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ABSTRACT: Lee A. Sheppard reports on comments about coming guidance affecting the financial sector by Treasury and IRS officials who attended the American Bar Association Section of Taxation meeting in Boston September 14 and 15.

SUMMARY: Published by Tax Analysts(R)

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AUTHOR: Sheppard, Lee A.
Tax Analysts

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When IRS Commissioner Douglas Shulman made his last official appearance before the American Bar Association Section of Taxation in Boston on September 15, he put in a plug for the Large Business and International Division's revived industry issue resolution (IIR) program for the development of industry-specific safe harbors. He promised that taxpayers would see "more and more" IIR guidance.

There is apparently no limit to issues that the program will accept. It seems that the IRS will even accept factual questions that would be ineligible for letter rulings. The insurance industry just obtained a special IIR for partial worthlessness of debt holdings (LB&I-04-0712-009, *Doc 2012-16297, 2012 TNT 148-17*).

The insurance industry -- whose players and their representatives are pretty easy to assemble in one place -- has some other IIR issues on tap, a representative reported at the September 14 luncheon of the various ABA tax section financial committees.

Kevin Brown of PricewaterhouseCoopers LLP, who held several posts in government, plugged the IIR program at the luncheon. "It is a bit of a negotiation" because the result has to be acceptable to both sides, said Brown of the program.

Other discussions at the financial committees explored more conventional routes to guidance.

Cost Basis Reporting

A discussion of the finalization of proposed cost basis reporting regulations in the Banking and Savings Institutions Committee session revealed that the IRS is being asked to resolve long-unresolved substantive questions about reporting of securities transactions. (For REG-102988-11, see *Doc 2011-24609* or *2011 TNT 226-11*.)

As observers including Steven M. Rosenthal of the Urban-Brookings Tax Policy Center suspected, it may be that some things were hardly ever reported correctly under the long-standing substantive provisions. (For his discussion, see *Doc 2012-7606*

or *2012 TNT 73-15*.)

"It's a very odd place to be deliberately or accidentally providing substantive guidance," said Pamela Lew, branch 3 general attorney in the IRS Office of Chief Counsel (Financial Institutions and Products). "We're very aware of that."

Lew reported that the IRS is working "as quickly as we can" to finalize the proposed regulations in time for brokers to gear up their programming to comply. A high priority is rules for calculation of basis for debt securities, which can change over time.

Historically, options generally were not covered by the rules for Form 1009-B, "Proceeds from Broker and Barter Exchange Transactions,", because they were closed out through offsets when no one took delivery of the optioned security. Retail investors now buy options, so there is a gap in coverage. Section 6045(h) now requires transaction reporting for options and differentiates cash-settled and physically settled options. But there are no special rules for section 1256 options in the proposed regulations, even though regular reporting could be dubious because it would not take previous marking into account. Lew said the IRS is working on the problem.

Problems can arise when wash sales are made in accounts with two different brokers, and in original issue discount reporting. The taxpayer may be conducting wash sales in two different accounts and not reporting them because the brokers have no way of knowing his other positions. Neither the OID rules nor the cost basis rules require the issuer and the holder to report consistently. And tax-exempt OID, market discount, and bond premium are currently not reported by brokers.

"Reconciliation is a really, really, really big concern," said Lew, who added that the IRS has been having forums with the American Institute of Certified Public Accountants to work to minimize the divergence in reporting between brokers and tax return preparers. "We are hoping that eventually the systems will be less divergent," she said, adding that adjustments will still be necessary for things that brokers are not required to report.

Rosenthal expressed surprise about how expensive basis reporting compliance has turned out to be. Stevie D. Conlon of Wolters Kluwer Financial Services Inc. noted that costs are driven up by the need to interject expensive humans to make sure compliance software functions properly. Debt securities are particularly touchy because compliance may require human beings to read offering documents. (For hearing coverage, see *Doc 2012-5606* or *2012 TNT 53-4*. For comments, see *Doc 2012-7283* or *2012 TNT 67-9* and *Doc 2012-3873* or *2012 TNT 37-13*.)

Contingent Payment Derivatives

Several former government officials who worked on derivatives projects joined Michael Novey, Treasury associate tax legislative counsel, at the ABA tax section Financial Transactions Committee session on September 14 to discuss the progress (or lack thereof) on guidance for tax accounting for contingent payment derivatives.

At times it appeared as though no one on the panel knew what an accounting method change is or how the IRS goes about permitting one. The preamble to 2004 proposed contingent payment swaps regulations stated that "wait and see" is not a reasonable accounting method. But the IRS did not issue a revenue procedure to permit an automatic change to a reasonable method. (For REG-166012-02, see *Doc 2004-4065* or *2004 TNT 40-19*.)

The preamble's unenforceable instruction left taxpayers -- many of which are financial intermediaries with their own agendas -- feeling free to use whatever method they wanted, even including wait and see. Happily, large accounting firms do not permit clients to use wait and see. David Shapiro of PricewaterhouseCoopers joked that the financial auditors are the real enforcers in this situation.

Most holders of contingent payment swaps are marking to market for book and using the same numbers for tax, without bothering about tax rules, according to Viva Hammer of KPMG LLP. Alan Munro of Ernst & Young LLP noted that the IRS initially refused some accounting method change requests but later permitted issuers to switch to mark to market, without breaking out a debt element in credit default swaps.

Some holders use their own projections of the contingent payments, or a modified full allocation method, so that expenses are netted out for individual investors who are subject to section 212, Munro said. Conlon interjected that no one uses the noncontingent bond method of the proposed regulations, because computer systems are not able to handle the required repricing of the contingency.

The participants concurred that clinging to the administrative definition of notional principal contract (NPC) in reg. section 1.446-3(c)(1) does not require the use of the same accounting method for every type of contract that meets that definition. That old definition has been broadened to include credit default swaps (CDS) and bullet swaps in 2011 proposed regulations. (For REG-111283-11, see *Doc 2011-19606* or *2011 TNT 180-13*.)

"There are very material economic and other distinctions between CDS and other plain vanilla NPCs," Novey said. "Not every NPC should be timed exactly the same way." Hammer concurred but argued that the government should explicitly disavow the 2004 proposed regulations.

Issuers are adopting wait and see for credit default swaps because of inaction, Munro said. CDS contracts do not all have the same terms. What is thought of as a conventional CDS with no periodic payments and a completely contingent payment at the end of the term -- for which wait and see would be appropriate -- hardly exists any more. (For discussion, see *Doc 2009-*

16610 or *2009 TNT 141-2*.)

Is wait and see reasonable? Novey allowed that it could be reasonable for the old-style CDS with no payments until the end. "With a CDS, maybe wait and see could, in the absence of guidance, be treated as reasonable," he said, noting that CDS do not have a lot in common with other NPCs.

But this method should not be the preferred approach to CDS. "Wait and see is not a good answer," Novey commented, having earlier noted his distaste for allowing CDS holders to accrue unrealized losses. Some CDS have large upfront payments, and even large periodic payments, making them unsuitable for wait and see, Munro explained.

Adding to the confusion, tax policymakers appear to be flying blind. They don't know who issues contingent payment swaps, and they don't know who buys them. Without knowing how these contracts are used, policymakers cannot know whether there is tax avoidance they should be concerned about, or alternatively, whether parties on both sides are marking their books, in which case book treatment may well be acceptable for tax reporting.

Total Return Swaps

Section 871(m) says what it says, but the whinging goes on. Hedge funds that claim foreign residence find it unacceptable that they should incur withholding tax on dividend equivalent payments on total return swaps on U.S. equities.

Michael Farber of Davis Polk & Wardwell LLP delivered the industry view at the Financial Transactions Committee session on September 14: Withholding should be limited to transactions in which the hedge fund held the shares, parked them with the swap counterparty, dictated the terms of the swap, and maybe even bought the shares back after the dividend date.

The statute doesn't say that. Section 871(m) states that as of March 18, 2012, withholding applies to any payment that is equivalent to a dividend. Section 871(m)(2)(B) asks whether the payment is "contingent upon, or determined by reference to, the payment of a dividend from sources within the United States." The IRS recently extended the effective date of withholding to January 2014 (Announcement 2012-35, 2012-38 IRB 356, *Doc 2012-19145*, *2012 TNT 180-33*).

Karl Walli, senior counsel (financial products) in the Treasury Office of Tax Legislative Counsel, explained that the extension gives the government more time to write a new and improved version of the much-maligned temporary regulations (T.D. 9572, *Doc 2012-1099* or *2012 TNT 13-6*).

Walli reiterated that reg. section 1.863-7 caused investors to plan into foreign-source income for swaps and emboldened them to switch between holding the physical shares to entering a swap and back again. Dividends showed up in many different forms, and some swap payments replicated them to the penny. This compelled Congress to act.

"As long as the United States has a withholding tax, we have a responsibility to ensure that there is no alternative regime with no withholding," Walli said.

It often seems as though hedge fund representatives are blaming the messenger when they complain to executive branch officials. But what they are really doing is more subtle. The financiers are giving an ultimatum: Either water down the statute so that nothing but the most blatant parking deals will be subject to withholding tax, or we will go to Congress. They are believed to be gearing up to ask for repeal.

The odd part of the industry calculus is the assumption that the IRS has a stake in section 871(m). Far from it -- the IRS has demonstrated again and again that it is ill-equipped to enforce withholding taxes on cross-border securities transactions.

But the agency has a clear incentive not to water down section 871(m), when the predictable result would be to subject Shulman or his successor to more grilling by Sen. Carl Levin, D-Mich., chair of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations. Of course, Levin proposed section 871(m), but he did not enact it into law on his own or in the dark of night. The entire Congress had to pass it.

FATCA

The members of the ABA tax section financial committees represent financial intermediaries, most of which would be subject to the Foreign Account Tax Compliance Act, enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147, *Doc 2010-6053* or *2010 TNT 54-59*).

Steven Musher, IRS associate chief counsel (international), appeared at the Financial Transactions Committee session to confirm the news that, yes, indeed, hedge funds and their management companies are foreign financial institutions (FFIs) subject to FATCA.

But final FATCA regulations are coming in the fall, so investment funds and other FFIs can adjust their computer systems. "We have them chained to their desks," Musher said of the regulations drafters. The regulations will be followed by draft FFI agreements and forms.

Musher would not admit that the final regulations would move in the direction of the intergovernmental agreements being negotiated with several European countries. He explained that IGAs were intended to accommodate national laws that would

not permit FFIs to give account information directly to the IRS. "We're looking at whether and how to harmonize the IGAs and the final regulations," he said.

For an investment fund to be a deemed compliant FFI under the model IGA, both the fund and the management company must be resident in an IGA partner country, Musher explained. That means that a fund with a London management company must itself be resident in the United Kingdom (and not the Cayman Islands) to be eligible for relief under the IGA negotiated with the British government.

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