



**Legislative Developments:
Tax Treatment of Derivatives**

Institute of International Bankers

June 25, 2008



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Overview

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 - Hearing on Tax Treatment of Derivatives
 - ◆ Current System
 - ◆ Specific Product-Related Issues Raised at Hearing
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 - Total Return Swaps to Avoid Withholding
 - Recent Developments
 - ◆ Kleinbard
 - ◆ Desmond
 - ◆ New Financial Products Branch

Tax Treatment of New Financial Products

Hearing on Tax Treatment of Derivatives

- March 5, 2008 Hearing by Ways & Means Committee, Subcommittee on Select Revenue Measures
 - Committee Members Present
 - ♦ Rep. Neal (D-MA) (Chair)
 - ♦ Rep. English (R-PA)
 - ♦ Rep. McDermott (D-WA)
 - ♦ Rep. Cantor (R-VA)
 - ♦ Rep. Reynolds (R-PA)
 - ♦ Rep. Herger (R-CA) (sitting in)
 - Witnesses
 - ♦ First Panel
 - Michael J. Desmond, Tax Legislative Counsel, United States Department of Treasury
 - Alex Raskolnikov, Associate Professor of Law, Co-Chair, Charles E. Gerber Transactional Studies Program, Columbia Law School
 - Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law, University of Michigan Law School
 - Keith A. Strycula, Chairman, on behalf of Structured Products Association
 - ♦ Second Panel
 - George U. “Gus” Sauter, Chief Investment Officer, The Vanguard Group; Managing Director, Quantitative Equity Group
 - William M. Paul, Covington & Burling, LLP, on behalf of Investment Company Institute (ICI)
 - Leslie B. Samuels, Partner, Cleary Gottlieb Steen & Hamilton LLP on behalf of Securities Industry and Financial Markets Association (SIFMA)
 - Michael B. Shulman, Partner, Shearman & Sterling LLP

Tax Treatment of New Financial Products

Hearing on Tax Treatment of Derivatives

- Committee noted that interest in and use of certain types of derivatives has increased over the last few years as many innovative structures have reached the financial markets
 - Hearing focused on tax treatment of various forms of derivatives
- In announcing the hearing, Chairman Neal stated
 - "The expanding derivatives market is already a \$516 trillion global enterprise, only some of which is subject to regulation and transparency. I think it is appropriate for Congress to review the tax rules as they apply to these complex financial products and determine whether changes may be necessary."

Tax Treatment of New Financial Products

Hearing on Tax Treatment of Derivatives

■ Current System

- Tax regime for derivatives consists of a “cubbyhole approach”
 - ◆ Determined in accordance with various factors including:
 - Identity of the derivative, the underlying property, and the associated cash flows
 - Type of taxpayer
 - Purpose for which the transaction is entered into by the particular taxpayer, and
 - Any applicable anti-abuse rules
 - ◆ IRS and taxpayers typically are required to assess all the terms of the instrument and decide into which existing cubbyhole the undivided instrument most neatly fits
 - In the case of some new financial instruments, no existing cubbyhole may be a wholly persuasive receptacle for the instrument
 - As a result, derivatives can create tax planning opportunities, allowing investors to choose or change the timing, character, or source of economically similar products

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

- Exchange Traded Notes (ETNs)
 - ETNs are senior, unsecured, unsubordinated notes issued by financial institutions designed to provide retail investors with access to the returns of various market benchmarks
 - ♦ ETNs usually pay no periodic coupons, have a maturity date, and are backed only by the issuers' credit
 - ♦ Though linked to the performance of market benchmarks, ETNs are not equities or exchange traded funds (ETFs)
 - Similar to equities, ETNs are traded on an exchange and can be shorted
 - Similar to ETFs, ETNs are linked to the return of benchmarks, but may not actually own the benchmarks they track
 - Current Tax Treatment of ETNs
 - ♦ ETNs are generally treated as prepaid forward contracts for U.S. federal income tax purposes
 - Investors do not realize income/recognize gain until sale
 - If held for more than one year, taxed at long-term capital gains rate
 - ♦ This treatment is different than the tax treatment of mutual fund or ETFs, as mutual fund and ETF investors
 - Are taxed on ordinary dividends in the year received or reinvested
 - Are taxed on gain on sale of the fund's shares
 - May be taxed on the fund's capital gains
 - IRS has ruled that ETNs referencing a single foreign currency do not receive prepaid forward treatment
 - ♦ Those ETNs are treated as debt

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ IRS Response to ETNs

- Revenue Ruling 2008-1
 - ♦ Issued December 7, 2007
 - Characterized a particular ETN as debt for tax purposes
 - Involved a financial instrument that was issued and redeemed in U.S. dollars, but that provided an economic return determined by reference to the Euro and Euro interest rates
 - ♦ Ruling stated that the legal remedies provided in the instrument were not materially different than those associated with debt instruments
 - Treasury and the Service concluded that the instrument described in the Ruling constituted debt for tax purposes, notwithstanding the fact that
 - » Payments made in one currency were determined by reference to another currency, and
 - » Currency fluctuations could cause the holder to receive an amount in U.S. dollars at maturity that is less than the holder's original investment
 - Characterization as debt requires the holder to recognize "interest" income over the term of the instrument at ordinary income tax rates
 - ♦ Ruling clarified that the result would be the same whether the instruments were privately offered, publicly offered, or traded on an exchange

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ IRS Response to ETNs (continued)

● Notice 2008-2

- Treasury and the Service requested comments on the proper tax treatment of prepaid forward contracts that are not otherwise characterized as debt instruments (such as the instrument described in Rev. Rul. 2008-1)
- The comments requested relate to whether accrual of income and expense during the term of such prepaid forward contracts is appropriate, as well as numerous other issues associated with these contracts, including:
 - If an accrual regime is appropriate, the proper methodology to be adopted, the scope of the regime, the character of any income accruals
 - Whether tax treatment should vary depending on the nature of the underlying asset and how the transactions are effected (e.g., executed on a futures exchange)
 - Whether transactions should be treated as debt pursuant to regulations issued under section 7872
 - Whether section 1260 applies or should apply (constructive ownership principles)
 - Whether withholding tax provisions of section 871 and 881 should apply
 - How certain subpart F provisions should apply to income recognized with respect to prepaid forward contracts, and
 - Transition rules and effective dates

● Comments Received on Notice 2008-2

- Keith Lawson of ICI
 - A comprehensive solution based on constructive ownership principles should be applied to ETNs
 - » Would lead to taxation similar to mutual funds
 - If no legislative solution is forthcoming, regulations based on the constructive ownership principles of section 1260 should be issued
- Heidi Stam of the Vanguard Group
 - ETNs should be taxed on a “comparable yield” method similar to the noncontingent bond method for contingent debt instruments
 - » Comparable yield is the best approximation of the implicit compensation of the forward buyer for prepayment, since it is equivalent to forward seller’s “cost to carry”

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ Neal Bill

- Rep. Neal (D-MA) introduced legislation (“Neal Bill” - H.R. 4912) that would require ETN holders to accrue and include interest income at monthly federal rate each month
- According to Neal Bill
 - ♦ Amount of interest income to be included capped at the difference between ETN’s fair market value at end of year and holder’s adjusted basis at beginning of year
 - ♦ Supporters argue that Neal Bill would place ETNs on a more level (although not equal) playing field with ETFs and mutual funds from a tax perspective, arguing
 - Congress should not allow “risky” ETNs to enjoy tax advantages that the highly regulated mutual fund industry cannot
 - Deferral and conversion should be Congressional decision
 - Accrued interest concept of Neal Bill is more appropriate because investors have effectively loaned money to issuer
 - Retail investors have uncompensated credit risk because they don’t understand the credit exposure of ETNs
 - ♦ Opponents argue
 - Neal Bill violates the basic realization tenet of the tax code and would force investors to pay tax on phantom income, even in cases where the ETN loses value
 - Long history of not accruing risk free rates of return on stocks and options, and ETNs are similar instruments
 - Pricing of ETNs has been affected by credit risk, especially in light of the large write downs in the financial services industry
 - Investor taking risk on a capital instrument, so investment should be treated as capital

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ Testimony and Comments

- Mr. Styracula (Structured Products Association) opposed H.R. 4912, arguing that it would likely impose a burdensome tax regime that would adversely impact a new American financial innovation
 - ♦ Equivalent of ETNs in Europe and Asia are generally “certificates” and “warrants” and, almost without exception, local foreign jurisdictions treat gains as long-term capital gains if held more than one year
- Mr. Sauter (Vanguard) supported H.R. 4912, arguing that the highly favorable tax treatment of ETNs is the result of a gap or loophole, not an express policy decision by Congress
 - ♦ If Congress does not act soon, retail investors will continue to purchase ETNs, and, as time goes on, it will be increasingly complicated to change the law
- Mr. Samuels (SIFMA) expressed serious concern with H.R. 4912, arguing that it (1) would impose overly complex tax regime, (2) singles out ETNs for unfavorable treatment, and (3) would require investors to pay tax on phantom income even when the ETN’s price falls
 - ♦ Acknowledged that investors are warned in ETN disclosures that law could change
- Mr. Shulman (Shearman & Sterling) opposed H.R. 4912, arguing that it would be substantially more adverse than the treatment that would apply to direct ownership of the underlying assets
 - ♦ Current treatment of prepaid forwards consistent with realization based approach, because ownership of a prepaid forward differs from ownership of underlying assets, in that
 - Investor bears the issuer’s credit risk and may not receive economics of underlying assets
 - Investor has no voting rights, dominion and control over cash flows
 - Investor has no control over acquisition/disposition of underlying assets

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

- Testimony and Comments (continued)
 - Hearing focused on more than just ETNs
 - ◆ Part of a process to develop comprehensive approach to derivatives taxation
 - Members of Congress asked the panelists primarily about four issues at the Hearing
 - ◆ Complexity
 - ◆ Competitiveness
 - ◆ Credit Risk
 - ◆ Impact on Retail Investors

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

- Testimony and Comments (continued)
 - Complexity
 - ♦ Rep. Neal (D-MA) asked whether the incremental approach from H.R. 4912 could work, or was it too complex
 - Prof. Raskolnikov testified that it was not too complex, and argued that
 - » There were more complex regimes in the tax code
 - » Generally, only sophisticated retail investors, with accountants and tax lawyers, would purchase ETNs (and those investors could manage the complexity), and
 - » Financial intermediaries will provide all necessary data
 - ♦ Rep. English (R-PA) asked whether investor liquidity was an issue, or should allowances be made for non-wealthy retail investors
 - Prof. Raskolnikov testified that he “suspects” that ETN investors are well off, and implementation of the Neal Bill would not be problematic, because financial intermediaries can provide all relevant information

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ Testimony and Comments (continued)

• Competitiveness

- ♦ Rep. English (R-PA) asked whether different tax rates for different financial products would distort the investment decision
 - Prof. Raskolnikov testified that it could, but it was a tradeoff:
 - » Investors would face higher rates on the imputation of interest but lower rates on the trading gains and dividend income deferred into the future
- ♦ Rep. English (R-PA) asked why ETNs should be taxed “differently”
 - Mr. Paul testified that “risky” ETNs should not have more favorable tax treatment than highly regulated mutual funds
 - » Noted that deferral and conversion (of ordinary income to capital gain) should be Congressional (as opposed to regulatory) decision
- ♦ Rep. Cantor (R-VA) asked for a breakdown of the market for structured products
 - Mr. Styracula testified that current market for structured products is roughly \$114 billion, of which approximately \$67 billion is in the hands of individual investors (majority of whom are high net worth or accredited investors), and \$30-40 billion in the hands of “retail” investors
 - » Noted that after the market crash of 2000, structured products have given average investors access to markets they otherwise could not access
- ♦ Rep. Herger (R-CA) asked, if the purpose of capital gains rates is to encourage investment, why should ETNs receive capital gains treatment if the investor is not buying the underlying asset
 - Mr. Samuels testified that as long as the investor is taking risk on a capital instrument, the capital gains rates should apply

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

- Testimony and Comments (continued)
 - Credit Risk
 - ♦ Rep. Neal (D-MA) asked about the credit risk in ETNs, and whether that risk was a concern of retail investors
 - Mr. Sauter testified that retail investors don't understand credit exposure of ETNs
 - » Argued that investors have effectively loaned money to issuer, which supports accrued interest concept of Neal Bill
 - Mr. Samuels testified that, contrary to Mr. Sauter's testimony, the pricing of ETNs has been affected by credit risk, especially in light of the large write downs in the financial services industry

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ Testimony and Comments (continued)

- Impact on Retail Investors
 - ♦ Rep. Reynolds (R-NY) asked what is best for the investor
 - Mr. Shulman testified that current system for ETNs is better
 - » Tax system always has avoided tax on phantom income
 - » Current treatment is in line with historic realization-based approach
 - Mr. Sauter testified, stripping away the tax consequences, that mutual funds are better for the investor
 - » Mutual funds are highly regulated, providing more protection to the investor
 - » ETNs have uncompensated credit risk
 - » ETN is effectively a mutual fund investment + a credit default swap, but investor not compensated for the credit default swap risk assumed
 - » Parity needed between tax treatment of mutual funds and ETNs

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ Total Return Swaps to Avoid Withholding

- IRS investigating use of derivatives to avoid U.S. withholding tax by foreign hedge funds or U.S. hedge funds with offshore operations
 - ♦ Generally, dividends paid on U.S. stocks are U.S. sourced
 - ♦ U.S. source periodic payments paid to foreign investors are generally subject to a 30% gross-basis withholding tax (which may be reduced by treaty)
- Certain derivative products may allow investors to avoid this 30% withholding tax by avoiding the production of U.S. source income
 - ♦ Example: Foreign investor enters into total return swap on U.S. dividend-paying equities with U.S. financial institution
 - Total return swap treated as a notional principal contract (NPC) under Treasury regulations
 - » Treasury regulations source income from NPCs to the residence of the recipient of the income, here, the residence of the foreign investor
 - ♦ Result: foreign investor receives dividend returns on U.S. equities free of withholding tax
 - Source is considered foreign under the regulations even though actual source of dividends is U.S. equities

Tax Treatment of New Financial Products

Specific Product-Related Issues Raised at Hearing

■ Comments and Testimony

- Rep. Neal (D-MA) asked if treating derivative instruments such as PRIDES, PEPS, DECS, etc. as equity (instead of as notes coupled with forward contracts) would solve the tax problem with dividend withholding
 - ♦ Prof. Avi-Yonah testified that yes, such treatment would solve the problem
 - The products are treated as equity in other contexts
 - To get the favorable tax treatment they currently enjoy, the products are split into two – a note and a forward contract
 - » Such bifurcation is rare
 - » “Normal” treatment is to aggregate them into a single product
- Rep. English (R-PA) asked if expanding the reach of U.S. withholding rules could impair U.S. investment by foreign investors
 - ♦ Prof. Avi-Yonah said that it could impair U.S. investment, and it could prove to be “too much law for too little revenue”
 - Suggested Congress may be better off eliminating withholding
 - » Admitted that eliminating withholding would have the unintended consequence of encouraging U.S. investors to move money offshore in an attempt to evade tax on dividends
- Rep. English (R-PA) asked if international coordination would be adequate to stop withholding tax abuse
 - ♦ Prof. Avi-Yonah said yes, because if the U.S., Europe and Japan coordinated their efforts, most of the problem would be eliminated
 - Investors would not be able to flee to non-OECD markets to avoid the withholding rules
 - » Reasoned that non-OECD markets do not have sufficient quality assets to accommodate the demand OECD coordination would generate
- Rep. English (R-PA) asked about the problems with the tax treatment of an equity swap with non-U.S. persons
 - ♦ Prof. Avi-Yonah said the fundamental issue is the source rule for NPCs
 - In securities lending, source is the underlying asset, and that treatment should be extended to other instruments
 - Also noted that the NPC source rule is the only major source rule adopted by regulation (instead of by statute), and that Congress should come up with legislative solution

Tax Treatment of New Financial Products

Recent Developments

- IRS Chief Counsel Kleinbard
 - Joint Committee Paper
 - Comments
- Former Tax Legislative Counsel Desmond
 - Comments
 - Questions and Answers from the Committee
- Financial Products Branch

Tax Treatment of New Financial Products

Recent Developments

- JCT Paper: Present Law and Analysis Relating to the Tax Treatment of Derivatives
 - ◆ Overview of Derivatives
 - ◆ Explanation of Synthetic Ownership
 - ◆ Description of Modes of Tax Analysis of Derivatives
 - Character of Income
 - Timing of Recognition
 - Source of the Income
 - ◆ Summary of Current Derivative Tax Rules
 - ◆ Case Study: Mandatory Convertible Securities

Tax Treatment of New Financial Products

Recent Developments

- JCT Chief of Staff Edward Kleinbard Comments May 22, 2008
 - Fundamental tax reform needed, but is extraordinarily difficult
 - ♦ Congress should rethink the taxing of capital income in a "new and holistic way"
 - The mistake that we make in trying to tax capital income today is that we see it [in] all these separate little buckets
 - ♦ Derivative income, capital gains, corporate income tax, the estate tax . . . all of these are part of a single story, which is how do we burden capital income
 - ♦ If you look at fundamental reform, you have to look at all of these issues together
 - Congress should take a nuanced approach toward the taxation of financial products and services that serve similar functions but are taxed differently
 - ♦ Congress should recognize and address these products and services in an equitable manner
 - ♦ Under current rules, financial products that do not fit into formally defined "cubbyholes" are not being taxed properly
 - Example: credit default swaps
 - » No clear guidance on how credit default swaps should be taxed, even though the credit default swap market had aggregate size of \$43 trillion in 2007
 - ♦ Congress has been reluctant to address amorphous financial products and services
 - Technical nature of financial products makes legislating difficult
 - Defining unique financial products has "competitive consequences" for different financial markets

Tax Treatment of New Financial Products

Recent Developments

- Former Treasury Tax Legislative Counsel Desmond
 - Prepared Testimony
 - ♦ Tax treatment of prepaid forward contracts is of continuing interest to Treasury
 - ♦ Financial innovation challenges the current system of taxing derivatives, because U.S. uses a “cubbyhole” system
 - New financial products assigned to category, or “cubbyhole” based on comparison to existing products
 - Cubbyhole approach results in different tax consequences for economically equivalent transactions
 - ♦ Issued Revenue Ruling 2008-1 in response to foreign currency ETNs
 - ♦ Continuing to examine appropriate treatment of other ETNs
 - “No conclusion about how to proceed, about what result should be reached, or about whether we are able to reach that result with administrative guidance”

Tax Treatment of New Financial Products

Recent Developments

- Former Tax Legislative Counsel Desmond
 - Questions and Answers
 - ♦ Rep. Neal (D-MA) asked if any guidance was forthcoming on the tax treatment of credit derivatives, or whether practitioners can effectively choose the treatment they see fit
 - Mr. Desmond testified that the IRS has been looking at the issue since 2004, and admitted that in the absence of guidance, practitioners can argue for different treatments
 - » Also noted that issues with respect to most credit derivatives (such as credit default swaps) are not necessarily tax issues
 - ♦ Rep. Neal (D-MA) asked if Treasury was more likely to follow through with guidance since ETNs are retail products
 - Mr. Desmond testified that Treasury looks at the number of affected taxpayers when deciding whether to issue guidance
 - » Noted that the fact that retail investors (as opposed to institutions, traders or dealers) were buyers of ETNs was an important consideration for Treasury
 - ♦ Rep. Herger (R-CA) asked about the policy concerns raised in Notice 2008-2, and what additional info was Treasury seeking
 - Mr. Desmond testified that Treasury does not want to interrupt the ordinary business use of derivatives, and is attempting to determine
 - » Whether current accrual is appropriate
 - » Best type of accrual, i.e., mark-to-market, original issue discount, etc., and
 - » Best means to deal with foreign tax and withholding issues

Tax Treatment of New Financial Products

Recent Developments

■ Financial Products Branch

- In May 2007, IRS established a branch of six attorneys to examine new financial products across an array of industries
- Financial Institutions and Products (FIP) realigned to create a branch that would focus on transactions in the field as well as identify and address new financial products as soon as they enter the marketplace
 - ♦ FIP IRS Associate Chief Counsel Lon Smith publicly conceded that the agency was “falling farther and farther behind” as markets became more complex
- IRS Chief Counsel Korb stated that the goal of the realignment is
 - ♦ to provide faster and more informed legal support to the Commissioner
 - ♦ to become more current with new developments in the financial markets, and
 - ♦ to resolve the most current legal issues, while maintaining a commitment to our more traditional work arising in the published guidance and letter ruling programs