

# ***Capital Markets Session II***

**November 3, 2011**



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# ***Agenda***

1. Dodd Frank related
  - New 1.1001-4 regulations
  - New 1256/swap/CDS regulations
2. Administrative/Judicial developments
  - Anschutz (variable share pre-paid forward)
  - Samuelli (securities loan of zero coupon bond)
3. Section 871(m)
4. OECD paper on beneficial ownership

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## ***Dodd-Frank related tax issues***

- Act may result in many transfers of customer swap positions between legal entities to achieve margin and netting benefits.
  - For customers: “Is moving swaps a realization event?”
  - For dealers,
    - Global dealing/transfer pricing
    - Documentation/compliance withholding
    - Section 475
- Mandatory clearing of swaps through clearing houses.
  - For customers: “Can/must cleared derivatives qualify as 1256 contracts?”
  - The potential for “embedded loans” in NPC’s is exacerbated by fixed coupons – creates 956 and withholding tax issues.
  - Should CDS be treated as NPCs or options for tax purposes?

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## ***Swap assignments -- New temp 1.1001-4***

- Dodd Frank results in dealer-to-clearinghouse assignments and will likely result in more dealer-to-dealer assignments.
  - Old 1.1001-4 excused dealer-to-dealer assignments where “**the terms of the contract permit the substitution.**”
  - Temp 1.1001-4 regulations make two changes:
    - Expanded to pick up dealer-to-clearinghouse assignments
    - Add “**whether or not consent is required.**”
  - Intent was to expand scope to cover situations where consent was required.
    - Awkwardly worded (both before and after 2011 change)
    - Still an open question as to whether the regulation is a safe harbor or a rule.

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## ***New Section 1256 regulations***

- Section 1256(b)(2)(B) excludes from section 1256 contract definition enumerated swaps and caps including “credit default swaps.”
  - Proposed regs reiterate the statutory rule and make clear that if something meets the literal definition of an NPC and a 1256 contract, NPC trumps.
    - To eliminate one source of ambiguity, proposed regulations change the definition of “regulated futures contract” to now require that it be a “futures” contract as designated by CFTC. (Curiously, the statutory definition in section 1256(g)(1) has no such requirement!)

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## ***New NPC definition***

- Current regulatory definition limits NPC status to contracts where one party makes 2 or more payments.
  - If there is only a net settlement payment at back-end, it is a cash-settled forward contract under current definition, and not an NPC.
- Proposed regulations **expand** the definition of an NPC by treating as “payments” amounts under a contract that are fixed along the way.
  - A contract that provides for “rolled-up” dividends or “rolled up” LIBOR-based charges would be an NPC under the proposed regs, despite the lack of actual periodic payments.
  - Most credit default swaps would be an NPC under the proposed regs because they have periodic payments.

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## ***New NPC definition -- Implications***

1. Expansion of NPC definition scope puts significant pressure on need for timing regulations (dormant since 2004).
2. Eliminates CDS-as-option approach for many investors.
  - Section 212 effects of NPC treatment are harsh; may make these products non-economic after-tax for large classes of investors.
  - Many used CDS-as-option to control timing and character.
3. Interaction with 871(m)
  - Dividend Equivalent concept there may have informed thinking.
4. Impact on traditional forwards?
5. Risk of insurance characterization (and corresponding withholding tax obligation) now mitigated.

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# ***Administrative/Judicial***

1. Anschutz (pending 10<sup>th</sup> Circuit)
  - Currently on appeal to 10<sup>th</sup> Circuit
  - Variable share prepaid forward contract with simultaneous securities loan.
  - Significant issue is scope of 1058(b)(3)
    - In testing the securities loan under 1058, are we required to integrate the forward contract?
2. Samueli (2011 9<sup>th</sup> Circuit)
  - Leveraged investment in securities loan of zero-coupon bond.
  - Intent was current interest deductions (from leverage) and back-end capital gain (from securities loan).
  - Recast as simple forward contract by courts – net profit was STCG so did not enjoy conversion benefit
  - Important for two reasons:
    - Implication that **term securities loans are not protected by section 1058**
    - Settlement by offset of longer-than-a-year forward resulted in same day acquisition and disposition and therefore short-term, not long-term capital gain.

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## ***Section 871(m)***

- **US Dividend Equivalents** are sourced as US dividends.
  - General concept is payment on a derivative that is “determined by reference to” a US source dividend.
  - Until March 2012, if the US DE is from a NPC will be excused so long as certain terms are met (i.e, NPC is not a “specified NPC.”).
  - After March 2012, all US dividend-referencing payments from NPCs will be DE’s (unless carved back by regulations)
- **Observations:**
  - Difficult to understand core tax policy informing
  - In other-than-straight pay-through situations, issues abound – Does a small dividend “taint” an entire payment?

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## ***OECD “beneficial owner” proposed changes***

- On April 19, 2011, OECD proposed changes to Commentary on meaning of “beneficial owner” under Model Tax Convention.
- Can be read to deny beneficial owner status to person who is “obligated” to pass on all or part of payment to another.
  - In highly leveraged businesses, this could be quite problematic.
  - If read literally, there could be situations where there is no beneficial owner of a particular item.
- “On payments” example:
  - Entity earns \$10x interest income, incurs \$9.5x interest expense.
  - If interest payments out are contingent on inflow, an argument can be made that entity is not beneficial owner on \$10x income item.
- “Payment equivalent” example:
  - Investment bank collects dividends, pays mirror items under swap or other derivative.

