Financial Transactions:
Section 163(j) and BEAT Proposed Regulations

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Agenda

• 163(j) proposed regulations
  • Definition of interest (see slide 9)
  • Guaranteed payments
  • Hedges
  • Swaps
  • Substitute interest
  • Commitment fees
  • Anti-avoidance rule

• BEAT proposed regulations
  • Section 988 transactions
  • Mark-to-market positions (netting rule)
  • Qualified derivative payments (exclusion of securities lending transactions)
163(j) – Broad Definition of Interest

• Authority
  • “[t]he amount allowed as a deduction under this chapter ... for business interest”
  • Preamble refers to 1.861-9T and 1.954-2 as a basis for treating amounts closely related to interest as interest; reducing uncertainty; avoiding distortions; and reducing taxpayer burden

• Approach – combination of specific rules and general principles, some of them unilateral

• Scope
  • Coordination with other rules of the Code
  • Possible roll-out of expanded definition under other rules of the Code?

• Administrability
  • Broad definition means taxpayers must develop new systems to track interest income and expense
  • Some rules are so vague that the outer boundaries of the rules are uncertain
163(j) – Guaranteed Payments

• Novel rule
  • Guaranteed payments for the use of capital are treated as interest

• Policy – avoiding distortion?
  • Guaranteed payments are for use of (equity) *capital*; but payments are deductible, unlike preferred stock dividends
  • Preferred return allocation can have similar effect of reducing the amount of income allocable to other partners

• Administrability
  • Distinction between guaranteed payment and preferred return is not always easy to make

• Scope
  • Beneficial for 163(j) purposes for US taxpayers receiving guaranteed payments
  • Would be taxpayer-favorable if also treated as interest for withholding tax purposes
163(j) – Hedges

- Derivatives that alter effective cost of borrowing or yield on loan give rise to interest
  - Interest rate swaps; foreign currency swaps; swaptions; forward rate agreements; futures contracts

- Policy?
  - Ensure same treatment regardless of whether taxpayer integrates hedge?

- Administrability
  - Does this rule apply to macro hedges? Gap hedges?
  - Possible ways to give more definition to the rule:
    - transactions that would qualify as integrated transactions;
    - transactions that would qualify as hedging transactions;
    - transactions identified as GAAP hedges
163(j) – Swaps

• Proposed regulations revive rules relating to swaps with significant nonperiodic payments
  • Do not apply to cleared swaps
  • No guidance on when a payment is “significant”

• Scope
  • Applies for purposes of 1.446-3 NPC regulations, not just 163(j)

• Policy?
  • Fundamental debt/derivative distinction – cf Schering-Plough

• Administrability – what is “significant”? 
  • Schering-Plough-like transactions?
  • Prior law’s examples?
  • Non-ordinary course transactions?
163(j) – Substitute interest

• Substitute interest
  • Substitute interest constitutes interest income/expense
  • Same concept in proposed 163(j) regulations under prior law

• Policy?
  • Borrowing Treasuries is equivalent to borrowing cash?
  • Lender of debt securities should not lose interest income treatment for coupons?

• Scope
  • No distinction between borrowing short-term Treasuries vs “junky” debt
  • Applies regardless of whether cash collateral is provided, in which case comparison to borrowing money is less obvious

• Administrability
  • Reduces significance of distinction between “real” repos vs securities loans
163(j) – Commitment fees

• Commitment fees
  • Fees in respect of lender commitment to provide financing treated as interest if “any portion of such financing is actually provided”
  • Same concept as 1.954-2(h)(2)(i)(G)

• Policy?
  • Alters effective cost of borrowing?

• Scope
  • Does not apply to dozens of other loan fees, some of which are also interest-like
  • Preamble asks for comments on other such fees
  • Consider also guarantee fees

• Administrability
  • “Portion of” rule does not make sense – assume small draw on large facility
  • Timing issue – if there is draw in Year 2, what is effect on fees paid in Year 1?
163(j) – “Anti-avoidance” rule

• Anti-avoidance rule
  • Deductible expense in transaction(s) in which taxpayer secures use of funds is treated as interest expense if expense is predominantly incurred in consideration of the time value of money
  • Same concept in 1.861-9T regulations

• Policy – anti-avoidance?

• Scope
  • Does not require intent to avoid rest of definition of interest
  • Applies only to expense. Preamble asks whether should apply to income too.

• Administrability
  • 1.861-9T regs list three examples: conversion transactions, hedge of foreign currency debt, prepayment on swap. All of these are already covered by other parts of the 163(j) definition.
  • So what is the outer boundary of this rule, given prevalence of time value of money in pricing?
163(j) Proposed Regulations – Definition of interest

• Compensation for the use or forbearance of money under a debt instrument, or amounts treated as interest under other Code provisions, including OID, QSI, acquisition discount, includible market discount, repurchase premium, section 483 deferred payments, section 467 rents, & amounts paid/received in connection with a repo treated as debt for tax purposes.

• Deemed interest on swaps with significant nonperiodic payments

• Premium

• Substitute interest

• Section 1258 gain

• Amounts affecting effective cost of borrowing, or effective yield on debt held by TP

• Commitment fees; debt issuance costs

• Guaranteed payments

• Factoring income

• Deductible expense in transaction(s) in which TP secures use of funds if expense is predominantly incurred in consideration of the time value of money (‘‘anti-avoidance rule’’).
BEAT Proposed Regulations – Section 988 Transactions

• Section 988 loss exclusion
  • Denominator of the base erosion percentage does not include any exchange loss within the meaning of 1.988-2 from a section 988 transaction described in 1.988-1(a)(1), including from transactions with unrelated parties.
  • Base erosion payments do not include any such exchange loss that results from a payment or accrual by a taxpayer to a foreign related party

• Policy?
  • Prevent taxpayers from blowing up denominator with foreign currency losses?

• Scope
  • Exclusion from numerator has pros and cons as policy matter
  • Exclusion from denominator very problematic for derivatives dealers; not clear that either policy or statute justify exclusion for such taxpayers

• Administrability
  • Foreign currency losses may be embedded in other transactions and hard to trace
BEAT Proposed Regulations – Section 988 Transactions

• Example 1
  • USCo accrues an item of expense to a foreign related party denominated in Japanese yen. On the date of accrual, the USD amount of the expense is $100.
  • USCo subsequently pays the expense in Japanese yen. On the date of the payment the yen have a USD value of $101.
  • The $1 exchange loss is not a base erosion payment.
  • If yen delivered had a USD value of $99 on payment date, base erosion payment is still $100.
  • If USCo had a basis of $110 in the yen delivered, $10 of exchange loss ($9 + $1) would be excluded from the denominator.

• Example 2
  • USCo accrues an item of income from a foreign related party denominated in Japanese yen.
  • Accrued amount is $100. Value of yen received is $99.
  • The $1 exchange loss is not a base erosion payment.
BEAT Proposed Regulations – MTM Positions: Denominator

• MTM/netting rule for denominator of base erosion percentage
  • Determine gain or loss for each “position”
  • Combine all items of income, gain, loss or deduction for the position during the year and determine net amount of gain or loss
  • For this purpose, marking allowed only on the last business day of the year or upon disposition of the position.

• Policy?
  • Avoid double-counting of MTM loss (=PV of future payments) and actual future payments, for derivatives?
  • Prevent use of more-than-annual marks

• Scope
  • “Transactions” or “positions”?

• Administrability
  • Depends on scope
BEAT Proposed Regulations – MTM Positions: Denominator

• How does this rule apply if 988 transactions are marked?
  • QDPs (payments to related parties) are excluded from denominator
  • But all 988 losses, including on unrelated party transactions, are excluded

• If there is a net deduction/loss after combining items, can the net item be a QDP?
  • Example: USCo receives $120 and pays ($30) on a derivative transaction with a foreign related party.
  • USCo has a MTM loss on the transaction of ($130) at year-end.
  • USCo has a net loss of ($40) (= $120 - $30 - $130).
  • Is the net loss a QDP excluded from the denominator?
    • 475 legislative history: “For purposes of [section 475], a security is treated as sold to a person that is not related to the dealer even if the security is itself a contract between the dealer and a related person.”
**BEAT Proposed Regulations – MTM Positions: Base Erosion Payments**

- **MTM/netting rule for base erosion payments**
  - “For any transaction with respect to which the taxpayer applies the mark-to-market method of accounting for federal income tax purposes, the rules set forth in 1.59A-2(e)(3)(iv) [the denominator rule] apply to determine the amount of the base erosion payment.”

- **What amounts are intended to be netted by this rule?**
  - A debt on which a US person pays interest to a foreign related party is not marked to market by the borrower (so is not covered by the rule).
  - Payments to a foreign related party on derivatives are QDPs (so also not covered).
  - MTM losses on physical securities generally are not transactions with foreign related parties (so also not covered)
  - Repos and securities loans?
    - Is there a distinction between a security loaned by a US person (a “securities lending transaction”) and a security borrowed by a US person?
• Exclusion of securities lending transactions from “derivative” definition
  • A derivative does not include any securities lending transaction, sale-repurchase transaction or substantially similar transaction.
  • Securities lending and sale-repurchase transactions have the same meaning as in 1.861-2(a)(7).

• Policy
  • “Because sale-repurchase transactions and securities lending transactions are economically similar ... these transactions should be treated similarly”.
  • Is this necessary in light of the rule excluding from QDPs a payment that would be a base erosion payment if not made pursuant to a derivative?