

Recent Developments: Tax Reform Considerations for Financial Transactions

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Agenda

- Section 163(j) Proposed Regulations
 - Definition of Interest
 - Debt Issuance Costs/Commitment Fees
 - The Anti-Avoidance Rule
 - The “Derivative Rules”
 - Section 988 Transactions
 - COD
- BEAT Proposed Regulations
 - Section 988 Transactions
 - Mark-to-Market Positions (Netting Rule)
- Section 199A



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Section 163(j)



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What is 'interest' for purposes of Section 163(j)?

- The Proposed Regulations provide a broad definition of 'interest' (income and expense) in Prop. Reg. § 1.163(j)-1(b)(20) comprising three categories of 'interest':
 - **Category 1:** Interest on indebtedness, (including original issue discount, market discount, and acquisition discount) and amounts treated as interest under other provisions of the Code (including amounts treated as interest under Sections 483 (deferred payment contracts) and 467 (certain rental agreements)).
 - **Category 2:** Certain swaps with 'significant nonperiodic payments.
 - **Category 3:** Certain other amounts that are 'closely related to interest and that affect the economic yield or cost of funds of a transaction,' although not otherwise deductible (or includible) as interest (e.g., interest equivalents).
- Regulatory authority?
- Need for a new definition of interest?



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Items not otherwise treated as interest for U.S. federal income tax purposes – “Category 3 Interest”

- Section 163(j) broadens the definition of “interest” to include items not otherwise treated as interest for U.S. federal income tax purposes, including:
 - Substitute interest payments;
 - Debt issuance costs;
 - Guaranteed payments;
 - Commitment fees (but only if some amount of financing is actually provided);
 - Certain amounts with respect to derivatives that affect the taxpayer’s effective cost of borrowing (such as gain or loss on an interest rate swap); and
 - Certain amounts that alter a taxpayer’s effective yield with respect to a debt instrument held by the taxpayer.



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Commitment Fees & Debt Issuance Costs

- Commitment fees:
 - Rule: Treated as interest if any portion of such financing is actually provided.
 - Observations:
 - Not proportional
 - Timing issues (what if no draws in year 1; draw in year 2; no draws in subsequent years)?
- Debt Issuance costs:
 - Rule: Treated as interest expense of the issuer.
 - Observations:
 - Unclear how third-party costs of the issuer are “interest equivalents”



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Income, Deduction, Gain, or Loss from Derivatives

Prop. Reg. § 1.163(j)-1(b)(20)(iii)(E) and (F)

- Income, deduction, gain, or loss from a derivative (as defined in section 59A(h)(4)) are treated as interest under the proposed regulations if:
 - the derivative alters a taxpayer's effective cost of borrowing with respect to a liability of the taxpayer; or
 - the derivative alters a taxpayer's effective yield with respect to a debt instrument held by the taxpayer.
- Items from derivatives are treated as an adjustment to interest expense and interest income respectively.



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Income, Deduction, Gain, or Loss from Derivatives, Con'd

- Under section 59(h)(4)(A), “derivative” means any contract (including any option, forward contract, futures contract, short position, swap, or similar 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 the following:
 - any share of stock in a corporation;
 - any evidence of indebtedness;
 - any commodity which is actively traded;
 - any currency; or
 - any rate, price, amount, index, formula, or algorithm.

- The term derivative does not include the actual items.



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Income, Deduction, Gain, or Loss from Derivatives, Con'd

Open Issues:

- What types of derivatives should be considered?
 - Is a guarantee a “derivative”?
- What is the standard to “alter” effective cost of borrowing or effective yield?
 - E.g., section 1221, Treas. Reg. § 1.1275-6, etc.
 - How does the standard apply for hedges of aggregate risk, anticipatory hedges, or gap hedges?
- How do the items from a derivative adjust interest expense or interest income?



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Income, Deduction, Gain, or Loss from Derivatives, Con'd

- Hedge timing rule under Treas. Reg. § 1.446-4 still applies for section 1221 hedging transactions.
 - Do items from a hedge of a debt instrument (*i.e.* a hedge of interest rate risk) need to match the deduction for business interest under section 163(j)?
 - *E.g.*, PLR 200415009 (ruling that hedging gain or loss was matched with a compensation deduction subject to section 404(a)(5)).
 - *But see* CCA 201135030 (concluding that gain from an interest rate hedge was not matched with COD income deferred under section 108(i)).



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Anti-Avoidance Rule - Prop. Reg. § 1.163(j)-1(b)(20)(iv)

- Rule:
 - An otherwise deductible expense or loss incurred by a taxpayer in a transaction (or series of integrated or related transactions) in which a taxpayer secures the use of funds for a period of time is treated as interest expense if the expense or loss is “predominantly incurred in consideration of the time value of money.”
- Observations:
 - Although labeled an anti-avoidance rule, there is no “intent” requirement
 - Asymmetrical – applies to expense but not income (preamble asks for comments with respect to whether it should also apply to income).
 - Based off of Treas. Reg. 1.861-9T – should it be similarly interpreted?



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Anti-Avoidance Rule, Con'd

- How broad is the rule?
 - Guarantee Fees?
 - Letter of Credit Fees?
 - Losses on factoring transactions?



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Foreign Currency Transactions

- Application of section 163(j) proposed regulations to FX transactions is unclear.
- Example under “hedging” rules:
 - Prop. Reg. sec. 1.163(j)-1(b)(20)(v), ex. 2 provides that payments on a foreign currency swap used to hedge a foreign currency denominated debt instrument alter the taxpayer’s cost of borrowing and therefore adjust the taxpayer’s interest income and expense.
 - A similar example is contained in Treas. Reg. sec. 1.861-9T(b).



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Foreign Currency Transactions, Con'd

■ Observations:

- Can the rule be read to look only to the interest differential in FX derivative (e.g., not all FX g/l)?
- Rule adjusts interest income/expense for FX gain or loss on the hedge; doesn't look to net FX gain or loss.
 - Why is the FX g/l adjustment one-sided?
 - Does the anti-avoidance rule (as currently drafted) capture FX loss on issued debt? What if it is unhedged?



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Foreign Currency Transactions, Con'd

■ Observations, con'd:

- Hedges of principal
 - Does the forward contract “alter” the cost of borrowing/rate of return?
 - Recall that an FX forward has two components: (a) interest differential (between two currencies) and (b) a spot-to-spot hedge of FX risk.
 - If so, does the rule pick up all of the FX gain or loss or just the forward points?
 - Consider challenge in determining this, and tracking for taxpayers that hedge with rolling forward contracts.
- Interaction with straddle rules?



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COD Income

- Assume taxpayer's accrued interest for the year is deferred under section 163(j); in the next year, the obligation to pay the interest is forgiven.
- Issues to consider:
 - Does section 108(e)(2) apply to the accrued interest?
 - What does it mean that a payment "would have given rise to a deduction" (when the deduction is subject to deferral under section 163(j))?
 - Case law supporting non-application of section 108(e)(2) for non-deductible (e.g., personal) interest.
 - If section 108(e)(2) does not apply, is there a common law doctrine that could apply to avoid COD income (e.g., the tax benefit rule)? *See Rail Joint v. Comm'r.*
 - If section 108(b) applies, is a section 163(j) carryforward an attribute that can be reduced?



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Base Erosion Payments - 988 Losses

- Rule
 - Foreign currency losses on section 988 transactions entered into with a foreign related party are excepted from definition of “base erosion payment”. Prop. Reg. sec. 1.59A-3(b)(3)(iv)
 - Foreign currency losses on ALL section 988 transactions (from transactions with foreign related parties and persons other than foreign related parties) are excluded from the denominator when computing the taxpayer’s base erosion percentage. Prop. Reg. sec 1.59A-2(e)(3)(ii)(D)).
- Observations:
 - Large issue for derivatives dealers (with large # of FX transactions with third-parties)
 - Note that some FX positions are not section 988 transaction (e.g., regulated FX futures)



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Mark-to-Market Positions (Netting Rule)

■ Rule:

- Gain or loss determined for each “position”
- Combine all items of income, gain, loss, or deduction arising with respect to the position during the taxable year, regardless of how each item arises (including from a payment, accrual, or mark).
- Marking only permitted on last business day of tax-year or on disposition (regardless of frequency taxpayer marks for other purposes).

• Observations

- Avoids double counting of mark-to-market losses (e.g., mark and payment) and the use of multiple marks within year.
- What is a “position”?



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Section 199A



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Section 199A

- Section 199A provides a deduction equal to 20% of domestic qualified business income ("QBI") from a sole proprietorship, partnership, or S corporation.
- QBI does not include income from certain disqualified service businesses including: accounting, financial services, brokerages services, investing and investment management, and trading or dealing in securities, partnerships interests, or commodities.
- Financial services does not include taking deposits and making loans, *but does include arranging lending transactions between a lender and a borrower.*



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Section 199A vs. Section 475(c)

Section 199A Dealing in Securities

- Regularly purchases securities from **and** sells securities to customers in the ordinary course of a trade or business.
- No negligible sales exception.
- Services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is dealing.

Section 475(c) Dealer in Securities

- Regularly purchases securities from **or** sells securities to customers in the ordinary course of a trade or business.
- Negligible sales exception may apply.
- Making loans to customers is treated as purchasing securities.



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Section 199A

Open Issues:

- How do you distinguish among:
 - “making loans”
 - “the performance of services to originating loans” and
 - “arranging a transaction between a lender and a borrower”?

- Does it matter whether there is a preconceived sale of an originated loan?



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