

# TaxTalk



## Editor's Note

As the financial crisis continues to ease, and capital markets continue to mend, policymakers can shift their attention to other important matters. In the first quarter of 2010, we continue to report on an emerging financial recovery, as well as movement on other important policy issues. Of particular note, we report on certain important revenue raisers in the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (together, the "Health Care Act"), which pays for increased health care by, in part, codifying the economic substance doctrine (effective immediately) and increasing the Medicare tax on high-income earners (beginning in 2013), and in the Hiring Incentives to Restore Employment Act (the "HIRE Act"), which codified the provisions of the Foreign Account Tax Compliance Act of 2009. In addition, we discuss an IRS issued Industry Director Directive on Total Return Swaps and *Container Corp. v. Commissioner* (T.C., No. 3607-05, 134 T.C. No. 5), which held that guaranty fees paid to a foreign guarantor are foreign source and therefore not subject to U.S. withholding tax. We also provide an update on contingent capital. And, in our regular feature, The Classroom, building on past issues discussing capital markets offerings, we discuss the boundaries of reopenings as applied to structured notes.

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## Authored and Edited By

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

# Health Care Act Revenue Raisers

As discussed in our client alert, [“Reconciliation Bill Codifies ‘Economic Substance’ Doctrine, Expands Medicare Taxes on High Income Earners and Imposes Reporting Requirements on Certain Payments to Corporations.”](#) on March 30, 2010, President Barack Obama signed into law the Health Care and Education Reconciliation Act of 2010, which supplements the Patient Protection and Affordable Care Act, which was signed into law on March 23, 2010. To pay for the new law, there are a number of revenue raisers, which include codification of the economic substance doctrine and additional Medicare taxes on high income earners, which we recap below.

## Economic Substance Doctrine

### Background

The “economic substance doctrine” allows the government to recast a transaction in a manner that reflects its substance, or to disregard a transaction and its related federal income tax consequences, when the transaction has no economic substance other than its intended tax consequences. There is a conflict in the U.S. Circuit Courts of Appeal as to the proper standard that should apply in determining when a transaction is to be disregarded on the basis of the economic substance doctrine. In applying the doctrine, the Fourth and D.C. Circuits have adopted a two-prong “conjunctive” test. Pursuant to this test, in order to disregard a transaction for federal income tax purposes, the court must conclude that the taxpayer, in entering into the transaction, fails both of the following requirements: (i) subjective business purpose, and (ii) objective profit potential. The Sixth, Eleventh, and Federal Circuits have adopted the same test in a “disjunctive” fashion (*i.e.*, if the taxpayer fails either of the aforementioned prongs, the transaction at issue may be disregarded). The Third, Ninth, and Tenth Circuits have adopted a “unitary” test. Pursuant to this

test, the subjective business purpose and objective profit potential, together, should be analyzed in order to determine whether a transaction has substance, apart from its tax consequences.

### Codification

The Health Care Act provides that any transaction (including a series of transactions) entered into after March 30, 2010 and to which the economic substance doctrine is relevant is treated as having economic substance only if (i) the transaction changes in a meaningful way the taxpayer’s economic position (the objective test), and (ii) the taxpayer has a substantial purpose for entering into such transaction (the subjective test). In applying the foregoing two tests, federal, state, or local income tax effects should be disregarded. The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision codifying the doctrine had not been enacted.

In determining whether the objective and subjective tests are met with respect to a transaction, a profit potential is only taken into account if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits from the transaction. In calculating any pre-tax profit, fees and other transaction expenses must be taken into account as expenses. Further, the Health Care Act requires Treasury to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profits in appropriate cases. In addition, achieving a financial accounting benefit that originates from a reduction of federal income tax is not taken into account in determining whether the taxpayer meets the above described subjective test.

The economic substance provision only applies to a transaction entered into by an individual if the transaction is entered into in connection with a trade or business or an activity engaged in for the production of income.

The technical explanation to the Health Care Act<sup>1</sup> clarifies that this provision is not intended to change the tax treatment of certain basic business transactions merely because these transactions involve a choice between meaningful economic alternatives and the choices are largely or entirely based on comparative tax advantages. Examples noted in the technical explanation include: (i) the choice between capitalizing an entity with debt or equity, (ii) the choice between using a foreign corporation or a domestic corporation to make a foreign investment, (iii) the choice to enter into a transaction (or series of transactions) constituting a (re)organization, and (iv) the choice to use a related party in a transaction.

**The Health Care Act further introduces a 3.8% Medicare contribution tax on unearned income (i.e., income not from wages) of certain high income earners.**

Further, the technical explanation states that no inference is intended as to the proper application of the common law economic substance doctrine and that the Health Care Act is additive to that doctrine.

### Penalties

The Health Care Act introduces a new strict liability penalty of 20% for an understatement attributable to a disallowance of claimed tax benefits by reason of a transaction entered into after March 30, 2010 lacking economic substance or failing to meet the requirements of any similar rule of law (and, therefore, it seems that the penalty would apply to both the statutory and common law version of the economic substance doctrine). The penalty is increased to 40% if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment of the transaction on its tax return or in a statement attached to the return. An amended tax return or a supplement to a tax return is not taken into account if it is filed after the taxpayer has been contacted for audit. Importantly, the “reasonable cause exception” is not available to avoid the penalty. Therefore, as the technical

<sup>1</sup> Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as amended, in combination with the “Patient Protection Act and Affordable Care Act,” as amended, *Joint Committee on Taxation*, March 21, 2010 (JCX-18-10).

# Health Care Act Revenue Raisers

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explanation points out, an opinion from outside counsel or an in-house analysis would not protect a taxpayer from imposition of the penalty.

## Medicare Tax

Under current law, both employers and employees are subject to a Medicare hospital insurance tax in an amount equal to 1.45% of the wages paid to the employee. The employee level tax generally must be withheld and remitted to the federal government by the employer. As from January 1, 2013, the Health Care Act increases the Medicare hospital insurance tax and imposes a Medicare contribution tax on unearned income, in each case on certain high income earners.

### Medicare Hospital Insurance Tax

The Health Care Act imposes an additional tax of .9% on the wages of an employee over a specified threshold amount. The threshold amount is \$250,000 in the case of a joint return, \$125,000 in the case of a married individual filing a separate return, and \$200,000 for single filers. The additional tax is also imposed on income from self employment.

### Medicare Contribution Tax

The Health Care Act further introduces a 3.8% Medicare contribution tax on unearned income (*i.e.*, income not from wages) of certain high income earners. Specifically, in the case of an individual, the tax is imposed at a rate of 3.8% on the lesser of (i) “net investment income,” or (ii) the excess of “modified adjusted gross income” over the threshold amount specified in the preceding paragraph. “Net investment income” equals the taxpayer’s gross investment income reduced by the deductions that are allocable to such income. Investment income generally includes passive income such as interest, dividends, annuities, royalties, and rents and capital gains. “Modified adjusted gross income” is adjusted gross income increased by the amount excluded from

income as foreign earned income.

### Current and Future Federal Income Tax Rates on Investment Income

The chart below shows the maximum federal income tax rate, assuming no changes to current law,<sup>2</sup> that applies to an individual earning in excess of the threshold amount with respect to three categories of investment income for the years 2010, 2011 and 2013 (taking into account the Medicare contribution tax starting in 2013).<sup>3</sup>

	2010	2011	2013
Dividends	15%	39.6%	43.4%
Interest	35%	39.6%	43.4%
Long-Term Capital Gain	15%	20%	23.8%

The Tax Foundation ([www.taxfoundation.org](http://www.taxfoundation.org)) provided a number of helpful examples on the effect of these additional taxes on certain taxpayers. For example, a single taxpayer earning \$200,100 in wages would see a Medicare tax increase of 90 cents (\$100 excess wages multiplied by .9%). A single taxpayer earning \$300,000 in wages would see a Medicare tax increase of \$900 (\$100,000 excess wages multiplied by .9%). Married filers earning \$5 million in investment income would be subject to a new Medicare unearned income tax of \$180,500 (\$4.75 million excess unearned income multiplied by 3.8%).

## HIRE Act FATCA Recap

As discussed in our prior client alert [“FATCA Provisions Enacted Into Law: New Withholding Tax, Ban on Bearer Bonds, and Withholding on Dividend Equivalents,”](#) on March 18, 2010,

<sup>2</sup> Note that the Obama administration’s fiscal year 2011 green book (available at <http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf>) contains a proposal which would provide for a reduced rate of 20% on qualifying dividends.

<sup>3</sup> The year 2012 is not included in the chart since, under current law, the federal income tax rates for that year are not scheduled to change from the 2011 levels.

President Obama signed into law the HIRE Act. We provide a recap of some of the more notable provisions below, including provisions which: (i) introduce a new 30% withholding tax on certain payments made to foreign entities that fail to comply with specified reporting or certification requirements, (ii) end the practice whereby U.S. issuers sell bearer bonds to foreign investors by repealing the U.S. bearer bond exception, and (iii) impose a withholding tax on “dividend equivalents” paid under equity swaps.

### New Withholding Tax

The HIRE Act introduces a new 30% withholding tax on any “withholdable payment” made to a foreign entity unless such entity complies with certain reporting requirements or otherwise qualifies for an exemption. A “withholdable payment” generally includes any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the U.S. It also includes gross proceeds from the sale of property that is of a type that can produce U.S.-source dividends or interest, such as stock or debt issued by domestic corporations. Different rules apply to foreign “financial institutions” (“FFIs”) and to other foreign entities.

The new 30% withholding tax on any “withholdable payment” made to an FFI (whether or not beneficially owned by such institution) applies unless the FFI agrees, pursuant to an agreement entered into with Treasury, to provide information with respect to each “financial account” held by “specified U.S. persons” and “U.S.-owned foreign entities.” The new disclosure requirements are in addition to requirements imposed by a “Qualified Intermediary” agreement.

The term FFI includes banks, brokers, and investment funds, including private equity funds and hedge funds. A “financial account” includes bank accounts, brokerage accounts, and other custodial accounts, or an equity or debt interest in the FFI (unless such interest is regularly traded). The term “specified U.S. person” includes any U.S. person, other than certain categories of entities, such as publicly-traded corporations and their affiliates, banks, mutual funds, real estate investment trusts and charitable trusts.

# HIRE Act FATCA Recap

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A “U.S.-owned foreign entity” for this purpose is any entity that has one or more “substantial U.S. owners,” which generally means (i) in the case of a corporation, if a specified U.S. person, directly or indirectly, owns more than 10% of the stock, by vote or value, (ii) in the case of a partnership, if a specified U.S. person, directly or indirectly, owns more than 10% of the profits or capital interests, or (iii) in the case of a trust, if a specified U.S. person is treated as an owner of any portion of the trust under the grantor trust rules. By entering into the agreement with

**The new withholding tax applies to any withholdable payment made after December 31, 2012, and, in the case of “obligations,” only with respect to payments on obligations issued after March 18, 2012.**

Treasury, the FFI agrees to (i) obtain information necessary to determine which accounts are U.S. accounts, (ii) comply with verification and due diligence procedures as required by Treasury, (iii) annually report certain information regarding U.S. accounts (including U.S. account holder identification information and annual account activity information), (iv) withhold on “passthru payments” made to (1) recalcitrant account holders, (2) other FFIs that do not enter into an agreement with Treasury, and (3) FFIs that have elected to be withheld upon (as further described below), (v) comply with requests by Treasury for additional information with respect to any U.S. accounts, and (vi) attempt to obtain a waiver from the U.S. account holder if any foreign law would otherwise prevent the reporting of required information or alternatively close the account. Instead of reporting the necessary U.S. account information, an FFI may elect to comply with the reporting requirements that apply to U.S. financial institutions, which generally means reporting on Internal

Revenue Service (“IRS”) Forms 1099.

Rather than agreeing with Treasury to act as a withholding agent in respect of reportable payments, an FFI may elect to provide the withholding agents from which it receives payments with the information necessary for the withholding agents to implement the new withholding tax (generally, information that discloses the extent to which payments made to the electing FFI are allocable to accounts subject to the 30% U.S. withholding tax). In addition, the agreement entered into between the electing FFI and Treasury must include a waiver of any right under any tax treaty of the U.S. with respect to any amounts withheld under this election provision.

Further, the HIRE Act contains a provision pursuant to which an FFI may be treated as meeting the specified reporting requirements if (i) it complies with procedures ensuring it maintains no U.S. accounts and meets certain requirements with respect to other FFIs maintaining an account with it, or (ii) such FFI is a member of a class of institutions that would not be subject to these provisions. Implementing procedures, requirements, and determinations in respect of this provision would be determined by Treasury in future guidance.

The new withholding tax also applies to any withholdable payment made to a non-financial foreign entity, unless the non-financial foreign entity provides the withholding agent with either (i) a certification that it does not have a substantial U.S. owner, or (ii) the name, address, and taxpayer identification number of each substantial U.S. owner. This provision does not apply to payments made to a publicly-traded non-financial foreign entity, or any of its affiliates.

If the beneficial owner of a payment is entitled to treaty benefits, the withholding tax rate imposed on any withholdable payment may be reduced or eliminated by the provisions of an applicable tax treaty and such beneficial owner would be entitled to a partial or full refund or credit. In addition, even if a treaty is not available, the beneficial owner (other than an FFI) of a withholdable payment on which the 30% tax is withheld may otherwise be entitled to a full refund or credit of the tax (e.g., because payments are eligible for the portfolio interest exemption or

represent gross proceeds from the sale of a capital asset). In such a case, a non-U.S. person would have to file a U.S. tax return to obtain a full or partial refund or credit. Similarly, a U.S. person with a foreign bank account on which it receives payments that are withheld on, presumably would have to claim a refund or credit on its U.S. tax return.

The new withholding tax applies to any withholdable payment made after December 31, 2012, and, in the case of “obligations,” only with respect to payments on obligations issued after March 18, 2012. Therefore, debt obligations (but not stock) outstanding on March 18, 2012, are grandfathered.

## **Repeal of U.S. Bearer Bond Exception**

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (“TEFRA”), which restricts the issuance of debt instruments in bearer form. Under TEFRA, issuers of debt instruments in bearer form generally are denied deductions for U.S. federal income tax purposes for interest paid with respect to such debt instruments and are subject to an excise tax (equal to 1% of the principal amount of the bonds times the number of years to maturity). Various sanctions also apply to holders. The aforementioned sanctions, however, do not apply with respect to bearer debt instruments that are issued under circumstances in which they are unlikely to be sold to U.S. persons. These circumstances include an issuance of foreign-targeted bearer debt instruments that complies with Treasury regulations referred to as “TEFRA C” and “TEFRA D.”

The U.S. imposes a 30% withholding tax on all U.S. source interest paid to non-resident aliens and foreign corporations. In 1984, Congress exempted “portfolio interest” from the U.S. withholding tax in order to encourage investment in U.S. debt. Portfolio interest is any U.S. source interest other than interest received from certain related parties, or interest earned by a bank on an extension of credit in the ordinary course of its lending business. In addition, Congress provided that debt instruments in bearer form do not qualify for the portfolio interest exemption (with the result that interest paid on such instruments is generally subject to the 30% U.S. withholding tax) unless such instruments are issued in compliance with the foreign-targeted requirements imposed

# HIRE Act FATCA Recap

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by TEFRA.

Many U.S. issuers have European medium-term note or other foreign-targeted programs pursuant to which they issue bearer notes to non-U.S. investors. These issuances comply with TEFRA regulations and, as such, the instruments are not subject to the sanctions described above or to U.S. withholding tax. In addition, many non-U.S. issuers include TEFRA restrictions in their debt offerings sold outside the U.S. to ensure that they are not subject to the TEFRA excise tax.

Some foreign jurisdictions, e.g., Switzerland, do not permit their residents to certify as to their identity. Accordingly, there are special rules in the TEFRA regulations that permit offerings to be sold into those jurisdictions in bearer form if certain additional requirements are met.

The HIRE Act ends the practice by U.S. issuers of selling bearer bonds to foreign investors under TEFRA C and TEFRA D. Thus, with respect to U.S. issuers of foreign-targeted bearer bonds, the HIRE Act repeals the exception to a denial of interest deduction for interest on bearer bonds. In addition, interest paid on such bonds would no longer qualify for treatment as portfolio interest, thereby subjecting such interest to a 30% withholding tax, and any gain realized by a holder of such bonds would be treated as ordinary income.

As a result, U.S. issuers will have to revise their existing securities offering programs, including medium-term note programs, to prohibit bearer debt. U.S. issuers may have a harder time raising capital in foreign jurisdictions to the extent investors in those jurisdictions are unwilling to provide the non-U.S. beneficial ownership certification (e.g., IRS Form W-8BEN)

required for registered debt. However, the HIRE Act includes a provision giving Treasury the authority to determine that certification as to non-U.S. beneficial ownership is not required to qualify for the portfolio interest exemption from withholding tax on payments of interest on certain registered debt obligations. In addition, the HIRE Act codifies IRS Notice 2006-99 providing that debt obligations cleared through dematerialized book-entry systems (such as JASDEC in Japan, or other book-entry systems specified by the Treasury) would be treated as being issued in registered form. It seems that these provisions are aimed at giving Treasury the authority to prescribe rules pursuant to which U.S. issuers would be able to raise debt capital from jurisdictions where bonds are typically held in dematerialized form or where

investors are legally barred from certifying as to residency (e.g., Switzerland). Whether Treasury would, in fact, exercise such authority remains to be seen.

The HIRE Act preserves the exception to the excise tax for bearer bonds issued under TEFRA-compliant

procedures. As a result, foreign issuers of a “foreign-to-foreign” bearer debt offering that is TEFRA-compliant would not be subject to the excise tax.

The repeal of the U.S. bearer bond exception applies to debt obligations issued after March 18, 2012. Therefore, debt obligations in bearer form outstanding on March 18, 2012 are grandfathered.

## “Dividend Washing”

In September 2008, the Senate Permanent Subcommittee on Investigations released a report entitled “Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends.” The report described a range of transactions employed by financial institutions aimed at enabling non-U.S. clients to avoid U.S. withholding taxes on dividends paid with respect to U.S. securities. As described in the report, U.S. withholding taxes on dividends are avoided through the use of either swaps or stock-lending transactions, or

a combination thereof. Transactions involving swaps rely on a Treasury regulation that provides that the source of any payments made pursuant to the swap is determined according to the country of residence of the person receiving the payment. 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 stock of a U.S. corporation), transactions involving stock lending rely on a decade-old IRS Notice (Notice 97-66) to avoid U.S. dividend withholding tax.

The HIRE Act treats as a U.S.-source dividend any “dividend equivalent” for purposes of U.S. withholding tax provisions. A “dividend equivalent” is (i) any substitute dividend (made pursuant to a securities-lending or “repo” transaction), (ii) any amount paid pursuant to a “specified notional principal contract,” and that is contingent on, or determined by reference to, the payment of a U.S.-source dividend, and (iii) any amount that the Treasury determines is substantially similar to a payment described in (i) and (ii).

A specified notional principal contract is any notional principal contract if (i) in connection with entering into the contract, any long party (*i.e.*, the party entitled to receive the dividend related payment) transfers the underlying security, (ii) in connection with the termination of the contract, any short party (*i.e.*, any party that is not a long party) transfers the underlying securities to any long party, (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral, or (v) the Treasury identifies the contract as a specified notional principal contract. In addition, unless the Treasury determines that a notional principal contract is of a type that does not have the potential for tax avoidance, any notional principal contract pursuant to which payments are made after March 18, 2012, will be a specified notional principal contract.

To address the concern with respect to the cascading effect of such a dividend withholding tax, the HIRE Act includes a provision pursuant to which the Treasury

**The HIRE Act treats as a U.S.-source dividend any “dividend equivalent” for purposes of U.S. withholding tax provisions.**

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may reduce the tax if one or more of the dividend equivalents is subject to tax and to the extent the taxpayer establishes that the tax has been paid on another dividend equivalent in the chain or if Treasury determines such reduction is appropriate to address the role of financial intermediaries. For purposes of this provision, an actual dividend payment is treated as a dividend equivalent.

This provision applies to payments of “dividend equivalents” made on or after September 14, 2010 (*i.e.*, the 180<sup>th</sup> day after enactment of the HIRE Act). Therefore, these provisions apply to existing swaps.

## Did You Catch That?

Keen readers of fine print may have noticed §561 of the HIRE Act and §1410 of the Health Care and Education Reconciliation Act of 2010. Those sections amend §6655 of the Internal Revenue Code which provides for the payment by corporations of estimated taxes. Generally speaking, large corporations (those with at least \$1 billion of assets) must pay estimated tax equal to 100% of their current year federal income tax in four installments during the taxable year. Putting §561 and §1410 together it appears that for July, August, and September 2014 large corporations will have to pay 173.5% of the normal required estimated tax installment to the IRS. The provision reverses itself in the next quarter. Why? Looking, in particular, at §1410 of the Health Care and Education Reconciliation Act of 2010, we surmise that 2014 marks the end of the 5-year reconciliation period (the federal fiscal year ends on September 30). For government budget purposes, approximately \$8 billion of revenue is raised through §1410 in the five year budget window. (On the other hand, over the 10-year horizon used to judge the health care legislation's overall impact, the increase is offset by

the subsequent decrease in estimated payments.) From what we can tell, this revenue accelerating budget device has been used before, although the 173.5% number appears to be a record. One imagines that in 2014 large corporations will be quite distressed to learn that they are being asked to make a short-term loan to the IRS.

## IRS Issues Industry Director Directive on Total Return Swaps

On January 14, 2010, the IRS issued an Industry Director Directive on Total Return Swaps Used to Avoid Dividend Withholding Tax (“IDD”). The IDD provides audit guidance to IRS field agents auditing financial institutions and contains six forms of Information Document Requests for IRS field agents to use in order to obtain information from financial institutions that have engaged in equity swap transactions. The purpose of the IDD is to assist IRS field agents in uncovering and developing cases related to total return swap transactions that may have been executed in order to avoid U.S. withholding tax with respect to non-U.S. persons. It seems that the IRS is looking to assert deficiencies against the financial institutions that facilitated the equity swap transactions, in their capacity as a withholding agent, rather than against the non-U.S. persons that have the substantive tax liability. The IDD includes a description of several transactions perceived to be potentially abusive involving equity swaps such as: cross-in and cross-out transactions, cross-in and interdealer broker out transactions, cross-in and foreign affiliate out transactions, and “fully synthetic” transactions. The IRS encourages its field agents to develop cases where it could be concluded that, in substance, the non-U.S. person retained ownership of the U.S. equities referenced by the swap transactions. As such, the non-U.S. person would be treated as having received a payment of a U.S. source dividend, instead of a payment under a swap which would be foreign source, and

which would be subject to U.S. withholding tax. The financial institution, as a financial intermediary, would be considered a withholding agent with respect to those payments and would be liable for the withholding tax if it failed to withhold and remit the withholding tax to the IRS. To avoid this liability, the financial institution would be expected to argue that the form of the swap transaction should be respected. It is not possible to predict the extent of the impact of the IDD on the equity swap market or the ultimate outcome of the transactions described in the IDD if litigated. We understand, however, that a number of financial institutions in the U.S. are already under audit on this issue.

## Container Corp. v. Commissioner: No U.S. Withholding Tax on Payment of Guaranty Fees by U.S. Subsidiary to Foreign Parent

In resolving what has long been an uncertain issue, the Tax Court held, in an opinion dated February 17, 2010, that a U.S. corporate subsidiary of a Mexican parent company was not required to withhold U.S. federal income taxes from the guaranty fees the subsidiary paid to its parent in connection with guaranteeing its debt.

The U.S. imposes a 30% withholding tax on all interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical (“FDAP”) gains, profits, and income that are U.S. source and paid to non-resident aliens and foreign corporations. Treasury regulations provide sourcing

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rules for certain, but not all, categories of FDAP income. For example, Treasury regulations provide that interest is sourced according to the place of residence of the payor and that payments for services are sourced according to where the services are performed. To the extent no sourcing rules are set forth in Treasury regulations, case law provides that the source of any such FDAP income would have to be determined by analogy. In *Bank of America v. U.S.*, 680 F.2d 142 (Ct. Cl. 1982), the court held that a bank's commissions received for acceptance and confirmation of letters of credit were sourced by analogy to interest because the bank substituted its credit for that of the foreign bank issuing the letters of credit. However, commissions received pursuant to transactions, in which the bank confirmed that the documentation presented by the beneficiary conformed to the terms of the letter of credit, were, according to the court, sourced by analogy to income from services. Until now, it was not clear what guaranty fee payments were analogous to.

In *Container Corp.*, a Mexican corporation guaranteed its U.S. subsidiary's notes, which were issued in connection with an acquisition. The U.S. subsidiary paid its Mexican parent a guaranty fee equal to 1.5% of the outstanding principal balance of the notes each year. The U.S. subsidiary did not withhold any U.S. federal income taxes from the fees.

The Internal Revenue Service ("IRS") asserted that the guaranty fees were FDAP income and should be considered

U.S. source since they were analogous to interest and paid by a U.S. corporation. Therefore, according to the IRS, the fee payments would be subject to U.S. federal withholding tax. The U.S. subsidiary admitted that the guaranty fees were FDAP income, but argued that the fees were not U.S. source (and therefore not subject to U.S. federal withholding tax) since they were for services performed in Mexico.

The Tax Court reasoned that the parent's creditworthiness, its goodwill, and its assets produced the guaranty fees and found that such fees were more analogous to payments for the performance of services because they were payments for incurring a contingent future obligation. The court then concluded that since the parent was located outside the U.S., the guaranty fees were not U.S. source and therefore not subject to U.S. withholding tax.

**Reopening a debt issue can have significant tax consequences, particularly where the additional notes, treated as debt instruments for U.S. federal income tax purposes, are issued with original issue discount ("OID").**

## Update on Contingent Capital

As we previously discussed in our prior issue of MoFo Tax Talk and elsewhere (see e.g., [MoFo Tax Talk, Volume 2, Issue 4, "Contingent capital instruments,"](#) and ["Is it a bird? A plane? Exploring contingent capital"](#)) contingent capital instruments are a novel hybrid security intended to provide a buffer for financial institution issuers during times of stress, when financial institutions may find it difficult to access the market in order to bolster their regulatory capital levels.

The first contingent capital instrument was Lloyds' Enhanced Capital Notes issued last November. A Lloyds Banking Group affiliate issued £7.5 billion in the form of contingent capital called "enhanced capital notes" to existing Tier 1 and Upper Tier 2 security holders. The enhanced capital notes have a ten year term and pay fixed, non-deferrable interest. The notes are

convertible into a fixed number of Lloyds ordinary shares if Lloyds' consolidated core Tier 1 ratio falls below 5%. In the Lloyds offering, the contingent capital instruments were offered as part of an exchange for poorly performing bonds. So it was not clear how a new offering of contingent capital instruments would be received by investors and the yield that investors would exact.

However, in March, Rabobank Nederland, the Dutch bank, issued €1.25 billion of new contingent capital notes (Rabobank "Senior Contingent Notes due 2020"). The notes were well received by investors, having an order book size of €2.6 billion and a yield of 6.875% (some expected that for the notes to sell, a higher yield would be required). In general, the notes act like regular fixed rate bonds but provide that if a trigger event occurs—i.e., that the bank has an equity capital ratio of less than 7%—the redemption price of the notes will be written down by 75% to 25% of the notional amount. Accordingly, the notes have contingent principal dependent upon the equity capital reserves of the bank.

## The Classroom: Reopening Structured Notes

As discussed in our prior issue of MoFo Tax Talk (see [MoFo Tax Talk, Volume 2, Issue 1](#)), debt issues are often "reopened," meaning that an issuer issues an additional tranche of notes ("additional notes") at some point after the original issuance ("original notes"). The additional notes bear the same terms and security identification code (e.g., CUSIP number) as the original notes. Generally speaking, the economic motive behind a reopening is to give existing holders a more liquid instrument and to give the issuer a lower cost of financing. To achieve these goals, the issuer's intent is that the original notes and the additional notes be indistinguishable and, therefore, completely fungible. Reopening a debt issue can have significant tax consequences, particularly where the additional notes, treated as debt

# The Classroom:

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instruments for U.S. federal income tax purposes, are issued with original issue discount ("OID").

Taxpayers are required to currently accrue OID on a constant yield basis for any debt instrument that is issued with more than a *de minimis* amount of OID. OID generally arises where a note is originally issued at a discount and is an attribute of the note itself (*i.e.*, OID "travels" with the note and does not vary depending on whether an original investor or a secondary market investor holds the note). In contrast, "market discount" generally arises when a secondary-market investor purchases a debt instrument at a discount after original issue. Market discount generally is not taxable currently as it accrues, unless the holder so elects.

Thus, where the original notes are not issued with OID, but where the additional notes are priced at a discount in excess of the statutory *de minimis* amount (*e.g.*, because interest rates have risen after original issue), a holder generally would prefer the original notes and the additional notes to be fungible from a tax standpoint, so that the additional notes (like the original notes) are not treated as having been issued with OID, but rather are treated as being acquired by holders at a market discount. The reopening rules discussed below police the boundaries within which the additional notes may be treated as fungible with the original notes in this manner.

If the original notes and the additional notes do not meet the requirements described below, the tax law treats the additional notes as a fresh issuance issued with OID and, accordingly, the original notes and the additional notes would not be fungible from a tax standpoint. If the original notes and the additional notes are nonetheless issued so that they are indistinguishable (*i.e.*, issued with the same terms and CUSIP number) it would be impossible for secondary market purchasers or, for that matter, the IRS, to trace securities through the chain of intermediate ownership and determine whether their notes were issued as part of the original issuance (issued without OID) or the additional issuance (issued with OID). There is a risk, then, that the

additional notes may taint the original notes, with the IRS treating both the original notes and the additional notes as having been issued with OID in the hands of a purchaser who buys notes after the reopening.

To be fungible from a tax standpoint, the reopening must satisfy one of three tests: the original notes and the additional notes must be part of the same "issue" (under the 13-day rule discussed below), or the additional notes must be part of a "qualified reopening" of the original notes (under either one of the two alternative tests discussed below). Under each of the three tests, a precondition is that the additional notes must have terms that are in all respects identical to the terms of the original notes.

## 13-Day Rule

Under applicable regulations, an "issue" of debt instruments includes all debt instruments that:

- a. are issued either pursuant to a common plan or as part of a single transaction or a series of related transactions, and
- b. are issued within a period of 13 days beginning with the date on which the first debt instrument that would be part of the issue is sold to a person other than a bond house, broker, or similar person or organization acting in the capacity of an underwriter, placement agent, or wholesaler.

## Qualified Reopening

The regulations provide rules for two types of qualified reopenings. Under the first rule, a reopening of debt instruments is treated as a qualified reopening if:

- a. the original notes are "publicly traded" (see discussion below),
- b. the issue date of the new notes (treated as a separate issue) is not more than six months after the issue date of the original notes, and
- c. on the pricing date of the reopening (or, if earlier, the announcement date), the yield of the original notes (based on their fair market value) is not more than 110% of the yield of the original

notes on their issue date (or, as is often the case, if the original securities were issued with no more than a *de minimis* amount of OID, their coupon rate).

Alternatively, a reopening of debt instruments (regardless of whether the reopening occurs within six months or not) is treated as a qualified reopening if:

- a. the original notes are publicly traded, and
- b. the additional notes (treated as a separate issue) are issued with no more than a *de minimis* amount of OID.

## Publicly Traded Test

Applicable regulations provide detailed rules that define when notes are treated as "publicly traded." The most common scenarios are (a) the notes are listed on a national securities exchange, or (b) the notes appear on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers or traders, or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a "quotation medium"). A quotation medium does not include a directory or listing of brokers, dealers or traders for specific securities that provides neither price quotations nor actual prices of recent sales transactions. Bloomberg and/or TRACE may qualify as a quotation medium for a particular issuance if there is sufficient trading frequency and volume within the testing period. Even if any particular tranche of notes does not satisfy the requirements of (a) and (b) above, they may nonetheless be treated as publicly traded under additional tests that are more fact specific.

## Reopening Structured Notes

Whether an issue of structured notes (for a taxonomy on structured notes, see our prior issue of [MoFo Tax Talk, Volume 1, Issue 1](#)) may be reopened without the above described adverse U.S. federal income tax consequences generally depends on the characterization of the note and the technical rules that apply to

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the structured note.

Type 1 notes are generally treated either as fixed rate debt instruments, variable rate debt instruments (“VRDIs”), or contingent payment debt instruments (“CPDIs”). The discussion above regarding the 13-day rule generally applies to all structured notes that are treated as Type 1 notes. In addition, the qualified reopening rules described above generally apply to all Type 1 notes that are treated as either fixed rate debt instruments or as VRDIs. However, the qualified reopening rules do not apply to Type 1 notes that are considered CPDIs for U.S. federal income tax purposes. Therefore, an issue of Type 1 notes treated as CPDIs can only be reopened for tax purposes if the reopening meets the requirements of the 13-day rule. If additional notes in an issue of CPDIs are issued outside of the 13-day rule, such additional notes will have a different issue date, a different issue price and a different adjusted issue price from the original notes. In addition, the issuer would be required to provide a new “comparable yield” and “projected payment schedule” with respect to the additional notes. Further, the additional notes would have to be distinguished from the original notes (e.g., through a different CUSIP number).

Type 2 notes are not treated as debt instruments for U.S. federal income tax purposes and, under current law, a holder of a Type 2 note is not required to accrue any income (including OID or market discount). As a result, the above described concern regarding the conversion of OID into market discount does not exist, and U.S. federal income tax law does generally not impose any restrictions on reopening Type 2 notes.

To the extent a Type 3 note is treated as an income-bearing single financial contract, the same considerations as to the reopening of Type 2 notes apply and U.S. federal income tax law generally does not impose restrictions on reopening. However, to the extent a Type 3 note is treated as a unit consisting of a debt component and a derivative, an analysis of a reopening of a Type 3 note will depend on the facts and circumstances, on the agreed upon treatment between the issuer and the holder of the particular

note and the prevailing market conditions at that time. As such, the reopening of Type 3 notes may be subject to the same considerations as the reopening of Type 1 notes or of Type 2 notes.

## Press Corner

The U.S. tax authorities will soon launch another prosecution against a foreign bank for facilitating offshore tax evasion, a la the case against Swiss bank UBS AG, according to an IRS agent speaking with Reuters. (See, e.g., Pascal Fletcher, “IRS: new UBS-style foreign bank prosecution ‘shortly,’” Reuters, <http://www.reuters.com/article/idUSTRE62E4OW20100315?feedType=RSS>.) Last year, UBS was accused of aiding and abetting offshore tax evasion by U.S. citizens. UBS settled two U.S. lawsuits against it, agreeing to pay a \$780 million fine and also agreeing to turn over account records to U.S. authorities. The threat to turnover account records led to many prior undeclared accounts being disclosed to U.S. tax authorities through a specially tailored voluntary compliance program, which expired on October 15, 2009, and, the pre-existing IRS voluntary compliance standards.

Charles Rangel (D – New York) temporarily stepped down as chairman of the House Ways and Means Committee until a continuing probe by the House ethics committee into ethics violations concludes. Rangel has been scrutinized for possible ethics violations for corporate payments, failure to pay taxes, failure to report assets on federal disclosure forms, misuse of rent-controlled apartments in New York, and improper solicitation of donations for the Charles B. Rangel Center for Public Service at the City College of New York. Sander Levin (D – Michigan) has been elevated to chairman in Rangel’s absence.

In what can be described as wishful thinking, in a vote of 386 to 33, the House passed H.R. 946, the “Plain Writing Act of 2010,” which would require government agencies to write in plain English. The term “plain writing” means writing that “the intended audience can readily understand and use because that writing is clear, concise, well-organized, and follows other best practices of plain writing.” Notably, however, the Plain Writing Act of 2010 would not apply to regulations.

As discussed in one of our prior issues of Tax Talk (see [MoFo Tax Talk, Volume 1, Issue 4](#)) in September of 2008, J.P. Morgan Chase and Co. (“JPM”) purchased all of the assets of Washington Mutual (“WaMu”) for approximately \$1.9 billion and assumed its deposit liabilities and debt (including covered bond obligations). A controversy later ensued with respect to who was entitled to WaMu’s tax losses—the bank holding company (and its creditors), or JPM. *The Wall Street Journal* recently reported (see Scott Thurm and Dan Fitzpatrick, “Tax-Break Battle Flares,” WSJ Online, March 24, 2010) that JPM could benefit from a tax refund of up to \$1.4 billion from its acquisition of the assets of WaMu due to the economic stimulus bill, which provides for a provision that relaxes the carryback limitation of net operating losses of corporations to up to five years. The carryback relief, however, restricted TARP recipients from receiving the benefit. Although JPM was a TARP recipient, WaMu was not, possibly allowing JPM to reap the rewards of the new law through its acquisition of WaMu assets. The FDIC, however, is not yet signed off on permitting JPM to share in the refund.

## MoFo in the News

On January 12, 2010, West Legalworks presented a webinar on “Foreign Private Issuers: Raising Capital and Maintaining Compliance.” Anna Pinedo and David Lynn of Morrison & Foerster LLP discussed the securities law aspects of financing strategies of foreign issuers, including private placements of debt securities and Rule 144A offerings, and recent developments, such as a number of amendments to the rules relating to foreign private issuers which are intended to enhance the information available to investors under the SEC’s Foreign Issuer Reporting Enhancements.

On January 21, 2010, the American Law Institute/American Bar Association presented a webinar on “PIPES and Registered Direct Offerings.” Anna Pinedo and James Tanenbaum of Morrison & Foerster LLP discussed the advantages and disadvantages of PIPE transactions (i.e., private investments in public equity in which a fixed number of securities are

# MoFo in the News

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sold to accredited institutional investors) and registered direct offerings (*i.e.*, fully registered transactions sold to select institutional investors) as potential capital raising alternatives, and the corporate and securities law aspects of such offerings, including shelf registrations and Rule 144A.

On January 21, 2010, Morrison & Foerster LLP presented “Structured Notes Tax Boot Camp” in the New York Office. Thomas Humphreys and Shamir Merali of Morrison & Foerster LLP discussed the U.S. federal income taxation of structured notes, including Type 1 notes (those treated as debt instruments), Type 2 notes (those treated as non-debt derivative financial contracts), and Type 3 notes (those that issuers have treated as a single non-debt derivative financial contracts or bifurcated as deposits and non-debt derivative contracts).

On January 29, 2010, Association of German Pfandbrief Banks presented “Why the U.S. Needs Covered Bonds.” Jerry Marlatt of Morrison & Foerster LLP joined the panel to discuss the advantages of covered bonds in the United States and recent developments. Covered bonds are debt instruments of an issuer (*e.g.*, a bank) in which an investor in the bonds has recourse against the issuer and a specified pool of collateral (the “cover pool”), which, in general, consist of high quality assets of the issuer. These instruments are a form of on-balance sheet financing and provide a possible source of alternative financing by banks in lieu of securitization. For a further discussion of covered bonds, see, *e.g.*, Anna Pinedo, “Covered Bonds in the U.S.,” *Practical Law The Journal*, February 2010, available at <http://www.mofo.com/files/Publication/ae238f08-a5a7-4394-b944-f91620717f52/Presentation/PublicationAttachment/6ae8aeb5-02ad-4503-ba0e-fa0f48ba5045/Article-%20Covered%20Bonds%20in%20the%20US.pdf>.

On February 2, 2010, West Legalworks presented a webinar on “Re-openings.” As discussed above in The Classroom, debt issues are often “re-opened,” meaning that an issuer issues an additional tranche of

notes at some point after original issue. The additional notes bear the same terms and security identification code (*e.g.*, CUSIP number) as the original notes. The issuer’s intent is that the original notes and the additional notes be indistinguishable and, therefore, completely fungible. Anna Pinedo and Remmelt Reigersman of Morrison & Foerster LLP discussed the securities law and tax requirements and limitations of such re-openings.

On February 3, 2010, *International Financial Law Review* presented a webinar on “U.S. and E.U. Hybrid Capital.” Panelists included Thomas Humphreys and Anna Pinedo of Morrison & Foerster LLP and Steve Sahara and Annabel Daws-Chew of Calyon. Panelists discussed recent developments with respect to hybrid securities in light of the financial crisis, including developments with respect to the regulatory framework for Tier 1 products and contingent capital.

On February 4, 2010, American Law Institute/American Bar Association presented a webinar on “At-the-Market Offerings.” 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 partners Anna T. Pinedo and David Lynn 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. Panelists also discussed advantages associated with at-the-market offerings, documentation, different marketing and sales mechanisms, and Regulation M and other securities law considerations.

On February 9, 2010, West Legalworks presented a webinar entitled “How Will Regulatory and Accounting Reform Change Securitization?” Thomas Humphreys and Jerry Marlatt of Morrison & Foerster LLP, and Thomas Rees of FTI Consulting, discussed various proposed and actual accounting reforms to the securitization market, including the proposed reforms by the current administration, and FASB 166 (*Accounting for Transfers of Financial Assets*) and 167

(*Amendments to FASB Interpretation No. 46(R)*), which would, in general, among other things, bring securitizations back onto the balance sheet of many issuers.

On February 22, 2010, Thomas Humphreys of Morrison & Foerster LLP presented a seminar entitled “European Tax College” on the U.S. taxation of financial instruments at the Katholieke Universiteit Leuven in Leuven, Belgium. Thomas Humphreys discussed the taxation of the basic building blocks of more complex financial instruments (*i.e.*, stock, debt, options, forwards and notional principal contracts), more complex instruments such as hybrid securities and structured notes, securitizations, and recent developments in this area.

On February 23, 2010, BNA presented a webinar on “Capital Raising Alternatives for Foreign Issuers; Update on Developments Involving Foreign Private Issuers.” Anna Pinedo of Morrison & Foerster LLP discussed the securities law aspects of private placements of debt securities and recent developments, such as those that are part of the SEC’s Foreign Issuer Reporting Enhancements.

On March 4, 2010, Morrison & Foerster LLP, in conjunction with Moody’s Investors Service and UBS Investment Bank, presented “Hybrid Capital.” Panelists include Thomas Humphreys and Anna Pinedo of Morrison & Foerster LLP, Barbara Havlicek of Moody’s Investors Service and Anthony Ragozino of UBS Investment Bank. Panelists discussed recent hybrid securities developments, including Tier 1 products and contingent capital.

On March 5, 2010 the Federal Bar Association Section on Taxation held its 34<sup>th</sup> Annual Tax Law Conference in Washington D.C. Thomas Humphreys of Morrison & Foerster LLP, staff members from the Joint Committee on Taxation and House Ways and Means Committee, as well as a Treasury Department representative presented on the “Latest Developments in U.S. Offshore Tax Compliance.” The panel discussed the provisions of FATCA, such as the new withholding tax on withholdable payments, the repeal of the bearer bond exception, and the tax treatment of dividend equivalent payments, as discussed above under “HIRE Act FATCA Recap.”

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On March 18, 2010, Practising Law Institute presented a webinar on “Foreign Issuers: Accessing the U.S. Markets.” Anna Pinedo and David Lynn of Morrison & Foerster LLP discussed various alternatives to initial public offerings by foreign issuers, including Rule 144A offerings, institutional debt private placements, Reg S offerings, and ADR programs.

On March 25, the Structured Products Association held its 7th Annual Conference at New York City’s Grand Hyatt Hotel.

Anna Pinedo and Thomas Humphreys of Morrison & Foerster LLP, Andrea O’Toole of Nomura Securities, Darren Greenberg of Royal Bank of Scotland, and Jeffrey Robins of Cadwalader were panelists on a presentation entitled “Legal, Regulatory, Compliance Summit: How the Industry Is Prepared for the New Litigation and Regulatory Climate.” Panelists discussed securities law, tax, and compliance issues for structured products in response to new litigation and the regulatory climate after the fallout of Lehman Brothers.

On March 25, 2010, Morrison & Foerster LLP was recognized with four awards at the *International Financial Law Review* Americas Awards ceremony. Morrison & Foerster LLP was selected as “Equity Team of the Year” for its U.S. and

international securities offering work on behalf of issuers and underwriters, and counsel on the Debt and Equity Linked Deal of the Year, on the Equity Deal of the Year, and on the Securitization Deal of the Year. *International Financial Law Review* is a leading publication for in-house counsel and practitioners in the financial markets. ■

## Contacts

### United States Federal Income Tax Law

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

Remmelt A. Reigersman  
(212) 336-4259  
rreigersman@mof.com

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

Armin M. Gharagozlou  
(212 ) 336-4327  
agharagozlou@mof.com

### Corporate + Securities Law

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

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

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