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Tax Topics Coming out of Dodd-Frank

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Introduction

Dodd-Frank raises many different tax issues.

Topics for today's panel (briefly):

- Derivatives trading
- Volcker rule and living wills
- Bank capital and liquidity requirements

Other topics, for another day:

- Securitization reforms
- Executive compensation and corporate governance

Swap Novations

Under prior law, a dealer-dealer assignment of an NPC did not give rise to a deemed 1001 exchange for the non-assigning party as long as “the terms of the contract permitted the substitution.”

- It was unclear whether the standard terms of an ISDA Master Agreement “permitted” a transfer, because of the general requirement for consent of counterparty.
- The rule was limited to NPCs; the rules for other derivatives were unclear.

As a result of Dodd-Frank (swaps registration rules, swaps push-out rules for banks, living wills, mandatory clearing of swaps) it is expected that end-users will want to transfer existing derivatives positions to dealer affiliates or to clearinghouses in bulk or on a mass basis (making this an important question).

- Customer-facing derivatives business activities will be reorganized so that the legal entity contracting with the customer is in the same regulatory jurisdiction as the customer.
- For bankruptcy/netting and collateral management reasons, both dealers and end-users generally prefer to use a single legal entity to face counterparties. Consequently, end-users will want to transfer their existing positions to the new customer-facing legal entity they will be dealing with or to a clearinghouse once they begin clearing new swaps.

Market participants were concerned that potential tax costs from deemed exchange treatment would affect customer willingness to transfer derivatives portfolios to dealer affiliates or to swaps clearinghouses.

Swap Novations, cont.

Temp. Treas. reg. § 1.1001-4T provides that a dealer-dealer transfer or assignment of a 475 security or commodity or an NPC does not give rise to a deemed 1001 exchange as long as (i) the terms of the contract permit the transfer, whether or not consent of the counterparty is required, and (ii) any modification to the terms of the contract do not give rise to a 1001 exchange. Also applies to transfers to/from clearinghouses.

What is the theory underlying the regulation?

- not Dodd-Frank-specific
- why need dealer or clearinghouse counterparty?
- significance of “terms of contract” requirement
- significance of form of transfer (*e.g.*, ISDA Novation Agreement)
- effect on assignor and assignee

Upfront payments; variation margin

Cleared swaps by definition will require both (a) payments under the contractual terms of the swap, and (b) daily variation margin payments.

- If the contract has standardized payment terms, like cleared credit default swaps, the swap will have an initial upfront payment and a corresponding initial variation margin payment in the same amount.

Commentators have raised a number of questions about upfront payments and variation margin payments:

- If an upfront payment is treated as a significant nonperiodic payment and deemed to give rise to a loan under Treas. reg. § 1.446-3, could that cause a non-U.S. taxpayer to be treated as engaged in a U.S. trade or business of originating loans, or a tax-exempt taxpayer to have UBTI? (MFA comment letter)
- Could a variation margin payment be treated as a "payment" on the swap under the 2011 proposed NPC regulations? (CME comment letter)
- Should an upfront payment where there is matching variation margin payment be excluded from the deemed loan rules? for cleared swaps only? or for OTC contracts as well? (MFA comment letter)

Upfront payments; variation margin, cont.

The commentators' questions raise more general issues:

What significance should be given to variation margin payments? Compare section 1256(g)(1) (definition of "regulated futures contract" includes requirement for daily VM system) and section 1256(b)(2)(B) (designated swaps are not section 1256 contracts).

- Did existence of VM play any role in shaping 2011 proposed NPC regulations?
- What does narrow application of section 1256 imply about the government's view on appropriate breadth of mark-to-market treatment of derivatives generally?

Is there something special about upfront payments on cleared swaps, as a result of the offsetting VM payments?

- Pros and cons of the MFA recommendation
- What implications does applying current law to cleared swaps have for the law applicable to the netting of payments/obligations?

“Fixings” Issue – Definition of NPC

Proposed Treas. reg. § 1.446-3(c)(1)(ii) defines a “payment” to include “an amount that is fixed on one date and paid or otherwise taken into account on a later date.”

Commentators have expressed concern that this definition would cause both OTC “bullet swaps” and certain exchange-traded futures contracts to be classified as NPCs, with the result that (a) for OTC contracts, current accrual would be required, and (b) for exchange-traded contracts, section 1256 would not apply. (FIA, CME, MFA and ICI comment letters). Examples include:

- various interest rate-linked futures, including Fed Funds futures contracts that began trading in 1988
- various weather-linked futures contracts
- various stock-linked futures contracts, including S&P 500 futures contracts that began trading in the 1980’s

“Fixings” Issue – Definition of NPC, cont.

Are commentators correct in their interpretation of the proposed regulations?

- If so, proposed regulations raise authority and line-drawing issues.
- If not, what was the intended dividing line between NPCs and non-NPCs?

The Volcker Rule and Living Wills

- The Volcker Rule prohibition on investments in hedge funds and private equity funds (subject to a *de minimis* exception) is fairly straightforward , although the scope of covered funds and investments is potentially very broad.
- The exact scope of the prohibition on proprietary trading is unclear. Is any trading within "limits" and other metrics considered to be proprietary trading?
- To avoid the reach of the Volcker rule foreign banks can book all of their investments and positions outside of the U.S., but all personnel involved in making the investments or trades must also do so outside of the U.S. and no fund interests may be offered or sold to U.S. persons or trades conducted with U.S. persons or on U.S. exchanges.
- A massive set of proposed regulations (300 pages with 300 questions seeking comments) were issued in the fall of 2011 on the Volcker Rule. The proposed regulations impose major reporting requirements on covered institutions.

The Volcker Rule and Living Wills, cont.

- Final regulations on living wills were issued in November 2011.
- Many institutions will be rethinking how their operations are structured in order to meet the dictates of the living will requirements. For example, regulators may want business lines held by discrete legal entities, so some businesses may have to be disentangled from their existing corporate structure.
- All bank holding companies (including foreign banks treated as bank holding companies) with $50 billion or more in <u>global</u> assets and all other companies designated for heightened systemic risk regulation by the FSOC must file living wills annually.
- The deadline for filing initial living wills is based on “non-bank” assets held by a foreign bank in the U.S. (non-bank assets are those not owned by the bank or a U.S. bank subsidiary, for example, a broker-dealer): $250 billion or more of such assets, deadline of July 1, 2012; $100 billion to $250 billion of such assets, deadline of July 1, 2013; all other covered institutions, deadline of December 31, 2013.

The Volcker Rule and Living Wills – Tax Issues

- Review the tax treatment of any corporate restructuring or the intercompany movement of assets.

- Decide if a legal entity rationalization program is desirable and, if so, how to handle the tax aspects of any such proposal.

- Determine how best to save significant tax attributes in any restructuring.

- Determine the impact on tax sharing agreements and service level agreements of any restructuring.

- Determine the impact of any possible restructuring on deferred tax assets that may be significant in regulatory capital calculations.

Additional Derivatives Trading Issues

- New rules require standard derivatives to be exchange-traded, cleared and reported to federal regulators.

- Derivatives not meeting the foregoing requirement must still meet margin and reporting requirements, and derivatives dealers must register with federal regulators.

- The rules do not cover transactions outside the U.S. with non-U.S. counterparties (trades with U.S. counterparties will be caught by the new rules regardless of where booked).

- Extraterritorial reach of the new rules is unclear. For example, assume a trading book with non-U.S. counterparties is moved from the U.S. to an entity in London, but traders in the U.S. continue to trade off of the book. Will these trades still be subject to Dodd-Frank? If so, which parts of Dodd-Frank? What if the London entity is a branch of a U.S. entity? A subsidiary with a guarantee from a U.S. entity?

Additional Derivatives Trading Issues – Tax Issues

- Determine tax treatment if trading businesses are moved to ameliorate the impact of the new rules, particularly on intangibles such as workforce in place, goodwill, etc.
- Determine tax treatment if historic positions are moved to a new entity or new jurisdiction.
- Review impact of new margin rules on fair values used in marking positions to market.
- Review functional analysis used for transfer pricing as functions are moved to deal with the Dodd-Frank rules.
- Review service level agreements to adjust to new transfer pricing arrangements and ensure that the implementation of these arrangements are fully operational.
- Determine whether transfer pricing arrangements that put risk in the U.S. may bring the Dodd-Frank rules into play even though the positions are between non-U.S. counterparties and booked outside of the U.S.

New Bank Holding Company Capital Requirements

- Previously, foreign banks with U.S. banking subsidiaries and U.S. companies owning these banks had to meet U.S. capital requirements only for the bank itself.

- Dodd-Frank extends these capital requirements to the U.S. holding companies.

- Many banks had capitalized their U.S. banks using debt funding at the U.S. holding company level; because of the new rules some banks are rethinking their U.S. corporate structure.

New Bank Holding Company Capital Requirements – Tax Issues

- Review means to create tax efficient capitalization of regulated subsidiaries (new forms of cross border funding; *e.g.*, utilization of bail-in debt).
- Determine the impact on return on capital caused by the new capital requirements and make any needed transfer pricing adjustments (*e.g.*, trading models that rely on a return on capital component).
- Determine impact on intercompany funding rates caused by the new capital requirements.
- Review tax treatment of bail-in debt (debt or equity) and determine if tax efficient hybrid structures can be created.
- In the U.S., review the possible use of a deemed holding company created under the "check the box" regime to form tax consolidated group even where an actual U.S. holding company has been eliminated to avoid the Dodd-Frank capital requirements.