KPMG TaxWatch Webcast:
Taxation of Derivatives and Hedging Transactions and Developments in the Derivatives Markets
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Administrative

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Introduction

Where are we today?

- Extremely complex labyrinth of tax and financial accounting rules with:
  - Recent and pending statutory and regulatory changes to the tax rules
  - Pending changes to accounting rules under both GAAP and IFRS

- Significant increase in the use of derivatives (both for hedging and other purposes), combined with the implementation of fundamental changes to the market (i.e., the Dodd-Frank Wall Street Reform and Consumer Protection Act)
What drives the tax complexity?

**Character Rules**
- General Character Rules (§1221)
- Written Options
- §1256 (60/40)

**Timing Rules**
- Hedge Timing Rules
- Mark to Market
- Open Transaction

**Status of Taxpayer**
- $475 Dealers & §475 Elections
- Hedges, Traders or Investors
- Commodities Derivatives Dealer

**Special Rules**
- Hedge & Subpart F
- Special Derivative Withholding Rules
- State Apportionment Rules
- “Significant” Nonperiodic Payments
- Hedging & §199 Deduction
- Termination Payments

**Other**
- Written Options

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Different Tax Regimes for Economically Similar Derivatives

**1256 Contracts**
- Character: Generally Capital (60/40 treatment)
- Timing: Mark-to-Market

**Swaps (Taxed as NPCs)**
- Character: Generally Ordinary
- Timing: Generally Realization Based Method
  - Other: - Accounting for Upfront Payments

**Other:**
- - Hedge Timing Rules vs. MTM
- - Mixed Straddle considerations
Tax Hedging Rules and the Potential Impact of Failing to Properly Address and Manage Hedging Transactions

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<tr>
<th>Tax Hedging Regime</th>
<th>Unaddressed Hedging Transaction</th>
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<tr>
<td><strong>Application</strong></td>
<td>Taxpayer must generally make a hedging identification in the manner and time proscribed by the regulations.</td>
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<td>Anti-abuse rules may create “whipsaw” (e.g., ordinary gain/capital loss) if taxpayer fails to properly identify hedging transactions.</td>
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<td><strong>Character</strong></td>
<td>Generally gain/loss on hedge and the hedged item will both be ordinary in nature.</td>
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<td>Matching of character generally advantageous to taxpayer.</td>
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<td>§1256 contracts may result in capital gain/loss.</td>
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<td><strong>Timing</strong></td>
<td>Method of accounting depends on nature of the hedged item but general intent is to “match” the realization of gain/loss on the hedge with the realization of gain/loss on the hedged item.</td>
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<td>Special timing methods apply to various items (e.g., accounting for hedges of inventory items depend on taxpayer’s method of accounting for inventory (i.e., LIFO)).</td>
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<td>Hedge not subject to the straddle rules of §1092 and mark-to-market regime of §1256 if properly identified.</td>
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<td><strong>Other</strong></td>
<td>Favorable treatment under §199 and subpart F for properly identified hedging transactions.</td>
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Background

The Dodd-Frank Act is fundamentally altering the landscape for many derivative transactions

- Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) enacted in 2010
- Tasks the SEC and CFTC with implementing the sweeping changes to the derivative markets provided for under Title VII of the Dodd-Frank Act
- Promulgation and implementation of the vast rules contemplated under Title VII is currently ongoing
  - However, many rules are currently in force and all indications are that rules will continue to be rolled out on an ongoing basis
- For additional details on these new regulatory rules, and other provisions, please visit:

Title VII of the Dodd-Frank Act

Changes to the OTC Derivatives Markets Under Title VII Include:

- Mandatory central clearing for many “swaps” (defined in Dodd-Frank Act)
- Requirement for trading in many “swap” transactions on exchanges or so-called “swap execution facilities”
  - “Swap Execution Facilities” – nature of these trade execution facilities remains unclear
- New collateral and margining requirements
- Trade reporting and record-keeping requirements
- Position limitations
- End-User Exception – may exempt certain users of derivative products from some of these new rules and requirements
  - Detailed rules define scope of this exception
Basics of Central Clearing Illustrated

Derivatives Clearing Organization (Clearinghouse)

1. Swap Terms Agreed on OTC Basis

2. Trade submitted by parties to DCO for clearing

3. Cleared Swap Trade

Trade submitted by parties to DCO for clearing

Cleared Swap Trade

Cleared Swap Trade

Comparing Derivatives Markets Pre & Post Dodd-Frank Act

Pre Dodd-Frank Act

Clearing Generally at Discretion of Parties

Many Derivatives Executed on an OTC Basis

OTC Execution Carried Greater Likelihood of “Bespoke” Terms

Post Dodd-Frank Act

Mandatory Clearing for Many Derivatives

More Likely Derivatives Executed on Exchanges (or “SEFs”)

Greater Emphasis on “Standardized” Terms

PLUS

Proliferation of New Swap & “Swap-Like” Derivative Products
Base Case

In evaluating the potential tax consequences of the various changes in the derivatives markets previously highlighted we will begin by assuming the following common transaction:

- Unrelated counterparties X and Y agree to enter into an uncleared (OTC) interest rate swap on a notional amount of $100 million, with a tenor of 5-years and the following terms:
  - Party X assumes the fixed rate leg (provides for annual payments at 4%)
  - Party Y assumes the floating rate leg (provides for annual payments based on LIBOR)
  - Assume that swap is "on-market" so neither party makes a compensating upfront or similar payment to the other at time of execution
**Base Case – Taxation**

- Interest rate swap will be taxed as a “notional principal contract” (NPC) under Treas. Reg. section 1.446-3
- Character: Generally ordinary for both parties
  - However, risk of capital character with regards to “termination” payments
  - Hedging treatment, if available and properly managed, may help address this often material risk
  - Also consider possible application of the “whipsaw” rules for unaddressed hedging transactions
- Timing: Determined under the rules of Treas. Reg. section 1.446-3
  - Generally, payments will be recognized in the period to which they relate
  - Special rules for “non-periodic” payments (discussed below)
  - Interaction of general timing rules with hedge timing rules?

**Taxation of Standardized and Cleared Swaps**

Possible tax consequences of standardizing and clearing:

- Threshold question: Will the interest rate swap in base case continue to be treated as a “NPC” once standardized and cleared? If not, what are some alternative treatments?
  - Section 1256 provides for unique timing (mark-to-market) and character (60/40 capital) rules and applies to a number of contracts defined in section 1256 including “regulated futures contracts,” which are defined as follows:
    
    **Section 1256(g)(1):** The term “regulated futures contract” means a contract—(A) with respect to which the amount required to be withdrawn depends on a system of marking to market, and (B) which is traded on or subject to the rules of a qualified board or exchange.
  
  - Could a “cleared” swap be treated as a “regulated futures contract” subject to section 1256?
- Consider recently enacted “Swap-Kickout Rule” (Section 1256(b)(2)(B))
  - Provision added to Code pursuant to sole tax-related provision of the Dodd-Frank Act
  - Provides that various contracts (including interest rate swaps and “similar agreements”) are NOT subject to section 1256
Taxation of Standardized and Cleared Swaps (continued)

Other tax considerations for users of standardized and cleared swaps:

- Hedging considerations:
  - Do the potential changes in the cash flows / economics resulting from standardized and cleared swaps lead treasury / risk management teams to reconsider use of cleared swaps for hedging purposes?
  - Alternatively, will the reduction in counterparty default risk as a result of clearing mean swaps be perceived as more attractive by certain taxpayers?
  - What changes are necessary to historic hedging policies and practices, in particular regarding hedging identifications?
  - Possible impact on “effectiveness” testing for transactions identified as hedges for book purposes?

- Taxation of “novation” transaction at outset?

- Upfront and similar “nonperiodic” payments?
  - Very likely that move toward swaps providing for “standardized” terms will implicate the rules for “upfront payments” on NPGs, as will be discussed in more detail below

New Exchange-Traded “Swap-Futures” Products

New swap-futures products suggest that efforts are also underway to “futurize” the swap markets

- Examples include:
  - Exchange-traded and cleared futures contracts that settle into a cleared interest rate swap
  - Exchange-traded and cleared futures contracts that are intended to replicate the economics of an OTC interest rate swap but are entirely cash settled and function in a manner similar to traditional financial futures contracts

- In general, these derivative products share the following key features:
  - Generally standardized terms
  - Traded on “designated contract markets” and subject to margining and a daily “marking-to-market” in the same fashion as traditional exchange-traded futures contracts

- Each day, the parties to these derivative contracts will post “daily variation margin” as the value of the contract moves and it is “marked-to-market”
  - Centrally cleared as a matter of course
**Taxation of New Exchange-Traded “Swap-Futures” Products**

Taxpayers contemplating the use of these new derivative products should consider various items, including:

- What is the proper characterization of the derivative for tax purposes? Is this a change from the status quo (i.e., treatment of traditional OTC Swaps)?
  - Subject to section 1256 as a “Regulated Futures Contract” for some or all of its term?
  - Treatment as an NPC?
    - Application of the “Swap Kickout Rule” and proposed regulations under section 1256 and Treas. Reg. section 1.446-3?
- Depending on the status of the taxpayer and the intended use of the derivative:
  - Hedging transactions and related considerations (see next slide)?
  - Mixed straddles vs. non-mixed straddles?
  - Section 475 dealers and section 475 elections?
- Possibility of payments on the contracts meeting the definition of “nonperiodic” payments subject to the special rules under Treas. Reg. section 1.446-3?
  - Certain payments on some of these contracts appear to be equivalent to an upfront payment on a traditional OTC swap
  - See more detailed discussion below

**Taxation of New Exchange-Traded “Swap-Futures” Products (continued)**

For taxpayers contemplating the use of these new derivative products in connection with their hedging activities, the considerations are numerous:

- Again, does the nature of the contract and potential change in cash flows / economics (relative to traditional OTC swaps) have any impact on whether the new products are used for hedging purposes?
  - May be a particularly challenging question to answer in this case given significant differences between these new products and traditional OTC swaps (and, to a certain degree, cleared swaps).
  - Change in economics and potential impact on demonstrating “effectiveness” for book purposes?
- If hedging treatment is available and desirable, various factors to consider:
  - Risk of character mismatch may be particularly acute if derivative is deemed subject to the rules of section 1256 in whole, or in part.
    - Contrast to base case where most payments on an OTC swap will be treated as ordinary in nature
  - What is the proper method of accounting for the contract under the hedge timing rules?
    - Does it differ from the method used for traditional OTC swaps?
Upfront : New derivative products may lead to more upfront payments

Understanding the Issue

- Modified Hypothetical:
  - Assume the prevailing market rate for an equivalent swap at the time X and Y agree to trade is 4.50 percent per annum, but the parties agree to a swap at 4 percent per annum.
  - Party X has negotiated a below-market swap
  - Party Y will likely require Party X to make a compensating payment at the outset of the trade (i.e., upfront payment). In most cases this upfront payment will generally be equivalent to the PV of a stream of payments at the rate differential calculated by reference to the notional amount (i.e., 50 bp for five years times $100 million notional).

- Movement to standardized terms are expected to increase frequency with which swaps are entered into “off-market” and thus require one party to make an upfront payment:
  - For example, if a standardized swap is available at 4 percent at a time when the market rate is 4.5 percent, an upfront payment would be required to compensate the swap counterparty on account of the below market rate.

Upfront Payments – General Tax Treatment

The current regulations provide general rules for accounting for such upfront payments:

- Tax treatment of upfront payments on NPCs generally prescribed by rules under Treas. Reg. section 1.446-3
  - Generally, taxpayer must recognize the upfront payment (as additional income/expense) over the term of the swap under a particular method prescribed under the regulations:
    - “Level-payment” method (not straight-line)
  - Special rules for “significant” upfront payments
    - If an upfront payment is considered to be “significant” the parties must bifurcate the swap into two distinct transactions which must be accounted for separately:
      - (1) On-market swap plus (2) Deemed loan

Deemed loan component will give rise to interest income / expense under the approach of the regulations

- Not clear when an upfront payment should be treated as “significant” as regulations only provide guidance in the form of very general examples:
  - Upfront payment equal to less than 10 percent of the PV of the total fixed payments due under hypothetical swap contract deemed not “significant” while upfront payment equal to in excess of 40% of the PV of the total fixed payments due under hypothetical swap contract is considered “significant.”
Upfront Payments – Potential Tax Considerations

Upfront payments with respect to swaps raise several challenges, both from a tax compliance and practical perspective:

- **Hedging Considerations:**
  - Potential challenges in accounting for the upfront payments if swap is entered into as part of a hedging transaction
  - How do the rules for accounting for upfront payments interact with the hedge timing rules?
  - What if upfront payment is considered “significant” and subject to the deemed loan rule?
  - Will the increased likelihood of upfront payments cause treasury / risk management function to look to a different derivative product for hedging purposes?
  - Does the upfront payment have any impact on the “effectiveness testing” required for transactions identified as hedging transactions for book purposes?

- **“Significant” upfront payments:**
  - Challenges in distinguishing "significant" upfront payments (subject to deemed loan rule) from other upfront payments
  - Withholding risk on deemed loan
  - UBTI risk / Application of “Debt-Financed” rules of section 514
  - Section 956 implications

- Many common software systems may not readily permit for amortization of upfront payments under the “level payment” method (or for that matter, the bifurcation approach required for “significant” upfront payments)
Closing Thoughts and Next Steps

Taxpayers should consider how developments in the derivatives markets are and will impact their hedging and derivative activities in order to best position themselves.

Key next steps would include:

- Reviewing existing hedging and derivative policies and procedures, elections, identifications, etc. to identify and understand status quo
- Discussing with treasury and trading functions, accounting, and other stakeholders to understand how operations and practices will change in response to the Dodd-Frank Act and other regulatory and marketplace changes
- Establishing proper controls and procedures to ensure that the tax consequences resulting from future changes are addressed or considered in advance
- Making new elections and identifications to achieve/maintain desired tax results
- Monitoring further regulatory rulemaking and other resulting market changes.
# Q&A (continued)

To ask a question, click ‘ask a question’ on your media player.

Today’s Presenters

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