

MORRISON | FOERSTER

---

# Tax Developments Affecting Financial Institutions and Financial Products

Thomas Humphreys  
Remmelt Reigersman

**March 8, 2017**

# Overview

- Tax Reform
- Camp and Wyden Derivative Proposals
- Changes to the Administrative Procedure Act
- Replacing the Affordable Care Act?
- Section 871(m) Regulations
- TLAC
- IRS Targeting “Basket Option” Contracts

# Tax Reform

- Now that Republicans have control of the Presidency, House and Senate, significant tax reform could be on the horizon.
- President Trump's plan was published as "Tax Reform that Will Make America Great Again." His campaign website also featured a later iteration of the plan.
- In June 2016 the House Republicans released a tax reform plan entitled "A Better Way: Our Vision for a Confident America."
- President Trump did not fully endorse the House plan, but later iterations of his plan were revised to look like the House plan.

- Individual Tax Rates
  - Trump Plan

Married Joint	Ordinary Income Rate	Capital Gains
\$0-\$75,000	12%	0%
\$75,000 - \$225,000	25%	15%
\$225,000+	33%	20%

- House GOP Plan

Married Joint	Ordinary Income Rate	Capital Gains
\$0-\$75,300	12%	6%
\$75,300 - \$231,450	25%	12.5%
\$231,450+	33%	16.5%

- President Trump's tax plan for businesses
  - Tax rates
    - Corporations: 15% tax rate
    - Pass-throughs:
      - September 2015 plan proposed 15% rate for pass-throughs
      - September 2016 plan removed explicit mention of pass-throughs
      - Clarifications from Trump campaign in September 2016 state plan would give all pass-throughs a 15% rate if such entities elect to file their taxes as if they were incorporated.
        - Unclear how this would work in practice.
  - Expensing Capital Investments and Interest Deduction Limits
    - Expensing: Trump's proposal would allow firms engaged in U.S. manufacturing to fully expense capital investments.
    - Interest Deductions: However, firms making such an election would lose the deductibility of corporate interest expense.

- House GOP tax plan for businesses
  - Tax rates
    - Corporations: 20% tax rate
    - Pass-throughs:
      - Would limit tax rate of small businesses and pass-throughs to 25%
      - However, small businesses and pass-throughs would be required to pay, or be treated as having paid, reasonable compensation to their owners
  - Expensing Capital Investments
    - The House proposal would repeal current depreciation system and allow the cost of capital (for both tangible and intangible assets) to be fully and immediately deductible
  - Interest Deduction Limits
    - Deductions for net interest expenses on debt would only be allowed as a deduction against interest income
    - Unused deductions could be carried forward

- House GOP Plan: Border Adjusted Cash Flow Tax
  - Cash flow tax
    - A business is taxed on its cash flow, i.e., business receipts less expenditures
    - Assets are immediately expensed
  - Border adjusted
    - A border adjusted conforms to the “destination-based” principle – generally, tax is levied where goods end up rather than where the goods were produced
    - Exclude from the tax base sales of goods/services to non-U.S. persons
    - Include sales to U.S. persons, including sales by non-U.S. persons to U.S.
  - Financial transactions in a Border Adjusted Cash Flow Tax:
    - Include: income from borrowing, deduction for investments in stocks or bonds
    - Exclude: ignore investments in stocks or bonds

# Camp and Wyden Derivative Proposals

- In 2014, former Representative Dave Camp [(R-MI)] released a draft tax reform plan, which included a mark to market proposal for derivatives.
- In May 2016, Senator Ron Wyden (D-OR) released a similar mark to market proposal, entitled the Modernization of Derivatives Act.
- Under the Camp proposal, a derivative held at the end of a taxable year would be required to be marked to market, with the resulting gain or loss treated as ordinary and as attributable to a taxpayer's trade or business.
  - The proposal generally defined a derivative as any contract, the value of which, or any payment or other transfer with respect to which, is directly or indirectly determined by reference to seven underliers listed by the discussion draft, such as stock, an index, or a partnership interest. Real property was included as an underlier, with some exceptions.

- The Camp proposal would generally treat the non-derivative portion of a straddle as a derivative for both timing and character purposes, and upon establishing a straddle, any built-in gain position would be treated as sold for its fair market value.

- Under the Modernization of Derivatives Act (the “Act”) introduced by Senator Wyden, a taxpayer would be required to mark to market an investment in the event of a “taxable event” with respect to a derivative or underlying investment.
  - A “taxable event” with respect to a derivative would be (1) the termination or transfer of such a derivative, or (2) the close of a taxpayer’s taxable year if the taxpayer had obligations and rights with respect to the derivative at that time.
  - The Act generally defines “derivative” the same as the Camp proposal (but includes the derivative component of a principal-back note).
  - Similar to the Camp proposal, any gain or loss under the Act would be treated as ordinary and as attributable to a taxpayer’s trade or business
- The Act would also replace current anti-abuse straddle rules and constructive sale rules with a new general rule for capital hedging for taxpayers that use derivatives to hedge capital assets, called “investment hedging units.”

# Changes to Administrative Procedure Act

- In *Chevron, U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984), the Supreme Court held that a court cannot overrule an agency regulation under an ambiguous statute unless it is “arbitrary or capricious in substance, or manifestly contrary to the statute.” The court is required to give deference to the agency’s interpretation.
- This so called “*Chevron* deference” allows agencies, including the IRS, to issue interpretive regulations with a high threshold for being overturned by a court.
- The Regulatory Accountability Act of 2017, already passed in the House, would modify a number of the rules surrounding the Administrative Procedure Act, including replacing “*Chevron* deference” with a de novo review of regulations.

# Replacing the Affordable Care Act?

- On February 24, a draft House bill dated February 10 meant to replace the Affordable Care Act was leaked
- The leaked bill would:
  - Repeal the 3.8 percent Medicare tax on net investment income, effective for tax years beginning after December 31, 2016
  - Repeal the codified economic substance doctrine and all related penalties and reasonable cause exceptions, effective for transactions entered into after December 31, 2016
  - Repeal the 2.3 percent excise tax imposed on sales of medical devices after December 31, 2017
- House Ways and Means Committee Chair Kevin Brady (R-TX) and House Majority Whip Steve Scalise (R-LA) said that the leaked bill is out of date, since the working draft is constantly changing

# Section 871(m) Regulations

- In September 2015, the IRS released final regulations on section 871(m), the Code provision which generally treats “dividend equivalents” paid under certain contracts as dividends from U.S. sources and therefore subject to a 30% U.S. federal withholding tax.
- In December 2016, the IRS released Notice 2016-76, which generally announced the IRS’s intention to delay the effective date of the section 871(m) regulations for certain contracts until January 1, 2018 (among other related announcements).
- On January 19, 2017, the IRS released final regulations as announced in Notice 2016-76, with additional changes, set to be published in the Federal Register on January 24, 2017.
- On January 20, 2017, President Trump’s Chief of Staff, Reince Priebus, sent a memorandum to all heads of executive departments and agencies instructing, among other things, that all regulations released but not yet published must be immediately withdrawn for review and approval.
- On January 24, 2017, the IRS announced that the new section 871(m) regulations were approved by the Office of Management and Budget and had an effective date of January 19, 2017. The IRS therefore published the regulations in the Federal Register in contravention to the executive order.

# TLAC

- Revenue Procedure 2017-12
- Issue: whether “internal TLAC,” i.e., debt issued by a domestic international holding company to foreign GSIB is debt for federal income tax purposes.
- Features:
  - Debt in form
  - Subordinated
  - Subject to federally mandated contractual trigger that causes conversion to equity
- IRS will treat this as debt even though it lacks several debt features

# IRS Targeting “Basket Option Contracts”

- In July 2015, the IRS released Notice 2015-47 and 2015-48, which designated certain “basket contracts” as “listed transactions” and others as “transactions of interest”
  - Generally, the transactions at issue involve the taxpayer treating an option or other derivative as open until a barrier event occurs, even if the basket of underliers is actively managed (and therefore the taxpayer does not recognize gain or loss while the basket is managed)
  - Characterization as a “listed transaction” or “transaction of interest” causes reporting and potential penalties to participating taxpayers
- In October 2015, the IRS released Notice 2015-73 and 2015-74, which narrowed the scope of the July notices
  - The October notices still cast a broad net
- On January 31, 2017, the IRS announced its 13 Large Business and International campaigns for 2017, listing basket transactions as one of those campaigns