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Exchange-Traded Notes: IRS Fires a Shot Across the Bow of "Wait and See" Taxation

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On December 7, 2007 the Internal Revenue Service ("IRS") and the Treasury Department ("Treasury") published Revenue Ruling 2008-1 ("Ruling") [1] and Notice 2008-2 ("Notice") [2] addressing the U.S. federal income tax treatment of prepaid forward contracts which include certain exchange-traded notes ("ETNs"). Viewed together, the Ruling and the Notice serve as a warning that the IRS is focused on whether the market's "wait and see" accounting system for ETNs and similar instruments is appropriate. However, the immediate impact will only be on a narrow class of single currency-linked ETNs.

As we have previously discussed, ETNs have collided, tax-wise, with exchange-traded funds ("ETFs") and mutual funds because the U.S. federal income tax treatment of ETNs is perceived by the financial markets to be more favorable than the U.S. federal income tax treatment of ETFs and mutual funds.[3] This is because most ETNs are treated as prepaid forward contracts rather than debt instruments under current law. As such holders generally adopt "wait and see" taxation: they do not include income on ETNs currently and report capital gain or loss when ETNs are sold.

Reports surfaced in October that the IRS and Treasury were studying the federal income tax treatment of ETNs. The IRS and Treasury have now concluded in the Ruling that a single currency-linked ETN should be characterized as a debt instrument, rather than a prepaid forward contract, for U.S. federal income tax purposes. Further, in the Notice, the IRS and Treasury have asked for public comments on a comprehensive list of tax issues regarding the U.S. federal income tax treatment of prepaid forward contracts including ETNs. This request for public comments comes as the tax treatment of ETNs has attracted scrutiny on Capitol Hill in recent weeks.

Revenue Ruling 2008-1

The Ruling discusses the characterization for U.S. federal income tax purposes of a three year instrument linked to the euro-dollar exchange rate (the "Instrument"). Pursuant to the terms of the Instrument, the holder ("Holder") delivers $100 to the issuer at inception, at which time $100 equals €75, in exchange for the payment at maturity of a U.S. dollar equivalent amount (determined at maturity) of (i) €75, and (ii) a euro-based compounded rate of return applied to €75, less a certain fee. The Holder's functional currency is the U.S. dollar. The Ruling goes out of its way to note that "there is a significant possibility" that the payment at maturity as determined in U.S. dollars "may be significantly less" than the payment at inception as determined in U.S. dollars.

The Ruling holds that the Instrument is a euro-denominated debt instrument for U.S. federal income tax purposes and that such characterization is not affected by whether the Instrument is privately offered, publicly offered or traded on an exchange. As a result, the interest accruing on the Instrument is taxable to the Holder on a current basis and any income realized by the Holder is taxed as ordinary income to the extent such income is attributable to accrued interest or foreign currency gains.[4]

No specific effective date or transition rules are mentioned in the Ruling, and, as a result the Ruling applies to all past, existing and future instruments with terms similar to those described in the Ruling.

What is striking about the Ruling is that the Holder does not have a fixed claim in U.S. dollars, its own functional currency. Thus, as noted above, the Ruling states that there is a "significant possibility" that the payment upon maturity as determined in U.S. dollars would be "significantly less" than the payment at inception as determined in U.S. dollars. In effect, the Ruling holds that the Instrument is characterized as a debt instrument for U.S. federal income tax purposes because it has the same economics as something that would be a debt instrument in a foreign currency. The Ruling, therefore, stands for the proposition that an instrument does not need to be characterized as debt from the perspective of the taxpayer's functional currency to be debt for U.S. federal income tax purposes.

Because the holding of the Ruling is limited to an instrument the payments on which are linked to a single foreign currency, it further raises the question how an instrument should be characterized if the payments on such an instrument are linked to a basket of currencies. The answer to this question will likely depend on the outcome of the process that the IRS and Treasury have started by issuing the Notice with the possible result that an instrument linked to a single foreign currency will be treated differently from an instrument linked to a basket of foreign currencies.

Notice 2008-2

In the Notice, the IRS and Treasury request public comments on a comprehensive list of tax issues regarding the U.S. federal income tax treatment of prepaid forward contracts if such contracts are not otherwise characterized as debt instruments for U.S. federal income tax purposes.[5] Although seemingly focused on prepaid forward contracts, it seems clear that this request has been triggered by the same concerns about ETNs as those that are being raised on Capitol Hill. The comprehensive list includes the following aspects:

- **Current Income / Expense.** The IRS and Treasury are considering whether the parties to prepaid forward contracts should accrue income / expense over the term of the contract. The Notice points out that this could be achieved through a mark-to-market methodology or through a method similar to the noncontingent bond method used for contingent payment debt instruments.
- **Character.** The Notice raises the issue of what the appropriate character of income accruals, if required, should be, what the character of amounts less than, or in excess of, such accruals should be and whether Section 1260 should apply to prepaid forward contracts. As the Notice points out, the character of income accruals can be capital or ordinary and the Notice raises the question whether any ordinary income should be classified as interest.[6]
- **Nature of Underlying Asset.** The IRS and Treasury question whether the tax treatment of a prepaid forward contract should depend on (i) the nature of the underlying asset (*e.g.*, equity vs. commodities), and (ii) whether the prepaid forward contract is listed on a futures or securities exchange.
- **International Aspects.** The Notice requests public comments as to the degree to which payments on prepaid forward contracts should be subject to withholding taxes if such payments are made to foreign holders. It further raises the issue of how prepaid forward contracts should be accounted for under the Subpart F regime and to what extent they should be treated as investments in "United States property" for purposes of Section 956.
- **Effective Dates and Transition Rules.** The Notice further requests input as to the appropriate effective dates of any future guidance and what kind of transition rules should apply.

In the short run, the Ruling and Notice will only impact a narrow class of current ETNs. However, in the long run, they mark the beginning of a high-stakes regulatory process that will closely examine "wait and see" taxation for ETNs, prepaid forwards and other similar instruments.

Footnotes:

[1] Revenue Ruling 2008-1, 2008-2 I.R.B. 1.

[2] Notice 2008-2, 2008-2 I.R.B. 2.

[3] Thomas A. Humphreys, Shamir Merali, Remmelt A. Reigersman, *The U.S. Tax Treatment of*

Exchange-Traded Notes – The Brewing Battle Between Mutual Fund Advisers and ETN Sponsors, November 2007, http://www.mofo.com/news/updates/files/13102.html

[4] Section 1.61-7(d) and Section 988. Section references are to the Internal Revenue Code of 1986, as amended, or Treasury Regulations promulgated thereunder.

[5] The deadline for submitting public comments on the tax issues raised by the Notice is May 13, 2008.

[6] Although it seems outlandish, arguing that an ETN ought to be treated in the same fashion as the underlying asset would mean that ETN holders could earn qualified dividend income ("QDI") eligible for 15% tax rate to the extent the underlying asset produces QDI.