

NUTS & BOLTS OF FINANCIAL PRODUCTS 2010

TAX ISSUES

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Tax Overview

- ▶ Taxation of financial products is heavily rule-based
- ▶ Standards play a role, but only at the margins
 - ▶ Method of accounting must clearly reflect income
 - ▶ Taxation governed by substance, not form
 - ▶ Sham transactions (transactions lacking economic substance and business purpose) can be disregarded entirely
- ▶ Different financial products (and in some cases different types of taxpayers) have different sets of rules. So transactions with very similar economics can have radically different tax results

Basic Tax Issues

- ▶ Character Issues – Capital Gain vs. Ordinary Income
- ▶ Timing Issues – Methods of Accounting
- ▶ Sourcing Issues – U.S. vs. foreign source
- ▶ Line-Drawing Issues
 - ▶ Debt vs. Equity
 - ▶ Sale vs. Financing

Internal Revenue Code

- ▶ Section 385(a):
 - ▶ “The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).”
- ▶ Section 385(b):
 - ▶ “The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:
 - (1) whether there is a written unconditional promise to pay on demand or on a specified 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 subordination to or preference over any indebtedness of the corporation,
 - (3) the ratio of debt to equity of the corporation,
 - (4) whether there is convertibility into the stock of the corporation, and
 - (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.”

Internal Revenue Code (cont'd)

- ▶ Section 385 was initially enacted as part of Tax Reform Act of 1969, Pub. L. No. 172, 91st Cong., 1st Sess. §415(a).
- ▶ The Revenue Reconciliation Act of 1989 amended section 385(a) to permit bifurcation of an instrument into debt and equity components under regulations to be prescribed. See Revenue Reconciliation Act of 1989, Pub. L. No. 239, 101st Cong., 1st Sess. § 7208 (a)(1).

Treasury Regulations

- ▶ Treasury initially published regulations under section 385 on March 24, 1980. Prop. Reg. §§ 1.385-1 through 1.385-12, 45 Fed. Reg. 18,957 (1980).
- ▶ These regulations were revised and issued in final form on December 31, 1980. T.D. 7747, 45 Fed. Reg. 86,438 (1980).
- ▶ Ultimately, the regulations were withdrawn, effective August 5, 1983, and no regulations have been issued since then. T.D. 7920, 48 Fed. Reg. 31,053 (1983).

Case Law

- ▶ Judicial factors set forth in case law evaluating the facts and circumstances of each case must be examined to determine whether an instrument is debt or equity.
- ▶ Determining factors. Notice 94-47, 1994-1 C.B. 357:
- ▶ (a) whether there is an unconditional promise on the part of the issuer to **pay a sum certain** on demand or at a **fixed maturity date that is in the reasonably foreseeable future**; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

Case Law (cont'd)

- ▶ No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity.
- ▶ The weight given to any factor depends upon all the facts and circumstances.
- ▶ The overall effect of instrument's debt and equity features must be taken into account.

Right to Receive a Sum Certain

- ▶ Traditional convertible notes have a substantial equity feature, but only on the upside. Cf. FSA 199940007 (June 15, 1999) (DECs are not debt) (“The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code”).
- ▶ Rev. Rul. 85-119, 1985-2 C.B. 60.
- ▶ Rev. Rul. 83-98, 1983-2 C.B. 40.

Rev. Rul. 85-119

- ▶ A domestic bank holding company (“HC”) issued mandatorily convertible debt.
- ▶ HC was unconditionally obligated to issue, in exchange for the notes, its own common or perpetual preferred stock at maturity.
- ▶ The holder did not receive a fixed number of shares per dollar of notes held, but rather a variable number of shares whose fair market value was equal to the principal amount of the notes.
- ▶ The holders could elect to be paid in cash, in which case they were deemed to receive stock and enlist HC to sell the stock on their behalf.
- ▶ IRS held that, based on these features, the holders did not share in the increase or decrease in the value of the stock while the notes were outstanding and that under these facts, the notes would be respected as debt.

Rev. Rul. 83-98

- ▶ Issuer issued Adjustable Rate Convertible Notes (“ARCN’s”) for an issue price of \$1,000.
- ▶ The ARCN’s mature in 20 years and on maturity the holder will be entitled to receive either \$600 cash or 50 shares of X common stock (worth \$1,000 at time of issuance).
- ▶ Each ARCN was convertible at any time into 50 shares of common stock.
- ▶ After two years, the Issuer can call the ARCN’s for \$600.
- ▶ An amount designated as interest will be paid on the ARCN’s quarterly at a rate based upon dividends paid on X common stock (subject to a floor of \$60 and a cap of \$175).
- ▶ The ARCN’s are structured so that under most likely eventualities they will be converted into X common stock.
- ▶ IRS held that because of the very high probability that all of the ARCN’s will be converted into stock, the ARCN’s do not represent a promise to pay a sum certain.

Fixed Maturity Date in the Reasonably Foreseeable Future

- ▶ The reasonableness of an instrument’s term (including that of any relending obligation or similar arrangement) is determined based on all the facts and circumstances, including the issuer’s ability to satisfy the instrument.
- ▶ A maturity that is reasonable in one set of circumstances may be unreasonable in another if sufficient equity characteristics are present.
- ▶ *Monon Railroad v. Commissioner*, 55 T.C. 345 (1970), acq. 1973-2 C.B. 3.

Monon Railroad

- ▶ Issuer issued an instrument with a 50-year term in exchange for most of the outstanding stock of one class.
- ▶ Court held that the debentures should be treated as debt based on mainly the following factors:
 - ▶ The issuer consistently treated the indentures as debt obligations;
 - ▶ The exchange was a voluntary arm's-length transaction;
 - ▶ The shareholders who exchanged their stock for these debentures were original senior creditors of the issuer prior to the bankruptcy and reorganization;
 - ▶ The debentures have a definite maturity date;
 - ▶ A 50 year term is not considered unreasonable taking into account the fact that the issuer had been in existence for 61 years prior to the issuance of the debentures;
 - ▶ The debenture holders were not entitled to vote;
 - ▶ The issuer's debt/equity ratio at the time of the issuance was 1.08 to 1.

Shareholder Loans and the “Independent Creditor Test”

- ▶ “[T]he acid test of the economic reality of a purported debt is whether an unrelated party would have extended credit in the circumstances.”
- ▶ Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal”, 26 Tax.L.Rev. 369 (1971).
- ▶ The Plumb article identifies more than 30 factors used in determining whether an instrument is debt or equity.

Shareholder Loans and Post-Issuance Conduct

- ▶ *Laidlaw Transportation v. Commissioner*, T.C. Memo 1998-232.
- ▶ In *Laidlaw*, advances were made by a Dutch financing subsidiary of a Canadian parent to the U.S. operating subsidiaries of the Canadian parent.
- ▶ Tax Court held that the advances were equity based on the following:
 - ▶ Even though most of the agreements had fixed maturity dates, the holders did not intend to request repayment;
 - ▶ Maturity dates were continually extended and never enforced;
 - ▶ The failure to demand repayment made the obligation to repay inferior to the regular corporate creditors;
 - ▶ *Laidlaw* was considered thinly capitalized;
 - ▶ There was a circular flow of funds resulting from “interest reinvestment loans”.

More About the Internal Revenue Code

- ▶ Congress enacted section 385(c) as part of the Energy Policy Act of 1992, Pub. L. No. 486, 102nd Cong., 2d Sess. §1936(a).
- ▶ Section 385(c) says :
 - ▶ Effect of classification by issuer.
 - (1) In general. The characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary).
 - (2) Notification of inconsistent treatment. Except as provided in regulations, paragraph (1) shall not apply to any holder of an interest if such holder on his return discloses that he is treating such interest in a manner inconsistent with the characterization referred to in paragraph (1).
 - (3) Regulations. The Secretary is authorized to require such information as the Secretary determines to be necessary to carry out the provisions of this subsection.

Trust Preferred Securities

- ▶ Monthly Income Preferred Securities (MIPS) or Trust Originated Preferred Securities (TOPrS)
 - ▶ Debt for Federal income tax purposes (interest deduction).
 - ▶ Initially, partnership/trust consolidated for book purposes with debt eliminated and preferred securities shown as “minority interest” (i.e., equity) – Since 2003, however, partnership/trust deconsolidated for book purposes with debt shown as a “liability” (i.e., debt). See *FAS 150 and FIN 46*.
 - ▶ Since 1996, Tier 1 Capital for Bank Holding Companies per Federal Reserve Board.
 - ▶ Tier 2 Capital for Banks regulated by the OCC/FDIC/OTS.
 - ▶ Basket B (25% equity) for Moody's/Intermediate Equity Content-Adequate for S&P.
 - ▶ MIPS evolved into TOPrS to get Form 1099 reporting rather than Schedule K-1.

Trust Preferred Securities (cont'd)

- ▶ MIPS initially issued by Texaco in 1993
- ▶ Typical terms
 - ▶ maturity is 20-49 years
 - ▶ interest is payable periodically and may be deferred, at issuer's option, for periods up to 5 years
 - ▶ subordinated to senior debt

Trust Preferred Securities (cont'd)

- ▶ Notice 94-47, issued by IRS in response to MIPS, identifies debt vs. equity factors, including (i) unreasonably long maturities, and (ii) whether instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.
- ▶ TAM 199910046 (November 16, 1998), analyzed a MIPS transaction and concludes that instrument issued to LLC is properly classified as debt for Federal income tax purposes.

Next Generation of Trust Preferred (Enhanced Trust Preferred)

- ▶ Longer maturities - Maturities of 60-80 years.
 - ▶ Unconditional obligation to pay
 - ▶ Value of principal payment relative to interest payments not very different from 49 years to 60-80 years
 - ▶ Investment grade credit rating can indicate likelihood of repayment
 - ▶ Interest rate step-ups can indicate a shorter effective term of the debt
 - ▶ Scheduled maturity date on which the issuer is required to issue equity to pay off the debt if possible vs. final maturity date
- ▶ Longer optional deferral features - Interest is payable periodically and may be deferred, under optional deferral provisions, for periods up to 10 years. Generally, issuer must begin making commercially reasonable efforts to issue equity to pay deferred interest after 5 years.
 - ▶ Remote likelihood given dividend stoppers for publicly traded companies with history of paying dividends
 - ▶ 10-year zero-coupon bond is debt

Next Generation of Trust Preferred (Enhanced Trust Preferred) (cont'd)

- ▶ Mandatory deferral features – Interest payments must be deferred if certain financial tests are satisfied that indicate the issuer is having financial difficulty. Generally, issuer must immediately begin making commercially reasonable efforts to issue equity to pay deferred interest. The likelihood of mandatory deferral is usually remote based on the financial tests.

Next Generation of Trust Preferred (Enhanced Trust Preferred) (cont'd)

- ▶ Replacement Covenants – Issuer must redeem instruments only out of the proceeds of equal or better equity content securities. There remains, however, an unconditional obligation to repay the loan.
- ▶ Interest Caps – In case of bankruptcy, holder's claim for deferred interest is capped at 25% of the principal amount of the instrument.
 - ▶ In cases where the likelihood of deferred interest is remote, the likelihood of an interest cap limiting lender's bankruptcy recovery is remote
 - ▶ Akin to contingent interest
 - ▶ Akin to subordination

Next Generation of Trust Preferred (Enhanced Trust Preferred) (cont'd)

- ▶ Moody's
 - ▶ Basket C (50% equity)
 - ▶ Basket D (75% equity)

- ▶ Standard & Poor's
 - ▶ Intermediate Equity Content-Strong

- ▶ ILM 200932049 (March 10, 2009), analyzed an enhanced trust preferred instrument and concluded that it should be treated as debt in part because the issuer had been in business for “an extended period using long-lived assets,” and paid “regular dividends.”

Contingent Capital Securities

- ▶ Issued in 2009 by Lloyds Banking Group
- ▶ Corporate Bonds in form paying coupon interest to investors.
- ▶ Convertible into equity of the issuer when certain triggers are breached.
- ▶ The triggers would be tied to the sufficiency of the issuer's equity capital.

Contingent Capital Securities (cont'd)

- ▶ Conversion may be automatic or at the issuer's option.
- ▶ Conversion may be into a fixed number of shares or may be based on a variable number of shares equal in value to the amount owed on the Corporate Bonds.
- ▶ Both versions of pending Financial Regulatory Reform bills authorize the issuance of contingent capital by banks.

Contingent Capital Securities (cont'd)

- ▶ Debt vs. equity
 - ▶ Fixed Right to a Sum Certain?
 - ▶ Surplus Notes Issued by Life Insurance Companies
 - ▶ *Harlan v. United States*, 409 F.2d 904 (5th Cir. 1969); *Jones v. United States*, 659 F.2d 618 (5th Cir. 1981); *Anchor National Life Insurance Co. v. Comm'r*, 93 T.C. 34 (1989); 1996 FSA LEXIS 583.
 - ▶ Mandatory Convertible Debt
 - ▶ Rev. Rul. 85-119, 1985-2 C.B. 60

Contingent Capital Securities (cont'd)

- ▶ Section 163(l)
 - ▶ No deduction for interest allowed with respect to a disqualified debt instrument.
 - ▶ A disqualified debt instrument is defined as an instrument a substantial amount of the principal or interest is payable in equity of the issuer or a related party or equity held by the issuer (or any related party) in any other person.

Contingent Capital Securities (cont'd)

- ▶ Section 163(l)
 - ▶ Debt is payable in equity for purposes of section 163(l) if:
 - ▶ Required to be paid or converted or at the option of the issuer is payable in or converted into such equity,
 - ▶ Payment is determined by reference to the value of such equity, or
 - ▶ Part of an arrangement reasonably expected to result in the aforementioned situations.

Contingent Capital Securities (cont'd)

- ▶ Section 163(l) does not generally apply to conventional convertible debt provided that the holder's right to convert is not substantially certain to be exercised.

- ▶ Are contingent capital securities "reasonably expected" to be paid in equity?

Contingent Capital Securities (cont'd)

- ▶ Section 108(e)(8)
 - ▶ Debt paid with stock is treated as having been satisfied for cash equal to the fair market value of the stock.

- ▶ This may result in COD income to the debtor when trigger is breached resulting in contingent capital securities being converted to equity (whether automatic or optional).

Capital vs. Ordinary

- ▶ Important because of capital loss limitation and in some cases preferential rates for capital gains
- ▶ Gains and losses from sales or exchanges of property are generally capital, with certain statutory exceptions, notably for inventory and property held for sale in the ordinary course of business
- ▶ Statute deems certain terminations to be sales or exchanges
- ▶ Hedging transactions have special rules

Overall Methods of Accounting

- ▶ Realization – stocks, OTC options, forwards
- ▶ Constant Yield – debt instruments (including contingent payment debt instruments)
- ▶ Mark to Market – futures, traded options, F/X
 - ▶ Also all securities for dealers and for traders who elect
- ▶ Special Rules – swaps, caps and other NPCs
 - ▶ Accrual accounting for periodic payments
 - ▶ Amortization of nonperiodic payments
- ▶ Hedge Accounting – hedging transactions
- ▶ Deemed Dispositions – constructive sales

Debt vs. Equity

- ▶ Still based on common law – attempts to codify the rules in the 1980s failed
- ▶ Various factors considered, with no one factor determinative
- ▶ *Sine qua non* of debt is an obligation to pay a fixed amount on demand or on a specified date not unreasonably far out

Taxation of Corporate Dividends

- ▶ Corporations get a dividends received deduction (DRD)
 - ▶ 100% or 80% or greater ownership
 - ▶ 80% if >20% ownership, otherwise 70%
- ▶ LLCs and Sub S Corps limit double taxation world to large publicly traded corporations
- ▶ Individuals get a 15% rate through 2010, subject to various special rules

Don't Bifurcate; Don't Integrate

- ▶ A single hybrid transaction is generally not split into its components
 - ▶ Convertible debt treated as straight debt until converted
 - ▶ A collar is not treated as a long put and short call (or vice versa)
- ▶ With limited exceptions, two separate transactions are not combined
 - ▶ Debt plus warrant respected as separate, so debt has OID equal to value of warrant
 - ▶ "Mandatory convertible" treated as debt plus a variable forward contract
- ▶ Separate trading is the key to separate tax treatment

Convertible Debt + Hedge and Warrants

- ▶ Many companies have issued convertible debt and entered into two side transactions with the investment bank handling the deal.
- ▶ Issuer buys a call on its own stock that perfectly hedges the conversion feature of the convertible. Typical cost is about 30% of the issue price. Issuer integrates the convertible and the purchased call, so it is permitted to treat the cost of the call as OID, deductible over the life of the debt. Under US GAAP, the cost of the call need not be treated as a debt cost.

Convertible Debt + Hedge and Warrants (cont'd)

- ▶ Issuer also sells warrants on its own stock at a higher strike price, typically for around 20% of the debt face amount. Warrants need not be integrated, so they reduce the up-front cost but not the OID deductions. Various features designed to assure the warrants will be respected as separate from the purchased calls.
- ▶ IRS issued a favorable advice memo on this transaction in August 2007. However, the accounting treatment of net-share settled convertibles is scheduled to change beginning in 2009, making these types of convertibles less attractive from an earnings perspective.

What are Exchange Traded Notes (“ETNs”)?

- ▶ A contractual obligation of the issuer to pay an amount based on changes in the value of an index.
- ▶ Debt in form, but principal amount can be as little as zero.
- ▶ Interim payments on the underlying are treated as reinvested in the index.

Intended Tax Treatment of ETNs under Current Law

- ▶ Not an ownership interest in an entity, unlike ETFs.
- ▶ No right to get the underlying property.
- ▶ Not principal protected, so not debt.
- ▶ Only one payment on each side, so not an NPC.
- ▶ Most reasonable approach - similar to a prepaid cash-settled forward contract.
- ▶ Open issues:
 - ▶ How is a rebalancing of the index treated?
 - ▶ How about an increase in the notional amount resulting from a reinvestment of interim cash flows on the underlying?
 - ▶ Possible application of section 1260.

Comparison with Treatment of Competing Products

- ▶ Mutual funds need to distribute (almost) all realized gains.
- ▶ CPDIs must accrue interest (arguably not really comparable economically, because ETNs lack principal protection).
- ▶ NPCs subject to the dreaded contingent swap regulations.

Securitizations

- ▶ Pass-throughs
- ▶ Senior/subs and coupon stripping
- ▶ REMICs
- ▶ Non-REMIC CDOs
- ▶ Common law sale vs. financing
 - ▶ Benefits and burdens analysis vs. “true sale”
 - ▶ Critical role of disregarded entities

Hedging Transactions

- ▶ Standards generally much looser than GAAP standards – all that is required is risk management and proper identification
- ▶ Tax hedges limited to hedges of ordinary property, ordinary liabilities and debt
- ▶ If transaction qualifies as a tax hedge, gains and losses are ordinary and timing must reasonably match timing of gains and losses on hedged item

Cross-Border Transactions

- ▶ Various “double dip” strategies have been devised to allow tax benefits in the U.S. and another company
 - ▶ Example: repo financing, treated as debt for U.S. tax purposes and equity abroad
- ▶ Withholding taxes
 - ▶ Zero rate on interest for portfolio debt and under many treaties
 - ▶ Generally no withholding on cross-border swap payments
 - ▶ Dividends generally subject to withholding at rates up to 30 percent
 - ▶ Withholding can be avoided to a large extent through derivatives and other economic equivalents

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