

# 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 article we 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.

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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 article represents the views of the author only and does not necessarily represent the views or professional advice of KPMG LLP.

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## TABLE OF CONTENTS

- I. Prelude
- II. Capital Adequacy
  - a. Regulatory Environment
    - i. Dodd-Frank
    - ii. Basel III
    - iii. Contingent capital
    - iv. Timing of implementation
  - b. CoCos
    - i. Background
    - ii. Issuances
    - iii. U.S. tax treatment of issuer
      - 1. Debt versus equity

- 2. Deduction of interest under section 163(l)
    - iv. Tax treatment if issued in the United States – treatment of holder
    - v. Tax treatment if issued by a controlled foreign corporation
  - c. Trust-Preferred Securities
  - d. Deferred Tax Assets
- III. Living Wills and the Volcker Rule
  - a. Living Wills
    - i. Regulatory background
    - ii. Effective date
    - iii. Tax considerations
      - 1. Taking inventory
      - 2. Planning for dispositions
      - 3. Planning for capital-raising and internal restructuring transactions
  - b. Minding the tax effects of living will transactionsThe Volcker Rule
    - i. Proprietary trading
    - ii. Investments in funds
    - iii. Effective dates
    - iv. Possible tax issues
- IV. Derivative Push-Out Rule
  - a. The Push-Out Rule
  - b. Tax Aspects of the Push-Out Rule
    - i. Background
    - ii. Treatment of Banks
      - 1. Swap book and associated personnel are in the Bank
        - a. Move personnel to a non-bank affiliate, leave existing swaps in the Bank, and book all new swaps in the affiliate
        - b. Move personnel and existing swaps from the Bank to a non-bank affiliate and book all new swaps in the affiliate
        - c. 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
      - 2. Swap book and personnel are split between the Bank and a non-bank affiliate
    - iii. Effect on customers
  - c. U.S. Branches of Foreign Banks
- V. Securitizations
  - a. Background
  - b. The Proposed Regulations
    - i. Scope of the proposed regulations
    - ii. Permitted methods of risk retention
      - 1. Vertical risk retention
      - 2. Horizontal risk retention
      - 3. L-shaped risk retention
      - 4. Representative sample
      - 5. Revolving asset master trust
      - 6. Asset-backed commercial paper conduit

- 7. CMBS
  - 8. Premium capture cash reserve account
  - iii. Hedging, transfer and financing restrictions
  - iv. Exemptions from the risk retention requirements
  - v. When are equity interests ABS interests?
  - vi. Cash reserve accounts
- c. Tax Effects of the Proposed Regulations
  - i. Issuing entity treated as a grantor trust
  - ii. Issuing entity treated as a disregarded entity
  - iii. Issuing entity treated as a partnership
  - iv. Issuing entity treated as a corporation
  - v. Issuing entity treated as a REMIC
  - vi. Effect of proposed regulations regarding hedging
- VI. Derivatives
  - a. Early Warnings of Derivative Regulation
  - b. OTC vs. Exchange-Traded Derivatives Before Dodd-Frank
  - c. Section 1256
  - d. Section 1256 and the Act
  - e. Regulation of Derivatives in Dodd-Frank
    - i. Swaps defined broadly for regulatory purposes
    - ii. Regulation of OTC derivatives
    - iii. Compulsory swap clearing
    - iv. Trading
  - f. Applicability of Section 1256
- VII. Executive Compensation and Corporate Governance
  - a. Shareholder Approvals and Disclosures
    - i. The Act's provisions
      - 1. Shareholder approval of executive compensation ("say on pay")
      - 2. Shareholder approval of golden parachutes
      - 3. Disclosure of executive pay versus performance
      - 4. Disclosure of employee and director hedging
    - ii. Effective dates
    - iii. Tax issues
  - b. Recovery of Compensation Determined as Excessive on an Accounting Restatement
    - i. The Act's provision
    - ii. Effective date
    - iii. Tax issues
  - c. Independence
    - i. The Act's provisions
    - ii. Tax issues
- VIII. Conclusion

## Appendix A: Living Wills – Tax Issues Checklist

Planning for Dispositions

Other Internal Restructuring and Capital-Raising Transactions (in Addition to the Above Issues)

Side Effects  
Other Considerations for Living Wills  
Establishing New Hedge Funds and Private Equity Funds

## Appendix B: Index to Provisions of the Dodd-Frank Act Having Tax Significance

Bank Capital and Liquidity  
Living Wills  
Volcker Rule  
Derivatives  
Securitization  
Executive Compensation and Corporate Governance

## Appendix C: Glossary of Terms

### I. Prelude

A single page is devoted to tax in the behemoth Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>1</sup>: 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 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. 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

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<sup>1</sup> P.L. 111-203, H.R. 4173 (hereinafter "Dodd-Frank" or "the Act").

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 the 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**

#### **i. *Dodd-Frank***<sup>2</sup>

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 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.<sup>3</sup>

#### **ii. *Basel III***

The Basel Committee on Banking Supervision<sup>4</sup> 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).

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<sup>2</sup> Section 171 of the Act contains the provisions regarding capital for financial institutions.

<sup>3</sup> 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 in order 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.

<sup>4</sup> 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.

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.<sup>5</sup>

Table 1. Summary of Basel III Capital Requirements		
	Capital as Percentage of Risk-Weighted Assets	
	Old Requirement	Basel III Requirement*
<b>Tier 1 &amp; 2 Capital</b>		
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%
<b>Additional Special Capital</b>		
Capital Conservation Buffer Common Equity	N/A	2.5%

<sup>5</sup> 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.

Counter Cyclical Capital Buffer	N/A	nil to 2.5%
*when fully implemented		

### **iii. *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.<sup>6</sup>

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.”<sup>7</sup> 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.<sup>8</sup> New CoCos convert from debt to equity when the 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.<sup>9</sup>

### **iv. *Timing of implementation***

<sup>6</sup> Basel committee, “Minimum Requirements to Ensure Loss Absorbency at the Point of Non-Viability,” issued with a press release (Jan. 13, 2011).

<sup>7</sup> Section 165(c) of the Act.

<sup>8</sup> The new CoCos are unlike any previously issued convertible instruments in that conversion is mandated when the 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).

<sup>9</sup> David Enrich, “Banks Find Loophole on Capital Rule,” *The Wall Street Journal* (Feb. 18, 2011).



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.<sup>10</sup>

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.<sup>11</sup> 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**

### **i. *Background***<sup>12</sup>

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.<sup>13</sup> 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.

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<sup>10</sup> Section 171(b)(4) of the Act.

<sup>11</sup> Basel III rules, *supra* note 5, at 27-29 and Annex 4.

<sup>12</sup> 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>.

<sup>13</sup> *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."

- (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.

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.

## **ii. *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.<sup>14</sup>

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 mitigate 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.

### **iii. U.S. tax treatment of issuer<sup>15</sup>**

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<sup>14</sup> 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.

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).

### 1. *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.<sup>16</sup> 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.<sup>17</sup>

For U.S. tax purposes, an instrument generally is treated as debt or equity,<sup>18</sup> 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.<sup>19</sup>

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<sup>20</sup> and Notice 94-47.<sup>21</sup>

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<sup>15</sup> 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.

<sup>16</sup> *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

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

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

<sup>19</sup> *Berkowitz v. United States*, 411 F.2d 818, 820 (5th Cir. 1969).

<sup>20</sup> 1985-2 C.B. 60.

<sup>21</sup> 1994-1 C.B. 357.

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 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.<sup>22</sup>

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) 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.<sup>23</sup>

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?<sup>24</sup> 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.

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<sup>22</sup> *John Kelley Co.*, 326 U.S. at 530; *Hardman v. United States*, 827 F.2d 1409, 1411-12 (9th Cir. 1987).

<sup>23</sup> See, e.g., *Hardman*, 827 F.2d at 1411-12; *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 at 696 (3d Cir. 1968).

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

U.S. tax authorities have long accepted the treatment of conventional convertible debt as debt for tax purposes.<sup>25</sup> 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<sup>26</sup> the IRS concluded that notes payable at maturity in a predetermined number of shares of stock must be treated as equity. This contrasts with Rev. Rul. 85-119,<sup>27</sup> 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.<sup>28</sup> 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."<sup>29</sup>

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<sup>25</sup> 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. vs. 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 the *Chock Full O'Nuts*); Rev. Rul. 72-265, 1972-1 C.B. 222 (conversion of convertible debenture into stock is tax-free).

<sup>26</sup> 1983-2 C.B. 40.

<sup>27</sup> *Supra* note 20.

<sup>28</sup> Reg. section 1.1275-4.

<sup>29</sup> *Id.*

Under those regulations, if there is a remote likelihood that a contingency will occur, it is assumed that it won't occur.<sup>30</sup> 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 and certain other adjustments) 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.<sup>31</sup> 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.<sup>32</sup> Another court considered it critical that the taxpayer was a stock insurance company regulated

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<sup>30</sup> Reg. section 1.1275-2(h)(2). See also ILM 200932049 (remote criteria applied outside the scope of the contingent payment regulations).

<sup>31</sup> 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 vs. Union Mutual Ins. Co. of Providence*, 386 F.2d 974 (1st Cir. 1967); Rev. Rul. 68-515, 1968-2 C.B. 297 (IRS will follow the *Union Mutual* decision); 1996 IRS NSAR 5975, 1996 WL 33325654 (July 30, 1996).

<sup>32</sup> *Jones*, 659 F.2d at 623.



by state statute.<sup>33</sup> 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.<sup>34</sup> Although these cases were developed in the distinct environment of 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 requires 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.<sup>35</sup>

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 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.<sup>36</sup> 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.

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<sup>33</sup> *Anchor Nat'l*, 93 T.C. at 409.

<sup>34</sup> *Id.* at 402.

<sup>35</sup> Two cases have adopted a bifurcation approach: *Farley Realty Corp. vs. Commissioner*, 279 F.2d 701 (2d Cir. 1960); and *Richmond, Fredricksburg & Potomac R.R. Co. vs. 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 these regulations.

<sup>36</sup> 2003-2 C.B. 380.

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."<sup>37</sup> 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 regulatory capital standards as true debt for tax purposes. That was the case for trust-preferred instruments in the United States and for similar instruments issued in the United Kingdom.<sup>38</sup>

## 2. *Deduction of interest under section 163(l)*

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<sup>37</sup> See Lloyds prospectus, *supra* note 14, at 168-173. The Lloyds prospectus does go on to discuss the treatment of the notes if they are found to be debt instruments by the U.S. tax authorities.

<sup>38</sup> For trust-preferred securities, see ILM 200932049 and TAM 199910046. In the United Kingdom, a partnership type structure was used somewhat like the way trust-preferred securities were used in the United States.

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.<sup>39</sup> 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 have 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 requirement appears to require issuers to build an evidentiary case against the likelihood of conversion to obtain an interest deduction.

#### ***iv. 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

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<sup>39</sup> Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97 (Dec. 17, 1997).

individuals, the payments will constitute qualified dividend income that is subject to a beneficial tax rate under current law.<sup>40</sup> For qualifying corporations, the holders may obtain a dividends received deduction.<sup>41</sup>

A problem may arise with the dividends received deduction, however. In Rev. Rul. 94-28,<sup>42</sup> 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.

***v. 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.<sup>43</sup> However, if the instruments are characterized as equity, 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.<sup>44</sup> 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

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<sup>40</sup> Section 1(h)(11).

<sup>41</sup> Section 243.

<sup>42</sup> 1994-1 C.B. 86. *See also* Rev. Rul. 90-27, 1990-1 C.B. 50.

<sup>43</sup> Sections 902, 964(a) and 986; reg. section 1.902-1(a)(9) and (10).

<sup>44</sup> Section 902; reg. section 1.902-1(b).

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.<sup>45</sup> This would further cloud 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<sup>46</sup> 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.<sup>47</sup> 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.<sup>48</sup>

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

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<sup>45</sup> 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. *See also* Notice 2010-92, 2010-52 I.R.B. 916 (dealing with pre-2011 splitter arrangements).

<sup>46</sup> The problems with hybrid securities in general are discussed more extensively above in Part II.b.ii.

<sup>47</sup> BAC Prospectus for 36 million shares of 6.25 percent capital securities (Mar. 21, 2006).

<sup>48</sup> Reg. section 1.1275-2(h).

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.<sup>49</sup> 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 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.<sup>50</sup>

#### **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.<sup>51</sup>

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."<sup>52</sup> Those preliminary conclusions were followed by final rules the Basel

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<sup>49</sup> 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.

<sup>50</sup> Reg. section 1.61-7(d).

<sup>51</sup> See Federal Reserve, "Capital Adequacy Guidelines" (Dec. 16, 1994) (dealing with the treatment of deferred tax assets in measuring a bank's regulatory capital).

<sup>52</sup> Basel committee, "Strengthening the Resilience of the Bank Sector," at 24 (Dec. 2009).

committee issued in December 2010<sup>53</sup> 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 to be 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 VOLKER RULE

Dodd-Frank introduces two new protections against risk taking by some banking and nonbanking 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).<sup>54</sup> 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.<sup>55</sup> 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<sup>56</sup> will be subject to continuing supervision<sup>56</sup> by the Federal Reserve even if they cease to be bank holding companies.<sup>57</sup>

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

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<sup>53</sup> Basel III rules, *supra* note 5, at 22, 26.

<sup>54</sup> 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).

<sup>55</sup> 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).

<sup>56</sup> The Capital Purchase Program was part of the Trouble Assets Relief Program under which Treasury's Office of Financial Stability purchased preferred stock from many large U.S. financial institutions.

<sup>57</sup> 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 anytime, but you can never leave."

and quantitative limits on the investment activities of non-bank financial companies subject to supervision by the Federal Reserve.<sup>58</sup>

**a. Living Wills**

**i. *Regulatory background***

SIHCs will be required to create living wills containing both recovery (or so-called remediation) plans<sup>59</sup> and resolution plans.<sup>60</sup>

*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.

**ii. *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.<sup>61</sup>

**iii. *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

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<sup>58</sup> Section 619 of the Act. The FSOC has issued preliminary guidance on how the Volcker rule should be formulated by the 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).

<sup>59</sup> The remediation plans may follow the current requirements of the FDIC for so-called prompt corrective action.

<sup>60</sup> 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 European Banking Authority, at the Wharton School of Management, entitled “Living Wills: How Can the Concept be Implemented” (Feb. 12, 2010).

<sup>61</sup> Section 168 of the Act.



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 (v) 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 effect of ongoing changes in operations, tax attributes, and other characteristics of entities within the group.

### 1. *Taking inventory*

*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.

*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.

*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,<sup>62</sup> and to determine what measures will apply on the separation of an entity.<sup>63</sup>

*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).<sup>64</sup>

*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.

## 2. *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

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<sup>62</sup> 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 shareholder can materially impair the value of the subject corporation's NOL-deferred tax asset. See section 382(g)(4)(D).

<sup>63</sup> 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 & 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*.

<sup>64</sup> 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 (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 carve-out for transfers required under the Act. See reg. section 1.1503(d)-3(b)(9).

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.

### 3. *Planning for capital-raising and internal restructuring transactions*

*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 impact of a section 382 limitation.

*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.

### 4. *Minding the tax effects of living will transactions*

*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.

*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.<sup>65</sup> For example, a distribution might be re-characterized as boot in a subsequent reorganization involving the same or related entities. The disposition or winding-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.<sup>66</sup> Dispositions of equity and capital raising transactions may affect the continuity of interest or “control immediately after” requirements for another transaction involving that entity.<sup>67</sup>

*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

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<sup>65</sup> 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).

<sup>66</sup> See, e.g., reg. section 1.368-1(d); sections 382 and 355(b).

<sup>67</sup> See, e.g., reg. section 1.368-1(e); section 351.

group, those interrelationships (including intercompany debt arrangements, guarantee fees, and management fees) should be reviewed from a transfer pricing perspective.

*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.

### *i. 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.<sup>68</sup> 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.<sup>69</sup> 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.<sup>70</sup>

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.<sup>71</sup> Until qualifying regulations are issued, the limits of the Volcker rule remain unclear.<sup>72</sup>

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<sup>68</sup> Section 619(h)(4) of the Act.

<sup>69</sup> Section 619(d) of the Act.

<sup>70</sup> For example, section 48 energy credits may fit in the statutory language stating that investments “of the type” specifically 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.

<sup>71</sup> 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).

## ***ii. 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.<sup>73</sup> 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.<sup>74</sup>

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 brokerage services. All of these activities are subject to the provisions of sections 23A and 23B of the Federal Reserve Act as enhanced by the 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.

## ***iii. 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.<sup>75</sup>

## ***iv. 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

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

<sup>73</sup> Section 619(d)(4) of the Act.

<sup>74</sup> Sections 619(a)(2) and (b)(2) of the Act.

<sup>75</sup> Section 619(c) of the Act.

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.<sup>76</sup> 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.<sup>77</sup>

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.<sup>78</sup> 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 purposes of the Act.<sup>79</sup> 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 nondeliverable 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 this issue.<sup>80</sup>

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

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<sup>76</sup> A non-bank affiliate is a subsidiary owned by a bank holding company but not owned directly or indirectly by a bank. See the discussion below and in Part III.b.ii of this report on foreign Edge Act subsidiaries for a possible limited exception to the Push-Out rule.

<sup>77</sup> Section 716(b)(D) of the Act. It is unclear what is meant by "tax breaks" in this provision.

<sup>78</sup> Section 716(e), (f) and (h) of the Act.

<sup>79</sup> Treasury, "Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act" (Apr. 29, 2011).

<sup>80</sup> 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 in 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).

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.<sup>81</sup>

**b. Tax Aspects of the Push-Out Rule**

*i. 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 Push-Out 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

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<sup>81</sup> 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).



netting with multiple related legal entities.<sup>82</sup> 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 need to review its current trading pattern and decide what books and people it will have 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 as employees of the Bank or its subsidiaries will probably not satisfy the Push-Out rule.<sup>83</sup>

## *ii. Treatment of Banks*

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

### *1. Swap book and associated personnel are in the Bank*

Banks may consider three taxable alternatives for moving a swap dealing book and associated personnel from a Bank to a non-bank affiliate.<sup>84</sup>

#### *a. 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.<sup>85</sup> Conversely, if the individual's services are provided under an employment contract or

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

<sup>83</sup> 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, this 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.

<sup>84</sup> 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.

<sup>85</sup> *Hosp. Corp. of Am. v. Commissioner*, 81 T.C. 520 (1983), *nonacq.*; *Ithaca Industries v. Commissioner*, 97 T.C. 253, 271-72 (1991), *aff'd.*, 17 F.3d 684 (4th Cir. 1994); *but see Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993).

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,<sup>86</sup> 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*,<sup>87</sup> 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 a 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.

*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.<sup>88</sup>

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<sup>86</sup> Section 197(d)(1)(C)(iv); *Newark Morning Ledger*, 507 U.S. 546.

<sup>87</sup> *See Hosp. Corp. of Am.*, 81 T.C. 520.

<sup>88</sup> Reg. section 1.1502-13.

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.

*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).<sup>89</sup> 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.

*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.<sup>90</sup> 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.<sup>91</sup> 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).

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*b. 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

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<sup>89</sup> Sections 954(c)(2)(C) and 954(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).

<sup>90</sup> Sections 351(a) and 368(c).

<sup>91</sup> 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).

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

established a novation protocol in 2005 that was updated in 2010.<sup>93</sup> 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.<sup>94</sup>

- c. 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 mirror swap transactions between a Bank and non-bank affiliate, Banks may find this process cumbersome and expensive.<sup>95</sup>

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

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<sup>93</sup> ISDA, “August 2010 Additional Provisions for Consent to, and Confirmation of, Transfer by Novation of OTC Derivative Transactions” (Aug. 25, 2010).

<sup>94</sup> 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. sections 1.446-3(f) and (g)(4) (treatment of assuming party). The treatment of derivatives not constituting NPCs should generally be the same.

<sup>95</sup> 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 certain 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.

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.

*2. 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.<sup>96</sup>

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.

*iii. 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.<sup>97</sup> 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

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

<sup>97</sup> 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.

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.<sup>98</sup> Generally, transactions between a U.S. branch of a foreign 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.<sup>99</sup>

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.

## **V. SECURITIZATION**

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<sup>98</sup> Sections 864(b), 864(c), and 882, and the regulations issued thereunder.

<sup>99</sup> Assets which 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) dealing with the disposition of property within 10 years of it ceasing to be effectively connected with such a trade or business.

The Act imposes new risk retention requirements on “securitizers” in securitization transactions. On March 28, 2011, a joint notice of proposed rulemaking on the risk retention rules was released.<sup>100</sup> The goal of the proposed regulations is to align the sponsor’s and investors’ incentives by ensuring that the sponsor retains meaningful exposure to the same credit risk that is borne by the investors in all classes of securities issued by a special purpose vehicle (SPV).

Final risk retention regulations applicable to residential mortgage-backed securities will take effect one year after their publication, and regulations applicable to other asset-backed securities (ABS) will take effect two years after publication of final regulations.

### **a. Background**

Securitization facilitates the monetization of future cash flows from financial assets. In general, a securitization program intended to raise cash from unrelated investors involves successive transfers of financial assets among related entities, with the assets ultimately being placed in a bankruptcy-remote SPV that issues securities to investors.<sup>101</sup> The legal structure of a securitization is intended to isolate the securitized assets for two purposes. The first is to ensure that the SPV’s assets will not be subject to the claims of any other entity’s creditors. The second is to ensure that investors in the securities issued by the SPV will be unable to look to any assets other than the securitized ones as a source of payment on their securities.

Because holders of securities issued by an SPV can look only to the securitized assets as a source of payment, holders are exposed to the credit risk of the securitized assets. Generally, the capital structure of the SPV will contain several classes of securities, each of which exposes the holder to a different degree of credit risk on the underlying assets.<sup>102</sup> Under the SPV’s hierarchy for distributing cash received on the securitized assets, senior classes of notes generally have first priority in receiving distributions of cash, followed by any junior (subordinated) classes of notes, followed by preferred or senior equity securities (if any), with the final claim to cash flow (the first loss position) belonging to the common or residual equity interest in the SPV. The junior note and equity classes act as a structural credit enhancement for the senior securities by absorbing losses before the senior.

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<sup>100</sup> As required by section 941(b) of the Act, the joint notice containing the proposed risk retention rules (the proposed regulations) was released by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the FDIC, the SEC, the Federal Housing Finance Agency, and the Department of Housing and Urban Development. As of July 2012, the proposed regulations have not been finalized. The Act originally required regulations to be prescribed no later than 270 days after the Act’s date of enactment (i.e., no later than April 17, 2011).

<sup>101</sup> For general background on the legal, financial accounting, and tax issues raised by securitizations, see James Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitizations* (4th ed. 2011).

<sup>102</sup> The securities may take the form of ownership interests in the SPV (for example, trust certificates, membership interests, or stock) or creditor interests (notes). As discussed in more detail below, the legal form of the security does not necessarily determine its tax classification.

That payment hierarchy would provide little protection from loss to the senior note classes if there is a high probability that losses on the securitized assets would exceed the principal entitlement of the subordinate classes. Consequently, securitizations typically are structured with other features intended to ensure that, except when losses on the securitized assets are much higher than expected, the senior note classes will be paid out in full. These additional features may include overcollateralization (the excess of the initial face amount of the securitized assets over the initial face amount of the note classes issued by the SPV), excess spread (the excess of the interest received on the securitized assets over the rate of interest paid on the notes), and a cash collateral or reserve account.<sup>103</sup>

Many securitizations are static – that is, the pool of securitized assets generally is fixed at the time the SPV is formed. In static securitizations, principal receipts on the assets typically are not reinvested in similar assets but are paid shortly after receipt to investors as distributions on their securities, and new assets are not added to the pool through the issuance of new liabilities. However, there are several common types of securitizations in which new assets are added to the collateral pool during the term of the transaction, either through reinvestment of principal receipts on existing assets or through the issuance of new interests in the SPV (or both). In a securitization done through a revolving asset master trust, (RAMT), there typically is an initial period (the revolving period) during which principal receipts are reinvested in new assets rather than used to pay down the SPV's liabilities. For a securitization done through an asset-backed commercial paper (ABCP) conduit, the SPV is engaged in an ongoing program of purchasing receivables from one or more originators, which may be funded both by reinvesting principal receipts and by periodic issuances of commercial paper. The proposed regulations define special risk retention methods adapted to both RAMTs and ABCP conduits.

In many securitizations, the senior note classes are publicly offered, while the subordinated notes and the formal equity classes are privately placed or retained by the sponsoring entity or an affiliate. Even before Dodd-Frank, it was typical for the sponsor to retain some kind of interest in the SPV or the securitized assets. However, the sponsor generally was not restricted from hedging any retained credit risk, and the degree of any retained credit risk may have been significantly lower than what the Act will require.

## **b. The Proposed Regulations**

### *i. Scope of the proposed regulations*

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<sup>103</sup> In some securitizations, excess spread is monetized through the issuance and sale of interest-only securities or premium bonds. The proposed regulations contain a special rule under which amounts received from monetizing excess spread must be held as a reserve.



The proposed regulations would apply generally to transactions involving the issuance and sale of ABS by an issuing entity.<sup>104</sup> For a securitization transaction, an issuing entity is defined to mean the trust or other entity created at the direction of the sponsor that owns or holds the pool of assets to be securitized and in whose name the ABS is issued. An ABS is defined generally to mean a fixed-income or other security collateralized by any type of self-liquidating financial asset that allows the holder of the security to receive payments that depend primarily on cash flow from the financial assets.

The proposed regulations also separately define a broader category of financial interests called an ABS interest, which refers to all types of interests or obligations from an issuing entity, the payments on which primarily depend on the cash flows on the collateral held by the issuing entity. An ABS interest does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that is issued primarily to evidence ownership of the issuing entity, and any payments are not primarily dependent on the cash flows of the collateral held by the issuing entity. The risk retention requirements will apply not only to ABS that are issued and sold to investors, but also to all ABS interests in the issuing entity.

Dodd-Frank provides that the risk retention rules apply to any securitizer. Under the proposed regulations, a securitizer to which the risk retention requirements apply is a person who organizes and initiates a securitization transaction by selling or transferring assets to the issuing entity.<sup>105</sup> When there are multiple sponsors, each sponsor is responsible for ensuring that at least one complies with the risk retention requirements.

The proposed regulations would allow a sponsor to shift some or all of the risk retention requirements to an originator of the securitized assets if conditions are met. An originator is defined as a person who, through the extension of credit or otherwise, creates a financial asset that collateralizes an ABS and then sells the asset to a securitizer.

## *ii. Permitted methods of risk retention*

The proposed regulations define four general methods for satisfying the risk retention requirement (vertical, horizontal, L-shaped, and representative sample), as well as several special risk retention methods adapted to specific types of issuing entities (revolving asset master trusts, ABCP conduits, and issuers of commercial mortgage-backed securities (CMBS)). The sponsor can generally choose the method it intends to follow. In

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<sup>104</sup> According to the preamble, the risk retention requirements of the proposed regulations would apply to securitizers of ABS offerings whether or not the offering is registered with the SEC under the Securities Act of 1933.

<sup>105</sup> The preamble to the proposed regulations notes that the definition of sponsor is substantially identical to the definition in the SEC's Regulation AB. It also notes that, in the context of collateralized loan obligations (CLOs), the CLO manager generally acts as the sponsor by selecting the loans to be purchased for inclusion in the collateral pool and then managing the securitized assets once they have been deposited in the CLO structure. Presumably, then, a CLO manager could be subject to the risk retention requirements of the proposed regulations.

addition to the basic risk retention requirement, the proposed regulations would impose an independent requirement that the sponsor fund and maintain a premium capture cash reserve account for any securitization that is not exempt from the risk retention requirements and results in an issuance of ABS interests at a premium.<sup>106</sup>

### *1. Vertical risk retention*

Under this method, the sponsor must retain at least 5 percent of each class of ABS interest issued in the securitization. The retention requirement applies regardless of the nature of the class of ABS interest (for example, , senior or subordinated).

### *2. Horizontal risk retention*

The proposed regulations describe two allowable methods of horizontal risk retention. Under the first method, the sponsor may retain an eligible horizontal residual interest in the issuing entity in an amount that is equal to at least 5 percent of the par value of all ABS interests issued in the securitization. An eligible horizontal residual interest is defined to be an ABS interest in the issuing entity that:

- (1) is allocated all losses on the securitized assets (other than losses that are first absorbed through the release of funds from a premium capture cash reserve account, if such an account is required to be established) until the par value is reduced to zero;
- (2) has the most subordinated claim to payments of both principal and interest by the issuing entity; and
- (3) until all other ABS interests in the issuing entity are paid in full, is not entitled to receive any payments of principal made on a securitized asset (except for the interest's current proportionate share of scheduled payments of principal received on the securitized assets in accordance with the transaction documents).

Alternatively, the sponsor can retain horizontal risk by establishing and funding in cash a reserve account at closing (a horizontal cash reserve account) in an amount equal to at least 5 percent of the par value of all the ABS interest issued in the securitization. The horizontal cash reserve account must be held by the trustee (or other person performing functions similar to a trustee) in the name, and for the benefit, of the issuing entity.

### *3. L-shaped risk retention*

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<sup>106</sup> The following summaries of the risk retention methods have been adapted from the explanations in the preamble to the proposed regulations. The risk retention methods themselves are defined in subpart B of the proposed regulations.

The proposed regulations allow the sponsor to use a combination of horizontal and vertical risk retention (hence, L-shaped risk retention) if the issuing entity retains (i) a vertical component containing at least 2.5 percent of each class of ABS interest issued in the securitization, and (ii) a horizontal component consisting of an eligible horizontal residual interest in the issuing entity in an amount equal to at least 2.564 percent of the par value of all ABS interest issued in the securitization, other than the interest required to be retained in the vertical component.<sup>107</sup> As under the horizontal risk retention method, the sponsor would have the option of replacing the eligible horizontal residual interest with a horizontal cash reserve account funded at closing.

#### 4. *Representative sample*

Under this method, the sponsor must retain a random sample from a pool of assets identified for a securitization equal to 5 percent of the credit risk in the pool, according to a process described in the proposed regulations. The sampling method is intended to ensure that the sample retained by the sponsor is equivalent in all material respects to the assets in the pool that are transferred to the issuing entity and securitized. Under this method, the sponsor does not retain an interest in the issuing entity but separately holds the representative sample of assets.

#### 5. *Revolving asset master trust*

Securitizations backed by revolving lines of credit, such as credit card accounts or dealer floor plan loans, often are structured using an RAMT. An RAMT allows the trust to issue more than one series of ABS backed by a single pool of revolving assets. In these transactions, the sponsor typically holds an interest known as the seller's interest. This interest is *pari passu* with the investors' interest in the receivables backing the ABS interest of the issuing entity until the occurrence of an early amortization event. Because the seller's interest is a direct, shared interest with all the investors in the performance of the underlying assets, the proposed regulations would allow the sponsor of an RAMT that is collateralized by loans or other extensions of credit under revolving accounts to meet the risk retention requirement by retaining a seller's interest in an amount not less than 5 percent of the unpaid principal balance of all the assets held by the trust (that is, the issuing entity).<sup>108</sup>

#### 6. *Asset-backed commercial paper conduit*

The proposed regulations contain a special risk retention option designed for ABCP conduits used to securitize receivables or loans that are supported by a liquidity facility with a regulated institution. An ABCP program typically involves one or more originator-sellers, usually clients of the sponsoring financial institution, each of

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<sup>107</sup> According to the preamble, the size of the horizontal component is calculated to avoid double counting that portion of an eligible horizontal residual interest that the sponsor is required to hold as part of the vertical component.

<sup>108</sup> As noted in the preamble, the size of the seller's interest typically adjusts to account for fluctuations in the outstanding principal balances of the securitized assets.

which sells eligible loans or receivables to an intermediate, bankruptcy-remote SPV established by the originator-seller. The ABCP conduit itself is a means for these originator-sellers to jointly monetize their financial assets. The ABCP conduit issues short-term ABCP to fund the purchase of the senior interests in the intermediate SPVs while the first-loss positions (represented by the residual interests in the SPVs) typically are retained by the originator-sellers. Under the proposed regulations, the sponsor of an eligible ABCP conduit<sup>109</sup> would be deemed to meet its risk retention requirement if each originator-seller who transfers assets to collateralize the ABCP issued by the conduit retains the same amount and type of credit risk in the assets transferred to its intermediate SPV as would be required under the horizontal risk retention option if the originator-seller were treated as the only sponsor of its intermediate SPV. In effect, if each intermediate SPV is treated as an issuing entity and each originator-seller (treated as the sole sponsor) meets the horizontal risk retention requirement for its intermediate SPV, the sponsor of the ABCP conduit is deemed to meet its risk retention requirement for the ABCP conduit.

## 7. *CMBS*

According to the preamble to the proposed regulations, the allocation of a first-loss position to a third-party purchaser (the so-called B-piece buyer) has been common practice in CMBS transactions for several years. To manage its risk, the B-piece buyer often is involved in the selection of pool assets, is designated as the controlling class under the pooling and servicing agreement or other operative document governing the transaction, and typically names itself or an affiliate as the special servicer in the transaction. Dodd-Frank itself acknowledges this market practice by providing that the agencies may allow sponsors of CMBS transactions to satisfy the risk retention requirement if third-party purchasers meeting specified requirements hold the first-loss position. One of the conditions required by the proposed regulations is that the B-piece buyer retain an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option. In addition, the B-piece buyer must comply with the same hedging, transfer, and other restrictions that would apply to a sponsor that had acquired an eligible horizontal residual interest.

## 8. *Premium capture cash reserve account*

As noted earlier, some securitizations are designed to allow the sponsor to monetize the excess spread that is expected to be generated by the securitized assets over the term of the transaction. The monetization is typically accomplished by the issuance of interest-only (IO) securities or premium bonds. The preamble expresses the agencies' belief that monetization of excess spread before the performance of the securitized assets can be observed allows sponsors to reduce the impact of any economic interest they may have retained in

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<sup>109</sup> According to the preamble, the definition is intended to ensure that this risk retention method is not available to entities or ABCP programs that operate as securities or arbitrage programs (*e.g.*, a structured investment vehicle).

the securitized assets and thus frustrates the intent of Dodd-Frank’s risk retention requirements. Consequently, the proposed regulations require that the sponsor of a securitization in which excess spread has been monetized fund a premium capture cash reserve account with an amount of cash determined by the amount of premium or purchase price, as applicable, received on the sale of the ABS interests that monetize the excess spread.

The amount of cash the sponsor is required to put into this reserve account is calculated under a formula that depends on the risk retention option chosen by the sponsor. Like a horizontal cash reserve account, a premium capture cash reserve account must be held by the trustee in the name, and for the benefit, of the issuing entity. The funds in a premium capture reserve account are to be used to cover losses before any other interest in or account of the issuing entity, including an eligible horizontal residual interest or a horizontal cash reserve account.

### *iii. Hedging, transfer and financing restrictions<sup>110</sup>*

Dodd-Frank states that the risk retention regulations shall “prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset.” Consistent with that intent, the proposed regulations would prohibit a sponsor from transferring any interest or assets that it must retain to any person other than an affiliate whose financial statements are consolidated with those of the sponsor (a consolidated affiliate).

However, the proposed regulations would allow a sponsor that chooses the vertical risk retention option or the eligible horizontal residual interest version of the horizontal risk retention option to allocate a portion of its risk retention obligation under that option to any originator of the securitized assets that contributed at least 20 percent of the assets in the pool. The amount of the retention interest held by each originator must be at least 20 percent, but cannot exceed the percentage of the securitized assets it originated. The originator would have to hold its allocated share of the risk retention obligation in the same manner, and under the same restrictions, as would have been required of the sponsor.

The proposed regulations would prohibit the sponsor or any consolidated affiliate (whether or not an ABS interest or asset has been transferred to any affiliate) from hedging in any fashion the credit risk of one or more ABS that the sponsor is required to retain. However, hedging transactions that are not materially related to the credit risk of the ABS that must be retained would not be prohibited. For example, the sponsor or its affiliates would be permitted to enter into positions related to overall market movements, such as movements of market interest rates, currency exchange rates, home prices, or the overall value of a broad category of ABS.

### *iv. Exemptions from the risk retention requirements*

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<sup>110</sup> The rules defining the restrictions on hedging, transfer and financing are set forth in subpart C of the proposed regulations.

Dodd-Frank requires that the regulations prescribed by the agencies provide for “a total or partial exemption [from the risk retention requirements] of any securitization, as may be appropriate in the public interest and for the protection of investors.” The Act exempts securitizations of qualified residential mortgages (QRMs) from the risk retention requirements, and also specifies that the regulations must provide for a total or partial exemption for securitizations of assets issued or guaranteed by the United States, any state or political subdivision, or an agency of the United States (the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp. are not to be treated as agencies of the United States), as well as for securitizations of qualified scholarship funding bonds. Also, the Act specifies that the agencies must prescribe regulations defining underwriting standards, and allowing reduced risk retention requirements, for securitizers of asset classes such as residential mortgages, commercial mortgages, commercial loans, auto loans, and “any other class of assets that the Federal banking agencies and the [SEC] deem appropriate.” Accordingly, the proposed regulations provide a definition of QRM for purposes of the statutory exemption, and also provide exemptions for securitizations of commercial mortgages, commercial loans and auto loans that meet specified underwriting standards.

If the sponsor of a securitization transaction is exempt from the basic 5 percent risk retention requirement, it also is exempt from the requirement to establish a premium capture cash reserve account for that transaction.<sup>111</sup>

*v. When are equity interests ABS interests?*

The definition of an “ABS interest” in the proposed regulations makes it clear that there may be equity or residual interest in the issuing entity that are not treated as an ABS interest. The distinction is important under the proposed regulations because non-ABS interest do not count toward meeting the 5 percent risk retention requirement and correspondingly need not be retained by the sponsor.

Although an equity interest such as a trust certificate, limited liability company interest, or share of stock demonstrates ownership of the issuing entity and thus will satisfy the first prong of the definition of an ABS interest, any payments regarding the interest may not be “primarily dependent on the cash flows of the collateral held by the issuing entity.”<sup>112</sup> If they aren’t dependent, the second prong of the test would not be satisfied, and the equity interest may not be an ABS interest. The agencies may need to clarify when an equity interest

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<sup>111</sup> The requirement to establish a premium capture cash reserve account is in subpart B of the proposed regulations, along with the general 5 percent risk retention requirement. Subpart D, which defines the categories of exempt securitization transactions, states for each type of exempt securitization, the “sponsor shall be exempt from the risk retention requirements in subpart B of this part.”

<sup>112</sup> One type of interest that almost certainly should not be treated as an ABS interest is that of a so-called special member in a single-member Delaware LLC. A special membership interest is a springing membership interest that arises automatically on the termination of membership, or dissociation, of the sole member, in order to prevent the LLC from dissolving because it has no members. Although the special member is treated as a member of the LLC under Delaware law, the special member has no economic rights to distributions from the LLC and generally no control rights either.

constitutes an ABS interest. As a practical matter, however, sponsors may be able to avoid the issue by defining a capital structure with a clear division between ABS interests and non-ABS interests.

*vi. Cash reserve accounts*

The proposed regulations would require that horizontal and premium capture cash reserve accounts be held in the name, and for the benefit, of the issuing entity. That language raises the question as to whether the issuing entity must have both legal and beneficial ownership of the assets in the reserve account or only a security interest in the assets.<sup>113</sup> While not certain, it seems that the assets in the reserve accounts are intended to serve as collateral, and that legal title to the assets need not be transferred to the issuing entity. If the sponsor conveys only a security interest to the issuing entity, the sponsor likely will be treated as the tax owner of the assets, and the sponsor may be treated as if it entered into a guarantee or indemnity arrangement with the issuing entity. If the arrangement is treated as a guarantee, the sponsor's tax treatment of any payments made under the guarantee may be governed by reg. section 1.166-9. However, at least one commentator has noted that there is some uncertainty regarding the timing and character of deductions or losses from payments made by a guarantor.<sup>114</sup>

**c. Tax Effects of the Proposed Regulations<sup>115</sup>**

In any securitization, two basic tax questions concern the tax characterization of the issuing entity and the tax characterization of the securities issued by the issuing entity. For tax purposes, the issuing entity generally will be a disregarded entity (DRE),<sup>116</sup> a grantor trust,<sup>117</sup> a corporation, a partnership, or a real estate mortgage investment conduit.<sup>118</sup> The securities issued by the issuing entity generally will be characterized as debt secured

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<sup>113</sup> See, e.g., *Wells Fargo & Co. v. United States*, No. 2010-5108 (Fed. Cir. Ct. Apr. 15, 2011) (regarding what constitutes tax ownership, "Ownership for tax purposes is not determined by legal title. Instead, in order to qualify as an 'owner' for tax purposes, the taxpayer must bear the benefits and burdens of property ownership." citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-73 (1978); and *Corliss v. Bowers*, 281 U.S. 376, 378 (1930)).

<sup>114</sup> See, e.g., David Miller, "Federal Income Tax Consequences of Guarantees: a Comprehensive Framework for Analysis," 48 *Tax Law.* 103 (1994).

<sup>115</sup> In the discussion that follows, we will continue to use the terminology of the proposed regulations and refer to the SPV that issues securities to investors as the "issuing entity." This discussion does not purport to be a complete discussion of all federal income tax issues that might arise from the application of the proposed regulations to securitizations.

<sup>116</sup> The legal entity that issues securities to investors may be (and typically is) a single-member or single-owner entity treated as a DRE for tax purposes under the entity classification rules of reg. section 301.7701-3. In that case, the issuer of the securities for tax purposes generally will be the first non-disregarded entity in the chain of ownership beginning with the entity that formally issues the securities.

<sup>117</sup> In the context of a securitization, a grantor trust usually refers to an investment trust as defined in reg. section 301.7701-4(c). Investment trusts are treated as grantor trusts subject to the rules of subpart E of the Code even though holders of beneficial interests in the trust might not be the original grantors that created the trust. The IRS has issued regulations and numerous ruling stating or agreeing that ownership of grantor trusts certificates, whether in the hands of the original grantor or a subsequent purchaser, represents beneficial ownership of the trust assets. See, e.g., reg. sections 1.671-2(e), 1.671-5(b)(22); prop. reg. section 1.671-2(f); Rev. Rul. 70-544, 1970-2 C.B. 6, and Rev. Rul. 70-545, 1970-2 C.B.7, both modified by Rev. Rul. 74-169, 1974-1 C.B. 147, and clarified by Rev. Rul. 84-10, 1984-1 C.B. 155.

<sup>118</sup> A REMIC is purely a creature of statute that "shall not be treated as a corporation, partnership, or trust for purposes of" subtitle A of the Code. Section 860A.

by the assets, a direct ownership interest in the assets (perhaps as a senior or subordinate ownership interest in the assets), or equity in a non-DRE (a corporation or partnership) that owns the assets.<sup>119</sup>

The two basic tax questions for a securitization are not independent; often, the tax characterization of the issuing entity will depend on the tax characterization of the securities issued by the issuing entity and the identity of the owners of those securities. Because the proposed regulations would not mandate any particular legal form or tax characterization for the issuing entity, the sponsor will be free to choose the tax characterization of the issuing entity. However, by requiring that a specified interest in the issuing entity be retained and by placing restrictions on which entities may hold the retained interest, the proposed regulations might affect both the tax characterization of the securities issued by the issuing entity and the tax characterization of the issuing entity itself.

*i. Issuing entity treated as a grantor trust*

If an investment trust is treated as a grantor trust for tax purposes, ownership of a trust certificate represents beneficial ownership of an interest in the trust assets. The beneficial interest owned by a certificate holder generally will represent a pro rata interest in the securitized assets. For a grantor trust with a single class of certificates, each certificate holder owns the same type of pro rata interest in all the trust assets. However, a grantor trust can have multiple classes of certificates. In some cases, the certificate classes represent substantially similar economic interests in the trust assets, although there will be one or more junior classes of subordinated certificates whose holders are deemed for tax purposes to have granted an implicit guarantee in favor of the holders of the senior certificate class or classes.<sup>120</sup> The regulations would also allow an investment trust with certificate classes representing different economic interests in the trust assets to be treated as a grantor trust if the multiple classes of trust interests “merely facilitate direct investment in the assets held by the trust.”<sup>121</sup> From the perspective of the taxpayer who originally places the assets in the grantor trust, the sale of trust certificates is treated for tax purposes as the sale of a portion of the assets in the trust.

Assuming that the issuing entity otherwise satisfies the necessary conditions, the risk retention requirements in the proposed regulations should not prevent a sponsor from treating an issuing entity as a grantor trust. Regardless of how many certificate classes were issued, the sponsor could follow the vertical risk retention method and retain 5 percent of each class. If there is a subordinate certificate class that satisfies the

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<sup>119</sup> Occasionally, an investor will hold an investment unit consisting of one of the three types of securities just described plus a derivative (e.g., an NPC; see the example in reg. section 1.860G-2(i) of a REMIC regular interest that is bundled with an interest rate cap in a grantor trust), but we ignore this complication.

<sup>120</sup> See reg. section 301.7701-4(c)(2), Example 2.

<sup>121</sup> See, e.g., reg. section 301.7701-4(c)(2), Example 4 (investment trust formed to facilitate a coupon strip of bonds under section 1286 treated as a grantor trust); cf. Example 3 (investment trust formed to strip dividends from publicly traded stock not treated as a grantor trust).



requirements for being treated as an eligible horizontal residual interest, the sponsor could retain that class under the horizontal risk retention method. Similarly, if there is a subordinate certificate class that satisfies the requirements for an eligible horizontal residual interest, the sponsor could follow the L-shaped risk retention method. Assets retained by the sponsor under the representative sample method need not have any legal or economic relation to the issuing entity at all and thus should not affect the tax treatment of the issuing entity as a grantor trust.

If the sponsor of a securitization effected as a grantor trust chooses to establish a horizontal reserve account or is required to establish a premium capture cash reserve account,<sup>122</sup> it seems likely that the sponsor would be able to establish the account apart from the issuing entity and contribute a security interest and guarantee to the issuing entity. A guarantee should not endanger the issuer's status as a grantor trust.<sup>123</sup> Some authorities support the position that the reserve assets could be contributed to the issuing entity.<sup>124</sup> However, any power to reinvest reserve assets held by an issuing entity would need to be analyzed to determine whether such power constitutes a prohibited power to vary the assets of the trust.

#### *ii. Issuing entity treated as a disregarded entity*

Many securitizations are executed through an issuing entity that is intended to be a DRE for federal income tax purposes. To achieve that tax treatment, the equity of the issuing entity must be held by a single taxable owner, and the issuing entity must be an eligible entity that does not elect to be treated as a corporation.<sup>125</sup> Because a DRE must have only one owner, securities issued to a person other than the tax owner of the issuing entity cannot represent ownership interests and must be respected as debt for tax purposes. For tax purposes, then, the securitization is intended to be treated as a secured borrowing, with the equity of the issuing entity representing the borrower's residual economic interest in the securitized assets.

For the ABS interests (generally in the form of notes) issued to investors by a DRE to be treated as debt for tax purposes, the owner of the DRE must retain most of the benefits and burdens of ownership of the assets (or at

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<sup>122</sup> Premium could be created if, for example, the sponsor sells a certificate class that is an IO strip (see reg. section 301.7701-4(c)(2), Example 4).

<sup>123</sup> There are several rulings in which the IRS has taken the position that mortgage passthrough certificates guaranteed by federal housing agencies are grantor trust certificates. *See, e.g.*, Rev. Rul. 84-10, 1984-1 C.B. 155 (Fannie Mae guarantee); Rev. Rul. 71-399, 1971-2 C.B. 433, *amplified by* Rev. Rul. 81-203, 1981-2 C.B. 137 (Freddie Mac guarantee); Rev. Rul. 70-544, 1970-2 C.B. 6, *modified by* Rev. Rul. 74-169, 1974-1 C.B. 147 (Ginnie Mae guarantee).

<sup>124</sup> *See, e.g.*, Rev. Rul. 90-7, 1990-1 C.B. 153 (investment trust holding a reserve for administrative expenses); Rev. Rul. 73-460, 1973-2 C.B. 424 (reserve to cover taxes or other governmental charges).

<sup>125</sup> *See* reg. section 301.7701-3(a) and (b) for definitions of domestic and foreign eligible entity; and reg. section 301.7701-3(c) for election to be treated as a corporation.

least not transfer them to the note holders).<sup>126</sup> Exposure to the credit risk of the obligors on the securitized assets is a key burden of ownership that generally cannot be passed to an investor intended to be treated as a lender. If too much credit risk is transferred to a class of note holders, those holders might be treated as owning an equity interest in the issuing entity for tax purposes, and the issuing entity would no longer be treated as a DRE for tax purposes.<sup>127</sup>

The level of retained equity in an issuing entity treated as a DRE will depend on the risk retention method chosen by the sponsor. The sponsor should be able to choose any of the horizontal, L-shaped, or vertical risk retention methods and have the issuing entity treated as a DRE. If the sponsor chooses to retain an eligible horizontal residual interest under the horizontal method, the 5 percent retained exposure required by the proposed regulations might be higher than the level of equity otherwise required for the sponsor to be confident that the notes issued to investors are properly treated as debt for tax purposes. However, if the sponsor chooses the L-shaped risk retention method, the required 2.564 percent horizontal credit risk exposure arguably is in line with current market standards, and if the sponsor chooses to use the vertical risk retention method, the proposed regulations would not impose any lower boundary on how thin the sponsor's residual economic interest in the securitized assets may be. Consequently, it seems likely that the 5 percent risk retention standard imposed by the proposed regulations would not cause a general increase in the market standard for retained equity in a securitization done through a DRE.

Any ABS interests treated as debt in the hands of unrelated third parties but initially retained by the sponsor under the L-shaped or vertical risk retention methods would be disregarded for tax purposes so long as they are held by the sponsor,<sup>128</sup> and they would be treated as intercompany debt if later transferred to a tax-consolidated affiliate or originator.<sup>129</sup> If notes initially retained by the sponsor are later transferred to an affiliate (whether or not tax-consolidated) or are transferred from a tax-consolidated affiliate to a non-consolidated affiliate, the notes would be treated as newly issued (in the first case) or as retired and reissued (in the second case).<sup>130</sup> Because of changes in market conditions between the date the original notes were issued and the date the deemed newly issued notes are issued, the new notes conceivably could be treated as having a different amount

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<sup>126</sup> Securitizers could transfer some or all of the retained credit risk to a party other than the note holders by means of a credit derivative. The rules to be promulgated under the Act are supposed to impose restrictions on the securitizer's ability to hedge retained credit risk that way.

<sup>127</sup> For a general discussion of the tax authorities on the question of whether a monetization transaction should be treated for tax purposes as a secured loan or a sale of assets, see Peaslee and Nirenberg, *supra* note 101, ch. 3.

<sup>128</sup> Notes issued by a DRE and held by the owner of the DRE would not be treated as debt, because the owner is the obligor on the notes for tax purposes, and a taxpayer cannot issue debt to itself (*see, e.g.*, PLR 200046015).

<sup>129</sup> *See* reg. section 1.1502-13(b)(1)(i)(C) ("intercompany transaction" includes the loan of money by one member of a consolidated group to another member).

<sup>130</sup> *See* reg. section 1.502-13(g)(7), Example 2 (deemed reissuance when intercompany obligation becomes a non-intercompany obligation by sale to a nonmember).

of original issue discount than the originally issued notes.<sup>131</sup> In an extreme case, if the issuer's credit was significantly downgraded during the interim period, the new notes might even be viewed as equity.<sup>132</sup>

A sponsor also should be able to choose the representative sample risk retention method without endangering the status of the issuing entity as a DRE. Instead of requiring the sponsor to follow the statistical procedure described in the proposed regulations to pick a "representative" sample of assets, it seems much simpler to permit the sponsor to contribute the entire pool of assets to a single-class grantor trust, contribute 95 percent of the trust certificates to the issuing entity, and retain 5 percent of the certificates. Under that method, the sponsor would retain the requisite amount of credit risk for all the securitized assets, and there would be no uncertainty about whether the sample retained by the sponsor was truly representative of the pool. Given that the definition of collateral in the proposed regulations includes "fractional undivided property interests in the assets or other property of the issuing entity," this suggested method seems to be in the spirit of the proposed regulations. However, neither the proposed regulations nor the preamble appear to contemplate such a method of retaining an ownership interest in the securitized assets.

An RAMT could be treated as a DRE if the sponsor holds all of the interests treated as equity for tax purposes. Even though a seller's interest is initially *pari passu* with the investor interests in its entitlement to principal receipts, tax practitioners have become confident that other features of the seller's interest (for example, subordination to the investor interests after an early amortization event, and fluctuation of the size of the seller's interest along with fluctuation in the size of the asset pool) support the position that it is properly treated as equity in the trust and that the investor interests are properly treated as debt.<sup>133</sup> Assuming that the seller's interests are the only interests in the RAMT that are properly treated as equity for tax purposes, a sponsor that chooses the special risk retention option for RAMTs should be able to treat the issuing entity as a DRE.<sup>134</sup>

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<sup>131</sup> Even if the two sets of notes have different amounts of OID, they could still be treated as part of the same issue of debt for tax purposes if the requirements of reg. section 1.1275-1(f) are met or if the requirements for a reopening in reg. section 1.1275-2(k) are met. However, it seems unlikely that the conditions of reg. section 1.1275-1(f) could be met under the assumed facts, since one of the requirements is that all the notes be issued with a period of 13 days beginning with the date on which the first note that would be part of the issue is sold to a person other than a broker, underwriter, placement agent, or wholesaler.

<sup>132</sup> *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), is a well-known case in which it was determined that the portion of a non-recourse note in excess of the value of the property securing the note did not represent valid indebtedness for tax purposes. Cases like this raise the question of whether notes issued by SPVs in securitizations are recourse or non-recourse for purposes of these authorities. The Tax Court addressed a similar question in *Great Plains Gasification Assoc. v. Commissioner*, T.C.Memo. 2006-276, concluding that a loan from the Department of Energy (DOE) to a special purpose partnership formed for the sole purpose of developing, constructing, owning and operating a project to produce natural gas from coal, and which was secured by all the assets of the partnership, was nonrecourse debt when determining the tax consequences to the partnership of DOE's foreclosure on the loan and subsequent conveyance of the assets.

<sup>133</sup> For a discussion of the features of a master trust that support the treatment of the investor interests as debt, see Peaslee and Nirenberg, *supra* note 101, ch. 3, sections D and E.

<sup>134</sup> That multiple securitizations are done using a single master trust suggests that the trust might consist of multiple partnerships for tax purposes if the seller's interests are held by different taxpayers. However, this question is moot if the seller's interests are the only equity interests in the trust and all of those interests are held by the sponsor.

The special risk retention option for ABCP conduits could also apply to issuing entities treated as DREs. Although ABCP conduits traditionally were organized as corporations, more recently the issuers are often organized as LLCs. Consequently, if an ABCP conduit organized as an LLC has a single member, it can be a DRE. However, for the ABCP conduit to be treated as a DRE, the commercial paper issued by the conduit would need to be respected as debt for tax purposes. ABCP conduits typically are thinly capitalized, and this feature emphasizes the question of whether the paper issued by the conduit is debt, an equity interest in the conduit, or perhaps an ownership interest in the intermediate SPVs formed by the originator-sellers. Assuming that the commercial paper issued by the ABCP conduit is respected as debt, the sponsor's use of the special ABCP conduit risk retention method should not endanger the conduit's status of as a DRE.

Although all the foregoing risk retention methods appear to be compatible with the treatment of the issuing entity as a DRE, there are many thorny problems in attempting to treat the issuing entity in a CMBS securitization as a DRE, including, most notably, trying to fit the B piece into the risk retention rules while treating a CMBS as a DRE. Accordingly, it seems unlikely that a sponsor would pursue this course for a CMBS.

### *iii. Issuing entity treated as a partnership*

The use of an issuing entity intended to be a partnership for tax purposes is unusual. Nevertheless, a sponsor that intends to treat the issuing entity as a partnership generally should be able to comply with the risk retention requirements by using any of the horizontal, vertical, L-shaped, or representative sample methods.

### *iv. Issuing entity treated as a corporation*

As for an issuing entity treated as a partnership, an issuing entity treated as a corporation will be a taxable entity separate from the sponsor. Consequently, any ABS interests retained by the sponsor are not ignored for tax purposes.

Once the sponsor has determined whether any of the equity interests in the issuing entity are non-ABS interests, the sponsor generally should be able to use any of the horizontal, vertical, or L-shaped risk retention methods, as desired. Because many ABCP conduits have been formed as corporations, the special ABCP conduit risk retention method might be available to the sponsor. An RAMT could also be a corporation (for example, if the sponsor elected to have the trust treated as a corporation for tax purposes), and the special RAMT risk retention method likewise could be available to the sponsor.

Because the proposed regulations generally contemplate that an issuance of ABS will be supported by collateral consisting of self-liquidating financial assets, most issuances of securities by regulated investment companies or real estate investment trusts probably will not be subject to the proposed regulations. However, sponsors of so-

called mortgage REITs may need to take a careful look at whether securities issued by their REITs are subject to the risk retention requirements of the proposed regulations. A mortgage REIT or a portion of a mortgage REIT might be treated as a REIT/taxable mortgage pool under the rules of section 7701(i)(3). The securities issued by the REIT that are subject to those rules could fit the definition of ABS interests and thus be subject to the risk retention requirements of the proposed regulations.

**v. Issuing entity treated as a REMIC**

A REMIC is a creature of statute and regulation that is not (unless explicitly stated otherwise in the Code) treated as a corporation, partnership or trust under subtitle A of the Code. Congress intended REMICs to be the exclusive (or at least preferred) SPV for financing pools of real estate mortgage loans through securitizations issuing multiple maturities of debt (the REMIC regular interests).

A sponsor<sup>135</sup> forms a REMIC by contributing allowable assets to a qualified entity<sup>136</sup> and taking back securities issued by the REMIC (the residual interest, and one or more classes of regular interests). As of the close of the third month beginning after the REMIC's startup day and at all times thereafter, substantially all of the REMIC's assets must consist of qualified mortgages and specified other permitted investments (the REMIC asset test).<sup>137</sup> A REMIC may treat a regular interest issued by another REMIC as a qualified mortgage.<sup>138</sup>

As noted earlier, Dodd-Frank requires that regulations be issued to exempt sponsors of QRM securitizations from the risk retention requirements. Under the proposed regulations, the sponsor of a securitization would be exempt from the risk retention requirements if (i) all the securitized assets that collateralize the ABS are QRMs, (ii) none of the securitized assets that collateralize the ABS are other ABS, (iii) each QRM is currently performing as of the closing of the securitization, and (iv) specified other conditions are met. The regulations similarly provide an exemption for some securitizations of commercial mortgages. However, it seems likely that many REMICs will not qualify for either exemption.

First, it is common for REMICs to hold regular interests issued by other REMICs. Because a regular interest is an ABS, not a mortgage loan, a REMIC that holds a REMIC regular interest will not qualify for the QRM

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<sup>135</sup> According to reg. section 1.860F-2(b)(1), a sponsor is a person who directly or indirectly exchanges qualified mortgages and related assets for regular and residual interest in a REMIC. This REMIC-specific definition is sufficiently close to the definition of sponsor in the proposed regulations that we will assume a sponsor under the REMIC regulations is a sponsor under the proposed regulations.

<sup>136</sup> A qualified entity includes an entity or a segregated pool of assets within an entity. Reg. section 1.860D-1(c)(3). A qualified entity elects to be treated as a REMIC by timely filing an initial Form 1066 for its first tax year of existence. Reg. section 1.860D-1(d).

<sup>137</sup> Section 860D(a)(4); reg. section 1.860D-1(b)(3).

<sup>138</sup> Section 860G(3)(C).

exemption and likely not for the qualifying commercial mortgage loan exemption, either.<sup>139</sup> Second, even if the only assets held by a REMIC (apart from cash or cash equivalents) are qualifying mortgages under the REMIC rules, those mortgages might not be treated as QRMs or qualifying commercial mortgage loans under the proposed regulations. In fact, the preamble to the proposed regulations notes that “many prudently underwritten” mortgage loans will not be treated as QRMs or qualifying commercial mortgage loans, and that sponsors of ABS backed by those mortgages will be subject to the risk retention requirements (unless another exemption is available). Consequently, the risk retention rules likely will have broad application to both residential and commercial REMICs.

The special tax rules for REMICs will cause any REMIC residual or regular interests that are retained by the sponsor in compliance with the proposed regulations’ risk retention requirements to be treated differently for tax purposes than ABS interests issued by DREs, partnerships, or corporations that are retained by the sponsor. The retained regular or residual interests are not ignored; instead, the sponsor takes non-recognized gain or loss on the retained interests into account during the period the sponsor holds those interests.<sup>140</sup> The non-recognized gain or loss taken into income by the sponsor also should not be treated as an intercompany item because the REMIC is not a corporation and thus cannot be a member of a consolidated group.

Whether the security evidencing tax ownership of the issuing entity is an ABS interest under the proposed regulations may have particular importance for sponsors of REMICs. Unlike sponsors of other types of securitizations, who generally retain tax ownership of the issuing entity (this is required if the issuing entity is to be treated as a DRE), sponsors of REMICs commonly dispose of the residual interest. The market that developed for trading in noneconomic residual interests (NERDs) apparently was sizable enough that the IRS issued regulations prescribing the tax accounting for so-called inducement fees received by transferees of NERDs.<sup>141</sup>

A NERD that does not entitle the holder to any distributions probably should not be treated as an ABS interest and, consequently, can be freely disposed of by the sponsor. For a residual interest that is not a NERD, the holder anticipates receiving sufficient distributions that the residual interest will be a net tax asset. That is why any residual interest that is not a NERD probably should be treated as an ABS interest and, as a result, will be subject to the risk retention requirements. Nevertheless, there is some uncertainty as to whether a NERD

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<sup>139</sup> The proposed regulations state that the securitization transaction must be collateralized “solely (excluding cash and cash equivalents)” by one or more commercial real estate loans, each of which meets the specified underwriting standards. Consequently, a REMIC holding a regular interest issued by another REMIC apparently would not satisfy the conditions for the exemption.

<sup>140</sup> The non-recognized gain or loss arises when the sponsor transfers mortgages to the REMIC in exchange for the REMIC’s regular and residual interests. That transfer is a nonrecognition transfer, and the sponsor allocates its basis in the mortgages among the regular and residual interests. Some of the gain or loss thus transferred to REMIC regular interests will be recognized upon a sale of those interests to investors. The balance is taken into account as described in section 860F(b)(1)(C) and (D).

<sup>141</sup> Reg. section 1.446-6. Because a NERD is a tax liability (on a net present value basis) to the holder, a transferor typically must make a payment to the transferee to cause the transferee to become or make the transferee become the tax owner of the NERD.

entitling the holder to some cash flow from the REMIC should be treated as an ABS interest. This uncertainty could complicate the sponsor's choice of which risk retention method to use.

For example, if the residual interest is an ABS interest but does not satisfy the requirements for being treated as an eligible horizontal residual interest, none of the regular interests may qualify as eligible horizontal residual interests, either, and the sponsor would likely be unable to use the horizontal or the special CMBS risk retention methods. However, the REMIC regulations contemplate that a REMIC residual interest might be senior to a class of regular interests regarding allocation of cash flow shortfalls resulting from defaults or delinquencies on the REMIC assets. A sponsor of a CMBS transaction having a residual interest that is an ABS interest might be able to use this rule to create a B piece that is subordinate to the residual interest and satisfies the requirements for an eligible horizontal residual interest. Consequently, the sponsor might be able to dispose of the residual interest and comply with the special CMBS risk retention rule by having an appropriate third party own the B piece.

Finally, if the sponsor intends to maintain a horizontal cash reserve account or is required to establish a premium capture cash reserve account, the sponsor may have the choice of treating the account as an asset of the REMIC (a reasonably required reserve<sup>142</sup>) or as an asset kept outside the REMIC (an outside reserve fund<sup>143</sup>).

#### *vi. Effect of proposed regulations regarding hedging*

The proposed regulations would allow the sponsor to hedge the interest rate or currency risk but not the credit risk of the retained ABS interests or representative sample of assets.

For tax purposes, a hedging transaction is any transaction that a taxpayer enters into in the normal course of the its trade or business primarily (1) to manage the risk of price changes or currency fluctuations for ordinary property that is held or to be held by the taxpayer; or (2) to manage interest rate, price change, or currency risk for borrowings made or ordinary obligations incurred by the taxpayer.<sup>144</sup> Under that definition, only three types of risk may be hedged for tax purposes: interest rate, price change, and currency risk. The proposed regulations would allow the sponsor to hedge the interest rate or currency risk of retained ABS interests or the representative sample of assets. Consequently, the proposed regulations do not restrict the sponsor's ability to hedge those risks for tax purposes.

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<sup>142</sup> Section 860G(a)(1)(B)(7)(B); reg. section 1.860G-2(g)(2) and (3).

<sup>143</sup> Reg. section 1.860G-2(h).

<sup>144</sup> Section 1221(a) (defining capital asset to generally mean "property held by the taxpayer (whether or not connected with his trade or business)," but providing exceptions for specific types of property); reg. section 1.1221-2(c)(2) (defining ordinary property and ordinary obligations under the hedging rules).

However, the proposed regulations might restrict a sponsor's ability to hedge the risk of price changes. In many cases, hedging the price risk of ABS will entail hedging both market risk (interest rate risk) and credit risk. For example, a dealer in securities subject to section 475 or a bank holding debt instruments subject to section 582 might hedge those positions against adverse movements in their price. Since the price of those positions could be influenced both by the issuer's creditworthiness and the movement of interest rates, a hedge that reduces both interest rate risk and issuer-specific credit risk likely will be viewed as violating the rule against hedging the credit risk of retained interests in ABS. However, the proposed regulations would allow hedges against the overall value of a particular broad category of ABS. For example, a sponsor might be able to take a position in a derivative based on a broad index of ABS that offers some protection against the risk of price decline in retained ABS positions without violating the risk retention requirement. Accordingly, while the proposed regulations would allow securitizers to enter into specific hedging transactions involving price risk, care will need to be exercised in choosing the hedges.

Dodd-Frank's effects on securitization cannot be known with certainty until final regulations in this area are published. However, based on the proposed regulations, it seems likely that:

- sponsors will not be constrained in their choice of legal form for a securitization;
- whatever legal form is chosen by the sponsor, the sponsor generally will be required to retain a minimum 5 percent interest in the securitized assets or 5 percent of each class of ABS interests issued by the SPV;
- sponsors generally will not be permitted to transfer or hedge the credit risk of the retained interests;
- sponsors will need to consider how the retention of ABS interests issued by the SPV will affect the tax characterization of the SPV and the retained ABS interests; and
- sponsors will need to consider whether the prohibition against hedging credit risk will affect the sponsor's ability to hedge price risk for tax purposes.

## **VI. DERIVATIVES**

A single page of Dodd-Frank is devoted to U.S. tax issues – the final one. That page purports to address one aspect of the tax consequences of comprehensive derivatives regulation introduced by the Act. It is curious that of all the potential tax issues raised by Dodd-Frank, of which this report describes only some, Congress chose to address only the derivatives issues. In this section we offer some explanation for the special treatment of the taxation of derivatives in the development of financial reform.

### **a. Early Warnings of Derivative Regulation**



Financial reform arose out of a widespread need to affix blame for the global financial crisis, to punish the wrongdoing, and to ensure the culprits were prevented from doing the offending deeds again. Over-the-counter (OTC) derivatives were considered to be among the central precipitants of the crisis. So as Congress was first considering a legislative response to the financial crisis, it turned its attention to increasing control over the OTC derivatives markets, by using familiar mechanisms: clearing, execution, and reporting of derivative trades.

Reports of Congress's intentions for OTC derivatives were widely disseminated, and tax practitioners began discussing the tax implications of extending clearing and execution of OTC derivatives, focusing on section 1256 and its definition of regulated futures contracts (RFCs).

### **b. OTC vs. Exchange-Traded Derivatives Before Dodd-Frank**

Immediately before the enactment of Dodd-Frank, most derivative contracts were negotiated privately between parties in what became known as the OTC derivative market. Pre-Act OTC derivative contracts were negotiated and concluded at market, so there was generally no cash payment at their inception, and no exchange, clearinghouse, or government agency came between the parties to the contracts or regulated them after the contracts were executed.

The tax rules governing the treatment of OTC derivatives are as diverse as life forms along the Amazon. Evolving ad hoc to address new financial transactions or to combat abuses, they combine an analysis of a contract's form (for example, an option, a forward, or a swap), its purpose (for example, for investment or for hedging), and its ability to do mischief (for example, being part of a straddle). Yet, despite an abundance of laws, uncertainty is the dominant characteristic in the taxation of financial transactions.

Exchange-traded derivatives, in contrast, mostly developed along a consistent path following the enactment of section 1256 in 1981.

### **c. Section 1256**

Section 1256 was a part of the phalanx of laws enacted to eliminate the tax straddle shelters popular in the 1970s.<sup>145</sup> The shelters used futures contracts traded on U.S. exchanges to create commodity straddles,<sup>146</sup> which

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<sup>145</sup> For more discussion of the history of section 1256, see Viva Hammer, "US Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty," 64 *Bull. Int'l Tax.* 176 (2010).

<sup>146</sup> In a commodity straddle, a taxpayer entered into two commodity futures contracts—a contract to buy the commodity and a contract to sell the commodity. The contracts had different delivery months. After some time to allow the underlying commodity price to move, one of the contracts would have decreased in value and the other would have increased in value, usually by nearly the same amount. The taxpayer then sells the loss contract and enters into an identical futures contract with a different delivery date, deducting the loss in the year of the sale. The following tax year, the taxpayer would sell the two remaining futures contracts, usually for a gain. That combination of transactions resulted in short-term capital loss in the first year, which can offset short-term capital gain, and long-

deferred capital gains and converted short-term capital gains into long-term capital gains, and U.S. Treasury bill straddles,<sup>147</sup> which sheltered ordinary income. The straddle shelters wreaked havoc on the U.S. Treasury and futures markets, and Congress devised a multi-pronged attack to eradicate them.

One prong of the attack was the loss deferral straddle rule now found in section 1092. Treasury believed the loss deferral rule might be impractical, so it suggested an alternative rule for taxpayers with many commodities transactions:

We propose that these persons be subject to a mandatory mark to market rule for their positions in futures contracts traded on an organized futures exchange. Because futures positions are marked to market on a daily basis under the normal operating rules of the exchange, with actual cash settlements on a daily basis, this rule does no more than make the tax laws reflective of the underlying market transactions.<sup>148</sup>

Congress and Treasury knew that taxing futures contracts under a mark-to-market system would be challenged, under the principle articulated in *Eisner v. Macomber*.<sup>149</sup> In that case, the Supreme Court said that a receipt could be taxed only if it represented “a gain, a profit, something of exchangeable value proceeding from property, severed from the capital however invested or employed, and coming in being ‘derived’ that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal.”<sup>150</sup> Further, in *Commissioner v. Glenshaw Glass Co.*,<sup>151</sup> the Court said that to be taxed, income must be “undeniable accessions to wealth, clearly realized, and [something] over which the taxpayers have complete dominion.”<sup>152</sup>

Anticipating a constitutional challenge to mark-to-market taxation, the Joint Committee on Taxation conducted research on the commodities futures markets.<sup>153</sup> The JCT report defines a commodities futures contract as a “standardized agreement either to buy or to sell a fixed quantity of a commodity to be delivered at a particular

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term capital gain in the second year, which is taxed at a lower rate. The taxpayer effectively deferred capital gains and converted short-term capital gains into long-term capital gains.

<sup>147</sup> In a Treasury bill straddle, a taxpayer entered into long and short futures contracts on Treasury bills with delivery months at the end of the tax year. At the time, futures contracts were characterized as capital assets, while Treasury bills were ordinary property. At year-end, the taxpayer would close the loss contract by taking delivery of the Treasury bills and would recognize an ordinary loss. Then the taxpayer would replace the futures contract with an identical contract, but with a later delivery date. In the following year, the taxpayer would recognize a long-term capital gain on the futures contract that had been held for the necessary long-term holding period.

<sup>148</sup> “Commodity ‘Tax Straddles’: Hearing before the H. Comm. on Ways & Means,” 97th Cong. 63 (1981).

<sup>149</sup> 252 U.S. 189 (1920).

<sup>150</sup> *Id.* at 207.

<sup>151</sup> 348 U.S. 426 (1955).

<sup>152</sup> *Id.* at 431.

<sup>153</sup> JCT, “Background on Commodity Tax Straddles and Explanation of S.626,” (June 12, 1981).

location in a specified month in the future.”<sup>154</sup> The report describes several unique features of exchange-traded contracts: (1) all trading in futures contracts must be transacted through an exchange by exchange members; (2) a clearing association guarantees performance on all contracts traded through an exchange by interposing itself as a counterparty to every contract after the trade is made; and (3) all futures contracts are standardized as to size, location of delivery, and dates of delivery.<sup>155</sup>

The JCT report highlights one feature of the futures markets: the use of margin deposits. For an exchange to guarantee all contracts, it must limit risk in any open positions. The exchange reduces that risk by demanding a deposit upfront for each contract entered into on the exchange. The amount of that deposit is usually a percentage of the value of the contract, depending on the riskiness of the contract and other positions traded on the exchange by the taxpayer. The most important aspect of the margining system is that the amount of margin held by the exchange changes daily. If the value of a taxpayer’s position declines because the market has moved against her, the taxpayer will owe money to the exchange; if the value of the taxpayer’s position increases because the market has moved in her favor, the taxpayer will be entitled to withdraw money from her account. This system of daily margin adjustments is called marking to market.<sup>156</sup>

Daily cash movements reflecting changes in the values of the contracts held by taxpayers – the margin system – provided Congress with the justification for mark-to-market taxation. Those cash movements came to be viewed as “undeniable accessions to wealth, clearly realized, and [something] over which the taxpayers have complete dominion.”

The futures industry strongly objected to being required to mark its positions to market for tax purposes, so lawmakers offered a sweetener: 60 percent of all gains and losses on exchange-traded positions would be taxed at a long-term capital gains rate, and the remaining 40 percent would be taxed at a short-term capital gains rate (60/40 treatment). At a time when long-term capital gains were taxed at 20 percent and the top rate for ordinary income was 50 percent, this offer was sweet indeed because it resulted in a considerable rate advantage, even for positions held only momentarily.<sup>157</sup>

Thus, section 1256 was born, eliminating straddle shelters through marking to market, but at the cost to the government of 60/40 treatment.

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<sup>154</sup> *Id.* at 3.

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 7-8.

<sup>157</sup> The 1981 act reduced the top tax rate from 70 percent to 50 percent and the top tax rate on long-term capital gains from 28 percent to 20 percent (as the result of a 60 percent exclusion for long-term capital gains).

As it turned out, 60/40 treatment was so favorable that immediately after it was enacted, other taxpayers clamored to bring their contracts within section 1256. Many more contracts have been brought under section 1256's purview since 1984.<sup>158</sup>

**d. Section 1256 and the Act**

Although the constitutionality of section 1256 was initially the subject of controversy,<sup>159</sup> its scope was not. As the particulars of derivatives reform became a reality in 2009, however, the meaning of one provision within section 1256 defining an RFC was suddenly the subject of debate.

Section 1256(g)(1) defines an RFC as a contract:

- (A) for which the amount required to be deposited and the amount that may be withdrawn depends on a system of marking to market;
- (B) that is traded on or subject to the rules of a qualified board or exchange.<sup>160</sup>

The term “qualified board or exchange” is defined as:

- (A) a national securities exchange that is registered with the SEC;
- (B) a domestic board of trade designated as a contract market by the CFTC; or
- (C) any other exchange, board of trade, or other market which Treasury determines has rules adequate to carry out the purposes of section 1256.<sup>161</sup>

When section 1256 was enacted, nothing in that definition caused uncertainty. It clearly intended to refer to futures contracts traded on U.S. exchanges or boards of trade. Derivatives reform muddied the waters, however, by proposing to impose onto OTC derivatives some of the requirements that exchanges impose on their members and on the contracts they trade, such as clearing, margining, and trading on an established exchange or some alternative swap execution facility.

What gave taxpayers pause in 2009 was the unclear relationship between the new clearing, margining and trading requirements for OTC derivatives and the old requirements for exchange-traded derivatives. Would

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<sup>158</sup> Congress subsequently added other types of section 1256 contracts, including foreign currency contracts, non-equity options, dealer equity options, and dealer securities futures contracts. *See* section 1256(b)(1).

<sup>159</sup> *See Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993).

<sup>160</sup> Section 1256(g)(1).

<sup>161</sup> Section 1256(g)(7). The IRS has recognized several qualified boards or exchanges. *See, e.g.*, Rev. Rul. 2010-3, 1 C.B. 272 (London International Financial Futures and Options Exchange); Rev. Rul. 2009-24, 2 C.B. 306 (ICE Futures Canada); Rev. Rul. 2009-4, 1 C.B. 408 (Dubai Mercantile Exchange); Rev. Rul. 2007-26, 1 C.B. 970 (ICE Futures, a U.K. Recognized Investment Exchange).

derivatives reform force a large percentage of OTC derivatives to become RFCs because they would now be traded on or subject to the rules of a qualified board or exchange?<sup>162</sup>

Financial reform did not have a tax bill associated with it, and congressional staffers did not expect that financial reform would raise tax issues directly. But tax practitioners understood that if OTC derivatives came within section 1256 as a result of financial reform, it could substantially alter the tax – and economic – consequences of entering into derivative transactions.

Taxpayers are in two major camps in their attitude toward section 1256. For individuals, 60/40 treatment is a significant benefit, especially when the tax rates for short-term and long-term capital gain diverge as much as they do today. This benefit eliminates the inconvenience of marking contracts to market. For corporations, there is no reduced rate for capital gains, and there is a substantial detriment in generating capital losses. Marking to market can add to a corporation's woes if it holds derivatives that experience great swings in value over their lifetimes, which is common.

If these two camps dueled it out in the halls of Longworth and Dirksen, we have no record of the battles. Dodd-Frank caused such seismic changes in the financial world that the taxation of derivatives hardly warranted an audience. One public statement emerged. Alan Fu of Prudential Financial Inc. wrote to Treasury outlining the problems for insurance companies if OTC derivatives were included in section 1256:

(1) Ordinary gains/losses on derivatives used to manage interest rate and foreign currency risks in our businesses now become capital. Capital is less favorable for corporations because: (a) capital loss can only be offset against capital gain, not operating income; (b) capital loss has a shorter carryforward period than ordinary loss; and (c) corporations do not enjoy a lower capital gains tax rate.

(2) Marking to market means there is a mismatch in recognizing taxable gain/loss on the derivatives and the economic reality. An interest rate swap that converts a fixed rate bond to floating rate would have to recognize phantom mark-to-market taxable capital gains/losses annually without the benefit of offsetting gains/losses on the bond.

(3) Because of great volatility in derivatives markets, marking contracts to market makes forecasting taxable income difficult, which in turn hinders rational business decision-making that depends on such forecasts.<sup>163</sup>

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<sup>162</sup> *But see* prop. reg. section 1.1256(b)-1(b), discussed below.

<sup>163</sup> Comments of Alan Fu of Prudential Financial Inc. (Apr. 23, 2010), Doc 2010-9908, 2010 TNT 86-22.

Prudential's objections to section 1256 treatment were fairly idiosyncratic in the insurance industry, because many other types of corporations could obtain hedging treatment under section 1221(a)(7) and reg. section 1.446-4 for the transactions Fu described, and they would therefore avoid both mark-to-market and 60/40 treatment.<sup>164</sup> Also, a large group of corporations – not including insurance companies – would have fallen under an “end user” exemption from the derivatives provisions in the precursors to, and the enacted version of, Dodd-Frank.<sup>165</sup>

Nevertheless, it was the view presented in Fu's letter that prevailed in the final drafting of the Act. Congressional budget economists believed that forcing OTC derivatives into section 1256 would be a boon to individuals and detrimental to the fisc.<sup>166</sup> And because of this budget issue, in the final half-hour of draft of the Act, staffers hastily added a “clarifying” provision drafted by Treasury, stating that some contracts do not become section 1256 contracts because of any provisions of the Act.

#### **e. Regulation of Derivatives in Dodd-Frank**

Dodd-Frank affected OTC derivatives as expected. It defined very broadly the derivatives population over which the regulatory institutions have jurisdiction, and it required the CFTC and the SEC to write rules safeguarding the derivatives markets. The possible tax consequences of the new rules are reduced in the last page of the Act, which provides a list of derivatives that Congress did not intend to be governed by section 1256. Practitioners are confused by the scope of the tax provision in Dodd-Frank for reasons described more fully below.

#### ***iv. Swaps defined broadly for regulatory purposes***

The Act regulates the derivatives markets by empowering the CFTC and the SEC to regulate swaps, security-based swaps, and mixed swaps. The definition of swaps is such that almost all imaginable derivative instruments are covered.

The definition of swap includes:

- options (including puts, calls, caps, floors, collars, and similar options);

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<sup>164</sup> Section 1256(e)(1).

<sup>165</sup> The end user exception offers a possible way for corporations that use OTC derivatives solely for hedging purposes to continue using OTC derivatives that are not subject to central clearing. But a corporation may opt to reap some of the benefits of central clearing and the associated regulatory structure, which could include enhanced security and liquidity. In that case, it would share the concern that section 1256 might apply.

<sup>166</sup> See Congressional Budget Office, “Cost Estimate, H.R. 4173, Restoring American Financial Stability Act of 2010,” (June 9, 2010), at 7, available at <http://www.cbo.gov/ftpdocs/115xx/doc11560/hr4173senatepassed.pdf> (estimating revenue loss of \$1.3 billion over 10 years).

- event contracts, which provide for purchase, sale, payment, or delivery that depends on the occurrence, nonoccurrence, or extent of occurrence of an event (other than a dividend on an equity security);
- derivative contracts commonly known as swap contracts (specifically including interest rate swaps, rate floors, rate caps, rate collars, cross-currency swaps, basis swaps, currency swaps, foreign exchange swaps, total return swaps, equity index swaps, equity swaps, debt index swaps, debt swaps, credit spreads, credit default swaps, credit swaps, weather swaps, energy swaps, metal swaps, agricultural swaps, emissions swaps, and commodity swaps)<sup>167</sup> and any executory contract (1) that provides for an exchange of a fixed or contingent payment or payments based on interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof; and (2) that transfers the financial risk associated with a future change in such value or level without conveying a current or future direct or indirect ownership interest in an asset or liability;
- any agreement, contract, or transaction that later becomes commonly known as a swap;
- security-based swap agreements; and
- any combination of any of the above or an option on any of the above.<sup>168</sup>

Unless exempted by Treasury, swaps include foreign exchange forwards, but Treasury has proposed exempting foreign exchange swaps and forwards from the definition of swaps for most purposes of the Act, including the clearing and trading requirements.<sup>169</sup>

The Act excludes the following from the definition of swap:

- futures contracts, options on futures, leverage contracts, security futures products, retail spot foreign exchange transactions described in Commodity Exchange Act (CEA) section 2(c)(2)(C)(i), and retail commodity transactions described in CEA section 2(c)(2)(D)(i) that are already regulated by the CEA;

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<sup>167</sup> Hereinafter referred to as traditional swaps.

<sup>163</sup> Section 721(a)(21) of the Act. On April 27, 2011, the CFTC and the SEC proposed rules for further defining swaps. They proposed that foreign exchange forwards, foreign exchange swaps, foreign currency options not traded on a national securities exchange, non-deliverable forward contracts involving foreign exchange, currency and cross-currency swaps, and forward rate agreements be included in the definition of swap for purposes of the Act. See SEC press release, "SEC Proposes Product Definitions for Swaps," (Apr. 27, 2011), available at <http://www.sec.gov/news/press/2011/2011-99.htm>.

<sup>169</sup> Section 722(h) of the Act. On April 29, 2011, under its authority under the Act, Treasury issued a proposed determination that would exempt foreign exchange swaps and forwards from the definition of swap for most purposes of the Act, including registration, clearing, and trade execution. 76 *Fed. Reg.* 25,774 (May 5, 2011).

- any sale of a nonfinancial commodity or security for deferred shipment or delivery, if the contract is intended to be physically settled;
- options on securities, straddles, certificates of deposit, or groups or indexes of securities subject to the Securities Act of 1933 and the Securities Exchange Act of 1934;
- foreign currency options listed on a national securities exchange;
- securities-based contracts (i) involving the purchase or sale on a contingent basis of one or more securities that are subject to the Securities Act of 1933 and the Securities Exchange Act of 1934, (ii) any debt that is a security under section 2(a)(1) of the Securities Act of 1933, and (iii) any contract that is based on a security and entered into by the issuer of the security to raise capital except when the contract is entered into to manage risk associated with raising capital;
- contracts with the Federal Reserve, the federal government, or any federal agency backed by the full faith and credit of the U.S. government; and
- security-based swaps other than mixed swaps.<sup>170</sup>

v. *Regulation of OTC derivatives*

The Act transforms the OTC derivatives markets in several ways by requiring:

- registration and satisfaction of specific other requirements for participants in swaps markets;<sup>171</sup>
- clearing of specified swaps;
- trading of specified swaps; and
- reporting of specified swaps.

Of particular relevance to the applicability of section 1256 are the clearing and trading requirements for specified swaps.

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<sup>170</sup> Section 721(a)(21) of the Act.

<sup>171</sup> The Act requires swap dealers and major swap participants to adhere to certain minimum requirements regarding capital, initial margin, and variation margin. On April 11, 2011, five federal agencies, including the Federal Reserve and the FDIC, issued proposed rules on these minimum capital and margin requirements. On April 14, 2011, the CFTC also issued proposed rules on these requirements.



**vi. Compulsory swap clearing**

Under the Act, it is unlawful for a party to enter into a swap unless it is entered into by, or subject to the rules of, a board of trade designated as a contract market under the CEA, or unless the party is exempt from clearing as an “eligible contract participant.”<sup>172</sup>

A swap that is required to be cleared must be submitted for clearing to a derivatives clearing organization (DCO). The CFTC or SEC must continually consider whether to require specific swaps to be cleared, and a DCO may propose to the CFTC or SEC that specific swaps be required to be cleared.<sup>173</sup> Under the Act, all economically equivalent swaps submitted for clearing to a DCO must be able to be offset against each other.

Every DCO must limit its exposure to potential losses from defaults by members and other participants in the DCO through the use of margin requirements and other risk control mechanisms.<sup>174</sup>

Under the end user exemption, the clearing requirement does not apply to a swap if one of the counterparties to the swap is not a financial entity,<sup>175</sup> is using the swap to hedge or mitigate financial risk, and notifies the CFTC of how it meets its financial obligations associated with entering into the swap. This exemption is an option, but not a requirement, of the nonfinancial counterparty to the swap.<sup>176</sup>

**vii. Trading**

If a swap is required to be cleared, parties must execute its trade on a national securities exchange, a board of trade designated as a contract market, or a swap execution facility,<sup>177</sup> unless none of these institutions agree to trade the swap.<sup>178</sup>

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<sup>172</sup> Section 2(e)(7)(C) of the CEA, added by section 723(a)(2) of the Act. An eligible contract participant includes financial institutions, insurance companies, investment companies, some corporations, partnerships and other entities with more than \$10 billion in assets, some commodity pools, employee benefit plans, governmental entities, and broker dealers, all acting for their own accounts. Section 1a(12) of the CEA.

<sup>173</sup> Section 2(h) of the CEA, added by section 723(a) of the Act.

<sup>174</sup> Section 5(b)(c) of the CEA, added by section 725(c) of the Act. The CFTC has issued proposed rules on the clearing requirements and risk management requirements for DCOs. *See* 76 *Fed. Reg.* 13101 (Mar. 10, 2011); 76 *Fed. Reg.* 3698 (Jan. 20, 2011).

<sup>175</sup> The term “financial entity” generally means a swap dealer, a major swap participant, a commodity pool, a private fund, an employee benefit plan, or a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature. Some exemptions apply for institutions with total assets under \$10 billion. Section 2(e) of the CEA, added by section 723(a) of the Act.

<sup>176</sup> Section 2(h)(7) of the CEA, added by section 723(a)(3) of the Act.

<sup>177</sup> A swap execution facility is a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility. Section 1a(50) of the CEA, added by section 721 of the Act.

<sup>178</sup> Section 2(h)(8) of the CEA, added by section 723(a)(3) of the Act. Since the exchanges and swap execution facilities will set their own standards for which swaps they will execute, swaps with particularly risky counterparties or swaps with exotic or hard-to-value terms might not be accepted by any exchange or swap execution facility.

The end user exemption described above applies to exempt some nonfinancial entities from the trading requirement as well.

**f. Applicability of Section 1256**

Although practitioners had considered OTC derivatives generally to be outside the purview of section 1256, the new clearing and trading requirements described above led many to reconsider whether traditional swaps would now be “traded on or subject to the rules of a qualified board or exchange” and therefore be within the definition of an RFC. That uncertainty caused Congress to add a list of exclusions from the definition of section 1256 contracts.<sup>179</sup>

The Act provides that section 1256 contracts do not include:

Any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.<sup>180</sup>

The list is odd. Although the tax page is incorporated into the Act, the list of swaps covered on the tax page is utterly unconnected to the list of swaps in the main regulatory body of Dodd-Frank. For example, the regulatory definition of swap in Dodd-Frank is extremely broad, covering every type of contract imaginable. The tax definition is short and appears to be based on the list of contracts within the definition of an NPC in reg. section 1.446-3(c)(1)(i), with the addition of credit default swaps.

Several questions are raised by the disconnection between the definition of swap for regulatory purposes and tax purposes. Why did the tax definition not simply refer to the regulatory definition of swap? And assuming the differences were intentional, what interpretive value should we draw from them? Several of the terms in the Dodd-Frank addition to section 1256 are new to the Code, including the term “swap.”

A tax professional might interpret the new 1256 list in Dodd-Frank any number of ways. We examine two here: (1) only NPCs and credit default swaps are excluded from section 1256 (whatever the term “credit default swap” means); and (2) all swaps are excluded (whatever the term “swap” means), because of the “or similar agreement” language at the end of the provision. One immediate question that comes to mind is whether “swap” includes a bullet swap that has only one payment at maturity and therefore is excluded from the definition of an NPC?

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<sup>179</sup> Before the Act, some taxpayers and advisers had maintained that their traditional swap contracts were RFCs and therefore section 1256 contracts. Because of the Act’s section 1256 exclusion and the lack of a transition rule, those taxpayers may have little alternative but to request the IRS Commissioner’s consent to change their method of accounting for existing and future swaps.

<sup>180</sup> Section 1601(a)(3) of the Act.

These interpretive problems are not merely academic; energy and weather derivatives are two common types of derivatives whose status is uncertain under the newly amended section 1256. Under interpretation (1), energy and weather derivatives now potentially fall within section 1256 because they are not specifically enumerated in the exclusion to that section. But under interpretation (2), they are excluded from section 1256 because of the “similar agreement” language in the amendment.

At a recent American Bar Association webinar, Patrick McCarty, a principal drafter of the Act, said, “This is how I view it: No swap gets 1256 treatment, period.”<sup>181</sup> He further added that the language “or similar agreement” is not meant to describe agreements similar to the listed ones only, but, any swap under the Act.<sup>182</sup> Of course, McCarty’s statements have no legal weight, but they may be helpful to the IRS and practitioners as they struggle to understand Congress’s intent.

Legislative history, another source of potential help to taxpayers, says that the amendment to section 1256 is “a provision to address the recharacterization of income as a result of increased exchange-trading of derivatives contracts by clarifying that [section 1256] does not apply to certain derivatives contracts transacted on exchanges.”<sup>183</sup> That language does not appear consistent with McCarty’s interpretation that all swaps should be excluded from section 1256. Some interest rate derivatives, for example, are traded on the Chicago Mercantile Exchange (CME) and could be characterized either as futures contracts subject to section 1256 or as interest rate swaps. McCarty would exclude these from section 1256, but it doesn’t appear that the legislative history would.

McCarty’s view that all swaps should be excluded from section 1256 also presents difficulties for some energy swaps. For instance, CME ClearPort provides clearing services in which OTC energy swaps are converted into futures contracts. The resulting contracts probably fell within section 1256 before the enactment of Dodd-Frank. Since these contracts generally provide for a single payment, they are not NPCs. In all likelihood, they would not be excluded under a reading of the section 1256 amendment that limits exclusions to NPCs, credit default swaps, and agreements similar to NPCs and credit default swaps. However, if the list is read to include the broad definition of swaps under the Act, a definition that includes energy swaps, these contracts might be taken out of section 1256.

Another contract with uncertain status is the interest rate swap cleared on the International Derivatives Clearing House (IDCH). The IDCH offers to clear the interest rate swaps by exchanging each interest rate swap position for a futures contract with equivalent payment terms. After clearing, each party transacting with the IDCH has

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<sup>181</sup> Marie Sapirie, “Mark-to-Market Exception Covers All Swaps, Former Staffer Says,” *Tax Notes*, Mar. 7, 2011, p1121, *Doc 2011-4585, 2011 TNT 43-4*.

<sup>182</sup> *Id.*

<sup>183</sup> H.R. Rep. No. 111-517, at 879 (2010).

a futures contract as a regulatory matter with payment terms equivalent to an interest rate swap. These contracts were certainly not contemplated by Congress when it enacted section 1256, which leaves questions about how periodic payments under the contracts would be taxed. Although Dodd-Frank specifically excludes interest rate swaps from section 1256, it is still unclear whether after clearing, this contract is best characterized as an interest rate swap (outside section 1256) or as a futures contract (within section 1256).

Treasury and IRS guidance is needed.<sup>184</sup> Scholars of tax policy offering advice to the government on the section 1256 dilemma raised by Dodd-Frank would begin with the tax policy ideals of efficiency, equity, and administrability. But neither equity nor efficiency will ever be optimized while we labor under the current Code. Whether a specific contract is within or outside section 1256 will not improve the efficiency of the financial markets when there is already such diversity of tax treatment between economically similar contracts. To fix that problem, we would need a tax reform as significant as the regulatory reform implemented by Dodd-Frank.

The only tax policy ideal Treasury and the IRS can fully uphold today is administrability, giving taxpayers a clear message on which instruments are within and which are outside section 1256. Commentators overwhelmingly support mark-to-market treatment for financial instruments,<sup>185</sup> and they equally despair at the nonsensicalness of 60/40 treatment. If the government must choose which transactions are fall under section 1256, both it and taxpayers will win some and lose some. The government alone can decide who falls on which side and when.

#### **g. Proposed Regulations under Section 1256**

On September 15, 2011, Treasury and the IRS issued proposed regulations that, if finalized, would clarify the meaning of the list of exclusions under section 1256(b)(2)(B) (Proposed Section 1256 Regulations).<sup>186</sup> The proposed regulations would broaden the definition of an NPC under reg. section 1.446-3(c) to include credit default swaps and certain weather derivatives (Proposed NPC Regulations).

The Proposed Section 1256 Regulations would specifically exclude NPCs from the definition of section 1256 contracts, providing that a “section 1256 contract does not include any contract, or option on such contract, that

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<sup>184</sup> See Sapirie, “Dodd-Frank Clouds Foreign Currency Swap Issues,” *Tax Notes*, Apr. 18, 2011, p. 237 *Doc 2011-7732*, or *2011 TNT 70-2* (“An expected announcement by Treasury Secretary Timothy Geithner regarding the regulation of foreign exchange swaps may add another layer of uncertainty to the question whether those swaps must be marked to market”).

<sup>185</sup> See, e.g., Yoram Keinan, “Mark-to-Market for Derivatives,” *Tax Notes*, Sept. 20, 2010, p. 1269, *Doc 2010-18356*, or *2010 TNT 184-10*; David S. Miller, “A Progressive System of Mark-to-Market Taxation,” *Tax Notes*, Oct. 13, 2008, p.213, *Doc 2008-20805*, or *2008 TNT 200-48*; David A. Weisbach, “Colloquium on Financial Instruments: Tax Responses to Financial Contract Innovation,” 50 *Tax L. Rev.* 491 (1995).

<sup>186</sup> REG-111283-11 (Sep. 15, 2011), 76 *Fed. Reg.* 57,684 (Sep. 16, 2011).

is a notional principal contract as defined in § 1.446-3(c).”<sup>187</sup> In support of this interpretation of section 1256(b)(2)(B), the preamble to the Proposed Section 1256 Regulations states that “Congress was attempting to harmonize the category of swaps excluded under section 1256(b)(2)(B) with swaps that qualify as notional principal contracts under § 1.446-3(c), rather than with the contracts defined as ‘swaps’ under section 721 of the Dodd-Frank Act.” Thus, the Proposed Section 1256 Regulations reject the broader interpretation of Dodd-Frank’s section 1256 exclusion that looks to the definition of swap under Dodd-Frank.

Notwithstanding the narrower view of what constitutes a “similar agreement” under section 1256(b)(2)(B), the Proposed Section 1256 Regulations would categorize options on NPCs as similar agreements even though the options themselves are not NPCs. The preamble to the Proposed Section 1256 Regulations explains that “[s]ince an option on a notional principal contract is closely connected with the underlying contract, the Treasury Department and the IRS believe that such an option should be treated as a similar agreement within the meaning of section 1256(b)(2)(B).” Furthermore, if a contract meets both the definition of an NPC and a section 1256 contract, under the proposed regulations, the contract’s NPC status would govern and cause it to be outside section 1256.<sup>188</sup>

The Proposed Section 1256 Regulations would also limit the definition of an RFC to a futures contract. In addition to the current statutory requirements for being an RFC (i.e., being subject to a system of marking to market and being traded on a qualified board or exchange), a contract would also have to meet the requirement that it not be required to be reported as a swap under the CEA to qualify as an RFC under the Proposed Section 1256 Regulations.<sup>189</sup>

Under the Proposed NPC Regulations, the list of included financial instruments listed as NPCs would be expanded to include credit default swaps and weather-related swaps.<sup>190</sup> The current definition of an NPC requires payments based on a specified index, which must be an index based on current, objectively determinable financial or economic information. Under the Proposed NPC Regulations, a specified index would include both a specified financial index and a specified non-financial index, which is defined as any objectively determinable information that (1) is not within the control of any of the parties to the contract and is not unique to one of the parties’ circumstances, (2) is not financial information, and (3) cannot be reasonably expected to front-load or back-load payments accruing under the contract. Weather-related swaps that provide

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<sup>187</sup> Prop. reg. section 1.1256(b)-1(a).

<sup>188</sup> *Id.*

<sup>189</sup> Prop. reg. section 1.1256(b)-1(b).

<sup>190</sup> Prop. reg. section 1.446-3(c)(iii). It is not clear what the significance of the list of contracts described as NPCs under the current regulations. The Proposed NPC Regulations also clarify that such list is only descriptive in nature by adding a limitation that the listed items must satisfy the definitional requirement of an NPC as specified in reg. section 1.446-3(c)(1)(i).

for payments based on a specified non-financial index would therefore be able to qualify as an NPC under the Proposed NPC Regulations.

Thus, if both the Proposed Section 1256 Regulations and Proposed NPC Regulations are finalized in their current form, credit default swaps and certain weather derivatives would be exempt from section 1256, and the excluded contracts under section 1256(b)(2)(B) would closely parallel the definition of an NPC under reg. section 1.446-3(c).

## **VII. EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE**

The Act contains several provisions regarding executive compensation and corporate governance.<sup>191</sup> Below we discuss the provisions with a tax impact.

### **a. Shareholder Approvals and Disclosures**

#### *i. The Act's provisions*

##### *1. Shareholder approval of executive compensation ("say on pay")*

The Act requires that at least once every three years, the issuer include in its proxy statement a resolution giving shareholders a nonbinding vote to approve the compensation of the issuer's executives. Also, at least every six years, shareholders must vote on a separate resolution regarding whether the shareholder vote is to occur every one, two, or three years.<sup>192</sup>

##### *2. Shareholder approval of golden parachutes*

The issuer's proxy statement must disclose any agreements with specified executive officers (currently the CEO and the three most highly paid officers) that concern any compensation based on an acquisition, merger, consolidation, sale, or other disposition of substantially all of the issuer's assets unless the agreement is already disclosed and voted under the say on pay provision. Shareholders must have a nonbinding vote to approve that compensation.<sup>193</sup>

##### *3. Disclosure of executive pay versus performance*

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<sup>191</sup> Subtitles E and G of Title IX of the Act contain the sections regarding corporate governance and executive compensation.

<sup>192</sup> Section 951 of the Act. On April 4, 2011, the SEC issued a final rule on the say-on-pay provision. See SEC Rule 14a-21. SEC, "Shareholder Approval of Executive Compensation and Golden Parachute Compensation" (April 4, 2011).

<sup>193</sup> *Id.* On April 4, 2011, as part of the say-on-pay rules that were issued, the SEC also addressed the golden parachute provisions of the Act.

The proxy statement must disclose the relationship between executive compensation actually paid and the issuer's financial performance, taking into account changes in share value, dividends, and other distributions. Also, the issuer must disclose (i) the median of the annual total compensation of all of the issuer's employees other than the CEO, (ii) the annual total compensation of the CEO, and (iii) the ratio of the amount in (i) to the amount in (ii).<sup>194</sup>

#### *4. Disclosure of employee and director hedging*

The proxy statement must disclose whether any employee or member of the board is permitted to purchase financial instruments for the purpose of hedging any decrease in the market value of securities that are paid in compensation or otherwise held by those individuals.<sup>195</sup>

##### *ii. Effective dates*

The say on pay provision and the golden parachute provisions are effective at a company's first shareholder meeting or proxy solicitation occurring after January 21, 2011. The effective date of the pay-versus-performance and the hedging provisions will be in rules the SEC intends to issue by mid-2011.

##### *iii. Tax issues*

The Act's rules regarding executive compensation revisit policies Congress has already considered in the tax law. Section 162(m) generally disallows a public company from deducting compensation that is paid to each named executive officer in excess of \$1 million per tax year. Performance-based compensation that is subject to goals established by a compensation committee comprising at least two outside directors is exempt from that rule. Section 280G provides an intricate set of rules that, if violated, would disallow a deduction for excess parachute payments made to executives in connection with the change in ownership or control of a corporation or a substantial portion of its assets. Executives receiving those excess payments are subject to a 20 percent excise tax under section 4999. The Act's provisions supplement these provisions by requiring public disclosure of much of the same information that is needed in analyzing the application of the tax provisions.

#### **b. Recovery of Compensation Determined as Excessive on an Accounting Restatement**

##### *iv. The Act's provision*

The SEC is required to write rules for the recovery of incentive-based compensation from current or former executive officers of a publicly traded corporation that is determined to exceed what should have been paid,

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<sup>194</sup> Section 953 of the Act.

<sup>195</sup> Section 955 of the Act.

based on revised figures in an accounting restatement of the corporation's financial statements.<sup>196</sup> For example, bonuses that are based on the reported income of a corporation would have to be recovered at least in part if that income was reduced by an accounting restatement. This "clawback" provision applies to compensation paid during the three-year period preceding the date of any accounting restatement.

*v. Effective date*

The effective date of the clawback provision will be included in rules the SEC intends to issue by mid-2011.

*vi. Tax issues*

When amounts paid by the issuer are subject to reporting and wage withholding in one year and later required to be paid back in a following year by the executive, there is no general relief or adjustment available for the withholding and reporting in the prior year of payment. Rather, each executive must approach the IRS with her own theory on why a refund of the prior-period withholding should be made. The most logical approach would appear to apply a claim of right theory under section 1341. The Act does not appear to prohibit indemnifying the executive for any unreimbursed taxes, but any such payment will be compensation subject to reporting and wage withholding.

**c. Independence**

*vii. The Act's provisions*

Compensation of executive officers of a public company is deliberated on and determined by the board's compensation committee. Those committee members must be independent members of the board. Determination of the member's independence takes into account the source of the member's compensation, including any consulting, advisory, or other fees paid by the issuer to the member, and whether the member is affiliated with the issuer. The Act also requires the issuer's compensation committee to take into account several factors (such as the level of work otherwise done for the company) in selecting compensation consultants and advisers to ensure their independence.<sup>197</sup>

*viii. Tax issues*

Section 162(m) disallows a deduction for publicly traded corporations of compensation exceeding \$1 million paid to the CEO and the four other highest paid officers of the corporation unless that compensation is approved

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<sup>196</sup> Section 954 of the Act.

<sup>197</sup> Section 951 of the Act. On March 30, 2011, the SEC issued proposed rules regarding the different independence provisions of the Act. SEC, "Listing Standards for Compensation Committees" (Mar. 30, 2011).



by a compensation committee of the board consisting of two or more outside directors.<sup>198</sup> Also, the compensation exceeding \$1 million must be based on performance goals that have been disclosed to, and approved by, a majority of the corporation's shareholders. While the independence provisions in the Act still await clarification from the SEC, the tax rules and the Act's rules ultimately may not match, and care should be taken not to confuse them.

## **VIII. CONCLUSION**

The seven provisions of Dodd-Frank discussed in this report are those most likely to significantly affect the corporate world from a tax perspective. These rules will affect many institutions, and as they work toward complying with the new rules, many tax issues could appear.

As the new provisions of the Act become effective, companies and their advisers should take particular care in navigating them and assessing the tax consequences of complying with them. Different roads to compliance will lead to different tax consequences, but careful planning can help reduce the adverse tax consequences and may even create valuable tax opportunities.

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<sup>198</sup> Reg. section 1.162-27(e)(3) contains detailed rules as to the independence required of outside directors needed to satisfy the statutory exception to the \$1 million cap on the deduction of executive compensation.

## APPENDIX A

### Living Wills – Tax Issues Checklist

The following checklist highlights many of the tax issues that should be considered in connection with disposition and internal restructuring transactions provided for in a living will. While this list focuses only on U.S. federal income tax matters, foreign, state, and local tax issues should also be considered. The list is for general information only, and is not a substitute for careful, individualized tax advice and analysis.

#### Planning for Dispositions

1. Will the disposition be structured as an asset or stock sale (or perhaps in some other manner, such as a transfer to a joint venture)?
2. Is the disposition expected to result in gain or loss, and should the transaction be structured to be taxable or tax-free?
3. If a tax-free spinoff is desired, will all the requirements under section 355 be satisfied?<sup>199</sup>
4. Can transactions be structured in a way that will maximize the use of (or minimize any limitations on) net operating losses and other tax attributes?<sup>200</sup>
5. Will the transaction trigger the recapture of credits or other items?<sup>201</sup>
6. If a controlled foreign corporation is involved, will gain be triggered under a gain recognition agreement?<sup>202</sup>
7. Will recognition of deferred intercompany items, excess loss accounts, or various recapture provisions be triggered?<sup>203</sup>
8. Will the unified loss rule or other limitations on the recognition of losses be brought into play?<sup>204</sup>

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<sup>199</sup> See Thomas F. Wessel et al., “Corporate Distributions Under Section 355” (PLI 2009).

<sup>200</sup> See generally Thomas Avent and John Simon, “Preserving Tax Benefits in Troubled Companies – Navigating Mostly Uncharted Waters” (PLI 2009); Deanna Walton Harris and Mark Hoffenberg, “Be Careful What You Wish For: Is Section 382’s Treasure Section 384’s Trash?” (PLI 2009).

<sup>201</sup> See, e.g., sections 42(j) (low-income housing credit), 45D(g) (new markets credit), and 48(d)(2) (energy credit); see also sections 1245 and 1250.

<sup>202</sup> Reg. section 1.367(a)-3(b) through (e) and (a)-8.

<sup>203</sup> Reg. sections 1.1502-13; 1.1502-19; 1.1503(d); 1.367(a)-6T; and 1.904(f)-2.

<sup>204</sup> Reg. section 1.1502-35 and -36; see also, section 382(h)(1)(B).

9. If a joint venture is involved, have the relevant partnership tax provisions been considered (including, for example, the rules on “hot assets,” section 704(c) property, and technical terminations)?<sup>205</sup>
10. Will the disposition of the business cause a “significant modification” to third-party or related-party debt, generating cancellation of indebtedness income or other tax consequences?<sup>206</sup>
11. Will the disposition of the business cause an exchange of derivative positions (or other financial instruments other than debt instruments) to one or both counterparties?<sup>207</sup>
12. Will significant transfer taxes be incurred?

### **Other Internal Restructuring and Capital-Raising Transactions (in Addition to the Above Issues)**

1. Will the raising of new capital create problems regarding a change of ownership under section 382, affect tax attribute use, or raise concerns about the anti-stuffing rules?<sup>208</sup>
2. Will the transfer of businesses or assets between members of a consolidated group create deferred intercompany items?<sup>209</sup>
3. Will items that are deferred for U.S. federal income tax purposes have immediate state or local tax consequences?<sup>210</sup>
4. Could restructuring transactions (individually or together with other transactions) be re-characterized for tax purposes in possibly overlapping ways to result in unexpected tax consequences?<sup>211</sup>

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<sup>205</sup> See sections 704(c), 708(b)(1)(B), and 751; see generally William S. McKee et al., *Federal Taxation of Partnerships and Partners*, ch. 16 (“Sales, Exchanges, and Other Transfers of Partnership Interests”). For a particular rule when an existing partner acquires all of the interests in a partnership, see Rev. Rul. 99-6, 1999-1 CB 432 (purchaser treated as acquiring all of the partnership assets directly by purchase).

<sup>206</sup> Reg. section 1.1001-3; section 108(e)(10) (issuer recognizes cancellation of indebtedness income if the issue price of the new modified instrument is less than the adjusted issue price of the old unmodified instrument). A significant modification may also give rise to OID. Some debt-for-debt exchanges may be treated as recapitalizations under section 368(a)(1)(E).

<sup>207</sup> See preamble to debt modification regulations under reg. section 1.1001-3; T.D. 8675, 1996-2 CD 60; Rev. Rul. 90-109, 1990-2 C.B. 191; James M. Peaslee, “Modifications of Nondebt Financial Instruments as Deemed Exchanges,” *Tax Notes*, Apr. 29, 2002, p. 737, *Doc 2002-10327*, or *2002 TNT 83-25*; reg. section 1.446-3(h), -3(f) and -3(g)(4) (treatment of termination payments on NPCs); reg. section 1.1001-4 (exception to gain for non-assigning counterparties for swaps novated between dealers under agreements permitting that novation).

<sup>208</sup> Sections 382(g) and (l)(1); 336(d)(2); see also Avent and Simon, *supra* note 200.

<sup>209</sup> Reg. section 1.1502-13.

<sup>210</sup> See, e.g., Cal. Rev. & Tax. Code section 23362, N.Y. reg. section 3-9.4; see generally, Thomas W. Giegerich, “Selected Tax Considerations in Corporate Restructurings” (PLI 2009).

<sup>211</sup> See generally Bernice L. Thigpen et al., “The Direction of a Merger – Federal Income Tax Consequences” (PLI 2009).

5. In a cross-chain sale of assets, could unintended tax consequences arise from the potential issuance of a nominal share of acquirer stock under the stockless D reorganization regulations?<sup>212</sup>
6. In a taxable transaction, what assets will receive a stepped-up basis for tax purposes, and will the potential step-up be caught by the anti-churning rules?<sup>213</sup>
7. On loss transactions, will section 267 defer or deny the use of any losses?
8. For transactions involving CFCs, will the transactions create subpart F income?<sup>214</sup>
9. Will foreign transactions be treated as covered asset acquisitions or be subject to the anti-splitter rules?<sup>215</sup>
10. Could the tax-free treatment of a reorganization, liquidation, or contribution be jeopardized by the questionable solvency of an entity?<sup>216</sup>
11. Could the potential re-characterization of intercompany debt as equity in a distressed entity alter the intended tax consequences of a restructuring transaction?
12. If an entity is insolvent, when and how should a worthless stock deduction be claimed, and can plans be made to take the loss as an ordinary or capital loss?<sup>217</sup>
13. If intercompany debt is partially or wholly worthless, what loss on the debt can be claimed?<sup>218</sup>
14. If distressed assets are being sold, how should the buying entity treat the market discount arising on the sale?<sup>219</sup>

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<sup>212</sup> Reg. section 1.368-2(l).

<sup>213</sup> Section 197(f)(9).

<sup>214</sup> Under the subpart F rules, the transferring CFC will not suffer an immediate tax, assuming it qualifies for the active financing exception under sections 954(c)(2)(C) or (h). 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. That exception covers sales of assets by CFCs that fall within the ambit of section 954(h). Also, reg. section 1.954-2(e)(1) and (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.

<sup>215</sup> Sections 901(m) (covered asset acquisitions) and 909 (FTC splitter transactions); Notice 2010-92 (setting out rules for pre-2011 splitter transactions).

<sup>216</sup> Reg. section 1.332-2(b); *see also*, prop. reg. sections 1.351-1(a)(1)(iii) and 1.368-1(f) and the preamble to the proposed “no net value” regulations at 2005-1 C.B. 835; *but see Scott v. Commissioner*, 48 T.C. 598 (1967); *see also* Thomas Avent, “Liquidations, Reorganizations and Contributions Involving Insolvent Corporations” (PLI 2009).

<sup>217</sup> Worthless stock deductions are covered by section 165(g). Worthless stock of an affiliate will give rise to an ordinary loss under section 165(g)(3). However, a liquidation of a company whose stock has no value may fall under section 331 and be treated as a sale or exchange giving rise to a capital loss. Reg. section 1.332-2(b); *Commissioner v. Spaulding Bakeries*, 252 F.2d 693 (2d Cir. 1958). Section 267 does not apply to losses on a distribution in liquidation. Section 267(a)(1).

<sup>218</sup> Worthless debt constituting a security is treated under section 165(g); other bad debts are covered by section 166.

## Side Effects

1. Will customers recognize gain or loss on derivative positions that are novated in a restructuring and will the restructuring give rise to changes in withholding tax rates on financial instruments or create other tax issues?<sup>220</sup>
2. Will any restructuring change the tax residence of a company for state and local tax purposes?<sup>221</sup>
3. Will restructuring give rise to a new permanent establishment offshore, or otherwise affect tax treaty positions?<sup>222</sup>
4. Will the movement of assets or entire business units shift the entities in which some important functions are performed, necessitating changes in existing transfer pricing policies and service level agreements?<sup>223</sup>
5. Will the change in an entity's business profile caused by a restructuring change the analysis of uncertain tax positions?
6. If assets are moved or disposed of, what will be the effect on hedging positions?<sup>224</sup>
7. For transactions affecting CFCs having a functional currency other than the U.S. dollar, will the transaction generate a foreign currency gain or loss?<sup>225</sup>
8. What will be the effect on GAAP accounting for income taxes of any disposition of a business or the movement of assets? Will the change affect an Accounting Principles Board No. 23 assertion made by a foreign subsidiary?<sup>226</sup>

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<sup>219</sup> Literally, the market discount rules in sections 1276-1278 would appear to apply to distressed debt bought at a deep discount. However, the legislation does not seem to target that situation, and these rules may not apply to such transactions.

<sup>220</sup> See reg. section 1.1001-3; TD 8675.

<sup>221</sup> The restructuring may result in an entity having a physical presence in a new state. Equally important, it may affect economic nexus considerations. Megan A. Stombeck, "Economic Nexus and Nonresident Corporate Taxpayers: How Far Will it Go?" 61 *Tax Law.* 1225 (2008); Andrew W. Swain and John D. Snethen, "Economic Nexus: Past, Present and Future," *State Tax Notes*, Apr. 23, 2007, p.243.

<sup>222</sup> In general, a PE is a fixed place of business through which the business of an enterprise is carried on in whole or in part. 2006 U.S. Model Income Tax Convention, art. 5(1). A similar definition is contained in article 5 of the OECD Model Tax Convention on Income and on Capital.

<sup>223</sup> Reg. section 1.482-1(d)(3)(i); *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, ch. 1, C(b)(2).

<sup>224</sup> For the effect of terminating hedges, see reg. section 1.446-4(e)(6) and sections 475(b)(1)(C) and (b)(2).

<sup>225</sup> For a thorough discussion of this topic, see the preamble to the proposed section 987 regulations, 2006-2 C.B. 698.

9. Will the change in how a business is structured trigger or require a change in accounting method?

### **Other Considerations for Living Wills**

1. When inventorying legal entities for the living will, has the company's organization chart been reviewed and updated, and has the tax department been apprised of all changes?
2. If the tax department chooses to conduct a general tax planning review when reviewing the organization chart and living will, are there stale tax planning structures that should be removed or new tax planning opportunities that should be created?
3. Are there opportunities for eliminating or consolidating entities in isolated circumstances or as part of a full-scale legal entity rationalization project?
4. Are any valuations or tax studies needed (including, for example, basis studies, earnings and profits studies, or section 382 ownership change and net unrealized built-in loss/net unrealized built-in gain determinations)?
5. Should the organization implement or update any tax allocation agreements?

### **Establishing New Hedge Funds and Private Equity Funds<sup>227</sup>**

1. What form should the new fund take?
  - Will a new hedge fund take the common form of a master-feeder structure with a master fund established offshore and treated as a partnership for U.S. tax purposes, a domestic feeder LLC for U.S. investors, and a foreign corporation for non-U.S. and tax-exempt investors?
  - For private equity funds, will a simpler Delaware limited partnership structure be established?
2. What tax year and accounting methods should the new fund elect?
3. Will a new hedge fund elect trader status under section 475(f)?

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<sup>226</sup> Under APB 23, a U.S. tax accrual is not imposed on the foreign earnings of a CFC if the foreign earnings are indefinitely invested overseas.

<sup>227</sup> For a general discussion of hedge fund and private equity fund tax issues, see Richard Lipton and John Soave III, "U.S. Taxation of Private Equity and Hedge Funds," 919 PLI/Tax 193-1 (Mar./Apr. 2008); Jerald August and Lawrence Cohen, "Hedge Funds – Structure, Regulation and Tax Implications Structure and Regulation," 919 PLI/Tax 192-1 (2010).

4. How will the partners' distributive share of income, gain, loss, deductions, and credits be allocated to give them substantial economic effect?
5. Will the partnership make a reverse section 704(c) election in order to allow historic partners who have terminated their investments to realize their share of unrealized appreciation or depreciation once those amounts have been realized?
6. Will the partnership make a section 754 election to account for retired and new investors in the fund?  
How will the decision on making a trader election affect the section 754 election?
7. How will the fund managers be compensated? Should they be given carried interests?
8. How should the fund deal with the rules in section 409A on deferred compensation under non-qualified deferred compensation plans?
9. How will the fund deal with withholding taxes on investments made by foreign investors?
10. How will the fund handle information reporting and the Foreign Account Tax Compliance Act requirements?

## **APPENDIX B**

### **Index to Provisions of the Dodd-Frank Act Having Tax Significance**

#### **Bank Capital and Liquidity**

Title I – Financial Stability

Subtitle C – Additional Board of Governors Authority for Some Non-Bank Financial Companies and Bank Holding Companies

- Section 165 – Enhanced supervision and prudential standards for non-bank financial companies supervised by the Federal Reserve Board of Governors and some bank holding companies.
  - Section 165(c). 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 stress.
- Section 171 – Leverage and risk-based capital requirements. Imposes risk-based and leverage capital standards currently applicable to U.S. banks on U.S. bank holding companies and on non-bank financial companies supervised by the Federal Reserve.

#### **Living Wills**

Title I – Financial Stability

Subtitle C – Additional Board of Governors Authority for Some Non-Bank Financial Companies and Bank Holding Companies

- Section 165 – Enhanced supervision and prudential standards for non-bank financial companies supervised by the Federal Reserve Board of Governors and some bank holding companies.
  - Section 165(b)(1)(A)(iv) and (d)(1) - Requires covered institutions to prepare resolution plans
- Section 166 – Early remediation requirements. Requires regulators to adopt rules dealing with the early remediation steps regulators should take with troubled institutions.



## **Volcker Rule**

### Title VI – Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions

- Section 619 – Prohibitions on proprietary trading and specified relationships with hedge funds and private equity funds. Amends the Bank Holding Company Act of 1956 to prohibit banking entities and their affiliates from (i) engaging in proprietary trading or (ii) sponsoring or investing in hedge funds and private equity funds, subject to a de minimis exception.

## **Derivatives**

### Title VII – Wall Street Transparency and Accountability

#### Subtitle A – Regulation of Over-the-Counter Swaps Markets

##### Part I – Regulatory Authority

- Section 716 – Prohibition against federal government bailouts of swaps entities. Requires swap dealers that are banks or other entities having access to Federal Reserve credit or FDIC assistance to limit their swap dealings to specified permitted activities.

##### Part II – Regulation of Swaps Markets

- Section 723 – Clearing. Requires mandatory clearing of affected swaps through a derivatives clearing agency.

Several sections of the Act also impose new reporting and record-keeping requirements, including:

- Section 727 – Public reporting of swap transaction data.
- Section 728 – Swap data repositories.
- Section 729 – Reporting and record-keeping.

##### Title XVI – Section 1256 Contracts

- Section 1601 – Certain swaps, etc., not treated as section 1256 contracts. Provides that section 1256 contracts do not include specified swaps or similar agreements.

## **Securitization**

Title IX – Investor Protection and Improvements to the Regulation of Securities

Subtitle D – Improvements to the Asset-Backed Securitization Process

- Section 941 – Regulation of credit risk retention. Imposes new risk retention requirements on “securitizers,” who in general must retain a minimum of 5 percent of the credit risk in the assets it sells into a securitization.

## **Executive Compensation and Corporate Governance**

Title IX – Investor Protection and Improvements to the Regulation of Securities

Subtitle E – Accountability and Executive Compensation

- Section 951. Shareholder vote on executive compensation disclosures. Periodically requires a resolution to be included in the issuer's proxy statement on which shareholders must have a nonbinding vote to approve the compensation of executives.
- Section 952. Compensation Committee Independence. Members of an issuer's compensation committee must be independent members of the issuer's board of directors.
- Section 953. Executive Compensation Disclosures. The proxy statement must disclose the relationship between executive compensation actually paid and the financial performance of the issuer.
- Section 954. Recovery of erroneously awarded compensation. Issuers must develop and implement a policy that provides for (i) disclosure of the issuer's policy on incentive-based compensation, and (ii) clawback of incentive-based compensation from current or former executive officers based on revised figures in an accounting restatement.
- Section 955. Disclosure regarding employee and director hedging. The proxy statement must disclose whether any employee or member of the board is permitted under company policy to hedge securities that are paid in compensation or otherwise held by those individuals.

## APPENDIX C

### Glossary of Terms

**Basel III** – The rules issued by the Basel Committee requiring banks to have specified levels of minimum common share equity, Tier 1 equity, and total capital. Basel III also introduced a requirement for a capital conservation buffer of common share equity of at least 2.5 percent of risk weighted assets.

**Basel committee** – 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.

**Collins amendment** – Provision of the Act that imposes on U.S. bank holding companies and nonbank 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.

**Contingent capital** – Debt convertible into capital of the issuer in times of financial distress. Basel III requires contingent capital to be converted into common equity of the issuer if the local banking regulator determines the bank would otherwise become nonviable.

**Contingent convertible bonds** or **CoCos** – New financial instruments that are issued as debt, but on the occurrence of specified events, will convert *automatically* into common equity of the issuing bank or bank holding company.

**Lincoln amendment** – Provision of the Act that establishes the derivatives push-out rule prohibiting FDIC-insured entities and other entities having access to Federal Reserve credit facilities from being dealers in almost all derivative instruments.

**Living wills** – Recovery plans providing for remediation steps if an institution encounters financial difficulty, and resolution plans that provide for the windup of a financially distressed institution.

**Push-Out rule** – This provision of the Act, established by the Lincoln amendment, prohibits FDIC insured entities and other entities having access to Federal Reserve credit facilities from being dealers in almost all derivative instruments. The rule is subject to several broad exemptions.

**Say on pay** – Provision of the Act that requires, at least once every three years, a resolution to be included in the issuer's proxy statement in which shareholders must be given a nonbinding vote to approve the compensation of the issuer's executives.

**Trust-preferred securities** – Also known as TRUPS, these hybrid securities have characteristics of both subordinated debt and preferred stock. The issuer generally forms a trust that issues securities in a public underwriting. The trust uses the proceeds received from the underwriting to acquire specified junior subordinated notes from the issuer. Before the enactment of Dodd-Frank, TRUPS were includable in the Tier 1 regulatory capital of banks, but the Act excludes them from the Tier 1 regulatory capital of banks beginning in 2013.

**Volcker rule** – Provision of the Act that prohibits banking entities from proprietary trading, and 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.