advocate for their tax positions most effectively proactively, before the problem arises. This requires that the tax department engage in planning, be vigilant about documentation and understand the company's finance activity.

Other arrows in the company tax department's quiver (which are mostly underutilized) involve the various branches of government. A deep understanding of the relationship between the Office of Tax Policy at the US Department of the Treasury (Treasury), IRS Chief Counsel, IRS field agents, the various Congressional committees and the Justice Department is exceedingly important, both in preventative work and in dealing with controversy as it arises. The discussion below will address the roles of the Office of Tax Policy, IRS Chief Counsel and the various Congressional committees. Investing in relationships with the technical staff in these agencies is certainly worthwhile for all taxpayers. Certainly knowledgeable, and often ready to help with questions, requests and suggestions, the right staff at Treasury and Chief Counsel are invaluable (and free!) resources for taxpayers facing or anticipating conflict with IRS agents.

5.1. Office of Tax Policy at the Department of the Treasury

The Office of Tax Policy (OTP) operates under the leadership of the Assistant Secretary of Tax Policy, a political appointee. This is the highest ranking office in the administration devoted to tax. Under the Assistant Secretary, there are various deputies and special counsel, as well as the Tax Legislative Counsel, International Tax Counsel and Benefits Tax Counsel. The last three manage a staff of approximately 25, each of which is an expert in her or his field. The OTP staff is fairly accessible, and often answer telephone questions from knowledgeable callers. This can be done anonymously. Any answer obtained from OTP can be regarded as representing current thinking by the Treasury, but in no way binds the government.

The OTP Counsel and Assistant Secretaries may also be available for meetings if a taxpayer has some pressing, novel or politically important issue. For example if a company were issuing a new type of hybrid debt instrument, it may behove the company's tax department to approach the Treasury to get its views on the instrument. However, even when made at the higher levels, verbal comments do not bind the government. They may provide comfort or caution a taxpayer, or may raise novel technical issues. However, they do not guide the IRS field agents or the controversy process.

For taxpayers facing IRS agents with ongoing technical misunderstandings, OTP is an excellent resource to appeal to for a change in guidance – in the form of regulations, or published rulings, for example. The Treasury and IRS publish a business plan which generally describes the ambit of projects being worked on. They may, however, open a new project if there are compelling reasons to do so, for example an IRS field development that OTP believes is out of line with appropriate tax policy. Appeals to Treasury for this purpose are usually sent in the form of a letter to the appropriate staff person, and can be followed with a request for a meeting. Sometimes a letter to Treasury may be combined with letters sent simultaneously to the IRS and to appropriate Congressional committees.

Treasury is not permitted to become involved in an individual taxpayer matter unless it has some particularly important implication for policy. Treasury cannot interfere in an audit controversy, so any assistance a taxpayer seeks from OTP must involve some higher-level policy issue or be of a proactive nature.

5.2. IRS Chief Counsel

The large staff at Chief Counsel works as technical advisors to the IRS field officers and as liaison with Treasury. Chief Counsel is responsible for taxpayer-specific guidance (e.g. private letter rulings and TAMs), as well as published guidance (e.g. regulations, revenue rulings, revenue procedures and general advice memoranda). The published guidance agenda is driven by the Business Plan, released jointly by the IRS and Treasury. In deciding which items to put onto this agenda, the IRS and Treasury consider requests and suggestions from the public. The guidance plan is an opportunity for a taxpayer to encourage the IRS and Treasury to consider issues which the taxpayer believes the field officers are approaching incorrectly. Many controversies precipitate changes in the law, and taxpayers should consider themselves as agents in this process rather than as passive participants. Those taxpayers which make an effort in getting to know the relevant staff at Chief Counsel often find it easier to resolve conflicts in other areas of the IRS as they arise.

5.3. Congressional committees and groups

Congress has various groups dealing with tax matters, and all are responsive, to some degree, to taxpayer comments and complaints. They are effective in making changes to the Internal Revenue Code, as well as correcting errors to the existing Code. Three primary bodies consider tax law their jurisdiction, namely the Joint Committee on Taxation, the Senate Finance Committee and the House Ways and Means Committee.