Financial Transactions Committee Shop Talk

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Section 163(d)/(j) overlap -- Background

• Section 163(d) limits a taxpayer’s deduction for “investment interest” to the amount of the taxpayer’s “net investment income.”

• “Investment interest” means any interest otherwise allowable as a deduction that is paid or accrued on indebtedness properly allocable to property held for investment.

• The term “property held for investment” shall include—
  • any property which produces passive income not derived from a trade or business, and
  • any interest held by a taxpayer in an activity involving the conduct of a trade or business—
    • which is not a passive activity, and
    • with respect to which the taxpayer does not materially participate.
Section 163(d)/(j) overlap -- Background

• Regs under section 469 provide that an activity of trading personal property for the account of owners of interests in the activity is not a passive activity.

• Rev. Rul. 2008-12 confirms that, in the case of a partnership, section 163(d) is applied at the partner level.

• Accordingly, pre-section 163(j), trader and investor funds both reported out interest expense to limited partners as subject to section 163(d) limitation.
Section 163(d)/(j) overlap -- Background

• Section 163(j) imposes a limit on the deductibility of business interest, applied at the partnership level.

• “Business interest” means any interest paid or accrued on indebtedness properly allocable to a trade or business. Such term does not include investment interest (within the meaning of section 163(d)).
  • Operation of these rules clear in the case of an investment partnership: section 163(j) does not apply.
  • But what about in the case of a trader partnership?
Section 163(d)/(j) overlap -- Preamble

• For partnerships engaged in trades or businesses that are not passive activities and with respect to which limited partners do not materially participate for purposes of section 469, as described in section 163(d)(5)(A)(ii) and as illustrated in Rev. Rul. 2008-12, section 163(j)(4) will apply to business interest expense allocable to such trade or business.

• To the extent such business interest expense is not limited under section 163(j), it may still be limited by section 163(d) at the limited partner level.
Section 163(d)/(j) overlap -- Considerations

• Clear that section 163(d) would apply, even if section 163(j) does not.

• Did Congress really intend for both to apply?
  • Is there any policy rationale for this?
  • How would it even work?
Securities trader elections:
treatment of section 1256 contracts

• Under section 475(f), a taxpayer that is engaged in the trade or business of trading in securities can elect mark to market accounting for its securities transactions.
  • Election is available only for trading activities, not investing.
    • Frequency and regularity is key – courts look at a number of factors, including number of trades in a year, number of trading days, average length of holding periods, whether frequent trades are substantial, among others.
  • If a securities trader election is made, gains and losses on mark to market securities are ordinary notwithstanding the taxpayer’s status as a trader.

• Generally, “section 1256 contracts” are also marked to market under section 1256.
  • Section 1256 contracts include regulated futures contracts, listed nonequity options, dealer equity options, dealer securities futures contracts, and foreign currency (forward) contracts.
  • Absent an exception, gains and losses on section 1256 contracts are generally subject to the 60/40 rule (60% long term capital and 40% short term capital).
Securities trader elections: treatment of section 1256 contracts

• Under section 475(c)(2), “securities” generally include stock, debt instruments, certain partnership or trust interests, and interest rate, currency and equity notional principal contracts.

• Under section 475(c)(2)(E), derivative financial instruments in stocks, bonds, and currencies are also “securities” for purposes of section 475, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.

• However, section 1256 contracts that are marked to market under section 1256(a) are excluded from the definition of a security under section 475(c)(2)(E) and do not qualify as securities unless they qualify as hedges of securities under section 475(c)(2)(F).
  • This section 1256 contract exclusion was part of the original section 475 rules, which initially applied only to securities dealers.
  • Except for the customer paper exclusion, no revisions were made to the definition of securities when the trader rules were adopted in 1997.
Securities trader elections: treatment of section 1256 contracts

• Dealer and traders in “commodities” may also elect mark to market accounting for their commodities transactions.

• Commodities are defined imprecisely in section 475(e) as:
  • any commodity which is actively traded (within the meaning of section 1092);
  • any notional principal contract with respect to any commodity;
  • any evidence of an interest in, or a derivative instrument in, any commodity, including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity; and
  • any position which is not a commodity but is an identified hedge with respect to such a commodity.

• The section 475(e) definition of a commodity includes section 1256 contracts (regulated futures and nonequity options) in actively traded commodities; under Prop. Reg. §1.475(f)-2(e)(2), gain or loss on commodities marked to market under section 475(f) is ordinary rather than 60/40.
Securities trader elections: treatment of section 1256 contracts

• Securities traders can have character mismatches between section 1256 contracts (60/40 capital) and non-section 1256 securities (ordinary).

• Can an electing securities trader avoid this character mismatch by relying on the hedging rules (section 475(c)(2)(F)) to pull section 1256 contracts into section 475?

• Can an electing securities trader avoid the character mismatch by making a section 475(f) commodities trader election?
  • Is the taxpayer engaged in a trade or business of trading in commodities separate and apart from the trade or business of trading in securities? See CCA 201432016.
  • Are section 1256 contracts commodities for purposes of section 475(e)(2)?
    • Commodity are defined in section 475(e)(2) only by reference to actively trading, or derivatives relating to any such commodity.
    • Commodity are not generally defined for federal income tax purposes (i.e., there is no generally applicable definition under section 7701 or otherwise).
Securities trader elections: treatment of section 1256 contracts

• Can an electing securities trader avoid the character mismatch by making a section 475(f) commodities trader election (cont’d)?
  • Does it matter whether the CFTC or the SEC regulates the section 1256 contract position?
  • Does it matter where the position trades (e.g., on a designated contract market regulated by the CFTC, such as S&P 500 futures traded on the NYMEX)?
Equity carry trades

• Example 1: Fund owns basket of 40 stocks outright and enters into short bullet swap with counterparty over the same 40-stock basket
  • Counterparty has right to modify swap basket on a quarterly basis
• Threshold questions
  • Is general arrangement respected?
  • Should swap be treated as a single transaction or multiple swaps on the individual stocks?
Equity carry trade – single swap

• Assume swap is a single transaction for tax purposes
  • Counterparty changes to basket- when does a tax event occur?
  • Basket notice issues?
• Example 1a – counterparty changes 1 of 40 stocks (e.g., switch of Google for Apple)
  • Fund sells Google shares and buys Apple shares to maintain its hedge
• If no Section 1001 event on the swap:
  • Assume overall gain on swap and loss on Google shares
    • loss on Google shares subject to straddle rules?
Equity carry trade – single swap (cont.)

• If Section 1001 event on the swap:
  • Assume overall loss on swap and gain on long stock basket
  • Wash sale rules: is modified swap substantially identical to unmodified swap?
  • Special rules for wash sale/straddle coordination under Treas. Reg. 1.1092(b)-1T
    • 1.1092(b)-1T(a)(1): No loss recognized on stock/securities if substantially identical stock/securities acquired within 30 day window
    • 1.1092(b)-1T(a)(2): No loss recognized to the extent of unrecognized gain in:
      • Successor positions (modified swap)
      • Offsetting positions to the loss position (long stock positions in original basket)
      • Offsetting positions to the successor position (long stock positions in modified basket)
    • Successor position defined as position offsetting to position (long stocks) that offset the loss position (original swap)
Equity carry trade – multiple swaps

• Assume now that basket swap is treated for tax purposes as a number of swaps, each on an individual stock in the 40-stock basket
  • Modification of swap (e.g., Google for Apple) and corresponding change to Fund’s hedge result in a better match for tax purposes
  • But rollover of swap upon its maturity may still result in a negative arbitrage, assuming Fund continues to hold the stock hedges that are included in the rolled-over swap
    • For example, assume Netflix and Facebook are in both original swap and rolled-over swap
    • Netflix shares have declined, so gain recognized on the Netflix “mini-swap”
    • Facebook shares have appreciated, but no loss recognized on the Facebook “mini-swap” under the wash sale or straddle rules
Equity carry trade – multiple swaps

• Character - Prop. Treas. Reg. 1.1234A-1 would treat gain/loss from settlement of a bullet swap as termination gain/loss
  • “Bullet swap” definition requires settlement of both parties’ obligations to be at or close to maturity

• Effect of interim swap modifications?
Cryptocurrency cash loans

• Notice 2014-21 provides generally that digital “currencies” are treated like property and that each transaction using these currencies is a separate taxable event.
  • The IRS stated in the Notice that general tax principles applicable to property transactions apply to transactions using virtual currency.
  • This means that a taxpayer has gain or loss upon an exchange of virtual currency for other property, as determined under section 1001 and Reg. §1.1001-1(a) (“gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent”).
Cryptocurrency cash loans

• An April 2, 2019, BNA article reported that cryptocurrencies are being used as collateral for cash loans.
  • “The lender’s pitch is that borrowing against cryptocurrencies lets borrowers unlock profits while avoiding capital gains taxes that would come from selling them.”

• Keeping in mind that Notice 2014-21 provides that general tax principles for property transactions apply to transactions using virtual currency, cryptocurrency cash loans raise a number of interesting issues including;
  • Loan versus sale treatment (benefits and burdens of tax ownership considerations).
    • Recourse versus nonrecourse loans? Is there an obligation to repay a substantial portion of the principal regardless of future value? Is there a shifting of risk of loss or opportunity for profit?
    • Is there a transfer of legal title, possession and power of disposition to the lender? Is the power of disposition limited to defaults similar to “repo” collateralized loan rulings?
Cryptocurrency cash loans

• Keeping in mind that Notice 2014-21 provides that general tax principles applicable to property transactions apply to transactions using virtual currency, token cash loans raise a number of issues including (cont’d):
  • Consider *Calloway* by analogy.
  • Is section 1058 available if a sale occurs? Can cryptocurrency fall into the section 1236 definition of “securities”?
  • If the transaction is neither a loan or a sale, is it properly characterized as a derivative (e.g., a prepaid forward)?
Controlling class receipt of incentive fee

• A REMIC has fallen on hard times. One of the regular interests is now the “controlling class,” and, as such, can choose the special servicer (needed to deal with defaults).

• A prospective special servicer has offered to share some of the fees it is entitled to receive under the REMIC documents with the owner of the controlling class.

• The owner of the controlling class is a partnership with a foreign corporate partner.
Controlling class receipt of incentive fee

• Is the payment by the special servicer to the regular interest holder considered ECI?
  • It clearly derives from a trade or business, but is it the trade or business of the regular interest holder?
  • Or of a deemed partnership in which the regular interest holder is a partner?

• If not ECI, is the payment U.S. source FDAP?
  • No sale or exchange in sight.
  • Foreign source?
  • Rebate?
  • Subvention payment?
Final regulation on RIC qualifying income

• Final regulations under Section 851(b) follow proposed regulations (and statute) in saying that subpart F inclusions and QEF inclusions are in the qualifying income category of dividends only if the related e&p is distributed by the CFC/PFIC

• Reversing proposed regs, final regs hold that subpart F/QEF inclusions derived from RIC’s business of investing in stock/securities/currencies are in “other income” qualifying income category

• ICI comments argued proposed reg would lead to inconsistent, non-policy driven results

• Types of CFCs: commodity CFC, equity tranche of CLO, portfolio investments
Index arbitrage – Section 871(m)

• Fund enters into long derivative on Index A and short derivative on Index B
• Assume both Index A and Index B are (independently) qualified indices
• Qualified index rule regarding short positions: Long qualified index derivative loses the benefit of QI status if taxpayer has short position that overlaps by 5%
  • Does it matter that short position here is also on a QI?
  • When is the 5% overlap tested?
• If Index A loses QI status as a result of overlap with Index B, how to measure dividend equivalents with respect to overlapping stocks?
Index arbitrage – Section 871(m)

• Treas. Reg. 1.871-15(l)(6):
  • “When a potential section 871(m) transaction references a qualified index and one or more component securities or other indices, the qualified index remains a qualified index only if the potential section 871(m) transaction does not reference a short position in any referenced component security of the qualified index, other than ... a de minimis short position described in paragraph (l)(6)(ii) of this section.”
  • “[a]n index may be a qualified index if the short position ... reduces exposure to referenced component securities of a qualified index ... by five percent or less of the value of the long positions in component securities in the qualified index.”
Credit default swaps: income tax accounting

• Since January 1, 2018, the net deduction from a notional principal contract for a year is not deductible to an investor fund.

• Funds can try to manage this exposure by matching net income and deduction on a swap to net down.

• But Treasury regulations deal comprehensively with swaps on which all payments are periodic, so management requires that a swap have a contingent nonperiodic payment.

• What about credit default swaps?
Credit default swaps: income tax accounting

• Assume a single name credit default swaps where the protection buyer pays 100 bps quarterly multiplied by the notional amount (e.g., $10 million).

• Are those payments periodic or non periodic?

• Is a payment made on default of the reference asset periodic or nonperiodic?