INVESTMENT COMPANY INSTITUTE

MEMO# 22025

December 11, 2007

IRS Issues Guidance on Exchange-Traded Notes, Comments Requested

[22025]

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TO: TAX COMMITTEE No. 50-07 RE: IRS ISSUES GUIDANCE ON EXCHANGE-TRADED NOTES, COMMENTS REQUESTED

The Internal Revenue Service has issued guidance (attached) regarding the tax treatment of exchange-traded notes ("ETNs"). Specifically, the IRS issued Rev. Rul. 2008-1, which holds that a foreign currency-based ETN is debt for U.S. tax purposes. The IRS also issued Notice 2008-2, which requests comments from the public regarding the proper tax treatment of prepaid forward contracts (sometimes referred to as ETNs).

Rev. Rul. 2008-1

In Rev. Rul. 2008-1, the IRS treats as debt for U.S. tax purposes an instrument that provides an economic return that is determined by reference to foreign currency. Pursuant to the instrument, the holder delivered $100 to the issuer on January 1, 2007, in exchange for the issuer's obligation (the "Instrument") to deliver to the holder in three years the U.S. dollar equivalent of an amount of euros. The U.S. dollar equivalent amount is determinable at the end of the three-year period and is the sum of the following amounts translated into U.S. dollars at the spot rate on January 1, 2010: (i) 75 euros, and (ii) an amount of euros calculated by reference to a compound stated rate of return applied to 75 euros from January 1, 2007, until January 1, 2010. The compound stated rate of return is the excess of a rate based on euro interest rates over a rate labeled as a "fee" for the benefit of the issuer. The spot rate of exchange on January 1, 2007, was $1 = 0.75 euros. The U.S. dollar equivalent amount to be paid by the issuer also may be determined by reference to a mathematical formula that generates the same substantive effect as the methodology described above.

The holder and the issuer expect that the issuer will pay the U.S. dollar equivalent amount on January 1, 2010. The legal remedies provided in the Instrument are not materially different than legal remedies associated with instruments that are debt for federal income tax purposes. There is a significant possibility that the U.S. dollar equivalent amount payable by the issuer on January 1, 2010, may be less than $100.

The IRS points to a line of court cases that have held that payments to be made in a foreign currency (also called a nonfunctional currency) can be debt for U.S. federal income tax purposes. The ruling also notes that section 988 and regulations thereunder provide that the acquisition of a debt instrument or becoming the obligor under a debt instrument is a section 988 transaction if the amount that a taxpayer is entitled to receive or is required to pay is determined by reference to the value of a nonfunctional currency. The ruling finds that these provisions indicate that a financial instrument, all the payments of which are determined by reference to a single currency, can be debt, notwithstanding the fact that (a) all actual payments due under the instrument are made in a different payment currency, and (b) the amount of the different payment currency that the issuer pays at maturity may be less than the amount of the different payment currency that was initially advanced.

The ruling states that the Instrument, in form, resembles a U.S. dollar denominated derivative contract in which the holder prepays its obligations under the contract and is entitled to receive a return based exclusively on the value of property at maturity (i.e., a prepaid forward contract). The amount payable at maturity on the Instrument, however, is determined exclusively by reference to (i) the U.S. dollar value of the euros at issuance and maturity, and (ii) market interest rates in respect of the euro. The fact that intervening currency fluctuations may cause the amount of U.S. dollars that the holder receives at maturity to be less than the amount of U.S. dollars that the holder paid for the instrument does not affect the characterization of the Instrument as debt, which is based on an analysis of payments with respect to the euro.

Therefore, the IRS ruled that the Instrument is euro-denominated indebtedness of the issuer. This result is not affected if the instrument is privately offered, publicly offered, or traded on an exchange.

Notice 2008-2

Notice 2008-2 requests public comments regarding the proper tax treatment of prepaid forward contracts (referred to as ETNs in certain circumstances). These transactions resemble typical forward contracts, but the purchase price is paid in advance of future delivery or cash settlement. Thus, these transactions typically involve an initial payment by one party in exchange for a promise of either (1) a future delivery of a particular asset or group of assets, or (2) a future payment determined exclusively by reference to the value of such assets.

In particular, the IRS is considering whether the parties to a prepaid forward contract should be required to accrue income or expense during the term of the transaction, if the transaction is not otherwise considered debt for U.S. federal income tax purposes. The IRS also is considering a number of other issues associated with these transactions, including:

- The appropriate methodology for accruing income or expense, if deemed appropriate (e.g., mark-to-market or a method resembling the noncontingent bond method);
- How an accrual regime might be designed so that it does not inappropriately or inadvertently cover routine commercial transactions involving property sales in the ordinary channels of commerce;
- The appropriate character of any income accruals required under such an accrual regime, as well as the character of amounts less than, or in excess of, these accruals;
- Whether the tax treatment of the transactions should vary depending on the nature of the underlying asset;
- Whether the tax treatment of the transactions should vary depending on whether the transactions are (i) executed on a futures exchange, or (ii) memorialized in an instrument that is traded on a securities exchange;
- Whether the transactions should be treated as indebtedness pursuant to regulations issued under section 7872;
- Whether section 1260 applies, or should apply;
- The degree to which such transactions (and any income accruals that may be mandated) should be taxed under sections 871 and 881;
- How the income with respect to such instruments should be treated for purposes of section 954;
- How investments in such contracts should be treated under section 956;
- Whether there are other issues that should be considered with respect to these transactions;
- Identifying arrangements similar to prepaid forward contracts that should be accorded tax treatment similar to that of prepaid forward contracts; and
- Appropriate transition rules and effective dates.

Request for Comments

The IRS has requested comments regarding the tax issues described in the Notice. Comments must be submitted to the IRS by May 13, 2008. We will discuss the IRS guidance and any comments on our next monthly Tax Committee call, scheduled for Wednesday, December 19. [1]

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Attachment

endnotes

[1] See Institute Memorandum (22020) to Advisor Distributor Tax Issues Task Force No. 22-07 and Tax Committee No. 49-07, dated December 7, 2007.

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