Derivative Tax Challenges: Navigating the Changing IRS Rules on the Treatment of Swaps and Futures

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Derivative Tax Challenges: Leveraging New IRS Regs for Swap Transfers and Navigating IRC 1256 Contracts

January 22, 2014

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Agenda

- Section 1256 Contract Developments: Proposed Regulations and Other Developments
- Swap Considerations: Swap Assignment Regulations and Upfront Payment Classification Issues
- Code §871(m) Equity Derivative Withholding Regulations
Section 1256 Contract Developments: Proposed Regulations and Other Developments
How are Derivatives Taxed?

- There is not a uniform set of tax rules for derivatives
- Tax character and timing depends – in part – on the type of derivative
  - futures contracts
  - forward contracts
  - options
  - notional principal contracts (swaps, caps or floors)
Code §1256

☐ Certain derivatives are classified as Section 1256 Contracts and are subject to special character and timing rules

☐ Derivatives that are not classified as Section 1256 Contracts are generally taxed as open transactions and subject to the tax character principles of Code §§1234 or 1234A

- special accrual accounting and tax character rules are provided for “notional principal contracts”

- special tax character rules are provided for derivatives classified as Section 988 Transactions under Code §988
Code §1256

- Code §1256 applies only to derivatives classified as Section 1256 Contracts and imposes two special rules:
  - the 60/40 Rule (capital gain or loss)
  - the Mark-to-Market Rule

- Exceptions to the 60/40 Rule include:
  - tax hedges under Code §1221(a)(7)
  - certain FX transactions considered “section 988 transactions”

- Exceptions to the Mark-to-Market Rule include:
  - tax hedges under Code §1221(a)(7)
What are Section 1256 Contracts?

Section 1256 Contracts are limited to five types of derivatives:

- Regulated futures contracts
- Listed nonequity options
- Foreign currency contracts
- Listed dealer equity options (single stock and narrow-based stock indices)
- Dealer securities futures contracts (single stock and narrow-based stock indices)
Regulated Futures Contracts Defined

- Regulated Futures Contracts are limited to contracts that are:
  - traded on or subject to rules of a qualified board or exchange and
  - subject to a system of daily mark-to-market (variation margin requirement)
What is a Qualified Board or Exchange?

- A qualified board or exchange is limited to:
  - a national securities exchange registered with the Securities and Exchange Commission
  - a domestic board of trade designated as a contract market by the CFTC
  - any other exchange, board of trade, or other market the Secretary determines has rules adequate to carry out the purposes of Code §1256
- there are currently a limited number of foreign exchanges designated as QBEs under this category
Section 1256 Contract Classification and Transition Issues

- **Intercontinental Exchange ("ICE")**
  - Effective October 15, 2012, transitioned energy contracts from its CFTC designated “exempt commercial market” to either ICE Futures US or ICE Futures UK (each of which is a CFTC “designated contract market”)
  - Open contracts were transferred

- **Nodal Exchange**
  - Effective September 30, 2013, Nodal’s CFTC designation changed from an “exempt commercial market” to a “designated contract market”
  - Extended to all Open Interests
Section 1256 Contract Classification
Issues: “Swaps” Distinguished

- Many swaps are taxed as “notional principal contracts,” defined in Reg. §1.446-3(c) as:
  - a financial instrument providing for two or more payments by one party to the other at specified intervals based on a notional (hypothetical) principal amount multiplied by an index based on objective financial information
Which Financial Products are Taxed as NPCs?

- Includes interest rate swaps, currency swaps, commodity swaps, equity swaps, and similar agreements
  - under 2011 proposed regulations would also include certain credit default swaps and weather swaps

- Includes option-like products with multiple payouts (caps and floors)

- Under existing Treasury regulations, excludes contracts calling for a single settlement payment, such as futures, options, forwards, and bullet swaps
Dodd-Frank Wall Street Reform and Consumer Protection Act

- Dodd–Frank, when fully implemented, will require that certain “swaps” be cleared and potentially traded on a registered exchange
- An end-user exception from exchange clearing and trading is provided in limited cases
- How will Dodd-Frank impact tax classification?
  - Congressional Budget Office scored the derivatives part of the Senate version of the bill as losing over $1 billion because taxpayers were expected to take the position Code §1256 is applicable.
Dodd-Frank Act “Swaps” Exclusion

- New Code §1256(b)(2) applies for tax years beginning after 2010
- Excludes the following from Section 1256
  Contract Classification: interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement
2011 proposed regulations relating to Code §1256(b)(2) and Treas. Reg. §1.446-3
- interprets the Dodd-Frank swaps carve out as applying only to NPCs and options on NPCs
- application to traditional options remains unclear
- would narrow number of contracts considered Section 1256 Contracts if a “deemed payment rule” is adopted
- includes an ordering rule providing that if a derivative is both a futures contract and an NPC, NPC classification prevails
Section 1256 Contract Classification Uncertainty

- Cleared swaps
- Swap futures
Agenda

Swap Considerations: Swap Assignment Regulations and Upfront Payment Classification Issues
Notional Principal Contracts: Three Categories of Payments

- NPCs are not taxed as Section 1256 Contracts, meaning Mark to Market and 60/40 Rules do not apply.
- Under the NPC regulations, different tax character and timing results for:
  - Periodic payments
  - Nonperiodic payments
  - Termination payments
Notional Principal Contracts: Periodic Payments

- Periodic payments: payments required to be made at periodic intervals of one year or less throughout the entire term of the contract

- General timing rule: amortize pro rata (daily) portion of periodic payments (year-end accrual)
  - This accrual method of accounting applies to all taxpayers
  - Accruals will approximate annual cash flows, but is not exact

- General character rule: ordinary income and deductions
Notional Principal Contracts: Nonperiodic Payments

- Nonperiodic payments: any NPC payment that is not a periodic payment or termination payment
  - Includes upfront premiums for off-market swaps, premiums for caps/floors, payments at irregular intervals, and end of term payments (total return or “bullet” swaps)
- General timing rule: amortize upfront nonperiodic payments over life of contract
- General character rule: ordinary income and deductions
- Potential embedded loan treatment for “significant” nonperiodic payments
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Notional Principal Contracts: Termination Payments

- Termination payments: payments made to assign or early terminate a NPC
- General timing rule: termination payments are generally recognized only upon assignment/termination (not subject to accrual principles)
- General character rule: depends on tax character of underlying asset (Code §1234A)
NPC Timing Rules -- Assignments

- Special issues for assignments under Code §1001
  - Proposed NPC regulations (1991) originally said non-assigning party had a taxable exchange
  - Final NPC regulations left issue to Code §1001 regulations
  - Dodd-Frank and changes to bank regulatory rules meant that many customer transactions would be novated (assigned) from one legal entity to another
NPC Assignment Transactions

- Possible assignment transactions include:
  - Assignment to central clearing organization, so swap becomes cleared
  - Assignment to affiliate of dealer
- Assignments require consent of counterparty

- Reg. § 1.1001-4 (obsolete) addressed assignments only in certain circumstances
  - Dealer-to-dealer assignments
  - “the terms of the contract permit the” assignment
NPC Assignment Tax Consequences

- Application of prior Reg. § 1.1001-4 was not certain:
  - Is a clearinghouse a “dealer”?  
  - Does the consent requirement mean that an assignment is not “permitted” under the terms of the contract?

- If assignment were taxable, taxpayers might refuse to move their derivatives positions:
  - Gain would be taxable
  - Loss might not be deductible
  - Integration elections would be terminated
New Regulations for NPC Assignments

- Under Reg. §1.1001-4 (2013), an assignment is not treated as a deemed exchange by the non-assigning party if:
  - Both assignor and assignee are either a dealer or a clearinghouse;
  - The terms of the derivative contract permit the assignment of the contract, whether or not the consent of the non-assigning counterparty is required; and
  - The terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange under Code §1001.
Nonperiodic payments are made to compensate one party to a swap for off-market payments.

Example: Assume that in an at-market interest rate swap, Party A would pay 5% x notional principal amount and Party B would pay LIBOR x the same NPA, for 5 years.

- But Party A wants to pay 4%
- Party B will not enter into the swap unless Party A makes an upfront payment to B to compensate B for receiving 4% instead of 5%
If there is a “significant” nonperiodic payment, under Reg. §1.446-3(g)(4),

- The payment is treated as a loan by the payor to the payee
- The loan is treated as paid back by the payee to the payor in installments (with interest) over the term of the swap
- The swap is restated as a swap with at-market payments (including amounts equal and offsetting to the deemed loan payments)
NPCs: Why Deemed Loans Matter

- A deemed loan could give rise to one or more of the following:
  - Complex calculations that do not correspond to financial accounting treatment
  - Withholding tax
  - Information reporting
  - UBTI (for tax-exempt counterparties)
  - Interest expense allocation/FTC issues

- Special rule for section 956: IRS may treat any nonperiodic swap payment as a loan
  - A deemed loan from a CFC to a US affiliate gives rise to an investment in United States property and a potential deemed dividend from the CFC
A nonperiodic payment may be made in many situations:

- Taxpayer wants to match the terms of an asset or obligation that it is hedging
- NPC is of a type that has coupons that are not market-level coupons (examples: credit default swaps, MAC swaps)
- Taxpayer takes delivery of swap in settlement of a futures contract
- Taxpayer assigns NPC in taxable transaction
NPCs: When Is A Nonperiodic Payment "Significant"?

- We don’t know.

- Regulations give examples that indicate:
  - Nonperiodic payment that is <10% of at-market fixed-rate payments is not "significant"
  - Nonperiodic payment that is >40% of at-market fixed-rate payments is significant
  - But these are only examples
  - And there is a big gap between 10% and 40%
Cleared Swaps

- When a swap is cleared:
  - A central counterparty becomes the legal counterparty to both sides of the transaction
  - Both parties must provide “initial” margin
  - The parties also pay or receive daily “variation margin” (collateral for the in-the-money value of the NPC)
Cleared Swaps with Nonperiodic Payments

- When a swap with an upfront nonperiodic payment is cleared:
  - One party (Party A) makes the upfront payment to the other (Party B), through the clearinghouse
  - Party B pays the same amount to Party A as variation margin, through the clearinghouse

- Is there a deemed loan here? Should there be?
If Party A is a CFC, and Party B is a US affiliate, does an upfront payment paid by Party A on a cleared swap give rise to a deemed loan?

Under Temp. Reg. §1.956-2T, the answer is no, provided that:

- Party A is a dealer
- The swap is cleared by a clearinghouse that is a US-regulated entity
- Party A makes the nonperiodic payment to Party B and Party B makes the offsetting variation margin payment to Party A, as specified in the regulations
NPCs with Significant Nonperiodic Payments in Other Contexts

- Preamble to Temp. Reg. §1.956-2T does not provide any theory or reasoning
- Regulations are based on considerations specific to section 956 and cleared swaps

- Alternative theories for concluding there is no deemed loan:
  - Netting?
  - Integration of swap and margin?
  - Other?
Agenda

Code §871(m) Equity Derivative Withholding Regulations
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The HIRE Act provides that a “Dividend Equivalent Payment” on a swap will be treated as a dividend from U.S. sources if:
- The stock referenced in the swap is a US stock and
- Swap is a “specified notional principal contract.”

Dividend equivalents also include manufactured dividend payments made in securities lending transactions over US stocks.

Dividend equivalents are subject to the same withholding rules as actual dividends.
What is a Specified Notional Principal Contract?

- In connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract (“crossing in”).
- In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract (“crossing out”).
- The underlying security is not readily tradable on an established securities market. (Pink Sheets?)
- In connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.
- The contract is identified by Treasury as a Specified Notional Principal Contract.
Netting and Withholding

- Dividend equivalent payments are to be computed on a gross basis.
- The fact that a dividend equivalent is subsumed or reduced by a funding payment made by the long party to the swap does not reduce or alleviate the obligation of the short party to withhold against the full amount of the dividend equivalent.
- Non-US payers of dividend equivalents are required to withhold & remit tax to the Internal Revenue Service in the same manner as US payers of dividend equivalents.
  - The rules cannot be skirted by having a non-US branch or party as the short swap party.
- ISDA had prepared a “HIRE Act Protocol” pursuant to which dividend withholding taxes would not be treated as a Indemnifiable Tax under a swap.
- ISDA Tax Representations had been amended to ask long party to represent that it would not sell referenced stock on the date of the swap opening or buy referenced stock on date of stock closing.
Broadened the definition of Specified NPC beyond the statute.

Under proposed regulations, an NPC containing any one of the following seven criteria would be a Specified NPC (7 Deadly Sins)

1. The Long Party is “in the market” on the Issuance or Termination Date
2. The Underlying is not “Regularly Traded”
3. The Underlying is posted as Collateral by the Short Party
4. Swaps less than 90 days
5. The Long Party controls the counterparty’s hedging
6. The NPC represents a significant percentage of the trading volume

Swap are specified NPCs if either:

a) It references 5% of the public float OR
b) It references more than 20% of the 30 day average trading volume of the underlying

The NPC provides for a payment of a Special Dividend

The NPC is entered into on or after the announcement of a special dividend but before the ex-dividend date for such dividend

A special dividend is a “nonrecurring payments to shareholders” that is in addition to a recurring dividend.

The proposed regulations provide that a payment determined by reference to an estimate of an anticipated dividend (not yet announced) is not a dividend equivalent so long as it does not reference or adjust to the amount of actual dividend.
Time line 871(m) code and regulations

MARCH 2010
- HIRE Act (which included Section 871(M) enacted. Rules immediately effective for securities lending transactions & specified NPCs.

JANUARY 2012
- Temporary & Proposed Regulations (“Seven Deadly Sins”) issued to be effective in March 2012.

MARCH 2012
- IRS postpones effective date of 2012 proposed regulations to January 2013

AUGUST 2012
- IRS revokes 2012 proposed regulations.
- Extends 4-filter definition of Specified Notional Principal Contract to payments made before January 1, 2014

DECEMBER 2013
- Final & 2013 Proposed regulations issued
- 4 filter test extended through 2015
- “Delta” testing for payments made or accrued beginning in 2016
## Proposed Regulations: The Delta Standard

- **Effective Dates** -- proposed to be effective for payments made **on or after 1/1/2016** (no grandfathering)
  - Special effective date for equity-linked instruments ("ELIs") -- proposed to apply only to payments made on ELIs that are acquired by a non-US person on or after 05 March 2014

- Delta-based standard applies to swaps and ELIs -- a Specified NPC or specified ELI is any NPC or ELI that has a delta of 0.70 or greater when acquired by the client
  - The "delta" of an NPC or ELI is the ratio of the change in the FMV of the NPC or ELI to the change in the FMV of the property referenced, determined in a commercially reasonable manner
  - The delta calculated for non-tax business purposes ordinarily is treated as the delta for § 871(m) purposes
  - A delta not reasonably expected to vary during the term of the transaction is treated as a delta of 1.0
  - Delta is tested on the date of acquisition by a non-US person
  - Note that an instrument, such as an option, may have a delta of less than 0.70 when issued, but if it has a delta of greater than 0.70 when acquired by a non-US person, the exchange or counterparty could have a withholding obligation when making payments to the non-US person.
What is an Equity-linked Instrument?

- Equity Linked Instruments -- defined broadly to include any financial transaction that references the value of one or more underlying securities, including forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments with payments linked to underlying securities.

- Equity linked debt instruments with a delta > 0.7 are not treated as passing through dividend equivalents but contingent interest may still be subject to withholding because interest linked to dividends on US stocks will no longer qualify for the portfolio interest exemption.

- Bifurcation Rule -- a transaction referencing more than one underlying security must be evaluated with respect to each underlying security without taking into account the other underlying securities, and may be a § 871(m) transaction with respect to one or more underlying securities referenced (except in the case of a qualified index).

- Combination Rule -- where client enters into two or more transactions that reference the same underlying security in connection with each other (even if months apart), the transactions may be treated as a single transaction for purposes of § 871(m) (e.g., put/call combinations).
  - A withholding agent is not required to withhold in this case unless the withholding agent knows that the counterparty entered into the transactions in connection with each other.
Dividend Equivalent Payments

- Dividend Equivalent Payments include any payment that references (i.e., is directly or indirectly contingent upon or determined by reference to) a U.S. source dividend payment that is a (a) substitute dividend made pursuant to a securities lending or sale-repurchase, (b) a payment pursuant to an SNPC, (c) a payment pursuant to an Specified ELI, or (d) any other substantially similar payment.

- A Dividend Equivalent Payment includes any gross amount that references a U.S. source dividend and is used to compute any net amount transferred to or from the client even if the client makes a net payment to the dealer or the net payment is zero.

- Payment is treated as made on the date the amount of the Dividend Equivalent Payments is fixed.

- Explicitly treats estimated dividend payments as Dividend Equivalent Payments, eliminating the exception for expected dividend payments in the 2012 proposed regulations.

- Includes implicit dividends such as contractual terms that are calculated based on an actual or estimated dividend (e.g., single stock futures).
The Amount of the Dividend Equivalent

- Securities lending or sale-repurchase -- the actual dividend paid on the underlying security multiplied by the number of shares transferred pursuant to the transaction.

- Specified NPC or Specified ELI – the dividend with respect to the underlying security multiplied by the number of shares referenced (subject to adjustment) multiplied by the corresponding delta at the time that the amount of the dividend equivalent is determined (which may be 1 if > 0.70 & is constant).

- Note the delta used to calculate the amount of Dividend Equivalent Payments may differ from the delta used to determine whether a transaction is a Specified NPC or Specified ELI.

- For a payment based on an estimated dividend, the actual dividend is used to calculate the Dividend Equivalent Payments amount unless the dealer identifies a reasonable estimated dividend amount in writing at inception of the transaction, in which case the per share dividend is the lesser of the estimated dividend or the actual dividend.

- Calculated by reference to the earlier of the ex-dividend date or the record date.

- For short-term transactions (≤ 1 year), the amount of Dividend Equivalent Payments is determined when the client disposes of the transaction.

- A client that acquires an option with a term of one year or less that is a Specified ELI will not incur a withholding tax if the option lapses.
Qualified Indices

- Where a transaction references more than one entity (including a non-qualified index) or different interests in the same entity, each security is treated as a separate underlying security.

- Qualified Indices are treated as a single security that is not an underlying security, and include any indices that satisfy the following six conditions as of the acquisition date:
  - References 25 or more underlying securities;
  - References only long positions in underlying securities;
  - Contains no underlying security that represents more than 10% of the index’s weighting;
  - Rebalances based on objective rules at set intervals. As currently written, S&P 500 index would not qualify;*
  - Does not provide for a high dividend yield (defined generally as > 1.5 times the current yield of the S&P 500 index); and
  - Is referenced by futures or option contracts that trade on a national securities exchanged or a domestic board of trade.
More on Multiple Exposures in a Specified NPC or ELI

- If a transaction references a qualified index and another position, the index may lose its qualified status if the other position (or a separate transaction acquired by the client or a party related to the client) reduces exposure on a portion, but not all, of the qualified index.

- A transaction that references an interest in an entity that is not a C corporation is treated as referencing the allocable portion of any underlying securities and potential § 871(m) contracts held directly or indirectly by that entity.

- Look-thru rule does not apply if the underlying securities and potential § 871(m) transactions represent, in the aggregate, 10% or less of the value of the interest in the referenced entity at the time the transaction is entered into.
Qualified dealer exception -- a transaction is not a § 871(m) transaction where a qualified dealer, acting in its capacity as such, enters into it as the long party (1.871-15(j)) – SG in its capacity as a dealer

- A qualified dealer is any dealer in securities under § 475 that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized

- Dealer must certify in writing to the client that it is a qualified dealer acting in its capacity as such and that it will withhold any tax imposed by § 871(m) when it is a short counterparty acting as a dealer

- **Does not apply with respect to Proprietary Trading of Dealer**

- Withholding exception where no money or property is paid -- a withholding agent is obligated to withhold on Dividend Equivalent Payments until the later of:
  - The time when the amount of DEPs is determined; or
  - The time at which (i) money or other property is paid, (ii) the withholding agent has custody or control of money or other property of the client on or after the Dividend Equivalent Payments is determined, or (iii) there is an upfront payment or a prepayment of the purchase price

- A dealer is required to determine whether a transaction is a Section 871(m) transaction if the counterparty is not a dealer.

- If both (or neither) parties are dealers, the short party must determine whether the transaction is a Section 871(m) transaction
More on Dealer Responsibilities

- The party required to determine whether a transaction is a Section 871(m) transaction has reporting responsibilities.

- Dealers must keep and provide the following information:
  - The delta of the transaction
  - The amount of tax withheld and deposited
  - The estimated dividend amount (if applicable)
  - Other information necessary to enable compliance with rules

- Dealers are treated as withholding agents on information required to be provided. If the dealer fails to provide information or provides inaccurate information and the person required to withhold fails to do so or withholds too little, the IRS may collect the tax from the dealer that was required to provide the information.

- Dealers must provide this information to:
  - Brokers who hold Section 871(m) transactions
  - Any person required to file an information return
  - Any person who is a party to the transaction
Concluding Remarks/Questions
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