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Advanced Swaps & Other Derivatives 2024 Derivatives Taxation

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The New IRS Form W-9

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Background: New Partnership Tax Reporting

- **Partnerships with interests in foreign partnerships may be required to complete and file Schedules K-2 and K-3**
- **Reporting is required if items of “international tax relevance” are passed through**
 - Information affecting FTCs (even if no foreign income is earned)
 - Information affecting foreign derived intangible income (FDII)
 - Subpart F and GILTI
 - PTEP from foreign corporations
- **Reporting is required if there are foreign partners (ECI & FDAP)**

Interaction of Schedules K-2 & K-3 with Form W-9

- **Partnerships with interests in lower-tier partnerships (& trusts) may not be able to complete Schedules K-2 & K-3 without receiving these Schedules from a lower tier partnership**
- **Upper-tier partnerships with foreign owners providing a Form W-9 to a lower-tier partnership must now check Box 3b**
- **If Box 3b is checked on the Form W-9, the lower-tier partnership must provide Schedules K-2 & K-3 to its partners**
- **Rules apply all entities taxable as partnerships (such as LLCs)**

Triggers to Checking Box 3b

- **Upper-tier partnership receives a Form W-8 from a partner or otherwise knows it has a non-US partner**
- **Upper-tier partnership receives a Form W-9 with Box 3b checked**

Pre-New Form W-9 Tiered Partnerships

- **Schedule K-2 & K-3 reporting began in 2022 for tax years beginning on or after 1/1/2021**
- **Upper-tier partnerships in existence in March 2024 are not required to provide a new Form W-9 to the lower tier partnership**
- **Lower-tier partnerships do NOT have a due diligence requirement to determine whether upper-tier partnership has foreign partners**
- **In these cases, the upper-tier partnership might not have sufficient information to complete Schedules K-2 & K-3**

Cryptocurrency Tax Reporting

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Latest Update on Cryptocurrency Tax Reporting

- **2021 US tax legislation required the IRS to promulgate rules for expanded tax reporting for “brokers” who facilitate cryptocurrency transactions in 2023 and after.**
 - **The question as to who constitutes a broker for this purpose has generated considerable Congressional and industry attention**
- **Final regulations were issued in July 2024, effective for transactions in 2025 (2026 reporting). Basis information must be gathered starting in 2026. A new IRS Revenue Procedure provides guidance.**
- **IRS Notice 2024-56 provides penalty relief for reporting of 2025 transactions for brokers making “good faith” efforts**

Transactions That Will Be Subject to Information Reporting

- **Dispositions of digital assets will be subject to information reporting:**
 - Cash
 - Digital assets for other digital assets that “differ materially in kind or extent”
 - Stored value cards
 - Broker services (including gas fees)
 - Property that itself is subject to information reporting (securities and real estate)

The New Form 1099-DA

- **In August 2024, the IRS released the second proposed version of the reporting form.**
- **This form removes the requirement to report transaction ID, the taxpayer's wallet address & time & date of the transaction.**
- **New boxes were added to report stablecoin and NFT transactions.**
- **Unhosted wallet provider information was removed from the Form.**

Transactions Exempt From Information Reporting

- **Exempt transactions include:**
- **Loans of cryptocurrencies**
- **Wrapping & unwrapping transactions**
- **Liquidity provider transactions**
- **Short sales**
- **Swaps**
- **De minimis transactions (<\$10,000); \$600 for stablecoins**

Rules for Cryptocurrency Derivatives

- **Dual reporting will not be required. Derivatives will be reportable either as a security or a cryptocurrency, but not both.**
- **Derivatives will be characterized crypto if the derivative trades on the blockchain.**
- **Derivatives will be characterized as securities if the derivative itself is not blockchain traded.**
- **The asset subject to the derivative will play no part in the characterization of the derivative.**
- **Derivatives physically settled in crypto will be subject to reporting.**

More on Cryptocurrency Derivatives

- **Trading on private or permissioned ledgers will be subject to reporting.**
- **Trading subject to reporting will include orders filled from dealer inventory as well as open market transactions.**
- **Digital asset reporting will take precedence over reporting for regulated futures contracts.**
- **Digitized financial assets will be subject to digital asset reporting only.**
- **Digitized real estate transactions will be subject to real estate reporting only.**

Determining When a Person Is a Digital Asset Broker

- **Broker must take possession of digital assets to be required to report.**
 - **Excludes non-custodial brokers (DeFi platforms & unhosted digital wallet providers)**
- **List of Persons treated as brokers include:**
 - **Digital asset platforms**
 - **Payment processors**
 - **Hosted wallet providers**
 - **Cryptocurrency issuers that regularly offer to redeem their coins (such as stablecoin issuers)**
 - **Digital Asset Middlemen**

Digital Asset Middlemen

- **Digital asset middlemen will include DAOs, whether or not the DAO is formed as an entity or just a collection of governance tokens.**
- **Any person who provides facilitative services that effect sales of digital assets by customers.**
- **Any person who controls payment asset services.**
- **Persons who facilitate the purchase and sale of securities and real estate with digital assets.**

Exemptions from Digital Asset Broker Status

- **Merchants that accept digital assets as payment for goods and services.**
- **Miners**
- **Stakers**
- **Hardware sales**
- **Software licensing**
- **Unhosted wallet providers**

Exemptions for Foreign Transactions

- **Location of transactions is determined with reference to the residence of the broker and customer.**
 - **Office location is irrelevant**
- **Broker must perform the acts necessary to complete the transaction from outside of the US and the instructions to complete the transaction must emanate from outside of the US.**
- **Any indication that the client is a US person will trigger reporting.**

Information to Be Reported

- **Name, address and taxpayer identification number of the payer;**
- **Gross proceeds (dollars or fair market value of goods and services, reduced by one-half of transaction costs);**
- **Final regulations permit aggregate (vs. transaction-by-transaction) reporting**
- **Consideration received for the cryptocurrency; and**
- **Information regarding the digital wallet from which payment is received or deposited**

New Focus on Creation-Redemption Transactions

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Some Background

- **Both open-end and closed-end mutual funds (ETFs) are entitled to a special tax advantage: The funds can redeem their shares for appreciated securities without being subject to tax on the appreciation.**
- **The shareholder receiving the appreciated securities takes a fair market value basis in the securities received in the redemption. It then sells the securities.**
- **Example: Bank buys \$1,000x of closed end mutual fund shares in the open market. Fund distributes securities with a basis of \$600x and a fair market value of \$1,000x. Neither the Fund nor the shareholder recognize gain or loss.**
- **Only SEC “authorized participants” can receive the appreciated securities in a non-pro rata distribution.**

Current Market Practice

- **Towards year-end, brokers buy stock directly from the mutual fund (the “Creation Transaction”)**
- **After some time has gone by, the RIC redeems the stock from the broker (the “Redemption Transaction”)**
- **Sometimes, the broker holding period is short. These transactions have sometimes been called “heartbeat” transactions because the broker only holds the shares for a heartbeat.**
- **The transactions serve to protect shareholders from being taxed on gains that can be attributable to shareholders who sell shares before the mutual fund shares before the RIC sells the appreciated securities.**

Tax Risks Presented by Current Practice

- There is a risk that the IRS could assert that the broker is not actually a RIC shareholder, but is acting as an agent of the RIC in selling the appreciated securities.
- There is a related risk that the IRS could assert that the creation-redemption transaction lacks economic substance.
- Primary risk is borne by the RIC, but the broker could be considered to have facilitated a tax avoidance transaction.
- In 2005, the IRS “blessed” the use of the tax rule by ETFs whose share prices did not reflect the ETF net asset value (NAV)

New Market Strategy

- **Some RICs buy long call options and sell put options on a single stock, creating a synthetic physical position.**
- **The RIC then sells call options and buys put option on the same stock. This creates a synthetic short position.**
- **The RIC's economic position is neutral.**
- **All options have the same strike and expiration date.**
- **The RIC then distributes the gain positions in a creation-redemption transaction and sells the loss positions and recognizes the loss.**

Tax Court Decision Provides ESOP Opportunity

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Some Background o the Sale to the ESOP

- **Employee Stock Ownership Plan (ESOP) rules allow a shareholder to sell their stock to an ESOP, invest the proceeds in qualified replacement securities & not pay tax on the sale to the ESOP.**
- **In many cases, a financial institution loans cash to the company for 2 notes – a long-term note and a short-term note.**
- **The company then loans the cash to the ESOP.**
- **The ESOP uses the cash to redeem the shareholder’s stock.**
- **The shareholder loans cash to the company in an amount equal to the short-term note.**
- **The company repays the short-term note.**

Qualified Replacement Property

- **In practice, many founders buy floating rate notes (FRNs) issued by financial institutions as qualified replacement property**
- **The founders then pledge the FRNs as security for a loan**
- **The loan proceeds are used to invest in stocks and securities**
- **The stocks and securities can be sold without triggering the gain realized (but not recognized) on the sale of the company stock for the FRN**

Berman v. Commissioner (July 2024)

- **ESOP issued its promissory note for the founder stock. Change from market-standard format.**
- **Founders then purchased FRNs with their own cash and the proceeds from loans (no pledge of the ESOP notes)**
- **Founders then “pledged” the FRNs to an unscrupulous promoter. This “pledge” was treated as a sale for tax purposes.**
- **Founders used the proceeds from the loan against the FRNs to buy a diversified portfolio of stocks and securities.**

Berman v. Commissioner (July 2024)

- **Since the pledge of the FRNs was treated as a sale for tax purposes, the taxpayers recognized gain on the sale to the ESOP.**
- **Taxpayers successfully asserted that they should be allowed to use the installment method for reporting gain on the sale to the ESOP.**
- **As a result, taxpayers only paid tax on cash received on the notes issued by the ESOP instead of all of the gain inherent in the stock that was sold to the ESOP.**
- **The FRNs had a fair market value basis (reduced by the gain recognized in the installment sale). Accordingly, only de minimis gain was recognized on the sale of the FRNs.**

Thank you!

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