

US capital markets

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Exchange-traded notes

In our last column (Tax disputes, *IFLR* December 2007) we discussed the battle brewing over the US federal income tax treatment of exchange-traded notes (ETNs). Since then the US Internal Revenue Service (IRS) and the US Treasury Department have published Revenue Ruling 2008-1 and Notice 2008-2 and new legislation has been introduced in the US House of Representatives by Congressman Neal, all addressing the US federal income tax treatment of certain ETNs. As discussed in our previous column, most ETNs are treated as prepaid forward contracts rather than debt instruments under law. As such, investors generally adopt wait-and-see taxation – that is, they do not report income or gains until the ETNs are sold.

The IRS and Treasury have concluded in the Ruling that a single, currency-linked ETN should be characterised as a debt instrument rather than a prepaid forward contract for US federal income tax purposes. As a result, interest accruing on the debt instrument is taxable to the holder on a current basis and any gains are taxed as ordinary income to the extent attributable to accrued interest or foreign currency gains. Because the holding of the Ruling is limited to instruments linked to a single foreign currency, it raises (and leaves unanswered) the question of how an instrument should be treated if payments are linked to a basket of currencies.

In the Notice, the IRS and Treasury have asked for public comment on a comprehensive list of tax issues regarding the US federal income tax treatment of prepaid forward contracts (including ETNs) generally. The list includes whether the parties to prepaid forward contracts should accrue income and expense over the term of the contract; whether the character of income should be ordinary or capital; whether the tax treatment of a prepaid forward contract should depend on the nature of the underlying asset or on the fact that the forward contract is listed on an exchange; and whether payments on prepaid forward contracts should be subject to withholding taxes if made to foreign holders. Public comments on these issues

may be submitted before May 13 2008.

Lastly under the Bill introduced by Neal, a holder of a prepaid forward contract acquired after the Bill's enactment into law would be required to include interest income in an amount equal to the product of his adjusted basis in the instrument at the beginning of the year and the monthly federal short-term rate for the first month ending during that year. The amount of interest income to be included with respect to a publicly traded prepaid forward contract, such as an ETN, would be capped at the difference between the fair market value of the ETN at the end of the year and the holder's adjusted basis in the ETN at the beginning of the year, plus any distributions received during the year. The Bill does not affect issuers of ETNs.

The Ruling and Notice are expected to affect a narrow set of ETNs, whereas the Bill would affect most if not all ETNs. At the time of writing, it is not possible to predict whether the legislation will be enacted in its proposed form, or whether any other legislative action may be taken in the future that may adversely affect the taxation of instruments such as ETNs. It is also not possible to predict with certainty whether any such legislation may apply on a retroactive basis, although it has been reported in the professional press that a senior member at the Treasury has indicated that any guidance issued should not be expected to apply retroactively. At the least, this marks the formal beginning of a high-stakes regulatory and, possibly, legislative process that can be expected to closely examine wait-and-see taxation for ETNs, prepaid forwards and similar instruments. This brewing battle promises to continue to simmer over the coming months.

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