Newfound Relevance for Age Old Issues:

How the 2017 Tax Act Has Reignited Long-Standing Financial Product Debates

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Topics

• Tax Ownership/What is a Securities Loan?
• Interest Equivalents
• Inventory Hedge/Mark-to-Market
• Inventory Hedge Capitalization
• Capitalization/Forgiveness of Interest Owed to a Foreign Parent
• Overbroad Capitalization
• Services as a Component of a Derivative
BEAT – QDP Exclusion/Securities Loan Exception

• For purposes of the BEAT regime, the term “base erosion payment” is defined to include any deductible amount paid or accrued by the taxpayer to a foreign related party.

• However, a base erosion payment does not include any qualified derivative payment (“QDP”), which is a payment made by a taxpayer pursuant to a “derivative” with respect to which the taxpayer applies a MTM accounting method and as to which all items are ordinary.

• The term “derivative” does not include any securities lending transaction, sale-repurchase transaction (“repo”), or substantially similar transaction.
BEAT – Base Erosion Percentage

• In order to be an “applicable taxpayer” (and thus potentially subject to the BEAT), a taxpayer must have a “base erosion percentage” (“BEP”) of at least 3% (or 2% for financial group members).

• \[ \text{BEP} = \frac{\text{Base Erosion Tax Benefits}}{\text{Gross Amount of Taxpayer’s Deductions}} \]

• As a result, the existence of a securities loan:
  – can affect the BEP numerator because payments made to a foreign related person with respect to a securities loan may not be eligible for the QDP exception.
  – can affect the BEP denominator because payments on a back-to-back securities loan tend to increase the amount of the taxpayer’s deductions.
Classic Securities Loan/Short Sale

• The Market Purchaser becomes the tax owner of the security. This makes sense because:
  – The Market Purchaser typically has no idea that it acquired a borrowed security, and
  – There can’t be more than one tax owner of the same security.

• The Security Lender is no longer the owner of the security but is not taxed on the transfer of the securities as long as the transfer satisfies the requirements of section 1058.

Security Borrower/Short Seller

Loan of Security

$100 of collateral

Security Lender

+ Obligation to return security
+ Obligation to pay substitute interest/dividends

Market Purchaser

Security

$100

Security Borrower/Short Seller

Security Lender

Loan of Security

$100 of collateral

Market Purchaser

Security

$100
Do the substitute payments constitute base erosion payments?

While securities loans are excluded from treatment as “derivatives,” the term derivative includes “short positions” – which is the position held by US Borrower.

The Preamble to the proposed regulations explains that repos are excluded from derivative treatment because they are secured loans – and thus the interest payments on such loans should be QDPs.

The Preamble goes on to say: “Because sale-repurchase transactions and securities lending transactions are economically similar ... these transactions should be treated similarly”
Typical Repo

The repo buyer generally is treated as making a secured loan to the repo seller.

Assuming that the repo seller has the unfettered right to transfer the repo security, who owns the security?

If the borrower/repo seller is no longer treated as the owner of the repo security, has a securities loan been created?

Lender (Security Buyer/Re-Seller)

Potential Pledge or Other Transfer of Security

Third Party

Borrower (Security Seller/Re-purchaser)

“Sale” of Security)

$100

+ Obligation to re-purchase for $100 plus interest charge

+ Obligation to pay substitute interest/dividends

$100

• The repo buyer generally is treated as making a secured loan to the repo seller.

• Assuming that the repo seller has the unfettered right to transfer the repo security, who owns the security?

• If the borrower/repo seller is no longer treated as the owner of the repo security, has a securities loan been created?
How Does One Trace?

Foreign Parent
- Securities loans
- Repos
- Pledges

Third Parties
- Securities loans
- Repos
- Pledges

US Affiliate
- Transfer of some but not all securities
- Other Securities Held by US Affiliate (e.g., proprietary positions or positions held in client brokerage accounts)

Third Parties
# Interest Equivalents

<table>
<thead>
<tr>
<th>Relevance</th>
<th>&quot;interest equivalent&quot;</th>
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<td><strong>Old</strong></td>
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<tr>
<td>Expense</td>
<td>Allocation/apportionment for FTC (§ 1.861-9T(b)(1))</td>
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<td>Income</td>
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<tr>
<td><strong>New</strong></td>
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<tr>
<td>Expense</td>
<td>Allocation/apportionment per Prop. Reg. 1.861-9(e)(8)</td>
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<td>Prop. Reg. 1.163(j)-1(b)(20)(iv)</td>
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<tr>
<td>Income</td>
<td>Prop. Reg. 1.163(j)-1(b)(20)(C) (substitute interest payment receipt)</td>
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<td></td>
<td>Prop. Reg. 1.163(j)-1(b)(20)(D) (section 1258 gain)</td>
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Inventory Hedge M2M

US Corp hedges commodities inventory with related foreign corp.

Hedge Timing rules allow **matching** OR **M2M** for hedge

See Reg. 1.446-4(e)(ii)(A) & (B)

But condition M2M on –

1. quick turning inventory (one year mismatch)
2. No LIFO.

**Old Relevance:** Desire to follow book treatment

**New Relevance:** BEAT. Not a QDP unless M2M
Inventory Hedge Capitalization

US Corp hedges commodities inventory with related foreign corp.

Capitalization into COGS --
  Montort of Colorado – hedging g/l can be capitalized into COGS
  Weight of authorities treat hedge as separate

**Old Relevance:** Desire to follow book treatment
**New Relevance:** BEAT
Capitalization/Forgiveness of Interest Owed to Foreign Parent

FP lends to US Sub; interest is accrued but not yet paid. US Sub is on cash method w/r/t interest per section 267.

FP capitalizes/forgives right to receive interest (potentially receiving stock)

Is the interest “paid”?

IRS said “yes” in a series of FSAs (FSA 199922034, 200006003)

Some argue “no” because Forgiveness ≠ Payment
Overbroad Capitalization

Prop. Reg. 1.263(g)-3

**Old Relevance:** Planned out of.

(Generally seek to avoid as current interest expense deduction more valuable than basis.)

**New Relevance:** Planned into.

BEAT & 163(j)
BEAT – Service Component of Derivatives

• A base erosion payment does not include any QDP.
• A derivative is any contract the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of stock, debt, or commodities, among other things.
• However, a QDP will be treated as a base erosion payment if
  – it would be treated as a base erosion payment if it were not made pursuant to a derivative, including any interest, royalty, or service payment, or
  – the payment is properly allocable to the nonderivative component.
• As a part of their global derivative dealing operations, US financial institutions make various payments to non-US affiliates.
• **Old question:** How do you determine a service component in other contracts (relevant to character, source)
• **New relevance:** Is it a QDP or a fee (in total or in part)?
Plain Vanilla Swap

- Floating rate payment spread received by dealer generally contains compensation for
  - committing capital,
  - assuming Counterparty’s credit risk (to the extent not reduced by collateral), and
  - Dealer’s profit component, which includes compensation for financial services (structuring, operational services, etc.)

Cross-Border Affiliate Mirror Swap

- Foreign Dealer enters into a USD plain vanilla swap with a foreign client, handling all client related and structuring aspects of the transaction
- Foreign Dealer hedges its exposure by entering into a mirror swap with its US Dealer Affiliate that manages USD book
- US Dealer Affiliate pays an amount to Foreign Dealer Affiliate (could be a global revenue allocation/profit split, or could be a commission or services fee)
1. Foreign Dealer enters into a USD plain vanilla swap with a foreign client, handling all client related and structuring aspects of the transaction.

2. Foreign Dealer hedges its exposure by entering into a swap with its US Dealer Affiliate that manages USD book.

The swap between Foreign Dealer and US Dealer Affiliate is priced with a spread reduced by the equivalent of the 50bps payment, to take into account different risk profile of parties. Pricing is arm’s-length.

1. Foreign Dealer Affiliate enters into a USD plain vanilla swap with a foreign client, handling all client related and structuring aspects of the transaction.

2. Foreign Dealer Affiliate hedges its exposure by entering into a back-to-back swap with its US Dealer Affiliate that manages USD book.

The swap between Foreign Dealer and US Dealer Affiliate is priced with a spread reduced by the equivalent of the 50bps payment, to take into account different risk profile of parties. Pricing is arm’s-length.
Service Component/Financial Transactions?

- *Kemon v. Comm’r*, 16 T.C. 1026, 1032 (1951) defines a dealer (vs. trader) by reference to services a dealer performs.
  - Dealer mark-up “represents *remuneration* for their labors as a middle man bringing together buyer and seller, and *performing the usual services* of retailer or wholesaler of goods.”
- *Burbank Liquidating Corp. v. Comm’r*, 39 T.C. 999 (1963) holds that loans held by a bank are ordinary assets if acquired in connection with services rendered by the lender.
  - Loans held by an originating bank or thrift are “notes receivable acquired in the ordinary course of trade or business *for services rendered*.”
  - “Services rendered” includes making loans (*Burbank*) and providing liquidity to the secondary market (*FNMA v. Comm’r*, 100 T.C. 541 (1993)).
Service Component in Lending?

- **Rev. Rul. 91-46**: a bank sells originated mortgage loans but continues to service, retaining a portion of each payment as compensation. “Normal” servicing is compensation for services while “excess” servicing gives rise to stripping, based on market practice and “reasonable compensation.”

- **Reg. Section 1.860D-1(b)(2)(i)**: right to receive compensation for services not interest in REMIC (even though may be computed as a percentage of interest payments or earnings)

- **Reg. Section 1.1273-2(g)(2)**: payments for services or property in a cash lending transaction do not reduce the issue price of the loan (Arranger vs. upfront fees? Synthetic standby letter of credit fees? Consent fees?).

- **Blitzer v. Comm’r**, 684 F.2d 874 (Ct. Cl. 1982): Does intent matter? Additional payments treated as interest instead of fees, because intended to raise the yield where the interest was capped by regulation.

- **Capital One v. Comm’r**, 133 T.C. 136 (2009): Interchange is OID, because compensates for processing costs, financial carrying costs and costs of credit risk and fraud risk, which are costs of lending money. But TAM 200533023: interchange is not connected with any particular lending and therefore fee for services.

- Value added taxes struggles with financial services due to definitional and administratibility concerns (often exempts).
BEAT Solution: How to Craft an Exception?

- Financial services – mix of financial capital, human capital and technology in ways that are difficult to separate

- How do you distinguish?
  - Let the form and documentation control?
  - Look to transfer pricing (e.g., global dealing regs or similar concepts)?
  - GAAP/IFRS?
  - Economic reality?