Recent months have seen significant IRS and judicial developments affecting financial institutions and market participants, including new FATCA changes and proposed regulations on dividend equivalent payments under section 871(m). These new changes and their possible impact on affected taxpayers are discussed below.

FATCA Update

There have been a number of Foreign Account Tax Compliance Act (FATCA) related developments during the past year. As of June 2 2014, about 77,000 foreign financial institutions (FFIs) registered with the IRS to comply with FATCA and the list of FATCA-registered FFIs is expected to continue to grow. The implementation deadline is July 1 2014 and, as it approached, foreign entities were scrambling to determine if they are subject to FATCA and how to become FATCA compliant.

Noteworthy are also the two voluminous sets of final and temporary Treasury regulations issued on February 20 2014; IRS Notice 2014-33 (May 2 2014) to implement a FATCA "transition period"; and IRS Announcement 2014-17 (April 2 2014) to allow for intergovernmental agreements (IGAs) that are "entered into substance" between the US and various countries. Additionally, new lengthier versions of IRS Form W-8s have been released, with a new Form W-8BEN-E for entities.

Final and Temporary Treasury Regulations

The first set of final and temporary regulations made important modifica tions to the previous final FATCA regulations, while the second set coordinates the FATCA withholding regime with the pre-existing chapter 3 withholding rules, that is, the long-standing cross-border withholding tax rules. Some of the key elements of the updated regulations include (i) the accommodation of direct reporting to the IRS, rather than to withholding agents, by certain non-financial foreign entities regarding their substantial US owners; (ii) the treatment of debt securitisation vehicles; (iii) the treatment of disregarded entities as branches of foreign financial institutions; (iv) changes to the definition of the expanded affiliated group; and (v) transitional rules for collateral arrangements before 2017.

The new temporary regulations expanded the scope of the special exception for holding companies by including partnerships and other noncorporate entities in the holding company definition if substantially all of their activities consist of holding stock in one or more expanded affiliated groups (EAGs) that are non-financial groups. For an EAG to be a non-financial group, (i) it must satisfy a three-year annual passive income and asset test, and (ii) any members of the EAG that are FFIs must register with the IRS or establish a deemed-compliant FFI exemption.

Transition Period for Enforcement

Notice 2014-33 announced a transition period during calendar years 2014 and 2015 for the purposes of IRS enforcement and administration of the due diligence, reporting and withholding provisions of FATCA. Particularly, the IRS will take into account the extent to which certain foreign entities (typically FFIs or foreign entities that are otherwise reporting information directly to the IRS) and withholding agents have made good faith efforts to comply with FATCA requirements. Additionally, a withholding agent that has a pre-existing obligation falling under a new transitional rule will have additional time to determine whether the entity is a payee subject to FATCA withholding. A pre-existing obligation includes a contract, debt, or an equity interest maintained, executed, or issued by the withholding agent that is outstanding on June 30 2014. The Notice states that the IRS will be issuing amended regulations to allow a withholding agent or FFI to treat an obligation held by an entity that is issued, opened, or executed on or after July 1 2014 and before January 1 2015, as a pre-existing obligation. This provides substantial relief as any withholdable payment made before July 1 2016 with respect to a pre-existing obligation is not subject to withholding, unless, generally, the payee is a prima facie FFI or a non-participating FFI.

IGAs in Effect

In Announcement 2014-17, the IRS provided important and needed coordination between the FATCA regulations and the increasing number of IGAs. As of June 2 2014, nearly 70 jurisdictions have entered into IGAs with the US.

For an entity to analyse whether it is an FFI, it must first determine whether an IGA exists between the US and the entity's country of formation and, if so, look to the definition of an FFI under the IGA. Announcement 2014-17 states that, even though a number of countries and the US have not yet signed IGAs, certain jurisdictions reached agreements in substance with the US on the terms of an IGA and have consented to be included on the Treasury and IRS IGA list. These jurisdictions will be treated as having an IGA in effect, but will need to sign an IGA by December 31 2014 to continue to be included on this list.

Even though the IGA FFI definitions are typically similar to the FFI definition under the Treasury Regulations, if, for example, an exception to FFI status is narrower under an IGA than under the regulations, it is unclear which definition takes precedence. The Tax Executives Institute (TEI) May 5 2014 comments on the FATCA regulations discuss this very issue with the example that an IGA FFI definition may not provide for the treasury centre and holding company exclusions. Announcement 2014-17 further complicates a foreign entity's FATCA analysis. A foreign entity in a country with an IGA in effect must evaluate its status as an FFI under that IGA. However, what if that IGA's FFI definition is inconsistent with the treasury regulations and that country does not sign an IGA by December 31 2014 or signs an IGA that alters the foreign entity's status as an FFI? Which definition should the foreign entity rely on in the interim?

In short, even though the IRS has issued a great amount of guidance and updates during 2014, many grey areas still exist.

New Section 871(m) Proposed Regulations

Section 871(m) of the Code, enacted in 2010, sought to prevent certain abusive transactions involving notional principal contracts (NPCs) that enabled foreign persons to avoid US withholding tax on dividends. An offshore investor, typically in a non-treaty country, would substitute a derivative position with respect to US stock for direct ownership of the shares, and treat dividend equivalent payments on the NPC as foreign source and not subject to withholding. Section 871(m) overrides the normal foreign source rules and imposes withholding tax on "specified" NPCs and other "substantially similar" payments. Specified NPCs are those NPCs entered into under circumstances considered to be abusive: for example, where the long party sells the physical security to the counterparty at the time the NPC was created (known as 'crossing in') or receives the physical security back from the short party on termination of the NPC ('crossing out'). Beginning two years after enactment, section 871(m) also applies to dividend equivalent payments on all NPCs, unless regulations otherwise apply to narrow the rule to other specified classes of equity-based NPCs.

In December 2013, the IRS finalised earlier temporary regulations under section 871(m) requiring withholding on dividend equivalent payments with respect to "specified NPCs". The final regulations apply to payments with respect to NPCs accompanied by crossing in or crossing out, NPCs on non-publicly traded securities, and NPCs where the short party posts the underlying security as collateral with the long party.

More significantly, at the same time, the IRS issued new proposed regulations under section 871(m) that take a radically different approach to taxing US equity derivatives held by offshore investors. Previously, in regulations proposed in 2012, the IRS would have required counterparties to analyse whether a NPC or other equity derivative met one of seven factors indicative of abuse. The new proposed regulations jettison this anti-abuse approach in favour of a bright-line rule: any US equity derivative would be subject to section 871(m) if the correlation of its expected price movements with the underlying US shares reflects a delta of 0.70 or higher. These new rules would take effect for all payments on NPCs made on or after

January 1 2016. For other equity-linked instruments (ELIs) besides NPCs, the proposed regulations would apply only to positions acquired on or after January 1 2016.

As with the earlier IRS proposal, the proposed rules are not limited to NPCs, but rather would apply to a broad array of equity derivatives, including options, forward contracts, futures contracts, exchange-traded notes and convertible debt. The withholding tax would apply not only to actual dividend equivalent payments (as in an NPC), but also any "implicit" dividends that factor into pricing of the contract. For example, if the parties to a forward contract agree to give the long party credit for the expected quarterly dividends between the contract date and the delivery date, the long party will be treated as receiving dividend equivalent payments subject to section 871(m). In such cases, section 871(m) generally will apply to the extent of the dividends actually paid on the underlying security. Alternatively, the parties may contemporaneously document and rely on a reasonable estimate of the dividends, in which case the lesser of the actual or estimated dividends will control taxation under section 871(m). Where the delta is less than 1.0, only a percentage of the dividends equal to the delta times the dividends per share will be taxable under section 871(m).

The new rules would exempt from section 871(m) treatment those derivatives that relate to qualified equity indexes. Thus, offshore investors would continue to be able to use derivatives to obtain tax-efficient exposure to the general US equity market or a sufficiently broad-based index. The IRS's approach here parallels its published guidance concerning NPCs that relate to US real property assets.

Once the proposed regulations come into effect, parties to US equity derivatives will have an affirmative obligation to analyse application of section 871(m) and the amount of payments subject to withholding. Generally, if the derivative is between a broker or dealer and its customer, the broker or dealer will be the reporting party required to have to analyse section 871(m). The reporting party must make a determination as to whether section 871(m) applies, the tax to be withheld, and certain supporting information. This information must be furnished to the counterparty on request, and as with determinations of original issue discount, generally is binding on both parties.

The breadth of the proposed regulations has already drawn significant commentary. For example, the application of section 871(m) to convertible debt has been questioned, as there already exist comprehensive US tax rules to require dividend withholding on convertible debt in appropriate cases. It has also been observed that the proposed regulations can be read to apply to employee compensation (such as RSUs) that tracks dividends on the parent's stock.

It remains to be seen how the proposed regulations will be modified in the course of finalisation. However, barring another policy about-face by the government, it appears that the days of derivatives providing offshore investors with a tax-advantaged vehicle to invest in a dividend-paying share may soon be drawing to an end.

Case Law Developments

Recent months have seen some significant new case law. If read broadly, these decisions could have impact on areas outside the specific transactions at issue before these courts.

Pilgrim's Pride

This decision of the US Tax Court concerns the proper scope of IRC section 1234A, which treats gain or loss from the expiration, lapse, cancellation or other termination of certain contract rights and obligations as capital gain or loss. Before section 1234A, courts frequently held that a termination of a contract right (or obligation) produced ordinary income or deduction, on the ground that there was no "sale or exchange" of a capital asset.

The specific issue in the Pilgrim's Pride case was a corporate taxpayer's abandonment of shares in a minority-owned subsidiary. The taxpayer received no consideration (it simply walked away from the shares), and thus argued that its deduction was ordinary on the grounds that there was no "sale or exchange" of the stock necessary to produce a capital loss.

In a potentially sweeping decision, the Tax Court held that the taxpayer's loss was capital under section 1234A. Rejecting the taxpayer's argument that section

1234A was limited to contractual rights or obligations in the nature of a financial derivative, the Court read the words "right or obligation with respect to an asset" to include direct ownership of the shares themselves. Accordingly, the abandonment of the stock produced a capital loss because the taxpayer thereby terminated its rights with respect to the stock.

If the Court's analysis is correct and taken seriously, it could have interesting applications in other areas. For example, one issue that has arisen is whether a taxpayer applying mark-to-market accounting under section 475 is permitted to treat units of foreign currency as a "security" that is marked-to-market.

The statute does not list currency itself as a "security", but rather includes only "an evidence of an interest in, or a derivative financial instrument in . . . any currency." See section 475(c)(2)(E). Under Pilgrim's Pride, direct ownership of currency would seem to also constitute "evidence of an interest" or possibly even a derivative financial instrument with respect to currency, and thus become subject to mark-to-market accounting.

It is also possible to conjure up issues where the court's approach (which states that every asset is a right with respect to itself) could produce mischief for taxpayers or for the Service.

Principal Life Insurance

Here, the Court of Claims explored the murky area of income stripping transactions: that is, where the rights to income from an asset are separated from the residual or fee ownership.

Specifically, in one of the transactions at issue in Principal Life, the taxpayer stripped out and retained the rights to dividend income from money market mutual funds for many years, and while selling a third party the residual interest after the retained income term. The taxpayer sought to recover the full amount of its tax basis on the sale of residual, producing a large loss.

The Court of Claims rejected this claimed tax loss. It held that the taxpayer was required to allocate a ratable portion of its tax basis by fair market value to the income rights that had been retained. While this ultimate conclusion is not surprising, the court's reasoning calls into question some of the leading authorities involving the converse transaction: the sale of an income stream by a taxpayer that retains the residual ownership interest.

Generally, taxpayers and the IRS have treated the true sale of a right to future income as accelerating income to the year of sale, with no recovery of the seller's basis in the underlying property. This was the result, for example, in Estate of Stranahan, where a father seeking to benefit from excess investment interest expense sold the rights to a stated amount of future dividends on shares to his son for cash. In Stranahan, the court held that the sale shifted the dividend income to the son and resulted in current income recognition to the father. In Principal Life, the Court of Claims dismissed the taxpayer's reliance on Stranahan, and also suggested that the case was an "exception" and "isolated anomaly" rather than controlling authority.

Does this mean that a taxpayer selling rights to future income is not able to achieve the desired income acceleration? Does Principal Life have any impact on the purchaser? Given the limited authority in this area, taxpayers engaged in the sale or purchase of rights to future income stream would do well to review Principal Life and analyse whether it creates any risks to the intended tax treatment of such transactions.

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