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Note from the Editors

The destabilizing effects of the credit crisis of 2008 continued to be felt during the first four months of 2009, as Wall Street institutions remained in a defensive stance, job losses mounted on Main Street and housing prices continued their downward trend. Since then, accounts of economic “green shoots” have been widely reported which, coupled with a rally on the world’s stock bourses, provided welcome respite from the incessant bad news. The economic turmoil continued to take its toll during the second quarter, however. The U.S. government administered its “stress tests” and Wall Street institutions have been diligently raising capital and mending their

capital structures. As we have reported in previous issues of this publication, the Internal Revenue Service and the U.S. Treasury Department have responded swiftly to address tax issues arising from these trying economic times. However, questions relating to distressed institutions and assets still remain, some of which are reported in this issue. We hope you find Volume 2, Issue 2 of MoFo TaxTalk a useful resource. We plan to continue to actively monitor developments. We hope in future issues of this publication and our client alerts to continue to provide analysis of developments, including the tax reform agenda of the new Administration. ■

Raising Capital and Mending Capital Structures on Wall Street

Recently, in efforts to shore up so-called tangible common equity in response to the “stress tests” administered by the Federal Reserve and to pay back government infusions of capital under TARP as quickly as possible, many financial institutions have raised capital and reshuffled their capital structures. Notable recent transactions include Citigroup’s \$58 billion offer to exchange common stock for preferred stock, Bank of America’s efforts to raise \$33.9 billion in tangible common equity through common stock offerings and

exchanges of common stock for preferred stock, Wells Fargo’s \$7.5 billion common stock offering, JPMorgan Chase’s \$5 billion common stock offering and Morgan
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Authored and Edited by

Thomas A. Humphreys
Shamir Merali
Anna T. Pinedo
Armin M. Gharagozlou
Remmelt A. Reigersman

Raising Capital

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Stanley's \$4.6 billion and \$2.2 billion common stock offerings.

The federal income tax consequences of recapitalizations and common stock offerings generally are fairly straightforward. A cashless recapitalization (*e.g.*, an exchange of common stock for preferred stock) is generally tax free to the issuer and the exchanging shareholders. When a corporation significantly reshuffles its capital structure, however, one issue that arises is the potential application of Section 382. As we have reported in prior issues of this publication (*see, e.g.*, MoFo Tax Talk, Volume 1, Issue 4, available at <http://www.mofo.com/news/updates/files/081219TaxTalk.pdf>), Section 382 is designed to limit the trafficking of tax attributes (notably, net operating losses ("NOLs")) from one economic group, to whom the attributes are viewed as properly belonging, to an unrelated economic group. In determining whether Section 382 applies, the test is whether a loss corporation has undergone a substantial change in ownership (an "ownership change"). An ownership change generally

results if the percentage of stock of the loss corporation owned by any one or more 5% shareholders has increased by more than 50 percentage points (by value) over a three-year testing period.

A Section 382 ownership change that limited the use of NOLs could, conceivably, reduce a financial institution's deferred tax assets which, in certain cases, can count toward meeting capital requirements.

The Treasury's first round of TARP financing, non-voting, non-participating preferred stock, was "plain vanilla" preferred that is disregarded as "stock" for purposes of Section 382.¹ However, some institutions may access the Treasury CAP where they exchange the plain

vanilla preferred for mandatorily convertible preferred. This latter preferred is not "plain vanilla" and would be considered "stock" for purposes of Section 382. Whether the government can or will relax the Section 382 test in this case remains to be seen.

If Section 382 applies, it limits the use of NOLs after the ownership change. The limitation, applied annually, generally equals the value of the stock immediately before the ownership change multiplied by a statutorily prescribed interest rate (currently 4.61%). A Section 382 ownership change that limited the use of NOLs could, conceivably, reduce a financial institution's deferred tax assets which, in certain cases, can count toward meeting capital requirements. As an example of the steps a financial institution will take to preserve its NOLs, on June 9, 2009, the Board of Directors of Citigroup adopted a "Tax Benefits Preservation Plan," the purpose of which was to preserve Citigroup's use of its tax attributes.² ■

¹ Notice 2009-38, 2009-18 I.R.B. 901.

² *See* Citigroup Inc. Current Report on Form 8-K (and exhibits thereto), available at <http://www.sec.gov/Archives/edgar/data/831001/000095010309001395/>

To Accrue or not to Accrue – Market Discount and Distressed Debt

When a taxpayer purchases a debt instrument in the secondary market at a discount to its face amount, the discount generally is subject to tax under special “market discount” rules. Under those rules, unless a taxpayer elects to accrue market discount on a current basis as interest income, the market discount rules treat any gain on the disposition of the bond as ordinary interest income up to the amount of “accrued market discount” determined under either a ratable accrual method or a constant yield method. Absent the market discount rules, the entire gain on disposition of a debt instrument would be treated as capital gain, which enjoys a more favorable tax rate.

One justification for treating market discount as ordinary interest income is that the yield on a secondary market bond generally should equal the yield on a newly issued equivalent debt instrument of the same issuer and, in the latter case, the entire yield generally is treated as interest. Accordingly, under this theory, market discount should be considered economically equivalent to interest income and should be treated as such for tax purposes.

When a bond is trading at a substantial discount due to a deterioration

in the credit quality of the issuer, however, some commentators and practitioners argue that the market discount rules should not apply, on the theory that the market discount on a distressed bond is not attributable to fluctuations in interest rates or reasonable commercial declines in credit quality of the issuer. Instead it is attributable to a substantial decline in credit quality of the issuer precipitated by an exceptional crisis. Investors discount the price of such an instrument based on an expectation of default by the issuer. Accordingly, in these circumstances, arguments can be made that market discount should be considered akin to an “equity” return rather than interest.

All of this said, the market discount rules are broad and can be read literally to apply to any discount on distressed debt. In addition, it is not entirely clear how to draw the line beyond which a debt instrument should be viewed as sufficiently distressed such that the nature of any gain is not essentially equivalent to interest income. That is, how deep does the discount have to be to be considered equity in nature? The answer, if there is one, is not readily apparent. ■

Revenue Procedure 2009-23 and Notice 2009-36 – The IRS on HAMP

On March 4, 2009, the U.S. Treasury released the guidelines for its Home Affordable Modification Program¹ (“HAMP”). HAMP is a mortgage modification program, the purpose of which is to reduce monthly payments on existing mortgages for certain distressed borrowers to a level that they can afford. If a borrower qualifies under the program,² the mortgage loan may be eligible to be modified (for example, by reducing the interest rate on the existing mortgage or forgiving principal) to reduce the borrower’s monthly payments to a “Front-End DTI” target of 31%, generally resulting in reducing the borrower’s aggregate mortgage, insurance and homeowners expenses to 31% of the borrower’s monthly gross income.³ To promote the program and help ensure its success, the program provides for a number of “incentive payments” to servicers, lenders and investors.⁴

Modifications of mortgages and the incentive payments made under HAMP raise a number of tax issues with respect to securitization vehicles, typically structured as real estate mortgage investment conduits

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Revenue Procedure

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("REMICs") or grantor trusts for federal income tax purposes. Modifications of mortgages held by securitization vehicles raise the same issues as previous broad-based modification programs, which the IRS has addressed on an *ad hoc* basis.⁵

One might query whether a better approach may be to statutorily amend the REMIC rules to allow for broad-based modification plans. Revisiting the REMIC rules on a comprehensive basis may help revive the securitization market.

One issue is whether a "significant modification" of a mortgage loan (resulting for tax purposes in a reissuance of the loan under a deemed taxable sale of the unmodified loan for the modified loan)⁶ would have adverse effects on a REMIC⁷ or a grantor trust⁸ for federal income tax purposes. Incentive payments made to a REMIC raise a number of additional issues, including,

for example, whether such payments are prohibited contributions⁹ and whether such payments are "permitted investments"¹⁰ under the REMIC rules.

To address issues raised by HAMP, the IRS issued Rev. Proc. 2009-23 and Notice 2009-36 on April 10, 2009. In Rev. Proc. 2009-23, the IRS provided that it will not challenge a securitization vehicle's tax status (as a REMIC or a grantor trust) nor will it impose a "prohibited transactions" tax on modifications made pursuant to HAMP.¹¹ In Notice 2009-36, the IRS announced that it will issue regulations exempting payments made pursuant to HAMP from the imposition of the 100% prohibited contributions tax.¹² Absent the Notice, incentive payments made to a REMIC may have been subject to penalty under existing law. Even with this guidance, however, unresolved issues remain. For example, it is not entirely clear whether the right to receive all HAMP payments made to a REMIC qualify as "permitted investments," which, if significant, could jeopardize the preferential tax status of the REMIC. However, one would expect that the government would not be inclined to pursue these sorts of technical issues.

Since late 2007, the U.S. Treasury has endorsed various broad-based modification programs. Each time a new plan is adopted or modified, the IRS has issued favorable guidance relaxing the rules relating to securitization vehicles. One

might query whether a better approach may be to statutorily amend the REMIC rules to allow for broad-based modification plans. Revisiting the REMIC rules on a comprehensive basis may help revive the securitization market. ■

¹ See Home Mortgage Modification Program Guidelines, http://www.ustreas.gov/press/releases/reports/modification_program_guidelines.pdf (last visited June 15, 2009).

² There are a number of eligibility requirements. For example, the mortgage must have been originated on or before January 1, 2009; the property securing the mortgage must be owner-occupied, a single family 1-4 unit property, and a primary residence, but cannot be investor owned, vacant or condemned; and the existing loan must have a principal balance equal to or below a certain threshold (\$729,750 for a 1 unit, \$934,200 for a 2 unit, \$1,129,250 for a 3 unit, and \$1,403,400 for a 4 unit property).

³ Specifically, the "Front-End DTI" ratio is the ratio of "PITIA" to "Monthly Gross Income." PITIA is defined as principal, interest, taxes, insurance (including homeowners insurance and hazard and flood insurance) and homeowners association and/or condominium fees. The borrower's Monthly Gross Income is generally the amount before any payroll deductions and includes wages and salaries, overtime pay, commissions, fees, tips, bonuses, housing allowances, other compensation for personal services, Social Security payments, annuities, insurance policies, retirement funds, pensions, disability or death benefits, unemployment benefits, rental income and other income.

⁴ For example, under the program servicers are eligible to receive (i) a \$1,000 up-front incentive payment for each eligible modification, (ii) "pay for success" payments of up to \$1,000 each year for up to three years, and (iii) a potential one-time bonus incentive payment of \$500 for modifications made while a borrower is still current on the loan; lenders are eligible to receive (i) compensation payments generally equal to 1/2 of the costs to bring down the borrower's Front-End DTI from 38% to 31%, (ii) a one-time bonus incentive payment of \$1,500 for modifications made while a borrower is still current on the loan, and (iii) certain home price depreciation payments to be used to offset potential losses from further home price declines; and borrowers are eligible to receive "pay for performance success payments" of up to \$1,000 each year for up to five years, which would reduce the principal balance on the mortgage loan, if the borrower is current on the payments on the loan.

⁵ See, e.g., Rev. Proc. 2007-72 and Rev. Proc. 2008-47 (providing that modifications of loans pursuant to the American Securitization

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Revenue Procedure

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Forum's fast-track loan modification programs will not cause securitization vehicles to fail); *see also* MoFo Tax Talk, Volume 1, Issue 4, available at <http://www.mofo.com/news/updates/files/081219TaxTalk.pdf>, for a more detailed discussion.

- ⁶ See the discussion in the Classroom below addressing modifications of debt instruments.
- ⁷ For an entity to qualify as a REMIC, among other things, substantially all of its assets must consist of "qualified mortgages" and "permitted investments" as of the close of the third month beginning after the startup day and at all times thereafter. With limited exceptions, a mortgage is not a qualified mortgage unless it is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC. If a qualified mortgage is significantly modified, resulting in a deemed reissuance, the newly modified loan may cease to be a qualified mortgage, unless the mortgage loan is in default or default is reasonably foreseeable. Any gain resulting from the disposition would be treated as income from a "prohibited transaction," resulting in a penalty tax on the REMIC equal to 100% of such income.
- ⁸ In general, a grantor trust is restricted from varying the investments it holds. A significant modification of a mortgage loan causing a deemed reissuance can raise an issue as to whether this rule has been violated.
- ⁹ Under the REMIC rules, if property is contributed at any time following the three-month period commencing on the startup day to the REMIC, subject to limited exceptions, a 100% tax is imposed on the amount of the contribution.
- ¹⁰ As described above, *supra* note 9, a REMIC may only hold qualified mortgages and permitted investments, and a *de minimis* amount of other assets.
- ¹¹ Specifically, the guidance provides that the IRS will not: (i) challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications are not permitted under the REMIC rules; (ii) contend that the modifications are "prohibited transactions"; (iii) challenge a securitization vehicle's qualification on the grounds that the modifications result in a deemed reissuance of the REMIC regular interests; and (iv) challenge a securitization vehicle's status as a grantor trust on the grounds that the modifications manifest a power to vary the investment of the certificate holders.
- ¹² Taxpayers may rely on the Notice pending further guidance.

13 Administration Proposals for Tax Reform

Previous issues of this publication have kept a close eye on the Administration's proposals for tax reform.¹ The Administration has recently made public additional information on those proposals. On May 11, 2009, the Administration published the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (the "Greenbook").² The Greenbook is a 131-page report that contains tax relief proposals and revenue raisers consistent with the President's campaign proposals to increase taxes on high-income earners, to provide tax cuts for the middle class, and to close perceived corporate tax loopholes and windfalls.

We have published a series of client alerts that provide a detailed discussion of the President's tax reform proposals which we have divided into several categories – those affecting individuals, those affecting businesses, those affecting international taxation, and those affecting private equity. For copies of these client alerts, see:

- "Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including Provisions Affecting Individuals,"

available at <http://www.mofo.com/news/updates/files/15620.html> (individuals);

- "Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including Provisions Affecting Businesses," available at <http://www.mofo.com/news/updates/files/15608.html> (businesses);
- "Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including International Provisions," available at <http://www.mofo.com/news/updates/files/15592.html> (international taxation); and
- "Obama Administration Tax Proposal - Relevant Provisions for Private Equity and Other Investment Funds," available at <http://www.mofo.com/news/updates/files/15612.html> (private equity).

Below we highlight 13 of the more important proposals in each category. Proposals (1)—(4) affect individuals, proposals (5)—(9) affect businesses, proposals (10)—(12) are international tax proposals and proposal (13) affects private equity.

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Tax Reform

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(1) Increase Tax Rates on High-Income Earners

The Administration proposes to increase income tax rates on high-income earners after 2010 (*i.e.*, generally reinstating the rates on high-income earners prior to the Bush-era tax cuts, which are to sunset after 2010). Beginning in 2011, the highest income tax rate would be increased to 39.6% from 35%. The proposal does not specify the amount of taxable income to which this rate will apply. (Generally, for 2009 the top tax rate applies to taxable income over \$372,950 for both single and joint filers.) The second highest rate would be increased to 36% from 33% and generally would apply to taxable income over \$250,000 less the standard deduction and two personal exemptions for joint filers, and to taxable income over \$200,000 less the standard deduction and one personal exemption for single filers.

(2) Reinstating the Phase-Out of the Personal Exemption and Limitations on Itemized Deductions

The Administration proposes to reinstate the phase-out of the personal exemption and limitations on itemized deductions beginning

in 2011 and indexed for inflation. Specifically, (a) the personal exemption would be phased out for taxpayers with adjusted gross incomes over \$250,000 (joint filers) or \$200,000 (single filers), and (b) itemized deductions (other than for medical expenses, investment interest, theft and casualty losses, and gambling losses) would be reduced by 3% of the amount by which adjusted gross income exceeds statutory floors (beginning at \$250,000 for joint filers and \$200,000 for single filers), but not by more than 80% of the otherwise allowable deductions.

(3) Increase Rates on Capital Gains and Qualified Dividends

For joint filers with taxable income over \$250,000 less the standard deduction and two personal exemptions and single filers with taxable income over \$200,000 less the standard deduction and one personal exemption the preferential tax rate on capital gains and qualified dividend income would be increased to 20% (the rate in effect before the Bush tax cuts).

(4) Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability

The Administration proposes to limit the value of all itemized deductions

by limiting the tax value of those deductions to 28% whenever they would otherwise reduce taxable income in the 36% or 39.6% tax brackets. A similar limitation also would apply under the alternative minimum tax. The proposal would apply to itemized deductions after they have been reduced under the separate proposal to reinstate limitations on certain itemized deductions discussed above, and would be effective for tax years beginning after December 31, 2010.

(5) Expand Net Operating Loss Carry back

Corporate taxpayers who incur a net operating loss ("NOL") are generally entitled to carry the NOL back to the two preceding taxable years and carry forward the NOL for up to 20 years. The American Recovery and Reinvestment Act of 2009 ("ARRA") included a provision that extended the carryback period for 2008 NOLs (up to the fifth preceding year) for certain small businesses. An initial proposal discussed by Congress would not have limited the carryback to small businesses. The Greenbook provides that the Administration "looks forward to working with the Congress to make a lengthened NOL carryback period available to more taxpayers."

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Tax Reform

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(6) Codify “Economic Substance” Doctrine

The economic substance doctrine is a common law doctrine that disregards the putative tax consequences of transactions that lack economic substance. The doctrine potentially may apply where, for example, a transaction does not have independent non-tax economic substance (such as a case in which there is little if any potential for economic profit apart from targeted tax benefits) or where there is no non-tax business purpose for the transaction (or for selecting the manner in which the transaction is effected). The Administration supports the codification of the economic substance doctrine in the Code. In general, the proposed codification would permit disallowance of tax benefits unless the transaction “changes in a meaningful way (apart from federal tax effects) the taxpayer’s economic position,” and “the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction.”

(7) Forward Sale of Corporate Stock

Section 1032 generally provides that a corporation does not recognize gain or loss on the receipt of cash or property in exchange for stock of the

corporation. This provision in some cases has been interpreted to include settlements under a forward contract on an issuer’s own stock. Under that interpretation, a corporation that enters into a forward contract pursuant to which it will sell an amount of its stock on a future date in exchange for specified consideration to be paid on such future date does not recognize gain or loss upon settlement of the forward contract. The Greenbook points out that a corporation that issues its stock currently in exchange for consideration to be paid in the future would recognize interest income with respect to the deferred consideration. The difference between the two situations is limited to the timing of the stock issuance (*i.e.*, the stock is issued upon settlement of the forward contract versus at inception of the transaction), and in both instances the issuing corporation will be compensated for the time-value of the deferred payments. Effective for forward contracts entered into after December 31, 2010, the proposal would require a corporation that enters into a forward contract to issue its stock to treat a portion of any deferred payment as a payment of interest which would, therefore, constitute taxable income to the corporation.

(8) Dealers in Equity Options and Commodities

Generally, taxpayers that are treated as a “dealer” for federal income tax purposes

must mark-to-market their positions at the end of each taxable year, and gain or loss on such positions is subject to tax at ordinary rates. The provision is not elective. However, certain categories of dealers, such as commodities dealers, commodities derivatives dealers, securities dealers and dealers in certain options are subject to tax at capital gains rates with respect to income derived through certain specified contracts unless the taxpayer elects otherwise. Under Section 1256, the income with respect to these contracts is taxed at a blended rate, so that 40% of gain or loss is treated as short-term capital gain or loss and 60% of gain or loss is treated as long-term capital gain or loss. The Administration proposes to eliminate the difference in treatment of the specified contracts, effective for taxable years beginning after the date of enactment. As a result, dealers such as commodities dealers, commodities derivative dealers, securities dealers and options dealers would be subject to tax on their income from dealer activities at ordinary rates.

(9) Disallowance of Deduction for Debt Repurchase Premium Expanded

Under Section 249, any premium paid by a corporation upon the repurchase of a debt instrument that is convertible into its stock (or into stock of a corporation in control of or controlled by such corporation) is generally not deductible unless the

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Tax Reform

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premium is attributable to the cost of borrowing and not to the conversion feature of the debt instrument. The premium attributable to the conversion feature is essentially treated as a non-deductible payment in redemption of stock. The term “control,” for this purpose means direct ownership (*i.e.*, includes only a parent corporation and its direct subsidiary) of 80% of the controlled corporation measured by vote and value. As a result, under current law, the disallowance rule described above may be avoided where there is an indirect relationship (*e.g.*, a parent corporation and a second-tier subsidiary). The Administration proposes to amend the definition of “control” to incorporate indirect control relationships. Thus, if amended as proposed, Section 249 would cast a wider net and could apply if, for example, debt is convertible into stock of a second-tier subsidiary. It is not readily apparent that this narrow expansion of Section 249 would have a significant impact on the market for convertible bonds.

(10) Dividend Withholding Taxes.

In recent years Congress has investigated the use by financial institutions of equity swaps and

stock lending transactions to enable their foreign clients to avoid U.S. withholding taxes on dividends paid with respect to U.S. securities. Although substitute dividend payments made under a stock lending agreement are sourced in the same manner as the dividends with respect to the underlying stock (and would therefore be U.S. source if made with respect to the stock of a U.S. corporation), many transactions involving stock lending rely on IRS Notice 97-66 (which addresses the potential problem of a “cascading withholding tax” on substitute dividend payments in stock lending transactions) to reduce or eliminate entirely a U.S. withholding tax on substitute dividend payments. Transactions involving swaps rely on a Treasury regulation which provides that the source of any payments made pursuant to the swap is determined according to the country of residence of the recipient of the payment and therefore are not subject to U.S. withholding taxes.

The Administration proposes to prevent the perceived abusive transactions. With respect to securities lending transactions, the Administration proposes that the Treasury Department revoke IRS Notice 97-66 and issue guidance that would address the concern involving

a cascading effect of dividend withholding tax while closing the door to the unintended benefits described above. With respect to equity swaps, the Administration proposes to cause any dividend equivalent amount with respect to a U.S. corporation paid under an equity swap contract to be U.S. source. As a result, such amounts would generally be subject to U.S. withholding tax to the extent paid to a foreign person (absent application of a beneficial treaty). However, the proposal would allow an exception for equity swaps that meet specified requirements (intended to carve out equity swaps that demonstrably have no tax avoidance intent or effect).

(11) Limit “Check-the-Box” Rules.

Expressing concern that check-the-box elections have been used to make offshore subsidiaries “disappear,” migrating earnings to low-tax jurisdictions in a manner that escapes U.S. taxation,³ the Administration proposes to mandate U.S. corporate taxation of certain overseas subsidiaries. Under the proposal, a foreign entity could only be treated as a disregarded entity for U.S. tax purposes if the foreign entity and its sole owner are both formed under the laws of the same jurisdiction. In other cases, a foreign entity with a single owner would be treated as a *per se* corporation for U.S. tax purposes, subject to a general exception for first-

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tier foreign entities that are wholly-owned by a U.S. person. The proposal does not appear to address foreign entities having multiple owners. Those entities may therefore remain eligible to elect partnership status, perhaps preserving some structuring flexibility for multinational business operations.

(12) Defer Deductions for Foreign-Related Expenses

Under current law, a U.S. taxpayer that incurs expenses properly allocable and apportioned to foreign-source income may generally deduct those expenses even if that income is not immediately included in income. Subject to an exception for research and experimentation expenses, the Administration proposes to defer a U.S. person's deductions allocable to its foreign source income until that income is repatriated and included in income for U.S. federal income tax purposes. Expenses would be allocated to foreign source income in accordance with existing Treasury regulations relating to expense allocation. Deductions allocated under the provision to foreign source income would only be allowed on a current basis in proportion to the group's foreign source income that is currently included in U.S. income. Deferred deductions would be carried over to future taxable years.

(13) Tax Carried (Profit) Interests as Ordinary Income

The Administration continues to propose to tax income derived from "carried" partnership interests as ordinary income rather than preferential capital gains rates.

Subject to an exception for research and experimentation expenses, the Administration proposes to defer a U.S. person's deductions allocable to its foreign source income until that income is repatriated and included in income for U.S. federal income tax purposes.

Specifically, the Administration proposes to tax at ordinary rates a partner's income derived from,

and gain recognized from the sale of, a "services partnership interest" ("SPI"). In addition, a partner holding an SPI would be required to pay self-employment taxes on income derived from the SPI. An SPI is generally defined as an interest in the partnership's future profits which is given to a partner in exchange for services provided (or to be provided) to the partnership. The proposal also contains an anti-abuse rule designed to prevent avoidance of these rules through the use of compensatory arrangements other than partnership interests. This anti-abuse rule provides that any person who performs services for an entity and holds a "disqualified interest" in such entity would be subject to ordinary income taxation on income derived from such disqualified interest. A "disqualified interest" is generally defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity but excludes partnership interests and stock in certain taxable corporations. The proposal would be effective for taxable years beginning after December 31, 2010. ■

¹ See, e.g., MoFo Tax Talk, Volume 1, Issue 4, available at <http://www.mofo.com/news/updates/files/081219TaxTalk.pdf> and MoFo Tax Talk, Volume 2, Issue 1, available at <http://www.mofo.com/news/updates/files/090310TaxTalk.pdf>.

² The Greenbook is available at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>.

Modifications of Nondebt Derivatives

A taxpayer generally realizes gain or loss from the sale or other disposition of property. More specifically, gain or loss is realized upon the exchange of property for other property that differs materially either in kind or in extent. As described in the Classroom below, special rules govern whether a modification of the terms of a debt instrument results in a taxable exchange. However, no specific rules address whether, and under what circumstances, a modification to the terms of derivatives (*e.g.*, options, forwards or swaps) results in a taxable exchange. As a result, this determination is made on a case-by-case basis and depends on all the facts and circumstances. For this purpose, a structured note may be viewed as a nondebt derivative for federal income tax purposes and, to that extent, the same considerations would apply as in the case of derivatives not embedded in structured notes.

In an almost two decade old revenue ruling, the IRS held that the exercise by a corporation of its option to change the insured person under a life insurance policy resulted in a taxable exchange of the life insurance policy

for a new policy. The IRS stated in that revenue ruling that a modification to the terms of the insurance policy through the exercise of an option provided for in the original insurance contract, results in a taxable exchange “if there is a sufficiently fundamental or material change that the substance of the original contract is altered.” As a result, under the ruling, modifications to a contract should be “fundamental” in order to cause a taxable exchange. Whether a particular change to a contract should be considered fundamental generally depends on which term or terms of the contract are modified and the character of the contract (*i.e.*, whether the contract is an option, forward or swap, etc).

With respect to options or forward contracts, parties to such contracts could agree to modify the term of the contract, change the underlying property, or alter the possibilities of cash or physical settlement. In each instance, the determination whether these modifications result in a taxable exchange depends on the facts and circumstances of the particular case at hand. There are some authorities – in the form of cases and IRS publications

– which conclude that the extension of the term of an option contract results in a settlement of the option and the writing of a new option.

In situations resulting in a taxable exchange of a derivative, it should be noted that the “wash sale rules” could apply to disallow the deduction of any loss realized as a result of the taxable exchange, a concern that is highlighted in the case of distressed derivatives, of which there are plenty currently. Under the wash sale rules, the deduction of a loss is disallowed if, among others, the taxpayer has acquired substantially identical securities within 30 days before or after the disposition of the loss security. The IRS could argue that, on the one hand, the modifications to a contract are fundamental, thereby resulting in a taxable exchange, and, on the other hand, that the modified contract is nonetheless substantially identical to the unmodified contract, thereby coming within reach of the wash sale rules. Not an enviable position for a taxpayer to be in if the unmodified contract had an embedded loss.

With respect to swaps that are treated as notional principal contracts for federal income tax purposes, Treasury
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Modifications

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regulations include a rule that specifically addresses the assignment of such swaps. Pursuant to that rule, the substitution of a new party to a notional principal contract, such as an interest rate or commodity swap, is not treated as a taxable exchange with respect to the non-assigning party as long as the terms of the notional principal contract permit the substitution and both the assignor and assignee are “dealers” in notional principal contracts for federal income tax purposes. In addition, the Treasury regulations dealing with notional principal contracts include specific rules addressing the federal income tax treatment of termination payments. However, these rules do not shed any light on when a modification of the terms of a swap result in a taxable exchange. As a result, in determining whether the modification of a swap results in a taxable exchange, the taxpayer only has the general rule of whether the swap differs materially either in kind or in extent from the unmodified swap and whether the change is fundamental, to work with. In addition, the considerations described above, as to the application of the wash sale rules, should also be taken into account. ■

The Classroom – Debt Modifications and the Tax Law

In general, an exchange of property for other property differing materially either in kind or in extent is treated as a taxable exchange for U.S. federal income tax purposes. Special rules govern whether a modification of the terms of a debt instrument results in a taxable exchange. These rules apply to any modification of a debt instrument, regardless of the form of the modification. For example, the rules apply to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. A modification of a debt instrument results in a taxable exchange of the original debt instrument for the modified instrument if the modification is a “significant modification.” In general, unless a modification falls under one of five enumerated categories of modifications, the modification is a “significant modification” only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. Special rules apply to modifications that fall under any of the five enumerated categories of changes. Two commonly-encountered modifications that fall under the enumerated categories are modifications that change the yield of a debt instrument and modifications that extend the maturity date of the debt instrument.

Change in Yield

Generally speaking, the change in the yield of a debt instrument is a significant modification if the yield on the modified instrument¹ varies from the yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of (A) 1/4 of 1% (25 basis points); or (B) 5% of the annual yield of the unmodified instrument.

For example, if a 10-year debt instrument originally issued for \$100x and having a stated redemption price at maturity for \$100x that pays interest at 10% per annum is modified at the end of the 5th year by reducing the principal to \$80x, there would be a significant modification because the yield on the modified debt instrument would be approximately 4.3%.

Extension of Maturity

A modification that changes the timing of payments due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the

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The Classroom

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instrument and the amounts of the payments that are deferred

The deferral of one or more scheduled payments within a prescribed “safe-harbor period” (described below) is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50% of the original term of the instrument.

For example, if a 10-year zero-coupon bond is modified by extending the maturity an additional 2 years (without increasing the stated redemption price at maturity), the deferral would fall under the safe-harbor period (*i.e.*, it is less than five years) and would not be a significant modification under the extension of maturity test (but note that the bond must also be tested under the change in yield test, described above). ■

¹ The yield of the modified debt instrument is the annual yield of a debt instrument with (i) an issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); and (ii) payments equal to the payments on the modified debt instrument from the date of the modification.

Samueli – A Securities Lending Transaction Gone Bust

Under a securities loan agreement, a borrower typically borrows securities from a lender and posts collateral to secure its obligation to return identical securities. Even though the securities are loaned, for U.S. federal income tax purposes, there is a transfer of ownership from the lender to the borrower resulting in an exchange upon entering into the agreement and upon termination. However, no gain or loss is recognized to the lender for U.S. federal income tax purposes upon the initial transfer of securities to the borrower and the return of identical securities to the lender upon termination of the securities lending agreement, provided the securities loan agreement meets certain requirements specified by Section 1058 of the Internal Revenue Code.

On March 16, 2009, the U.S. Tax Court ruled in *Samueli v. Commissioner*, 132 T.C. 4, that a transaction documented as a securities loan did not meet those specified requirements with the result that the taxpayer failed to achieve his sought-after tax benefits. The taxpayer had purchased stripped Freddie Mac bonds (*i.e.*, zero-coupon bonds) from his broker on margin.

The taxpayer subsequently loaned the stripped bonds back to the broker and the broker posted cash collateral with the taxpayer. The taxpayer used the cash collateral to repay the margin loan. The taxpayer took the position that he was not required to accrue income on the stripped bonds because he was not the owner for tax purposes. Under U.S. federal income tax law, there is no accrual of interest or original issue discount on a securities loan. The taxpayer took the position that his holding period in the stripped bonds, once returned to him, included his holding period in the securities loan agreement. As such, the taxpayer argued he had converted original issue discount, generally taxed at ordinary tax rates, into long-term capital gain generally taxed at lower preferential rates.

One of the requirements a securities loan agreement must meet in order to qualify for favorable treatment is that it must not reduce the lender’s risk of loss or opportunity for gain in the securities loaned. Treasury regulations that were proposed more than two decades ago, but which have never been finalized, clarify that

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the securities loan agreement must provide that the lender may terminate the loan upon notice of not more than five business days in order to meet the aforementioned requirement. The notion is that if the securities rise in value, the lender can terminate the loan and sell the securities in the market. The securities loan agreement entered into between the taxpayer and his broker had a term of approximately 15 months and prevented the taxpayer on all but three days during that period from causing the broker to transfer the stripped bonds, or identical securities, back to the taxpayer.

The Tax Court held that the transaction between the taxpayer and his broker was not a securities loan agreement that qualified for favorable treatment under the Internal Revenue Code because the taxpayer's ability to cause his broker to transfer the stripped bonds, or identical securities, back on only three days of the entire 15-month term of the agreement reduced the taxpayer's opportunity for gain in the stripped bonds. This was the case, according to the court, because the taxpayer could only realize any inherent gain in the securities if the gain continued to be present on one

of the days the taxpayer was able to cause his broker to transfer the stripped bonds, or identical securities, back.

Although the Tax Court did not refer to the proposed Treasury regulations, after the *Samueli* case it seems wise to structure securities loan agreements to give the lender the right to cause a return of the loaned or other identical securities on short term notice – generally not more than 3 days (because today's regular way stock settlement is three days) – in order to qualify for Section 1058 treatment.

The bottom line? Once the court had determined that the securities loan agreement did not qualify for Section 1058 treatment, it recharacterized the transaction as two separate sales and a forward contract between the taxpayer and his broker. The court treated the taxpayer as purchasing and selling the stripped bonds for the same price upon entering into the transaction. Upon settlement of the transaction, the court treated the taxpayer as purchasing the stripped bonds pursuant to the forward contract and as immediately selling them to his broker for a gain, which was treated as a short-term capital gain taxable at ordinary tax rates. ■

Press Corner

Structured products (or some flavors of structured products) are making a comeback, a development that may indicate that their benefits (structured payouts that are otherwise difficult to replicate) outweigh perceived complexities.¹ During the financial turmoil, the issuance volume of structured products, like the volume of other capital market securities, dropped significantly. As the recession has begun to ease, however, structured products, especially principal protected interest rate structures (including curve steepeners and range accrual notes),² are experiencing a resurgence. For example, according to mtn-i,³ the U.S. structured note market is on pace to deliver sales above \$100 billion in 2009, the first time since 2007 and only the second time in its history.

The ballooning deficit from federal bailouts, legacy debts, unfunded Social Security and Medicare, has led the Administration to propose various new revenue raisers, including limiting the rate at which deductions are taken by higher income earners. The press has recently reported the possibility of the introduction of a value added tax ("VAT") (*i.e.*, a national sales tax imposed on the transfer of goods and services) as a revenue raiser.⁴ Proponents of VAT argue that a VAT could help balance the budget

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and pay for Social Security and Medicare. Thus far, however, the Washington Post reports that the Administration has indicated it is unlikely to be proposed as a revenue raiser.

In our prior issue (*see* Tax Talk, Volume 1, Issue 4, available at <http://www.mofo.com/news/updates/files/081219TaxTalk.pdf>) we discussed *In re Bilski*, No. 2007-1130 (Fed. Cir. Oct. 30, 2008) and tax patents. *Bilski* held that a method of hedging risk associated with volatile commodity prices by entering into swaps was not patentable because the claim was a “non-transformative process that encompasses a purely mental process of performing requisite calculations without the aid of a computer or any other device” and, as a result, it did not meet the court’s test of being tied to a particular machine or apparatus or transforming a particular article into a different state of things in order to be patent eligible. This test was at odds with an earlier decision in *State Street & Trust Co. v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998), which held that a business method is patent eligible as long as it produces a “useful, concrete, and tangible result.” On June 1, 2009, the Supreme Court granted *certiorari* for *Bilski*. (For a discussion, see our prior client alert, “The Supreme Court Grants Certiorari in *Bilski*,” available at <http://www.mofo.com/news/updates/files/15649.html>). ■

MoFo in the News

On March 19, 2009, MoFo hosted “The SEC and Hedging Transactions” in the New York office. Panelists included MoFo partners David H. Kaufman and David M. Lynn, and Associate General Counsel of Bank of America Securities LLC Eric Hambleton. Panelists began with an overview of hedging transactions, including the use of derivatives and short-sales. They then discussed applicable SEC rules, regulations, and limitations on such hedging activities, including Regulation SHO (regarding limitations on abusive short-sales) and Regulation M (preventing persons from covering short-sales with securities purchased from an underwriter, broker, or dealer participating in an offering if the short-sale were effected generally five days before pricing). The panel also discussed recent SEC actions, including the temporary ban on short-sales by the SEC amidst the financial storm in the fall of 2008 and the SEC’s reconsideration of the up-tick rule.

On March 24, 2009, MoFo hosted “At-the-Market Offerings” in the New York office. An at the market offering (also referred to as an “equity distribution” or “equity dribble out” program) is a continuous offering that allows an issuer to issue securities

into the secondary market over a period of time at the publicly available bid price, rather than at a fixed or negotiated price of a traditional securities offering. MoFo partner Anna T. Pinedo discussed the benefits of such a program over traditional securities offering programs, which may include, for example, increased flexibility by the issuer in the amount and timing of securities offered, lower underwriting costs, and minimized marketing efforts (*e.g.*, no requirement of a road show). Ms. Pinedo also discussed various aspects of the applicable securities law and regulations with respect to establishing and maintaining such a program, including, for example, the preparation and filing of a shelf registration statement with the SEC on Form S-3, the execution of the distribution agreement between issuer and broker-dealer and the filing of such agreement with the SEC on Form 8-K, and the proper and continuous disclosure required to be given to investors over the term of the program.

On April 2, 2009, MoFo received an award from the Legal Marketing Association in the “best newsletter” category for its quarterly publication of Tax Talk.

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On April 14, 2009, MoFo hosted “Hybrid Offerings, Overnighters and Targeted Public Offerings” in the New York office. MoFo partners Anna T. Pinedo and James R. Tanenbaum discussed business, corporate, and securities law aspects (including Rule 144) of “PIPE” (“Private Investment in Public Equity”) transactions and registered direct offerings (sometimes referred to as “registered PIPEs”). In general, a PIPE transaction is a private placement of securities of a public company that is made to selected accredited investors and which requires the issuer to file a resale registration statement covering the resale from time to time of the privately purchased securities. It is used to raise capital without the burdensome process of a public offering. An issuer benefits from such an offering by lowering its transaction costs over a public offering. An investor benefits from such an offering by purchasing securities of the issuer at a discount over current market prices. In contrast, a registered direct offering is an offering that is registered (*i.e.*, a “public offering” under the securities law) but sold by a placement agent on an agency, or best efforts, basis (rather than a firm commitment underwriting) to a selected number

of accredited investors. It is generally used where a traditional public offering is not necessary to raise the capital needed by the issuer.

On April 16, 2009, MoFo hosted “Liability Management” in the New York office. MoFo partners Anna T. Pinedo and Thomas A. Humphreys discussed various aspects of liability management, including business, corporate, securities, and tax law considerations, of the restructuring of debt securities. This discussion included redemptions, repurchases, and tender offers for cash and property. The tax law discussion focused on the potential for cancellation of indebtedness income with respect to the restructuring of debt securities and the temporary (but significant) relief provided by Section 108(i) of the Code, which was enacted on February 17, 2009 in the American Recovery and Reinvestment Act of 2009. As discussed in our prior client alerts (*see, e.g.*, “Temporary Deferral of Cancellation-of-Indebtedness Income Under the Recovery and Reinvestment Act of 2009,” available at <http://www.mofo.com/news/updates/files/15268.html>), Section 108(i) allows an issuer to defer for up to a period of five years cancellation of indebtedness income with respect to certain restructurings of debt securities, including debt-for-debt exchanges. Once the initial deferral period expires, an issuer generally will be required to include

the discharged debt ratably over a subsequent five year period.

On April 21, 2009, MoFo hosted “Credit Derivatives and Regulatory Reform” in the New York office. MoFo partner David H. Kaufman and MoFo counsel David A. Trapani discussed various initiatives for regulatory reform of the derivatives market, including the Administration’s “framework” for regulatory reform of the financial system, first introduced on March 26, 2009 by Treasury Secretary Geithner. The framework focuses on, among other things, minimizing and preventing systemic risk on the financial system. To do so, the framework proposes to establish a single independent regulator to measure, quantify, and identify systemic risk in the financial system; to establish and enforce higher standards on capital and risk management for systemically important firms; to require certain hedge fund advisers with assets under management above a threshold to register with the SEC; and to establish a comprehensive framework of oversight, protections and disclosure for the over-the-counter (“OTC”) derivatives markets. For more detailed information, see our prior client alert, “Credit Derivatives: Recent Regulatory Developments,” available at http://www.mofo.com/news/updates/files/090420Credit_Derivatives.pdf.

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On April 30, 2009, MoFo hosted “Good-Bank-Bad Bank for Insurance Companies” in the New York office. MoFo partner Chiahua Pan and MoFo counsel David A. Trapani discussed various aspects of the restructuring of MBIA Insurance Corp., including its effect on credit default swaps. For more detailed information regarding this restructuring, see our prior client alert, “Good Bank-Bad Bank for Insurance Companies,” available at <http://www.mofo.com/news/updates/files/20090309GoodBank.pdf>.

On May 7, 2009, MoFo was named best law firm of the year (Americas) by Structured Products magazine for its work on structured products. MoFo has represented issuers and underwriters on over 130 structured note offerings over the preceding 12 months to April of 2009, representing

approximately \$2.4 billion of securities issued.

On May 20, 2009, MoFo, in collaboration with the International Financial Law Review, hosted an “Executive Compensation Roundtable” in the New York office, where panelists analyzed compensation reform and emerging best practices in the aftermath of the financial crisis, including certain restrictions imposed by the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 (including, *e.g.*, limiting “luxury” expenditures, creating say-on-pay shareholder voting rights, imposing a compensation clawback right on the 25 most highly paid executives, and limiting a corporation’s tax deduction for compensation paid in excess of \$500,000 per annum). Panelists included MoFo partner David M. Lynn. For more information, see our prior client alert, “A New Era for Executive Compensation: Recovery Plan’s Retroactive Restrictions and

Say-on-Pay Mandate,” available at <http://www.mofo.com/news/updates/files/090302NewEra.pdf>.

On May 28, 2009, MoFo, in collaboration with the Structured Products Association, hosted “OTC Derivatives Regulation,” where panelists discussed proposals for regulating the over-the-counter derivatives (“OTC”) market in the U.S., including the Treasury’s recommendation to amend the Commodity Exchange Act and the federal securities laws to require clearing of all standardized OTC derivatives through regulated clearinghouses. Panelists included MoFo partner Oliver I. Ireland and MoFo Counsel David A. Trapani. For more detailed information, see our prior client alert “Credit Derivatives: Recent Regulatory Developments,” available at <http://www.mofo.com/news/updates/files/090420CreditDerivatives.pdf>. ■

Contacts

United States Federal Income Tax Law

Thomas A. Humphreys
(212) 468-8006
thumphreys@mofo.com

Shamir Merali
(212) 336-4149
smerali@mofo.com

Corporate and Securities Law

Anna Pinedo
(212) 468-8179
apinedo@mofo.com

Lloyd Harmetz
(212) 468-8061
lharmetz@mofo.com

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