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Today’s presenters

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Agenda

► Recent debt-equity cases
► Recent economic substance guidance
► New regulations addressing broker reporting for debt and options
► Camp proposals regarding distressed debt
► Camp proposals regarding derivatives
In the pro-taxpayer decision, the court concluded that notes issued by a sub to its parent were debt.

The court concluded that the instruments were debt notwithstanding that:

- Funding for the repayment of the notes was expected to come from asset sales (as opposed to operating income).
- Notes lacked some customary creditor protections: “Certain creditor protections are not as important in the related-party context.”
- Sub did not make all payments on the notes as they came due (and parent did not insist on such payments): “Strict insistence on payment when due is not expected and consistent with business realities in the related party context.”
- A portion of the notes were later recapitalized into equity.
PepsiCo Puerto Rico, Inc. v. Comm’r, T.C. memo 2012–269

- The pro-taxpayer decision held that “advance agreements” that had a fixed maturity date and provided for a preferred return were held to be equity, even though they were treated as debt for foreign tax purposes.
- The court ruled that the 40-year term (which could be extended for an additional 15 years) “effectively subjected the principal amounts of the instruments to an uncertain international economic climate for an inordinate period.”
- The hybrid nature of the instrument was “legitimate tax planning.”
Hewlett-Packard Co. v. Comm’r, 139 T.C. 8 (2012)

► In the pro-government decision, the Tax Court ruled that HP’s preferred stock investment in a foreign entity was “more appropriately characterized” as debt.

► Similar to the transaction in *Pritired 1 LLC* (S.D. Iowa 2011), the transaction was structured to allow HP to claim FTCs for the taxes paid by the foreign entity, while minimizing HP’s risk of loss with respect to its investment.

► The key to the court’s decision was its conclusion that HP’s right to put its shares to a third party should be integrated with its rights and obligations under the shareholders’ agreement, and therefore HP should be viewed as having creditor’s rights.

- In the pro-government decision, the district court concluded that limited partnership interests issued to foreign banks were “in the nature of debt, not equity.”

- As in TIFD III-E, Inc. (Castle Harbor), 666 F.2d 836, the transaction was structured so that, for tax purposes, the majority of the partnership’s income was allocated to the banks, but the income was actually received by the general partner.

- The district court ruled that the banks’ interests should be treated as debt because it was almost certain that (1) the partnership would have sufficient cash flow to repay the banks, and (2) the limited partners would never receive more than their fixed rate of return.

- Chemtech marks another step in the recent trend of courts adopting a broad definition of debt to reach pro-government results in structured transactions involving partnerships. (See Castle Harbor, Pritired, Asa Investerings, 201 F.3d 505 (D.C. Cir 2000))
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The taxpayer engaged in a Structured Trust Advantaged Repackaged Securities transaction (STARS), pursuant to which Bank of New York (BoNY) put assets into a UK trust in which a foreign taxpayer held an interest pursuant to a repurchase transaction (e.g., a secured financing transaction). BoNY claimed FTCs for the UK taxes paid by the trust and the foreign taxpayer also claimed a credit for the UK taxes.

The tax Court held that STARS lacked economic substance and thus disallowed the FTCs claimed by BoNY.

In deciding whether BoNY could realize a pre-tax profit potential, the Tax Court treated the foreign taxes as an expense and ignored the fact that BoNY could credit those taxes. The Tax Court thus refused to follow the reasoning of both Fifth and Eighth Circuits. See IES Industries, 253 F.3d 350 (8th Cir. 2001) and Compaq Computer Corp., 277 F.3d 778 (5th Cir. 2001) The Tax Court also held that the higher pre-tax cost of the transaction meant that it lacked economic substance.
The foreign securities lender lends dividend-paying stock to the foreign securities borrower before dividend payment date and receives substitute dividend payment.

The issue is whether the parties may rely on Notice 97–66, which would eliminate the otherwise-applicable US withholding tax on the substitute dividend payment.

The conclusion was that the lender taxed as though it retained ownership of the shares. Justification for the conclusion included the following:

- There was no business purpose for the transaction because the transaction was initiated by the borrower to reduce the lender’s withholding tax.
- The transaction was off-market.
- The lender retained economic benefits and burdens of share ownership.
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Final regulations on broker reporting for debt and options – debt highlights

► Basis reporting on “complex” debt securities delayed until 2016.
► Debt securities with an original term of one year or less will be permanently exempt from basis reporting.
► The treatment of possible customer elections has been changed substantially:
  ► Default choice for market discount accrual is now straight-line
  ► Brokers must reflect actual customer elections
► One-year delay for transfer statements after the effective date for each stage of debt instruments.
► Under temporary regulations, Form 1099 reporting for debt with premium must assume the holder has elected to amortize premium. This conforms the 1099 reporting to the basis reporting.
Two-year deferral for basis reporting for complex debt instruments

- Basis reporting required beginning in 2014:
  - Fixed yield instruments calling for a single fixed rate of interest payable at least annually in cash
  - Instruments whose yield can be computed based on the assumed exercise or non-exercise of put and call options
  - Demand debt with a fixed yield

- Basis reporting delayed until 2016 (main categories)
  - Convertible debt instruments
  - Debt instruments issued as part of an investment unit (i.e., issued together with warrants, stock or another property right)
  - Stripped bonds or coupons
  - Foreign currency denominated debt instruments
  - Debt with a PIK feature
  - Contingent payment debt instruments
  - Variable rate debt instruments
  - Inflation-indexed debt instruments
Market discount accrual

- The statutory default choice is straight-line accrual of market discount, and this is also the default rule under the final regulations.
- Straight-line accrual is always faster than constant yield accrual, so virtually the only reason a taxpayer would not want to elect constant yield is to avoid the burden of the more complex computation.
- But if the broker is going to make the computation, the taxpayer has no reason not to elect constant yield accrual.
- The constant yield election is not due until the return for the year in which it first affects a taxpayer’s taxable income, which is the year of sale unless the taxpayer elects to include market discount in income as it accrues or the bond calls for principal prior to maturity (both rare).
- Form 1099-B must be filed earlier, so brokers will either have to report straight-line (undesirable) or will have to devise a mechanism to get customers to inform the broker in writing that they intend to make the constant yield election (cumbersome).
Final regulations on broker reporting for debt and options – rules affecting options

► “Nonequity options” marked to market under Section 1256 will be excepted from cost basis reporting.

► Compensatory options will be outside the scope of basis reporting. Brokers will no longer be permitted to adjust the basis of securities acquired through compensatory options for compensation income recognized.

► Single stock futures contracts governed by Section 1234B will be subject to 1099-B reporting, effective for contracts entered into after 2013.
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Issue price proposal

► The proposal defines the issue price of a debt instrument in a debt modification as the lesser of the adjusted issue price of the existing debt instrument or the issue price of the new debt instrument, as determined under section 1274. Under current law, if the debt is publicly traded, its issue price would be its fair market value, which is lower if the issuer is in financial distress.

► This means that if a debt instrument is modified, the issuer will not have cancellation of indebtedness (COD) income, so long as the principal amount is not reduced and the modified debt calls for interest at a rate not lower than the applicable federal rate (AFR).

► Same rules would apply to holders. No special rules for investors in distressed debt in the current Camp draft.
Market discount

- The current inclusion on a constant yield basis was extended to market discount.
- There is a limitation on the amount of the market discount accrual to the greater of (i) original yield plus 5% or (ii) AFR as of the date of the acquisition plus 10%.
- The base on which this rate accrues appears to be improperly drafted, but Camp staff has indicated this will be rectified.
- Retained same exceptions from treatment as interest as under current market discount rules (section 103, 871(m), 881, 1441, 1442 and 6049).
- Broker reporting rules will be key to making sure taxpayers have the necessary information to apply the rules.
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Hedge identification proposal

- Limited financial accounting hedge ID conformity rule:
  - The tax hedge ID requirement deemed satisfied if a transaction is:
    - Explicitly identified as a tax hedge (current law)
    - Or
    - Treated as a hedging transaction for purposes of an audited financial statement of the taxpayer that (i) is certified as being prepared in accordance with GAAP and (ii) is used for the purposes of a statement or report to shareholders, to partners or other proprietors, to beneficiaries, or for credit purposes
  - No change to definition of a “hedging transaction” for tax purposes
Mark-to-market proposal
General rules

- All derivatives are marked-to-market (MTM).
- All items of income, gain, loss and deduction are treated as ordinary income or loss.
- MTM and ordinary rules do not apply to any qualifying tax financial instrument or other contract that is part of a hedging transaction.
Mark-to-market
Straddles

► If a derivative is a position in a straddle, MTM plus ordinary apply to all positions in such straddle.

► Any built-in gain position that becomes part of a straddle is treated as sold at the time that the straddle is established, but the gain generally is capital.

► Built-in loss on a position that becomes part of a straddle is deferred loss (i.e., the loss position is marked-to-market, but the loss is not recognized before the non-derivative loss position is sold).
Mark-to-market
Very broad definition of “derivative”

► Any evidence of an interest in (or any derivative financial instrument with respect to):
  ► Any share of stock in a corporation
  ► Any partnership or beneficial ownership interest in a partnership or trust
  ► Any note, bond, debenture, or other evidence of indebtedness
  ► Generally, any real property
  ► Any commodity that is actively traded
  ► Any currency

► Any notional principal contact

► Any “derivative financial instrument” with respect to any interest or instrument described above
Mark-to-market
Embedded derivatives

“Derivative” includes:

- Any embedded derivative component (i.e., any terms of a debt instrument that affect some or all of the cash flows or the value of other payments required by the instrument in a manner similar to a derivative).
- Such component and the debt instrument shall be treated as two separate instruments for all tax purposes.

But a debt instrument is not treated as having an embedded derivative component “merely” because:

- The debt instrument is denominated in a nonfunctional currency.
- Payments are determined by reference to the value of a nonfunctional currency.
- The debt instrument is a contingent payment debt instrument, variable rate debt instrument or a debt instrument with alternative payment schedules.

Is convertible debt all that remains?
Average basis proposal

► The proposal requires the average basis method for specified securities (stock, debt, commodity, commodity derivative and any other financial instrument if subjected to cost basis reporting).
► It appears to be a substantive rule rather than just basis reporting rule.
► Technical problems remain if lots have different holding periods.
► It applies to sales, exchanges and dispositions after 31 December 2013.
► Transition rule: specified securities acquired before 1 January 2014 are treated as a separate account from any such security acquired after 31 December 2013. Requires basis to be maintained on a separate account-by-account basis.
► Enactment as proposed seems unlikely, but may move to a mandatory FIFO system for stock as an alternative.
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