The Taxation of Dodd-Frank

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One page of the behemoth Dodd-Frank Wall Street Reform and Consumer Protection Act is devoted to tax, but the legislation's tax implications extend far beyond that page. In this report Hammer and Bush discuss the tax aspects of seven parts of the new law: (1) bank capital and liquidity, (2) "living wills," (3) the Volcker rule, (4) banks as dealers in derivatives, (5) securitization, (6) derivatives, and (7) executive compensation.

This report will be published in two parts. The first part will provide an introduction and discuss bank capital and liquidity, living wills, the Volcker rule, and banks as dealers in derivatives. The second part will discuss securitization, derivatives, and executive compensation. The second part will also provide three appendices.

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The information in this report is general in nature and based on authorities that are subject to change. Its applicability to specific situations is to be determined through consultation with your tax adviser. This report represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG.

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I. Prelude

A single page is devoted to tax in the behemoth Dodd-Frank Wall Street Reform and Consumer Protection Act[1]: the final one. Rarely has Congress been so circumspect. Dodd-Frank asserts federal control over every imaginable arena of America's finances, and Congress could have drafted a tax provision to partner with each financial law. But in Dodd-Frank, Congress addressed only the taxation of derivatives and has left all the rest to commentators.

Following the model Congress set for conciseness, this report addresses fewer than all of the possible tax implications of Dodd-Frank, focusing on some particularly important ones: (1) bank capital and liquidity, (2) "living wills," (3) the Volcker rule, (4) banks as dealers in derivatives, (5) securitization, (6) derivatives, and (7) executive compensation.

Bank capital and liquidity. Dodd-Frank imposes risk-based and leverage-capital standards on U.S. bank holding companies and non-bank financial companies supervised by the Federal Reserve.

[1]P.L. 111-203, H.R. 4173 (hereinafter "Dodd-Frank" or "the Act").

These new standards, in combination with the Basel III guidelines, impose more stringent capital requirements on banks than existed before. New instruments, called contingent convertible bonds or CoCos, have been developed to satisfy the standards. These are issued as debt but automatically convert into the issuer's common stock when certain distress indicators become evident. The mandatory conversion feature presents interesting tax issues for both issuers and holders. The Act also excludes trust-preferred securities from Tier 1 capital of bank holding companies, so these will be redeemed or distributed to shareholders over time.

Living wills. The Act requires large financial institutions to create so-called living wills — recovery plans detailing remediation if the institution encounters financial difficulty, and resolution plans for the windup of a financially distressed institution. Recovery plans will likely focus on how distressed financial institutions can raise additional capital and manage liquidity needs. Resolution plans will likely be designed to facilitate a takeover by a regulator of a severely distressed financial institution.

The Volcker rule prohibits banking entities from engaging in proprietary trading of specified securities and from sponsoring or investing in hedge funds or private equity funds, with some exceptions. Implementation of recovery or resolution plans may have significant tax consequences, because they will involve separating assets and entities and internal restructurings.

Derivatives dealing in banks. The Act prohibits most banks from being dealers in derivative instruments. Banks will have to terminate or move their activities as dealers in derivatives to non-bank affiliates of bank holding companies. Banks are further prohibited from providing assistance to swap dealers. This report discusses various ways banks may rearrange their swap dealing activities and the resulting tax consequences. For example, banks may decide to: (1) move trading personnel to non-bank affiliates, book new swaps in the affiliates, and leave existing swaps in the banks; (2) move trading personnel and existing swaps to non-bank affiliates, book all new swaps in the affiliates; or (3) move trading personnel to non-bank affiliates, book all new swaps in the affiliates, and transfer the risk in existing swaps to affiliates by entering into intercompany swaps.

Securitization has been transformed by Dodd-Frank. The goal of the new law is to align the incentives of securitization sponsors and investors by ensuring that the sponsor retains meaningful exposure to the same credit risk borne by the investor. Proposed regulations define four general methods for satisfying the risk retention requirements, as well as several special risk retention methods adapted to specific types of issuing entities. Also, the rules require that a sponsor fund and maintain a cash reserve account in some situations, and they generally limit a sponsor's ability to transfer or hedge its retained credit risk. This report discusses the proposed rules and their tax consequences, which depend largely on the tax characterization of the issuing entity and the securities it issues.

Derivatives. The Act radically changes the U.S. derivatives marketplace, for example by imposing new clearing and trading requirements for over-the-counter derivatives. This report discusses the tax treatment of OTC derivatives before the Act, and the tax implications of the new regulation of derivatives under the Act. It then examines the Act's lone tax provision, which ''clarifies'' the relationship between section 1256 and OTC derivatives.

Executive compensation. Dodd-Frank provides new rules on shareholder approval of executive compensation, shareholder approval of golden parachutes, disclosure of executive pay in connection with performance, and disclosure of employee and director financial hedging transactions. The Act provides for recovery of compensation that is determined to be excessive. Finally, it requires that specified members of a corporation's compensation committee be independent, and it lists factors to be used in selecting compensation consultants and advisers to ensure their independence as well. For the most part, these rules dovetail with existing tax law, but there are some important differences.

Each of these areas and their related tax issues are discussed in more detail below.

II. Capital Adequacy

Dodd-Frank establishes a new capital adequacy framework for banks and other financial institutions. Almost simultaneously with the promulgations of the Act, new capital guidelines were released under Basel III. We discuss both sets of rules and their impact on financial institutions.

A. Regulatory Environment

1. Dodd-Frank.[2] Under the Collins amendment, the Act imposes on U.S. bank holding companies and non-bank financial companies supervised by the Federal Reserve the risk-based and leverage-capital standards previously applicable only to U.S. banks. These standards will also be applied to U.S. bank holding company subsidiaries of foreign banks. The Act sets minimum capital standards only; banks

[2] Section 171 of the Act contains the provisions regarding capital for financial institutions.

will be required to follow the Basel III standards when the latter are more stringent.

Most significantly, trust-preferred securities, which today constitute a major component of Tier 1 capital of bank holding companies, will no longer count as part of Tier 1 regulatory capital under the Collins amendment.[3]

2. Basel III. The Basel Committee on Banking Supervision[4] is responsible for banking regulations within member countries. In 2009 it started issuing consultative documents tightening existing banking regulations, and in mid-2010 it began issuing final rules (collectively, Basel III).

Under Basel III, banks are required to have minimum common share equity of 4.5 percent of risk-weighted assets, an increase from the current 2 percent requirement. Tier 1 equity (including common share equity and qualifying Tier 1 capital instruments) must be at least 6 percent of risk-weighted assets. Total capital (consisting of both Tier 1 and Tier 2 equity, including qualifying contingent capital and subordinated debt) must be at least 8 percent of risk-weighted assets. Basel III also introduced a novel requirement: a capital conservation buffer of common share equity of at least 2.5 percent of risk-weighted assets. The buffer can be drawn on in times of distress. Finally, local regulators may require an additional countercyclical buffer of common equity of up to 2.5 percent of risk-weighted assets. This buffer is expected to be built during periods of excess credit growth to absorb losses when a bank is in distress.[5]

Table 1. Summary of Basel III Capital Requirements

	Capital as Percentage of Risk-Weighted Assets	
	Old Requirement	**Basel III Requirement***
Tier 1 and 2 capital		
Common equity	2.0%	4.5%
Total Tier 1 capital (includes common equity and qualifying Tier 1 capital instruments)	4.0%	6.0%
Total Tier 1 and 2 capital (includes Tier 1 capital and qualifying Tier 2 capital instruments)	8.0%	8.0%
Additional special capital		
Capital conservation buffer common equity	N/A	2.5%
Counter cyclical capital buffer	N/A	Nil to 2.5%
*When fully implemented.		

3. Contingent capital. A new instrument — CoCos — will probably be an important component of bank capital in the future. They will be issued as debt, but on the occurrence of specified events, they will convert automatically into common equity of the issuing bank or bank holding company.

The Basel committee has already addressed the use of contingent capital. It issued a notice on January 13, 2011, directing that all non-common Tier 1 and Tier 2 instruments issued by any internationally active bank be written off or converted into common equity if the local banking regulator determines the bank would otherwise become "non-viable."[6]

Dodd-Frank authorizes the Federal Reserve to require bank and nonfinancial holding companies "to maintain a minimum amount of contingent capital that is convertible to equity in times of financial distress."[7] The Financial Stability Oversight Council, created as a collaborative body of financial regulators under the Act, will probably address the use of contingent capital by U.S. institutions later this year.

The CoCos of the future should not be confused with older instruments carrying similar names.[8] New CoCos convert from debt to equity when the

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[3]Section 171 of the Act bars bank holding companies from using trust-preferred securities indirectly. It imposes on holding companies the capital standards set for regulated banks. Regulated banks cannot use trust-preferred securities as part of their capital. Some banks have created real estate investment trusts to issue preferred stock to generate innovative Tier 1 capital. That type of preferred stock appears not to have been adversely affected by the Act. However, the Basel III rules that allocate capital between a bank and third-party investors in consolidated subsidiaries may eliminate much of the regulatory capital benefit in issuing REIT preferred stock.

[4]The Basel Committee on Banking Supervision comprises senior representatives of bank supervisory authorities and central banks from the member countries of Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, Switzerland, where its permanent secretariat is located.

[5]Basel committee, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Dec. 2010) (the Basel III rules). The Basel committee is reviewing whether the countercyclical capital buffer could include types of capital beyond common share equity.

[6]Basel committee, "Minimum Requirements to Ensure Loss Absorbency at the Point of Non-Viability," issued with a press release (Jan. 13, 2011).

[7]Section 165(c) of the Act.

[8]The new CoCos are unlike any previously issued convertible instruments in that conversion is mandated when the

(Footnote continued on next page.)

issuer's capital declines to a specified level or when the institution fails to meet the viability standard of the bank regulator. Variants of the new CoCos have been issued by Lloyds Bank, Rabobank, and Credit Suisse.

Both the Act and Basel III are causing banks to undertake major reviews of their capital structures. Some foreign banks are giving up their U.S. bank holding companies to avoid the capital requirements imposed on those companies by Dodd-Frank.[9]

4. Timing of implementation. The implementation dates of the Basel III standards and the capital adequacy provisions of Dodd-Frank are complicated. In simplified form, the Collins amendment will be phased in incrementally from January 1, 2013, to January 1, 2016, for U.S. institutions. Foreign institutions with U.S. bank or financial holding companies will have five years after Dodd-Frank's enactment date to change the capital of their subsidiaries.[10]

The Basel III capital standards will be phased in between January 1, 2013, and January 1, 2018. Member countries must implement the rules before 2013 so that they can take effect by 2013.[11] Institutions will receive credit toward their capital requirements for trust-preferred securities until 2013, at which time the credit for those instruments issued before the effective date of the Act will begin phasing out over a three-year period.

In this report we focus on three topics in the capital adequacy provisions: CoCos, the treatment of trust-preferred securities, and tax accounting for deferred tax assets.

B. CoCos

1. Background.[12] In the press release announcing the new Basel III capital requirements, the Bank for International Settlements (BIS) said that the purpose of contingent capital is to ensure that all classes of capital instruments fully absorb losses at the point of nonviability before taxpayers are exposed to loss.[13] The Basel committee proposed that all non-common equity Tier 1 and all Tier 2 instruments have a requirement that they be written off or converted into common stock of the instrument's issuer if the authorities supervising the financial institution decide the issuer would not be viable without a write-off of debt or government support.

Contingent capital is claimed to have the following advantages:

> (1) It automatically increases capital and reduces debt of a distressed financial institution. It raises capital in conditions when other sources of funds are unavailable because shareholders will not agree to dilute their equity by share issuance or by fire sales. This could limit contagion during systemic stress.
>
> (2) It would prevent market failure by providing another buffer before a bank default.
>
> (3) The threat of losses from conversion and dilution would limit risk taking by managers, shareholders, and bondholders.
>
> (4) Requiring bondholders to partner in a future recapitalization would motivate them to encourage managers to exercise financial discipline.
>
> (5) Paying manager bonuses in CoCos would internalize externalities in some risky behavior.

Contingent capital is considered more useful in absorbing loss than existing hybrid capital (such as trust-preferred securities). During the 2007-2009 crisis, hybrid capital did not absorb losses effectively. Its main loss-absorption mechanisms were deferral of interest payments and extension of maturity, both at the discretion of the issuing institutions. During the crisis, however, banks were afraid to send alarming signals to the markets by notifying investors of the need to postpone payments on these instruments, and governments preferred to inject cash into the financial sector rather than allow banks to breach regulatory ratios. Many banks bought their debt back at great discounts, which improved their capital position but inverted the priority of payments as between debt holders and shareholders. Contingent capital instruments are believed to avoid these disadvantages of hybrid capital.

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company has financial difficulties and is designed to be automatic based on a decline in the issuer's regulatory capital or on the determination of the issuer's bank regulator. For other types of debt instruments bearing the same or similar names, see John Creed and Noah Beck, "The Demise of CoCos and the Tax Consequences of Exchanging Convertible Debt," 896 *PLI/Tax* 955 (2009); Edward Kleinbard et al., "Contingent Interest Convertible Bonds and the Economic Accrual Regime," 791 *PLI/Tax* 305 (2007).

[9]David Enrich, "Banks Find Loophole on Capital Rule," *The Wall Street Journal*, Feb. 18, 2011.

[10]Section 171(b)(4) of the Act.

[11]Basel III rules, *supra* note 5, at 27-29 and Annex 4.

[12]This discussion draws on *Contingent Capital: Economic Rationale and Design Features* Pazarbasioglu, Ceyla; Jian-Ping Zhou; Vanessa Le Lesle; Michael Moore; Staff Discussion Note No. 11/01, Jan. 25, 2011, *available at* http://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf.

(Footnote continued in next column.)

[13]*Id*. at 14, citing BIS press release (Jan. 13, 2011), "Basel Committee Issues Final Elements of the Reforms to Raise the Quality of Regulatory Capital."

The triggers that would require conversion of the CoCos into equity are the vital parts of the new financial structure. Various types of triggers have been debated:

(1) "High"-level triggers would require conversion of notes if a bank's financial condition deteriorated but was not close to collapse, as a form of crisis prevention. "Low"-level triggers would require conversion of notes if a bank is in true distress. Both carry the same risk as hybrid capital — forcing an institution into a humiliating cliff-fall which would be expected to spiral into a market crisis. The cliff effect of the trigger would be counter-productive in a culture driven by panics and a herd mentality.

(2) Triggers could be based on national financial criteria as well as on an individual institution's condition.

(3) How objective should the triggers be? The Basel committee proposed that the triggers should be within the regulator's discretion. But commentators have noted that such subjectivity would make it difficult to price and sell CoCos.

The rate at which the instruments convert into equity determines whether the convertible debt holders or existing stockholders bear the risk of distress more. With a high rate of dilution, existing shareholders lose more; with a low rate of dilution, contingent debt holders lose more. Also, the rate of conversion could be set by the bank's stock value at the time of the issuance of the contingent debt, or it could be determined based on the bank's stock value at the time of conversion. The latter option could be disastrous if the stock price was close to zero and a potentially infinite number of shares would have to be issued to satisfy the terms of the note.

2. Issuances. Lloyds Banking Group issued CoCos in 2009 and Rabobank in 2010, before the Basel committee's pronouncement. Neither instrument would satisfy Basel III because they do not force conversion to common equity if the bank regulator finds the issuer to be nonviable. In February 2011 Credit Suisse issued CoCos designed to meet Basel III standards.[14]

All three issuances were targeted to non-U.S. investors, but Lloyds sold some securities in the United States. They have some common terms: They are labeled debt; most have a fixed maturity date (one tranche of Lloyds' issuance is perpetual); and they pay cash interest regularly (although some interest deferral is permitted).

Lloyds' instruments are called enhanced capital notes and were issued by two U.K. special purpose entities with parent company guarantees. The notes are subordinated to the senior debt of the parent and will automatically convert into Lloyds common equity if the bank's consolidated core Tier 1 ratio decreases to less than 5 percent (at issuance, it was about 8.6 percent). The conversion price is approximately 65 percent of the price of Lloyds' common shares at issuance. If conversion had occurred immediately after the notes' issuance, each holder would have received consideration of about 1.5 times the principal amount of its investment. Assuming conversion would be triggered by Lloyds' poor performance, the designers of the notes built in a cushion to minimize investors' loss on the notes resulting from a decline in the issuer's stock value.

Rabobank's instruments were issued directly from the bank. They constitute senior debt but will be redeemed at 25 percent of their principal amount if Rabobank's consolidated equity capital ratio decreases to less than 7 percent (at issuance, it was 12.5 percent). The resulting gain on redemption would add to Rabobank's common equity.

Credit Suisse's notes were issued out of a Guernsey special purpose entity with a Swiss parent guarantee. The notes are subordinated debt and have a term of 30 years. If the common equity Tier 1 ratio of the Credit Suisse group falls below 7 percent (at issuance, it was about 10 percent) or Credit Suisse becomes nonviable (as defined in the Basel committee notice on contingent capital), the notes will automatically convert into the common equity of the Swiss parent. The conversion price is the higher of $20 or the then-current market price of the shares. Thus, if the market price at conversion is $20 or higher, holders will receive shares equal to the full principal amount of their investment, but if it is below $20, they will suffer a loss equal to the difference between $20 and the lower market price. Credit Suisse shares were trading at about $40 when the notes were issued.

Because of the conversion options in both the Lloyds and Rabobank instruments, the instruments were issued — and are trading in the secondary markets — at yields higher than comparable straight debt instruments.

[14]Lloyds Banking Group prospectus for 5 billion sterling enhanced capital note program (Dec. 1, 2009); Rabobank prospectus for 1.25 billion euro 6.875 percent senior contingent notes due 2020 (Mar. 17, 2010); Credit Suisse preliminary information memorandum for Tier 2 buffer capital notes due 2041 (Feb. 14, 2011). Credit Suisse also announced an exchange of contingent capital notes for the outstanding debt held by several Middle Eastern investors that will take place in 2013.

3. U.S. tax treatment of issuer.[15] A U.S. issuer of CoCos will be most concerned with the deductibility of interest on the instruments. Interest deductibility depends on whether CoCos are considered debt for U.S. tax purposes and whether the interest is deductible under section 163(l).

a. Debt versus equity. For U.S. federal income tax purposes, whether an instrument is debt or equity of the issuer depends on the substance rather than the form of the instrument.[16] One court described the debt-equity distinction as follows:

> The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.[17]

For U.S. tax purposes, an instrument generally is treated as debt or equity,[18] rather than a mix of the two. No single factor determines how an instrument should be classified; the analysis requires an examination of all the facts and circumstances surrounding the transaction.[19]

Section 385 authorizes Treasury to issue regulations to "determine whether an interest in a corporation is to be treated . . . as stock or indebtedness." Section 385(b) lists the following five factors among those that the regulations may take into account in determining whether an instrument is debt or equity: (1) whether there is a written unconditional promise to pay on demand or on a specific date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (2) whether there is a subordination to, or a preference over, any indebtedness of the corporation; (3) the corporation's ratio of debt to equity; (4) whether there is convertibility into the corporation's stock; and (5) the relationship between holdings of stock in the corporation and holdings of the interest. Treasury has never finalized regulations under section 385.

Fortunately, the IRS has stated its views on the debt-equity distinction several times, including in Rev. Rul. 85-119[20] and Notice 94-47.[21]

In Rev. Rul. 85-119, the IRS ruled that certain instruments issued by a bank holding company were debt for U.S. federal income tax purposes. The instruments were publicly issued, widely held, and not held proportionately to the bank holding company's stock. They were designated by the parties as debt, and amounts designated as interest were payable quarterly, irrespective of earnings, at a floating rate comparable to the market rate for similar instruments. Any default on the payment of those amounts resulted in a legally enforceable right to the holders against the issuer for payment of the amount in default. The instruments had a 12-year term. The issuer was not thinly capitalized, and its debt-to-equity ratio was within the industry norm. The holders were not entitled to vote or participate in management of the issuer. The IRS concluded that the issuer and holders intended to create a debtor-creditor relationship.

The IRS found that the factors described above supported debt classification, but that other factors supported equity classification, including the subordination of the rights of the holders to the rights of general creditors, and a convertibility feature at maturity.

The IRS noted that on insolvency or bankruptcy, the holders had the status of creditors and that even though their claims would be subordinated to those of other general creditors, they were entitled to priority over shareholders' claims. Also, although the instruments were convertible into the issuer's stock at maturity, the fair market value of the stock issued to the holders on that conversion had to be equal to the principal amount of the instruments. That conversion was at the election of the holders, and if a holder did not elect to receive stock, the issuer was required to sell that amount of stock on behalf of the non-electing holder in a secondary offering with the net cash proceeds to be delivered to the holder. Those net cash proceeds had to be equal to the principal amount of the instrument. The issuer's failure to deliver those cash proceeds would constitute a cause of action for money damages under state law.

Although the IRS found that the instruments described in Rev. Rul. 85-119 were debt, in Notice 94-47 it emphasized that Rev. Rul. 85-119 is limited to its own facts. It said that an instrument would not qualify as debt if it had terms "substantially identical" to the notes in Rev. Rul. 85-119 except

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[15]For a more in-depth discussion on the U.S. taxation of CoCos, see Paul Carman et al., "U.S. Tax Treatment of Contingent Convertibles," 13 *Derivatives & Fin. Instruments* no. 3 (2011). That edition of the journal contains a review of the tax treatment of CoCos internationally.

[16]*John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

[17]*United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943).

[18]*Commissioner v. H.P. Hood & Sons Inc.*, 141 F.2d 467, 469 (1st Cir. 1944).

[19]*Berkowitz v. United States*, 411 F.2d 818, 820 (5th Cir. 1969).

[20]1985-2 C.B. 60.

[21]1994-1 C.B. 357, *Doc 94-3984*, *94 TNT 75-1*.

that: (1) a provision in the instrument requires the holder to accept payment of principal solely in stock of the issuer; (2) the holder's right to elect cash payment on its instrument is structured to ensure the holder would choose stock; or (3) the instrument is nominally payable in cash but does not in substance give the holder the right to receive cash because, for example, the instrument is secured by the stock and is non-recourse to the issuer.

Notice 94-47 also lists the following eight factors that may be taken into account in characterizing an instrument as debt or equity, although the IRS said no particular factor is conclusive:

1. whether there is an unconditional promise by the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;

2. whether the holders of the instruments have the right to enforce the payment of principal and interest;

3. whether the rights of the holders of the instruments are subordinate to the rights of general creditors;

4. whether the instruments give the holders the right to participate in the management of the issuer;

5. whether the issuer is thinly capitalized;

6. whether there is identity between holders of the instruments and stockholders of the issuer;

7. the label the parties placed on the instruments; and

8. whether the instruments are intended to be treated as debt or equity for nontax purposes, including regulatory, rating agency, or financial accounting purposes.

The courts have also applied various factors in determining the classification of an instrument as debt or equity. No one factor controls, and all relevant factors must be considered.[22]

The factors applied by the courts and those applied by the IRS differ from case to case, but the ones most commonly considered are: (1) the label or name given to the instrument; (2) the presence or absence of a fixed maturity date; (3) whether there is a written, unconditional promise to pay on demand, or on a specific date, a sum certain in money in return for an adequate consideration in money or money's worth; (4) the source of payments on the instrument; (5) the right to enforce payment of principal and interest; (6) the extent to which the holder's rights are subordinated to the general creditors of the issuer; (7) whether there is identity of interest between holders of the instrument and stockholders of the issuer; (8) the extent to which the holder has the right to participate in the management of the issuer; (9) the intent of the parties; (10) whether the issuer is adequately capitalized; (11) the corporation's ability to obtain loans from outside lending institutions; and (12) whether the instrument is intended to be treated as debt or equity for nontax purposes, including regulatory, rating agency, or financial accounting purposes.[23]

CoCos will have the main debt attributes described here, with one exception: Are the banks issuing CoCos really promising to pay a sum certain at maturity?[24] CoCos must be converted into common equity if a triggering event occurs at which point holders are no longer guaranteed a return of their principal.

U.S. tax authorities have long accepted the treatment of conventional convertible debt as debt for tax purposes.[25] Conventional convertible debt provides full principal protection because it converts into equity only if the issuer's stock price rises significantly higher than its price at issuance. Unlike conventional convertible debt, the conversion features of the CoCos issued by Lloyds and Credit Suisse do not guarantee that the conversion will give the holder stock having a value equal to or greater than the principal amount of the debt because conversion would be forced when the issuer is in distress. If Rabobank's CoCos are converted, for example, the holder will suffer a loss of 75 percent of the principal on the bonds.

The IRS has ruled that debt instruments that will be converted at maturity into an amount of equity at a ratio fixed at the instrument's issuance date should not be treated as debt for tax purposes. Thus, in Rev. Rul. 83-98[26] the IRS concluded that notes payable at maturity in a predetermined number of shares of stock must be treated as equity. This

[22] *John Kelley Co.*, 326 U.S. at 530; *Hardman v. United States*, 827 F.2d 1409, 1411-1412 (9th Cir. 1987).

[23] *See, e.g., Hardman*, 827 F.2d at 1411-1412; *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Fin Hay Realty Co.*, 398 F.2d 694 at 696 (3d Cir. 1968).

[24] *See Fin Hay Realty Co. v. United States*, *supra* note 23; *Dobkin v. Commissioner*, 15 T.C. 31 (1950), *aff'd*, 192 F.2d 392 (2d Cir. 1952).

[25] For the most part, the tax authorities and courts have just assumed debt treatment for convertible bonds. *See, e.g., Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971) (conversion option is ignored in determining the issue price of convertible debt); reg. section 1.1272-1(e) (same principle adopted as articulated in *Chock Full O'Nuts*); Rev. Rul. 72-265, 1972-1 C.B. 222 (conversion of convertible debenture into stock is tax free).

[26] 1983-2 C.B. 40.

contrasts with Rev. Rul. 85-119,[27] in which the IRS found that debt that would be retired at maturity either with shares of stock then equal in value to the principal amount of the debt or with the proceeds from the sale of stock yielding an amount sufficient to retire the full amount of the debt in cash constituted debt for tax purposes. The IRS reiterated in Notice 94-47 that the earlier ruling applied only when the holders clearly have the option for full cash payout on their investment.

The key to these rulings is that the holder of the debt instrument cannot be at risk of the fortunes of the issuer in recovering the principal amount of its investment. There must be a guarantee of the return of a sum certain equal to the principal amount of the debt in order for the instrument to be treated as debt for tax purposes. With CoCos, the investor is not guaranteed a return of its investment, because if the debt is converted into stock, the investor's return is pegged to an amount of stock that has no minimum value on the date of conversion. Yet several arguments may still be made in favor of debt treatment for these instruments.

Given the contingent nature of the principal repayment of CoCos, the contingent debt regulations may provide a useful guide to their taxation.[28] These regulations do not address the debt versus equity issues but they do give a sense of the government's views on instruments with contingencies. If there is a remote likelihood that a contingency will occur, the regulations assume it won't occur.[29]

Under those regulations, if there is a remote likelihood that a contingency will occur, it is assumed that it won't occur.[30] By analogy, the conversion feature might be ignored if the conversion is "remote." It is highly unlikely that any of the issuing banks intend to convert their CoCos they have issued into common equity. Moreover, the conversion ratios that have been set by Lloyds and Credit Suisse offer some hope that a forced conversion will not necessarily result in a holder's loss of principal. However, the regulatory requirement for the issuance of contingent capital appears to undercut the remoteness argument, and because conversion probably will occur when a financial institution is in financial distress, it makes a loss of principal in a conversion possible or even likely.

In theory, CoCos could be issued with a conversion price pegged to the value of the issuer's equity at the conversion date to bring them closer to the instruments described in Rev. Rul. 85-119. However, such a feature could require a distressed bank to issue an exceedingly large number of shares, which would contribute to the instability of the institution instead of fortifying it.

Alternatively, to improve the probability of CoCo's debt characterization, the conversion price could be to the amount of the issuer's tangible common equity (defined generally as common equity less goodwill and other intangible assets, and deferred tax assets in excess of deferred tax liabilities), as determined under U.S. generally accepted accounting principles or under bank regulatory accounting guidelines. In a panicked market, the prices at which shares of common stock trade arguably are not a reflection of true FMVs, and tangible common equity might be viewed then as a better measure of value. A provision of this type could be seen as a step toward satisfying the requirements of Rev. Rul. 85-119.

A line of cases addressing surplus capital notes issued by insurance companies to meet regulatory requirements may also offer some support for treating CoCos as debt. In those cases, the interest and principal on the notes could be paid only out of "surplus" capital, so that payment of principal and interest on the notes was contingent on the issuer having adequate earnings. Nevertheless, the courts uniformly found that the notes were debt for tax purposes. They relied heavily on the fact that the notes were likely to be paid and that their form was dictated by insurance regulations.[31] One court found the critical factor to be that state regulations limited the taxpayer's options in structuring the instruments, a view that would similarly support the characterization of CoCos as debt.[32] Another court considered it critical that the taxpayer was a stock insurance company regulated by state statute.[33] That court also said that insurance companies are distinct from other businesses because they must retain large reserves and surplus capital notes are often issued until the company can gradually accumulate sufficient reserves.[34] Although these cases were developed in the distinct environment of

[27] *Supra* note 20.

[28] Reg. section 1.1275-4.

[29] *Id.*

[30] Reg. section 1.1275-2(h)(2). *See also* ILM 200932049, *Doc 2009-18002*, *2009 TNT 151-21* (remote criteria applied outside the scope of the contingent payment regulations).

[31] *See Jones v. United States*, 659 F.2d 618 (5th Cir. 1981); *Anchor Nat'l Life Ins. Co. v. Commissioner*, 93 T.C. 382 (1989); *Harlan v. United States*, 409 F.2d 904 (5th Cir. 1969); *Commissioner v. Union Mutual Ins. Co. of Providence*, 386 F.2d 974 (1st Cir. 1967); Rev. Rul. 68-515, 1968-2 C.B. 297 (the IRS will follow the *Union Mutual* decision); 1996 IRS NSAR 5975, 1996 WL 33325654 (July 30, 1996).

[32] *Jones*, 659 F.2d at 623.

[33] *Anchor Nat'l*, 93 T.C. at 409.

[34] *Id.* at 402.

insurance issuers, there seems to be no clear principle preventing their extension to other industries.

Issuers might also argue that CoCos should be considered to have two separate parts: straight debt and an option that requiring conversion of the instrument upon the occurrence of certain events. If the two parts were separately analyzed for tax purposes, the debt part would probably be considered true debt. However, the IRS and the courts have resisted dividing instruments into their components and characterizing each part independently.[35]

Another approach might be to consider CoCos investment units. The investment unit would consist of a straight debt instrument and an option. Several securities have been issued in which a debt instrument is been combined with an agreement to buy the issuer's stock some years in the future. One version was titled FELINE PRIDES. The instrument was intended to provide the issuer a deduction for interest on the debt in addition to forcing the debt's conversion into the issuer's stock in the future. By combining two discrete instruments into one unit, the issuers hoped to avoid the equity treatment of the mandatorily convertible notes as discussed in Rev. Rul. 83-98.

The IRS addressed this type of that investment unit in Rev. Rul. 2003-97.[36] In the ruling, each unit consisted of a five-year note and a three-year forward contract to purchase a specified quantity of the issuer's common stock. The forward contract required the holder of the note to pay the principal to the issuer on the contract's settlement date in exchange for stock equal in value to that amount — if the issuer's stock was trading within a prescribed range on that date. If the issuer's stock was trading below or above that range on the settlement date, the holder received the same amount of stock it would have if the share price were at the lower limit or upper limit, respectively. The pricing of the conversion feature in the ruling is similar to the conversion formula used in Credit Suisse's CoCos, at least at the lower boundary. If a conversion is triggered in Credit Suisse's notes, a holder would receive shares of stock at a conversion rate of $20 per share even if the value of the Credit Suisse stock is less than $20 on the conversion date.

In Rev. Rul. 2003-97, the note was pledged as security against the holder's purchase obligation. Nevertheless, the note and the purchase obligation could be separated if the holder substituted a Treasury security as collateral for its purchase obligation or if the issuer retained an investment bank to remarket the notes to unrelated parties on preset dates. With a successful remarketing, the proceeds from the sale of the notes to new holders would be used to satisfy the original holder's obligation under the purchase contract to acquire the issuer's stock.

The IRS ruled that the notes constituted true debt for tax purposes, and it identified four essential factors in reaching that determination:

1. the holder had an unrestricted right to divide the unit into its two constituent pieces: it was not economically compelled to keep the investment unit together;

2. in the event of the issuer's bankruptcy, the stock purchase obligation would terminate and the note would be released to the holder;

3. the notes would stay outstanding for a significant period after the remarketing; and

4. on the issue date, it was substantially certain that the remarketing effort would succeed.

CoCos in their current form could satisfy all these requirements except the second which might be inapplicable because CoCos would be expected to be converted into equity before any insolvency proceeding would be brought.

Some of the Lloyds CoCos were issued privately in the United States, and the prospectus contained a U.S. tax section. It states that for the portion of the notes that has a set maturity date, there is a ''strong likelihood that [they] will be treated as equity for U.S. federal income tax purposes, and . . . [Lloyds] will treat [them] as equity for such purposes.''[37] Other issuers are of course not bound by Lloyds' analysis.

Although we know of no formal survey on the matter, the tax authorities in the past have sometimes been supportive of banking regulators by treating instruments satisfying debt-satisfying regulatory capital standards as true debt for tax purposes. That was the case for trust-preferred

[35]Two cases have adopted a bifurcation approach: *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960); and *Richmond, Fredricksburg & Potomac R.R. Co. v. Commissioner*, 528 F.2d 917 (4th Cir. 1975). However, no other courts appear to have adopted a similar approach. A bifurcation approach in the contingent payment regulations was once suggested, but in the final regulations, that approach was restricted to nonpublicly traded notes. *See* Louis Freeman et al., ''Tax Consequences of Business and Investment-Driven Uses of Financial Products,'' 897 *PLI* 145 (July 2008), for a history of those regulations.

[36]2003-2 C.B. 380, *Doc 2003-17272*, *2003 TNT 142-20*.

[37]*See* Lloyds prospectus, *supra* note 14, at 168-173. The Lloyds prospectus goes on to discuss the treatment of the notes if they are found to be debt instruments by the U.S. tax authorities.

instruments in the United States and for similar instruments issued in the United Kingdom.[38]

b. Deduction of interest under section 163(l). Section 163(l) was enacted in 2004 to deny issuers interest deductions on securities that were mandatorily converted into stock. Those debt issues took a variety of forms, but their common feature was a formula in which the holder would share in some of the upside of the stock referenced in the debt issue but assume the full risk of a reduction in the stock's price.

Even if CoCos are treated as debt instruments for other purposes of the U.S. tax law, the issuer must still satisfy the terms of section 163(l) before it can deduct the interest paid on a CoCo. Section 163(l) provides that no deduction will be allowed for interest paid on a ''disqualified debt instrument.'' A disqualified debt instrument is defined as an instrument to which one of the following subparagraphs of section 163(l)(4) applies:

> A. a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer is payable in, or convertible into, the equity of the issuer;
>
> B. a substantial amount of the principal or interest is required to be determined, or at the option of the issuer is determined, by reference to the value of such equity; or
>
> C. the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described above.

Section 163(l) controls only the deductibility of interest by the issuer; it does not affect the inclusion of interest income by the holder.

Section 163(l) was directed at instruments mandatorily convertible into equity.[39] CoCos are not mandatorily convertible into equity by the issuer. Indeed, the issuer does not expect them to be converted into equity, and it does not control over whether that conversion takes place. For CoCos, interest deductibility would seem to turn on whether it is reasonable to expect that the instruments will be converted into the issuer's stock under subsection (C) above. This requrement appears to require issuers to build an evidentiary case against the likelihood of conversion to obtain an interest deduction.

4. Tax treatment if issued in the United States — treatment of holder. If CoCos are treated as debt, the issuer is a U.S. corporation and the holders are U.S. taxpayers (whether corporations or individuals), the holder will include interest income at ordinary income tax rates. If CoCos are treated as equity, the issuer will lose the benefit of an interest deduction. However, given sufficient earnings and profits in the issuer, holders will recognize dividend income for the interest payments. For qualifying individuals, the payments will constitute qualified dividend income that is subject to a beneficial tax rate under current law.[40] For qualifying corporations, the holders may obtain a dividends received deduction.[41]

A problem may arise with the dividends received deduction, however. In Rev. Rul. 94-28,[42] the IRS ruled that the holding period needed to qualify for this deduction was tolled by the debt features of an instrument treated as stock for tax purposes but as debt under corporate law. Its reasoning was that the holder's right to a fixed principal amount on retirement of the instrument was effectively a put option to sell the stock, and this option tolled the holding period provision in section 246(c)(4). Accordingly, the holder could not satisfy the required 45-days-or-more holding period needed to qualify for the dividends received deduction. If CoCos are treated as equity, it will be because they are viewed as lacking a set principal payment at maturity. This would appear to negate the application of Rev. Rul. 94-28.

5. Tax treatment if issued by a controlled foreign corporation. U.S. multinationals will also be required to meet capital requirements for their subsidiaries operating under Basel III. In some cases, these institutions will have established offshore holding companies that will be required to meet consolidated capital requirements for all of their subsidiaries considered collectively. We expect that some of these CFCs will issue CoCos to related overseas financing subsidiaries as a way to meet their capital requirements.

For local law purposes, offshore issuances of CoCos may be subject to a local debt-equity analysis, but the U.S. tax treatment of those instruments is also important. Payments on the instruments, irrespective of whether they are characterized as debt or equity, will reduce the issuer's E&P.[43] However, if the instruments are characterized as equity,

[38]For trust-preferred securities, see ILM 200932049 and TAM 199910046, *Doc 1999-9636*, *1999 TNT 49-15*. In the United Kingdom, a partnership-type structure was used somewhat like the way trust-preferred securities were used in the United States.

[39]Joint Committee on Taxation, ''General Explanation of Tax Legislation Enacted in 1997,'' JCS-23-97 (Dec. 17, 1997), *Doc 97-33838*, *97 TNT 244-12*.

[40]Section 1(h)(11).

[41]Section 243.

[42]1994-1 C.B. 86, *Doc 94-3981*, *94 TNT 75-4*. *See also* Rev. Rul. 90-27, 1990-1 C.B. 50.

[43]Sections 902, 964(a), and 986; reg. section 1.902-1(a)(9) and (10).

interest payments will be treated as dividends and the dividends will reduce the pool of foreign tax credits available for the issuer's common stock.[44] Moreover, since CoCos typically lack voting rights, the deemed dividends will not be associated with stock satisfying the dictates of section 902, and the credits allocated to those dividends will be lost permanently to the issuer's U.S. parent.

If CoCos were characterized as debt under local tax law and equity under U.S. tax law, they would need to be analyzed under the anti-splitter rules in section 909. Section 909(a) provides that a taxpayer may not claim an FTC until the tax year in which it takes into account the related income for U.S. federal income tax purposes. Section 909(b) provides that if there is an FTC splitting event regarding a foreign income tax paid or accrued by a foreign corporation eligible for section 902 treatment, the tax is also not taken into account before the tax year in which the related income is taken into account for U.S. tax purposes. For example, following an illustration in the Joint Committee on Taxation report on the provision, if a foreign subsidiary issued CoCos to its foreign parent (which is owned by a U.S. corporation) and the CoCos were treated as equity for U.S. tax purposes and debt for local tax purposes, the deduction of accrued interest under local law (accompanied by a significant deferral of the Actual cash interest payment) would give rise to a splitter transaction to which section 909 would apply.[45] This would further cloud the issuing group's ability to claim FTCs for the taxes paid by the issuer or a related corporation.

C. Trust-Preferred Securities

Trust-preferred securities[46] first began being issued by bank holding companies in the 1990s. Their essential terms can be illustrated with securities issued by Bank of America Corp. (BAC) in March 2006.[47] BAC established a special purpose trust that issued capital securities in a public underwriting. The trust used the funds from the underwriting to acquire junior subordinated notes from BAC. The trust was treated as a grantor trust for U.S. tax purposes, and the holders of the trust certificates were treated as the owners of the notes. Interest payments on the notes are fixed but could be deferred for up to five years. Since such a deferral was deemed remote at the time the capital securities were issued, the potential deferral of interest did not give rise to original issue discount.[48]

BAC's capital securities issued by the trust are mandatorily redeemable when the notes are paid. The notes have a maturity of 49 years from the date of issuance, and the capital securities will be redeemed no later than that date. They can be redeemed at BAC's option anytime after five years from their issuance date, and they can be redeemed at any time if there is a capital treatment event. A capital treatment event is defined as one in which the capital securities and notes no longer give rise to Tier 1 equity for bank regulatory purposes. BAC also has the right to terminate the trust at any time and distribute the notes (or their equivalent) directly to holders of the capital securities.

U.S. bank holding companies have issued billions of trust-preferred securities. Under current guidance, they typically count as Tier 1 capital within a limit for innovative Tier 1 capital. In most cases, they permit the issuer to call them if they are no longer treated as giving rise to good Tier 1 equity for regulatory purposes. The cost to the issuer on trust-preferred securities, while less than equity, is greater than for other forms of more traditional debt. Consequently, as Dodd-Frank comes into force and these instruments no longer give rise to Tier 1 equity, many of them may be called.

The BAC capital securities were issued with an opinion stating that the notes would be treated as debt for U.S. tax purposes. Faced with the change in the banking regulatory law mandating that trust-preferred securities no longer qualify as Tier 1 equity, BAC can leave the capital securities outstanding, terminate the trust, and distribute the notes to the holders of the capital securities or retire them for cash and cause the redemption of the capital securities. If the trust is liquidated and the notes are distributed to the holders of the capital securities in redemption of them, that transaction would be treated as a nontaxable event. The holders would take a carryover basis in the notes.[49] BAC more likely will choose to redeem the notes for cash and have the trust redeem the capital securities with the cash. This would be a taxable event with gain or loss realized by the holders of the capital

[44]Section 902; reg. section 1.902-1(b).

[45]JCT, ''Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment of H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010,'' JCX-46-10 (Aug. 10, 2010), at 6, *Doc 2010-17846*, *2010 TNT 154-16*. *See also* Notice 2010-92, 2010-52 IRB 916, *Doc 2010-25933, 2010 TNT 234-10* (dealing with pre-2011 splitter arrangements).

[46]The problems with hybrid securities in general are discussed more extensively above in Part II.B.2.

[47]BAC prospectus for 36 million shares of 6.25 percent capital securities (Mar. 21, 2006).

[48]Reg. section 1.1275-2(h).

[49]Because the grantor trust is disregarded for U.S. tax purposes, the liquidation of the trust and the distribution of the notes held by it aren't taxable.

securities equal to the difference between the holders' basis in the notes and the principal amount of the notes paid in liquidation. The amount realized would in most cases be treated as capital gain or loss, with the gain or loss being long term if the notes have been held for more than one year. Cash received for accrued but unpaid interest will give rise to ordinary income.[50]

D. Deferred Tax Assets

As a result of the global financial crisis, many banks have deferred tax assets on their balance sheets representing tax benefits they have claimed for GAAP but have not been realized for U.S. tax purposes. These assets typically represent either the amount of book losses exceeding the tax losses realized or the amount of tax losses and related tax attributes realized that the bank cannot use to recover cash taxes paid in prior years. For U.S. bank regulatory purposes, banks can take a tax loss benefit for a specified amount of these deferred tax assets in determining their regulatory capital, generally equal to the amount of deferred tax liabilities on the bank's balance sheet together with its projected earnings for the next 12 months.[51]

In a consultative document issued in December 2009, the Basel committee concluded that deferred tax assets ''which rely on future profitability of the bank to be realized should be deducted from the common equity component of Tier 1 capital.''[52] Those preliminary conclusions were followed by final rules the Basel committee issued in December 2010,[53] which confirmed that deferred tax assets, net of deferred tax liabilities arising in the same jurisdiction, must be deducted in full against common equity.

An exception permits deferred tax assets relating to temporary differences (for example, allowance for bad debt losses) to be used, up to 10 percent of a bank's common equity. The 10 percent limit is subject to another limit calculated by combining all of a bank's minority investments in other financial institutions, mortgage servicing rights, and deferred tax assets, and limiting the exemption for deducting those assets against common equity to an amount not exceeding 15 percent of the bank's common equity. The portion of those three assets not deducted against common equity is risk-weighted for the general capital calculations at 250 percent of their amount. The effective date of the new rules for deferred tax assets is unclear, but they apparently will begin to apply in 2014 with full implementation to be phased in over a five-year period.

III. Living Wills and the Volcker Rule

Dodd-Frank introduces two new protections against risk taking by some banking and non-banking entities.

First, the Act imposes new prudential standards on systemically important bank holding companies and non-bank financial firms (in both cases, defined generally as those institutions with more than $50 billion in consolidated assets) (SIHCs).[54] These provisions require banks to adopt what are known as ''living wills'' that set out both recovery plans for the remediation of distressed institutions and resolution plans for the windup of those institutions.[55] Under the ''Hotel California'' provision of the Act, financial institutions that were bank holding companies with consolidated assets of $50 billion or more and received assistance under the Capital Purchase Program[56] will be subject to continuing supervision by the Federal Reserve even if they cease to be bank holding companies.[57]

Second, as added protection against improvident risk taking, the Volcker rule prohibits banking entities (bank holding companies and their subsidiaries) from proprietary trading, and from sponsoring and investing in hedge funds and private equity funds. The Volcker rule also authorizes U.S. regulators to impose capital requirements and quantitative limits on the investment activities of non-bank financial companies subject to supervision by the Federal Reserve.[58]

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[50]Reg. section 1.61-7(d).

[51]*See* Federal Reserve, ''Capital Adequacy Guidelines'' (Dec. 16, 1994) (dealing with the treatment of deferred tax assets in measuring a bank's regulatory capital).

[52]Basel committee, ''Strengthening the Resilience of the Bank Sector,'' at 24 (Dec. 2009).

[53]Basel III rules, *supra* note 5, at 22, 26.

[54]In January 2011 the Financial Stability Oversight Council (FSOC) issued guidance on what items to consider in determining whether a non-bank financial firm was systemically important so as to be covered by the prudential rules in the Act. FSOC, ''Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies'' (Jan. 2011).

[55]Sections 165(b)(1)(A)(iv) and (d)(1) (resolution plans) and section 166 (remediation plans) of the Act. On March 29, 2011, the FDIC and the Federal Reserve issued proposed rules designed to implement the provisions of section 165(d). Federal Reserve and FDIC, ''Resolution Plans and Credit Exposure Reports Required'' (Mar. 29, 2011).

[56]The Capital Purchase Program was part of the Troubled Assets Relief Program under which Treasury's Office of Financial Stability purchased preferred stock from many large U.S. financial institutions.

[57]Section 117 of the Act. The ''Hotel California'' nickname for the provision comes from the Eagles' song of the same name with the line ''You can check out any time you like, but you can never leave.''

[58]Section 619 of the Act. The FSOC has issued preliminary guidance on how the Volcker rule should be formulated by the

(Footnote continued on next page.)

A. Living Wills

1. Regulatory background. SIHCs will be required to create living wills containing both recovery (or so-called remediation) plans[59] and resolution plans.[60]

Recovery plans — recovery plans are likely to have several features:

(1) Capital — Institutions will probably be required to raise more capital during good times — by issuing CoCos, for example.

(2) Liquidity — SIHCs may be required to have backup sources of liquidity and adequate collateral to be pledged to be able obtain funding from private or central banking sources when in distress.

(3) Dispositions — SIHCs may be required to identify businesses to be sold at a profit or closed down to avoid further losses.

(4) Trading books — Institutions may be required to show how they would reduce their trading books and desire for capital.

(5) Total sale — SIHCs will show how the entire institution might be presented for sale if necessary.

Resolution plans — resolution plans in living wills are designed to aid a banking regulator's takeover of a severely impaired financial institution. The plan will provide adequate information so the takeover will be as efficient as possible. After designing its plan, an institution may restructure operations to facilitate the takeover.

2. Effective date. Within 18 months of the enactment of the Act, the Federal Reserve must issue final regulations covering the new prudential standards to be imposed on SIHCs.[61]

3. Tax considerations. Implementation of a recovery or resolution plan under a living will may have significant tax consequences that are best considered as the plan is being designed. The key aspects of developing a living will that should be of interest for tax purposes include: (i) taking inventory of all legal entities, the characteristics (including tax attributes) of those entities, and the relationships among them; (ii) reviewing existing tax plans and structures; (iii) determining how, in the event of distress, businesses, assets, or entities may be separated from the group and how interrelationships may be severed; (iv) evaluating the impact of any internal restructuring and capital-raising transactions provided for in the living will; and (iv) analyzing tax consequences of any of those measures.

The potential tax issues and opportunities will vary. The areas identified below provide an introduction to common tax considerations from which a more individualized analysis can follow.

Once a tax-sensitive living will has been developed, it should be revisited regularly to take into account changes in tax law, and the effect of ongoing changes in operations, tax attributes, and other characteristics of entities within the group.

a. Taking inventory.

i. Group organization chart. The preparation of a living will brings a new level of focus to the SIHC's legal structure. This is the time to not only update the organization's family tree but also to create clear channels for its maintenance. If the person tasked with updating the structure chart is not a member of the tax department, procedures should be put into place for keeping the tax department apprised of all proposed changes to legal entities. The tax department should also be consulted on policies and procedures surrounding the future creation or elimination of legal entities.

ii. Legal entity rationalization opportunities. Because the preparation of a living will generally requires a multidisciplinary examination of an institution's structure, it is an ideal time to undertake a legal entity rationalization project. This will assess the need for existing entities and consider whether any can be eliminated or consolidated. Simplification of the organization's legal structure can streamline the recovery and resolution plan for the SIHC's living will and may also make day-to-day operations more efficient.

iii. Intercompany tax relationships. A living will should take into account interrelationships between an SIHC's different legal entities, including any tax allocation, tax sharing, or tax indemnification agreements. Those agreements should be reviewed to determine whether they account for actions that one entity can take that may affect the tax assets and liabilities of related entities,[62] and to determine what measures will apply on the separation of an entity.[63]

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agencies having direct regulatory authority over financial institutions covered by the Act. FSOC, "Study & Recommendations on Prohibitions on Propriety Trading & Certain Relationships With Hedge Funds & Private Equity Funds" (Jan. 2011).

[59]The remediation plans may follow the current requirements of the FDIC for so-called prompt corrective action.

[60]For a good discussion of what might be expected to be included in a living will in terms of remediation plans, see the speech by Thomas F. Huertas, of the Financial Services Authority (U.K.) and the European Banking Authority, at the Wharton School of Management, entitled "Living Wills: How Can the Concept Be Implemented?" (Feb. 12, 2010).

[61]Section 168 of the Act.

[62]These actions can go beyond the use of another entity's tax attributes when filing a consolidated or combined tax return. For example, a worthless stock loss claimed by a majority

(Footnote continued on next page.)

iv. General tax planning review. When an SIHC is taking an entity inventory, it should also take stock of tax attributes of related entities (for example, inside and outside bases, E&P, amounts of previously taxed income, tax credits, net operating losses, and built-in losses). This is an opportunity to undertake studies in basis, E&P, section 382, etc. The SIHC might also want to assess the need for policies and procedures to reduce the risk of unintentionally triggering dormant tax liabilities such as excess loss accounts, gain recognition agreements, and various recapture provisions (overall foreign loss recapture, branch loss recapture, and dual consolidated loss recapture).[64]

v. Examination of tax planning structures. The general inventory of entities and operations undertaken as part of a living will project likely will help identify the location of intellectual property, workforce and management functions, and other intangibles. This will provide the tax department an opportunity to take a fresh look at those items and consider the tax impact of their locations. A reevaluation of the capital structure of legal entities within the group, including tax-advantaged funding and debt-equity characterization, may prove helpful. Taking steps to avoid future insolvency of subsidiaries may help preserve the flexibility to engage in some tax-free transactions in the future that might otherwise be unavailable if the institution's solvency is in question. If there are troubled entities within the group, institutions should consider how to best use worthless stock losses, bad debt deductions, operating losses, or built-in losses, and to minimize the effect of section 382 or other limitations on the use of losses and other tax attributes.

b. Planning for dispositions. The determination of how to disentangle lines of business and legal entities should consider tax ramifications. If a business is not in a form that allows its easy disposition if the SIHC becomes distressed, some preliminary restructuring may need to be completed immediately (including segregating tangible and intangible assets and operations into separate legal entities) to facilitate an orderly and rapid disposition later.

c. Planning for capital-raising and internal restructuring transactions.

i. Capital-raising transactions. Recovery plans will certainly contemplate raising additional capital. The evaluation of tax issues concerning raising capital should consider not only the tax treatment of the instruments used to raise capital but also whether the anticipated capital-raising transactions or other changes to the capital structure of the affected entities shift the debt-equity balance or otherwise change the entity's tax profile in a meaningful way. The SIHC should consider a section 382 change in ownership, and it may want to consider alternative ways to raise capital or pre-transaction restructuring to reduce the effect of a section 382 limitation.

ii. Internal restructuring transactions. A living will may provide for a variety of internal restructuring transactions to simplify the group's operational and legal structure, to prepare for dispositions, or for other reasons.

d. Minding the tax effects of living will transactions.

i. In general. Dispositions, capital-raising transactions, and internal-restructuring transactions can all have indirect and collateral tax consequences that will vary depending on the circumstances.

ii. Step transactions. When evaluating the tax consequences of transactions in a living will, the transactions should be viewed both individually and as a whole. The step transaction doctrine and related concepts (including, for example, contribution-distribution, liquidation-reincorporation, and circular cash flow) may alter the tax outcome when transactions are viewed together.[65] For example, a distribution might be re-characterized as boot in a subsequent reorganization involving the same or related entities. The disposition or winding

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shareholder can materially impair the value of the subject corporation's NOL-deferred tax asset. *See* section 382(g)(4)(D).

[63]*See generally* ''Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure,'' 63 C.F.R. 64757 (Nov. 23, 1998); Burgess J.W. Raby and William L. Raby, ''Non-Tax Aspects of Tax-Sharing Agreements in Affiliated Groups,'' *Tax Notes*, June 3, 2002, p. 1491, *Doc 2002-12925*, or *2002 TNT 104-5*.

[64]The dual consolidated loss recapture provisions may prove particularly vexing because of the mandatory combined separate unit rule in reg. section 1.1503(d)-1(b)(4)(ii), which requires U.S. consolidated groups to combine all flow-through operations on a country-by-country basis. Thus, the disposition of assets or interests in foreign flow-through operations may trigger a dual consolidated loss recapture amount attributable to the entire combined separate unit, unless the disposition falls under the de minimis rule in reg. section 1.1503(d)-3(c)(5). *See* AM 2009-001, *Doc 2009-1777*, *2009 TNT 19-13* (application of de minimis rule in combined separate unit context). The government appears sympathetic to compulsory transfers, but the triggering event exception applies only to edicts and actions of foreign governments. *See* reg. section 1.1503(d)-6(f)(5). The government should provide a carveout for transfers required under the Act. *See* reg. section 1.1503(d)-3(b)(9).

[65]*See generally* Saul Levmore, ''Recharacterizations and the Nature of Theory in Corporate Tax Law,'' 136 *U. Pa. L. Rev*. 1019 (Apr. 1988); Lewis R. Steinberg, ''Form, Substance and Directionality in Subchapter C,'' 52 *Tax Law.* 457 (1999).

down of a business may affect a continuity of business, active trade or business, or similar requirement that may be relevant to another transaction or to a section 382 limitation.[66] Dispositions of equity and capital-raising transactions may affect the continuity of interest or ''control immediately after'' requirements for another transaction involving that entity.[67]

iii. Transfer pricing. As part of the internal restructuring transactions, important business functions may move from one entity or jurisdiction to another. The shifting of these functions may require a change in transfer pricing policies. Moreover, as an SIHC takes inventory of the interrelationships among legal entities within the group, those interrelationships (including intercompany debt arrangements, guarantee fees, and management fees) should be reviewed from a transfer pricing perspective.

iv. Cross-border transactions. On the international front, institutions should examine existing treaty positions and review which may need to be updated in light of changes to an institution's corporate structure and pattern of cross-border transactions. An inventory of withholding tax provisions should coincide with any treaty review.

B. The Volcker Rule

Section 619 of Dodd-Frank sets out the provisions of the Volcker rule, which has two parts: It prohibits banking entities from engaging in proprietary trading of some securities, and it prohibits them from sponsoring or investing in hedge funds or private equity funds.

1. Proprietary trading. There is doubt about the reach of the Volcker rule. It covers bank holding companies and some foreign entities treated as such under banking statutes, as well as any affiliates of those entities. Proprietary trading is defined as ''engaging as principal for the trading account of the banking entity'' in an enumerated list of securities that are identified by the banking regulators, the SEC, or the Commodity Futures Trading Commission as falling within the scope of the rule.[68] There are several permitted activities carved out of the rule, including, most importantly, trading in federal, state, and local securities, acquiring and disposing of securities in connection with underwriting and market-making activities, hedging direct risks on an institution's balance sheet, facilitating customer transactions, and making public welfare investments.[69] The Act lists investments that are qualified rehabilitation expenditures as being included in public welfare investments, but it is vague about other common investments made by financial institutions.[70]

As indicated above, there is considerable uncertainty as to the breadth of the proprietary trading rule. In almost every dealer account managed by a banking entity, taking positions within specified limits is the norm. It is doubtful that every position in a dealer account would be fully hedged at all times. There has been press speculation that some financial institutions may be examining ways to maintain proprietary trading desks under the new rules.[71] Until qualifying regulations are issued, the limits of the Volcker rule remain unclear.[72]

2. Investments in funds. The Act prohibits banking entities from investing in hedge funds and private equity funds, subject to a de minimis exception. Under the exception, a banking entity can invest in no more than 3 percent of the total ownership interests in a hedge fund or private equity fund. Also, the aggregate amount of a banking entity's otherwise permitted investments in hedge funds and private equity funds may not exceed 3 percent of the banking entity's Tier 1 capital. Moreover, the aggregate amount invested must be deducted from the banking entity's assets and tangible capital in determining its compliance with the capital requirements under the Act and relevant regulations.[73] The prohibition on investments does not apply to systemically important non-bank financial companies supervised by the Federal Reserve. However, those firms may be subject to additional capital requirements and limits on investments imposed under rules issued by the Federal Reserve, the SEC, or the CFTC.[74]

Subject to the limits set by the Act, some banking entities are assisting in the establishment of new hedge funds that will be run by proprietary traders previously employed by the bank. This assistance may take the form of providing seed money to the new fund, raising new capital from third parties, and providing services to the fund, including prime

[66]*See, e.g.*, reg. section 1.368-1(d); sections 382 and 355(b).

[67]*See, e.g.*, reg. section 1.368-1(e); section 351.

[68]Section 619(h)(4) of the Act.

[69]Section 619(d) of the Act.

[70]For example, section 48 energy credits may be affected by the statutory language stating that investments ''of the type'' specified in section 619(d) of the Act are not subject to the Volcker rule, but this is not clear from the wording of the statute.

[71]*See, e.g.*, Courtney Comstock, ''Details on How Citi Plans to Use Star Prop Trader Sutesh Sharma Under the Volcker Rules,'' *Bus. Insider*, July 28, 2010 (the trading operations may be moved into a fund that can be invested in by third-party customers, possibly taking advantage of the client-related exemption in the Act).

[72]The FSOC's proprietary trading guidelines, *supra* note 58, are general in nature, and more clarification from the regulatory agencies is expected.

[73]Section 619(d)(4) of the Act.

[74]Section 619(a)(2) and (b)(2) of the Act.

brokerage services. All of these activities are subject to the provisions of sections 23A and 23B of the Federal Reserve Act as enhanced by Dodd-Frank. Sections 23A and 23B require that all transactions between a banking entity and a related party be conducted strictly at arm's-length standards. Further, intercompany obligations are restricted and often require the posting of collateral with the banking entity to ensure that the related party's obligations will be met.

3. Effective dates. The Volcker rule becomes effective 12 months after the issuance of final regulations issued under Dodd-Frank, but no later than two years after enactment of the Act. Existing investments may be grandfathered for periods up to five years after the effective date of the rule.[75]

4. Possible tax issues. The tax issues relevant to the Volcker rule will concern two areas.

The first relates to the disposition of existing proprietary investments and the businesses that generated them. Should the business be sold or spun off in some form to shareholders, or will the investment activities simply cease? Can the existing business be put in a new fund as seed money? If so, what form should a banking entity's investment in the new fund take? If the investment activities are ceased and the business is terminated, what previously capitalized costs can be written off?

The second tax issue relates to the creation of new funds to replace old funds. How will the new funds be structured? If there are tax-exempt investors or foreign investors, what structuring must be done to take into account their tax sensitivities? Will the new fund be established onshore or offshore? How will the different capital and debt interests in the fund be formulated? How will the hedge fund managers be compensated? Will they be given carried interest?

A checklist of tax items of interest relating to living wills and the Volcker rule is attached as Appendix A.

IV. Derivative Push-Out Rule

Under the Lincoln amendment, Dodd-Frank establishes a new derivative Push-Out rule for FDIC-insured entities and other entities having access to Federal Reserve credit facilities.

A. The Push-Out Rule

The Lincoln amendment — the Push-Out rule — is a sweeping provision prohibiting most banks from being dealers in almost all derivative instruments (swaps). However, it is subject to several broad exemptions, so its reach will be more limited than it might seem.

The Push-Out rule operates through indirect legislation. Section 716 of the Act states that no federal assistance can be provided to a swaps entity, and federal assistance is defined to include FDIC insurance. Because FDIC insurance is required for almost all banks, the section effectively prohibits banks and their subsidiaries from being swaps dealers, except for exempt activities.

Under section 716(d) of the Act, banks may engage in the following types of swaps activities:

- being a swaps dealer in swaps involving rates (interest rate swaps and related derivatives);
- being a swaps dealer in swaps involving bank-eligible assets (most importantly, loans, some asset-backed securities (ABS), U.S. government and agency securities, some state obligations and municipal bonds, foreign currency, bullion, and marketable corporate grade debt securities); and
- engaging in hedging activities related to the bank's banking activities.

Any activities a bank is prohibited from engaging in must be terminated or moved to a non-bank affiliate of a bank holding company.[76] Those include nonqualifying credit derivatives and equity and commodity derivatives. A bank is prohibited from entering into any assistance arrangement (including providing tax breaks), loss sharing, or profit sharing with any swaps dealer.[77]

The Act prospectively applies to new swaps beginning in July 2012. In appropriate circumstances, banking regulators may provide a further two-year transitional period for banks to push out nonqualifying swaps activities. This period appears to run from July 2012.[78] Hence, swaps entered into before July 2014 should not violate the new rules, and they may be left in a bank.

Some uncertainty existed under Dodd-Frank about whether the Push-Out rule applies to foreign exchange swaps and forwards. Under the Act, the secretary of the Treasury has authority to determine whether the definition of a swap should include these types of derivatives. On April 29, 2011, the Treasury secretary issued a proposed rule taking them out of the definition of a swap for most

[75]Section 619(c) of the Act.

[76]A non-bank affiliate is a subsidiary that is owned by a bank holding company but not owned directly or indirectly by a bank. *See* the discussion below and in Part III.B.2 of this report on foreign Edge Act subsidiaries for a possible limited exception to the Push-Out rule.

[77]Section 716(b)(D) of the Act. It is unclear what is meant by "tax breaks" in this provision.

[78]Section 716(e), (f), and (h) of the Act.

purposes of the Act.[79] The effect of the proposed rule is to remove those contracts from the clearing and exchange trading (but not the reporting) requirements of the Act as well as from the Push-Out rule. The proposed rule does not cover foreign exchange options, currency swaps, and non-deliverable forwards.

It is unclear whether the Push-Out rule applies to U.S. branches of foreign banks. By its terms, the Act applies to all those branches. For branches that are insured by the FDIC, both the rules and the exemptions from the rules should apply. For branches that are not insured by the FDIC, the rules apply but the wording of the Act excludes them from the exemptions. This was not the intention of the legislation's drafters, and a technical correction may be needed to resolve the issue.[80]

The Act's application to foreign Edge Act subsidiaries of a bank is also unclear. Edge Act subsidiaries are foreign corporations owned by a federally incorporated bank subsidiary that acts as a holding company for those foreign companies. The foreign subsidiaries are authorized under the Federal Reserve Act to engage in a broad set of banking activities overseas and the law was designed to permit them to compete effectively with locally incorporated banks, allowing them to perform trading activities that would otherwise be prohibited to banks under Dodd-Frank. Rules issued in April by the Federal Reserve and other agencies suggest that Dodd-Frank provisions regarding clearing and exchange trading of swaps may apply to Edge Act subsidiaries. If that is the case, the Push-Out rule may also apply.[81]

B. Tax Aspects of the Push-Out Rule

1. Background. The tax issues arising from the Push-Out rule will depend on how different institutions choose to arrange their swap dealing activities once the rule becomes fully effective. Many large institutions already split some swap dealing activities between their banking subsidiaries and non-banking affiliates. The focus of the following discussion will be on U.S. incorporated banks (Bank or Banks) owned by U.S. bank holding companies (Bank Holdcos).

Before Dodd-Frank, a Bank would typically be the dealer for interest rate and credit-related swaps and would conduct all foreign exchange activity. Because of restrictions in the banking regulations on equity and equity derivative dealings in a Bank, non-bank affiliates would typically engage in these types of dealer activities.

Many Banks today book their swaps in one entity, and traders may trade off that book in remote locations. For example, a Bank may choose to book all of its non-U.S.-dollar interest rate swap activities in a U.K.-based entity and all of its U.S.-dollar interest rate swap activities in a Bank. Traders may trade off these books from a multitude of locations outside the United States and the United Kingdom. In some cases, these books will be maintained in the Bank, and the traders trading off the books will be employed by both branches of the Bank and non-bank affiliates. In other cases, an interest rate swaps book may be maintained in a non-bank affiliate, and traders employed by both the Bank and non-bank affiliates may trade off that book. Many other variations of these facts are possible.

In the future, Banks will need to decide whether they want to unify all their swaps dealings in a non-bank affiliate or split that activity among the Bank, its subsidiaries, and its non-bank affiliates. A Bank is generally more creditworthy than a non-bank affiliate. Hence, Bank Holdcos may want to retain as much swap activity as possible in their Banks. Conversely, Bank Holdcos may want to net or offset as many swaps positions as possible with their counterparties to minimize risk and the amount of capital needed to be set aside for their swap trading activities. Generally, netting between two different legal entities is more legally effective than netting with multiple related legal entities.[82] Consequently, the desire to net positions may cause Banks to rid themselves of all swap positions.

Assuming a Bank Holdco decides to move some or all of its swap dealing activity from a Bank to a non-bank affiliate, the Bank will have to review its current trading pattern and decide what books and people it will need to move to meet its new trading pattern. At a minimum, it will have to comply with the Push-Out rule. Moving a trading book from a Bank to a non-bank affiliate but leaving the traders

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[79]Treasury, "Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act" (Apr. 29, 2011).

[80]Former Sens. Blanche Lincoln and Christopher J. Dodd said on the floor of the Senate that the Act should apply to noninsured branches of foreign banks the same way that it applies to insured branches. This intent may need to be reflected in a technical corrections act. 156 *Cong. Rec*. S5903-S5904 (July 15, 2010).

[81]Federal Reserve, Office of the Comptroller of the Currency, FDIC, Farm Credit Administration, and Federal Housing Finance Agency, "Margin and Capital Requirements for Covered Swap Entities" (Apr. 2011); *see also* Aline van Duyn, "ET Stokes Fears About Sweeping Swaps Rules," *Fin. Times*, May 3, 2011.

[82]For a discussion of netting issues, see Financial Accounting Standards Board, "Proposed Accounting Standards Update, Balance Sheet (Topic 210), Offsetting" (Jan. 28, 2011).

as employees of the Bank or its subsidiaries will probably not satisfy the Push-Out rule.[83]

2. Treatment of Banks. In this section, we evaluate the Push-Out rule under several fact patterns common in banking groups prior to Dodd-Frank, confining ourselves to possibilities for the taxable transfer of assets and related liabilities from a Bank to a nonbank affiliate.

a. Swap book and associated personnel are in the Bank. Banks may consider three taxable alternative for moving a swap dealing book and associated personnel from a Bank to a non-bank affiliate.[84]

i. Move personnel to a non-bank affiliate, leave existing swaps in the Bank, and book all new swaps in the affiliate.

Intangible assets. If existing swaps will remain in the Bank, there is a question as to whether any intangible assets have been transferred. The movement of a small group of traders and sales personnel should not constitute a taxable event. Reg. section 1.482-4(b) provides that the services of any individual, on their own, do not constitute a valuable intangible. Taxpayers often argue that the services of a person employed at will cannot be sold, and there is case law supporting the position that a workforce in place is not a discrete intangible asset for U.S. tax purposes.[85] Conversely, if the individual's services are provided under an employment contract or are covered by an agreement not to compete, the contracts themselves will constitute an identifiable intangible asset.

Section 197(d)(1)(C)(i), however, recognizes a workforce in place as an identifiable intangible for purposes of section 197, irrespective of whether the employees are covered by employment contracts. Further, a workforce is considered to be a part of the platform intangible under the temporary cost-sharing regulations in reg. section 1.482-7T.

The movement of a trading book and associated personnel may also move a customer-based intangible. While those intangibles are recognized under section 197 and have been recognized in case law,[86] a customer-based intangible of value often does not exist in a bank's derivative trading operations, because of the nature of a bank's relationship with its counterparties: it has no assurance of future profitable business from them.

In *Hospital Corp. of America v. Commissioner*,[87] the IRS argued that a U.S. corporation that directed a foreign subsidiary to enter into a contract that the parent had done the preliminary negotiations on transferred a business opportunity intangible to the subsidiary. The Tax Court held against the IRS, finding no intangible property had been transferred. By analogy in the current context, the mere movement of future trading activity might not constitute the transfer of a business opportunity intangible, because the transferor will play no role in the creation of the new trading positions and the transferee's capital will be deployed to absorb the risk of the new positions.

Even if workforce in place, customer-based, and business opportunity intangibles do not constitute identifiable intangible assets for tax purposes in the current situation, the movement of a swaps business may still involve the transfer of goodwill and going concern value. Given the conflicting views on the treatment of intangibles, a facts and circumstances approach could be useful. When a substantial group of people constituting an entire business is being moved, the analysis will start with the assumption that there is a tax realization event. If that view is adopted, the taxpayer will have to determine whether the stand-alone business has an FMV over the tax basis of any assets being transferred. Since the historic positions are being left behind, few of the assets being transferred will have book value. Accordingly, the valuation issue will largely concern the value of self-generated intangibles such as goodwill. If the intangibles have value, we consider their tax treatment (and that of any related assets) when they are transferred under three scenarios.

a. Transfer within a U.S. controlled group. In the simplest case, the business will be transferred between members of the U.S. parent's consolidated group and the intercompany transaction regulations will apply.[88] Also, the rules in section 267(f) will cover transfers between members of a controlled group that are not members of the U.S. consolidated return group.

[83]If under a group's transfer pricing policy, a Bank assumed no risk for the trading positions booked in a non-bank affiliate (even though the traders were employed by it), the mere booking of positions outside the Bank might satisfy the push-out rule. However, that transfer pricing policy would not be acceptable under the local laws of most countries. *See* the analysis in the OECD, "Discussion Draft on the Attribution of Profits to Permanent Establishment (Part III (Enterprises Carrying on Global Trading of Financial Instruments)) (Feb. 2001). It may not be acceptable under the Push-Out rule, either.

[84]Under reg. W of the U.S. banking regulations (12 C.F.R. 223), any property transferred to or from the Bank must be transferred at FMV.

[85]*Hosp. Corp. of Am. v. Commissioner*, 81 T.C. 520 (1983), *nonacq.*; *Ithaca Industries v. Commissioner*, 97 T.C. 253, 271-272 (1991), *aff'd*, 17 F.3d 684 (4th Cir. 1994); *but see Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993), *Doc 93-4810, 93 TNT 87-1*.

[86]Section 197(d)(1)(C)(iv); *Newark Morning Ledger*, 507 U.S. 546.

[87]*See Hosp. Corp. of Am.*, 81 T.C. 520.

[88]Reg. section 1.1502-13.

b. Transfers between CFCs. If a business is assigned from one controlled foreign corporation to another, the subpart F rules provide that the transferring CFC will not be taxed immediately, except if it qualifies for the active financing exception under section 954(c)(2)(C) or (h).[89] There is an exception from foreign personal holding company income in section 954(c)(1)(B) for income from the sale of section 954(h) property. Also, reg. section 1.954-2(e)(1) and -2(e)(3) generally should provide protection from foreign personal holding company income treatment for gains from the sale of dealer property and intangible assets (including goodwill and going concern), respectively, used in an active trade or business. While the sales discussed here involve related parties, they should not trigger foreign base company sales income under section 954(d), because either the property involved (i) will be treated as sold for use in the country where the selling CFC is incorporated, or (ii) was created in the country where the CFC is located.

c. Transfers from a U.S. entity to a CFC. If the transfer is between a bank and an Edge Act CFC, it is potentially covered by sections 351 and 367(a). This type of transfer is not usually covered by section 351 because the transferor, standing alone, will not satisfy the post-transfer control test.[90] In a few cases, the test may be satisfied jointly, either under reg. section 1.1502-34 when the CFC acquirer is a first-tier CFC and the existing owner is a member of the consolidated group, or, less often, when the historic owner of the CFC contributes additional capital to the CFC as part of the same plan in which the swaps business is being moved out of the United States.[91] When the requirements of section 351 are satisfied, the provisions of section 367(a) and (d) must still be met. In all other cases, the movement of a business out of the United States will probably be taxable. Losses arising from the assignment will be subject to the disallowance rules of section 267(a) and (d).[92]

ii. Move personnel and existing swaps from the Bank to a non-bank affiliate and book all new swaps in the affiliate. This alternative may be the most attractive if a Bank wishes to maximize the netting of its swaps book, but it will require every existing swap to be novated. The International Swaps and Derivatives Association established a novation protocol in 2005 that was updated in 2010.[93] Many financial institutions use it. Nevertheless, novating a large portfolio is a costly and laborious project.

Assuming a taxable transfer of assets and related liabilities, the analysis of the treatment of intangibles is similar to that in the discussion in the section above. Because existing positions will be moved under this alternative, there is a greater likelihood that an entire trade or business has been moved out of the Bank.

If the value of the swaps being transferred has changed from the time the swaps were entered into, an upfront payment will be required from one of the parties to the transaction to reflect that change in value. The Bank may realize some gain or loss on those positions. The timing of the recognition of that gain or loss will be subject to the same analysis as discussed in the preceding section.

The non-bank affiliate taking on the swap will typically be a swaps dealer. The transfer of the swaps from the Bank will move the swaps to the balance sheet of the affiliate and put the affiliate in the same position as if it had originally entered into the swaps.[94]

iii. Move personnel to non-bank affiliate, book all new swaps in the affiliate, and transfer the risk in existing swaps by mirroring intercompany swaps with the affiliate. Because existing swaps may be difficult to novate, some Banks may try to keep their historic books and new books integrated through internal swaps between the Bank and the non-bank affiliate entering into the new swaps. This might be done by a single master swap between the Bank and the affiliate or by a series of back-to-back swaps for each derivative position between the Bank and the affiliate. However, while Dodd-Frank does not appear to prohibit

[89]Section 954(c)(2)(C) and (h) were extended to the tax years of foreign corporations beginning before January 1, 2012, by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, section 750 (P.L. 111-312).

[90]Sections 351(a) and 368(c).

[91]An accommodation exchange by an existing shareholder will be disregarded in analyzing the post-transfer control test. *See* Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Proc. 77-37, 1977-2 C.B. 568, section 3.07 (for ruling purposes, property contributed by the existing shareholder must equal at least 10 percent of the value of the stock it already owns).

[92]The triggering of dormant tax liabilities (*e.g.*, gain recognition agreements and recapture provisions) must also be considered.

[93]ISDA, ''August 2010 Additional Provisions for Consent to, and Confirmation of, Transfer by Novation of OTC Derivative Transactions'' (Aug. 25, 2010).

[94]Reg. section 1.446-3(h) provides for the treatment of termination payments of notional principal contracts (NPCs). The NPC regulations do not directly provide for the treatment of payments to or by an assuming swaps dealer. However, the payment will put them in the same position economically as if they had entered into the swap initially and should simply establish the derivative's position on the non-bank affiliate's books. *See generally* reg. section 1.446-3(f) and (g)(4) (treatment of assuming party). The treatment of derivatives not constituting NPCs should generally be the same.

mirror swap transactions between a Bank and non-bank affiliate, Banks may find this process cumbersome and expensive.[95]

If a Bank does enter into mirror swap transactions, the execution of those swaps raises several interesting questions. When a Bank books a swap in one entity and wishes to move the position to a related entity, it will typically enter into a back-to-back swap that mirrors a third-party transaction with the transferee entity. The effect of the back-to-back swap is to transfer market risk on the position to the transferee entity, but absent an additional contractual provision transferring the third-party credit risk, that risk will be left with the transferor entity. Leaving the credit risk with the transferor entity will often be optimal since it holds collateral from the third party to cover any credit risk. If the related parties wish to transfer credit risk as well as market risk, another contractual provision can be drafted, to reflect the reduction in credit risk attributable to the collateral held by the transferor.

The swap and the related payment may have to be split into two pieces: an on-market swap and a loan under reg. section 1.446-3(g)(4). However, in most cases involving the Push-Out rule, both the Bank transferor and the non-bank affiliate transferee will be swaps dealers. In those cases, the novation rules discussed in the preceding section might apply, the bank would treat any payment as a termination payment, and the non-bank affiliate would treat any payment as putting it in the same position as if it had entered into the mirror swap when the original third-party transaction was executed.

b. Swap book and personnel are split between the Bank and a non-bank affiliate. Under this scenario, the typical pattern is that the swaps are booked in the Bank because of its greater creditworthiness, and trading personnel are employed in one or more Bank and non-bank affiliates. An institution having this type of structure will split the trading profits between the Bank and the non-bank affiliate using its transfer pricing policy.[96]

In those cases, the Bank will need to move the trading book and any trading personnel in the Bank to satisfy Dodd-Frank. The tax analysis here is similar to the prior analysis regarding the movement of intangibles and trading books.

3. Effect on customers. If swaps in the Bank are novated and the existing swap positions are assumed by a non-bank affiliate, the assignment of the swaps may trigger a taxable event to the Bank's customer (the non-assigning counterparty). Under the general principles in section 1001, the substitution of a new counterparty generally constitutes a taxable event.

The regulations contain an exception to this general rule.[97] Under it, the assignment of a notional principal contract (NPC) between two parties both of which are dealers in NPCs is not treated as a deemed taxable exchange if the terms of the contract permit the substitution. This exception could apply in some instances, but it may not cover most contracts being assigned by a Bank to a non-bank affiliate. When the exception doesn't apply, some negotiation with the non-assigning counterparty may be necessary under the ISDA protocol to transfer or assign the swap, because counterparties are likely to resist any novation that would cause them adverse tax consequences.

C. U.S. Branches of Foreign Banks

U.S. branches of foreign banks must comply with Dodd-Frank and must transfer nonexempt swaps and related personnel to their own non-bank affiliates. Alternatively, they may simply move the affected trading operations out of the United States. When the foreign bank moves a swaps book and associated personnel to a non-bank affiliate, the tax analysis will be similar to the prior analysis. The tax treatment of the movement of trading operations out of the United States to the foreign head office or another non-U.S. branch of the bank is more complicated.

The U.S. tax treatment of U.S. branches of foreign entities involves a two-step approach. Firstly, a determination is made of the activities conducted in the branch and the assets effectively connected with it. Secondly, expenses are allocated and apportioned to the assets effectively connected with the branch based on the connection of the expenses to those assets or based on a formulary approach.[98] Generally, transactions between a U.S. branch of a foreign

[95]The transactions would be subject to the covered transaction rules in reg. W requiring arm's-length dealing and the posting of collateral to cover specified related-party positions. Also, the transferee swaps entity may need additional capital to cover the internal swap positions while the banking regulators may not permit a reduction of the capital in the transferor Bank by virtue of the mirror swap.

[96]The transfer pricing policy must satisfy both the tax rules and the reg. W rules. There is no single acceptable transfer pricing policy, but most transfer pricing policies in this area involve either a return on capital model or a hedge fund model.

[97]Reg. section 1.1001-4 sets out an exception to the taxable treatment of a novation of some derivatives when the assignor and the assignee of an NPC are both dealers and the contract permits the substitution.

[98]Sections 864(b), 864(c), and 882, and the regulations issued thereunder.

corporation and the corporation's head office or another branch of the corporation are ignored for U.S. tax purposes.

Once a determination is made that assets are effectively connected with a branch, the sale of those assets to another branch of the same entity will not be viewed as effectively transferring the assets for U.S. tax purposes. In some cases, the sale indicates an underlying change in how the business is being run, affecting the control of the assets. A good argument can then be made that there has been an effective movement of the assets under U.S. tax law. Given the Push-Out rule, this argument may prove persuasive regarding the movement of a trading book from a U.S. branch to a non-U.S. branch.[99]

While the U.S. tax authorities seem to be concerned about the taxation of the movement of a workforce in place, the transfer of a swaps workforce (or any other intangibles) from a U.S. branch to a non-U.S. branch is likely not to be treated as a taxable event.

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[99]Assets that cease to be effectively connected with a U.S. trade or business may trigger a branch profits tax under section 884 or call into play the rule in section 864(c)(7) regarding the disposition of property within 10 years of its ceasing to be effectively connected with such a trade or business.