

# TaxTalk



## Editor's Note

*Dateline: Occupied Wall Street (Oct. 19, 2011).* The 24th anniversary of Black Monday, October 19, 1987, dawns on an occupied Wall Street amid persistent gloom in global financial markets. The largest U.S. banks are in the midst of announcing their Q3 earnings, of which at least \$12 billion comes from accounting gains due to a decline in their credit quality (we're not kidding). Nevertheless, our readers will be pleased to know that the tax law marches on and the Internal Revenue Service ("IRS") and the courts continue to work through the backlog of tax issues left over from the golden era in financial instruments. Thus, in the Q3 edition of Tax Talk we discuss proposed regulations that treat credit default swaps as notional principal contracts and that may spell doom for certain types of "bullet swaps," an IRS ruling addressing the connection (or lack thereof) between the deferral of cancellation of debt income and unamortized hedge gain and the Ninth Circuit's affirmation of the Tax Court's ruling in *Samueli v. Commissioner*. We also provide a brief summary of the IRS and Treasury Department ("Treasury") 2011-2012 priority guidance plan in the capital markets area and a summary of the GOP Presidential candidates' income, corporate, capital gains, and sales tax positions. In the return of our "Classroom," we address the rules that apply to "synthetic debt instruments." Finally, we are excited (or as excited as these things go) to announce the launch of **KNOWFatca.com**, Morrison & Foerster's online resource that tracks FATCA's development (for information on how to gain access, see page 10).

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# Proposed Regulations Would Expand and Clarify What Contracts Qualify as NPCs for Tax Purposes

In response to the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) to, among other things, increase regulation of the capital markets. In Congress’s attempt to increase regulation, Dodd-Frank requires the Commodity Futures Trading Commission (“CFTC”) to establish a comprehensive regulatory framework for swaps,<sup>1</sup> which includes the trading of swaps on registered exchanges. With the advent of swaps trading on registered exchanges, however, Congress feared such swaps would now qualify as “section 1256 contracts,” resulting in specific character and timing (e.g., mark-to-market) treatment for tax purposes. As a result, Congress included section 1256(b)(2)(B)<sup>2</sup> in Dodd-Frank, which carves out swaps and other similar agreements, even if traded on or subject to the rules of an exchange, from the definition of a “section 1256 contract.” On September 16, 2011, the IRS and Treasury published proposed regulations providing guidance on the category of swaps and similar agreements that are included in the carve-out from a “section 1256 contract” and on the scope of the notional principal contract definition.

Section 1256 provides that “section 1256

contracts” are marked-to-market at the end of each year and that any gain or loss is generally treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. A “section 1256 contract” is defined as a regulated futures contract, foreign currency contract, nonequity option, dealer equity option, or dealer securities futures contract which, with the exception of a foreign currency contract, must be traded on or subject to the rules of a “qualified board or exchange.”

## Clarifying the Definition of a Section 1256 Contract

A primary focus of the proposed regulations is to clarify the scope of swaps excluded from section 1256 treatment (i.e., swaps excluded from the definition of a “section 1256 contract”). As enacted under Dodd-Frank, swaps included in the section 1256 carve-out were modeled after the Treasury Regulation definition of a notional principal contract with the addition of credit default swaps, as opposed to the Dodd-Frank definition of “swaps.” Following this principle, the proposed regulations provide that a section 1256 contract does not include a contract that qualifies as a notional principal contract.<sup>3</sup> Also, according to the preamble to the proposed regulations, the IRS and Treasury believe that an option on a notional principal contract should be treated as an agreement similar to a notional principal contract; therefore, the proposed regulations carve out options on notional principal contracts from section 1256 treatment as well. The proposed regulations provide that any contract that is both a section 1256 contract and a notional principal contract is treated as a notional principal contract, with the result that such contract does not qualify for section 1256 treatment.

## Expanded Swap Definition

The proposed regulations also provide an updated definition for the term “notional principal contract.” As the scope of the current definition of a notional principal

contract<sup>4</sup> has been questioned by many, especially post-Dodd-Frank, the proposed regulations refine the scope by providing that a notional principal contract requires one party to make two or more payments to a counterparty. For this purpose, the fixing of an amount is treated as a payment, even if the actual payment reflecting that amount is to be made at a later date. With respect to this definition, the preamble to the proposed regulations provides the following example: a contract that provides for a settlement payment referenced to the appreciation or depreciation on a specified number of shares of common stock, adjusted for actual dividends paid during the term of the contract, is treated as a contract with more than one payment with respect to that leg of the contract.

We understand this proposal has caused a lot of excitement because it would substantially expand the notional principal contract definition. For example, a “bullet swap,” which provides for payments only at maturity, is currently treated as a forward contract for federal income tax purposes. If, however, the bullet swap provides for the interim fixing of payments then under the proposed regulations it would be treated as a notional principal contract, subject to current accrual and ordinary income and loss.

The definition of a notional principal contract is also expanded under the proposed regulations by expressly providing that credit default swaps are included in such definition.<sup>5</sup> This includes credit default swaps that permit or require physical settlement in satisfaction of one leg of the swap. This proposed definition of a notional principal contract is intended to be the operative definition for all federal income tax purposes, except where a different or more limited definition is specifically provided.

The proposed regulations also expand those “specified indices” which notional principal contracts can reference. According

<sup>1</sup> Dodd-Frank defines a “swap” as including specified derivatives across various asset classes, but excludes, among other things, nonfinancial or security forwards that are intended to be physically settled, futures contracts, listed FX options, debt securities, securities options and forwards that are subject to the Securities Act of 1933 and the Securities Exchange Act of 1934, and security-based swaps.

<sup>2</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

<sup>3</sup> As the proposed regulations provide an updated definition of “notional principal contracts,” references in this memorandum to “notional principal contracts” incorporate such updated definition.

<sup>4</sup> Current Treasury Regulations define a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.

<sup>5</sup> In Notice 2004-52, the IRS and Treasury requested comments from the public for specific guidance on the tax treatment of credit default swaps.

## Proposed NPC Regulations

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to the preamble, the IRS and Treasury felt that a swap on a non-financial index should be treated as a notional principal contract. The proposed regulations expand a “specified index” to include those non-financial indices that comprise any objectively determinable information that is not within the control of any of the parties to the contract and is not unique to one of the parties’ circumstances, and that cannot be reasonably expected to front-load or back-load payments accruing under the contract. For example, a “weather swap” would be treated as a notional principal contract under the proposed regulations.<sup>6</sup>

### Effective Date

If adopted, the proposed regulations would be effective for all contracts entered into on or after the date such regulations are finalized.

## The Handwriting is on the Wall

In light of the proposed NPC regulations discussed in the prior piece, we noted with interest a comment by Steve Larson, IRS Associate Chief Counsel (Financial Institutions and Products) last week in New York reported in Tax Notes.<sup>7</sup> Mr. Larson said that the IRS will issue revised regulations for contingent payment notional principal contracts (proposed regulations were issued in 2005) and for prepaid forward contracts. He also said the rules for prepaid forwards will be “roughly similar” to the rules for contingent notional principal contracts. Coupled with the proposed regulations’ treatment of payment “fixing” as a payment under the notional principal contract definition, this all points to an expanded current accrual regime for

non-option financial instruments possibly including certain “bullet” swaps, as well as prepaid forward contracts and non-debt structured notes.<sup>8</sup> Right now, current law generally gives these instruments “wait and see” capital gain and loss tax treatment. The timing of such guidance (and exactly how the new regime will work) is currently unknown (and it may not happen all at once) but it appears the wheels are starting to turn in Washington, DC on the issue.

## Recognition of Unamortized Hedge Gain Could Not Be Deferred

On September 2, 2011, the IRS issued a Chief Counsel Advice<sup>9</sup> (the “CCA”) in which it concluded that a taxpayer could not defer gain from a hedge with respect to debentures repurchased at a discount by the taxpayer that elected to defer cancellation of debt (“COD”) income on such debentures.

A taxpayer that repurchases its own debt at a discount realizes COD income equal to the difference between the debt’s adjusted issue price and the amount paid on repurchase. Under a provision included in the American Recovery and Reinvestment Act of 2009, COD income incurred in connection with a repurchase of debt instruments in 2009 and 2010 may be deferred for a 5-year (if reacquired in 2009) or 4-year period (if reacquired in 2010).<sup>10</sup> After the deferral period, the taxpayer must include the deferred COD income ratably over the following five years.

As for hedging transactions, which are transactions generally entered into by a taxpayer to reduce the risk of interest rate, currency or price fluctuations with respect to its borrowings or obligations, the applicable Treasury regulations employ a matching principle where the method of accounting

(i.e., the timing of income, deduction, gain or loss) selected by a taxpayer for such hedge must reasonably match the method of accounting of the items being hedged.<sup>11</sup> Based on this matching principle, gain or loss recognized by a taxpayer on a hedging transaction must be taken into account with the terms of the debt instrument and the period to which the hedge relates. For example, in Revenue Ruling 2002-71,<sup>12</sup> where a taxpayer entered into a swap that only hedged the initial five-years of a ten-year instrument, the ruling held gain or loss realized from the early termination of the hedge at the end of year two was required to be spread over the next three years as that was the period the hedge related to.

The facts of the CCA are as follows: the taxpayer issued junior subordinated debentures with an initial fixed rate, followed by a floating rate. Prior to the issuance of the debentures, the taxpayer entered into a 10-year swap to lock-in interest rates for the initial fixed-rate term of the instruments. The swap was intended to protect the taxpayer from interest rate changes from the inception of the swap until the completion of the issuance of the debentures. The taxpayer terminated the swap on the date of issuance of the debentures, resulting in gain realized by the taxpayer due to a termination payment by the swap counterparty. The taxpayer amortized the hedge gain over the remaining fixed rate interest period of the debentures (i.e., 10 years). The taxpayer later repurchased a percentage of the outstanding debentures, realizing COD income, and elected to defer the recognition of such COD income. The taxpayer argued that it could defer the unamortized hedge gain allocable to the repurchased debentures until the years the COD income was recognized.

The CCA concluded, despite the deferral of COD income, the taxpayer could not defer the unamortized hedge gain based on three arguments. First, the IRS argued that there was a lack of a connection between the COD income and the hedge gain with the result that, pursuant to the applicable matching principles, the hedge gain was required to be spread over the term to which the hedge relates (i.e., only the initial fixed rate term of the debentures).

<sup>6</sup> Thus answering a question that has been around for more than a decade, see Thomas A. Humphreys, “Gambling on Uncertainty—The Federal Income Tax Treatment of Weather Swaps, Cat Options, and Some Other New Derivatives,” Tax Forum No. 528 (November 2, 1998).

<sup>7</sup> See 2011 TNT 199-1.

<sup>8</sup> See Notice 2008-2, 2008-2 IRB 252, 12/07/2007.

<sup>9</sup> CCA 201135030.

<sup>10</sup> Section 108(i).

<sup>11</sup> See Treasury regulation section 1.446-4.

<sup>12</sup> Rev Rul 2002-71, 2002-2 CB 763.

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## Hedge Gain Could Not Be Deferred

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Second, the COD income did not arise as a result of changes in interest rates even if it was interest rate risk that the hedge was intended to manage. Third, when the debentures were repurchased, the items being hedged were terminated, and to clearly reflect income, the unamortized hedge gain allocable to the repurchased debentures should be recognized in the year of repurchase since, in the IRS's view, the relevant Treasury regulations do not permit the continued amortization of hedge gain once the hedged item was terminated.

## Ninth Circuit Affirms *Samueli* Ruling

On September 15, 2011, the United States Court of Appeals for the Ninth Circuit (the "Ninth Circuit") held that the securities loan transaction at issue did not qualify for nonrecognition treatment as a securities loan under section 1058, affirming the March 16, 2009 Tax Court ruling,<sup>13</sup> in *Samueli v. Commissioner*.<sup>14</sup>

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 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 by the lender for 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.

In *Samueli v. Commissioner*, 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 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 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. The Ninth Circuit affirmed the Tax Court's decision that the transaction failed to meet the section 1058(b)(3) requirement for these same reasons. The Ninth Circuit noted "[the taxpayer] relinquished all control over the [s]ecurities... for all but two days in a term of approximately 450 days. During this period, [the taxpayer] could not have taken advantage of a short-lived spike in the market value of the [s]ecurities, because they had no right to call the [s]ecurities... and sell them at that increased price until several months later. Common sense compels the conclusion that this reduced the opportunity for gain that a normal owner of the [s]ecurities would have enjoyed."

The Ninth Circuit, in disagreement with the Tax Court, held the interest deductions claimed by the taxpayer should have been allowed, although such error was harmless and did not make a difference in the ultimate determination of the tax deficiency since allowing the interest expense deduction resulted in offsetting additional short-term capital gain.

## Countdown to March 18, 2012: Are You Ready?

**148 Days to March 18, 2012**

Despite this summer's extension of the FATCA withholding rules (scheduled to be phased-in over 2014 and 2015), FATCA's next effective date (March 18, 2012) will continue to greatly impact global financial transactions. While the IRS and Treasury

<sup>13</sup> *Samueli v. Commissioner*, 132 T.C. 37 (2009). See [MoFo Tax Talk Volume 2, No. 2](#) for a detailed discussion of the tax court case.

<sup>14</sup> *Samueli v. Commissioner*, No. 09-72457 (9th Cir. 9/15/11).

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## March 18, 2012

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have indicated FATCA regulations will be issued prior to the end of 2011, only time will tell whether such regulations help ease the transition. Until any guidance is in fact issued, March 18, 2012 continues to be an extremely significant date.

As the clock continues to tick, there are a few items that one should be mindful of.

1. Section 871(m) treats a "dividend equivalent payment" as a U.S. source dividend. The term "dividend equivalent" includes a payment made under a "specified notional principal contract" that is either directly or indirectly contingent on or determined by reference to a U.S. source dividend. 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.
2. FATCA provided that the new section 1471 & 1472 withholding tax on "withholdable payments" applies only with respect to payments on "obligations" issued after March 18, 2012. Even though withholding will not take immediate effect, obligations

issued after that date will ultimately be subject to section 1471 & 1472 withholding.

3. March 18, 2012 marks the end of the practice whereby U.S. issuers (and controlled foreign corporations) can sell bearer bonds to foreign investors.

## IRS and Treasury Release 2011-2012 Priority Guidance Plan

On September 2, 2011, the IRS and Treasury released the annual Priority Guidance Plan for 2011-2012 (the "Plan"), which contains 317 projects that are priorities for both agencies during the plan year (July 2011 through June 2012).<sup>15</sup> The Plan is broken down into various areas of the Internal Revenue Code, including consolidated returns, corporations and their shareholders, tax-exempt bonds and international issues. The Plan includes, among others, the following capital markets related projects:

1. Revenue ruling on the treatment of an interest in a money market fund as a cash item for regulated investment company (i.e., mutual funds and closed-end funds) asset test purposes (section 856(c)(4)(A));
2. Final regulations amending the definitional section of the straddle rules (section 1092(d));
3. Guidance addressing the character and timing of hedge gains and losses for hedges of guaranteed living benefits and death benefits provided with regard to variable annuities;
4. Notice to determine how to compute the accruals of original issue discount on pools of revolving cardholder debt held by credit card issuers;
5. Final regulations for determining when a debt instrument is publicly traded

<sup>15</sup> The 2011-2012 Priority Guidance Plan can be found at the following address: [http://www.irs.gov/pub/irs-utl/2011-2012\\_pgp.pdf](http://www.irs.gov/pub/irs-utl/2011-2012_pgp.pdf).

(section 1273);

6. Regulations amending the inflation-indexed debt instruments issued at a premium regulations (section 1.1275-7);
7. Regulations to address basis reporting for options and debt instruments (section 6045);
8. Regulations on prepaid forward contracts;
9. Regulations relating to accruals of interest (including discount) on distressed debt; and
10. Regulations that remove any reference to, or requirement of reliance on, "credit ratings" in regulations under the Internal Revenue Code pursuant to Dodd-Frank.

## Even Though Republicans Now Control Ways and Means Committee – Accounting Gimmicks Still Used as Pay-Fors

One thing Democrats and Republicans in Congress apparently can agree on is the use of accounting gimmicks to avoid tough spending and revenue decisions. In 2010 we included two pieces, "Did You Catch That?"<sup>16</sup> and "Did You Catch That, Again?"<sup>17</sup> which addressed newly enacted legislation's periodic increases of the amount of estimated taxes that certain large corporations must pay over the course of the year, effectively providing the government with a short-term loan. The Republican-controlled House Ways and Means Committee on October 5, 2011,

<sup>16</sup> See [MoFo Tax Talk Volume 3, No. 1](#).

<sup>17</sup> See [MoFo Tax Talk Volume 3, No. 3](#).

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## Pay-Fors

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favorably reported out three pending free trade agreements which were funded in part by estimated tax pay-fors. The three free trade agreements, the United States-Colombia Trade Promotion Agreement Implementation Act (H.R. 3078), the United States-Panama Trade Promotion Agreement Implementation Act (H.R. 3079), and the United States-Korea Free Trade Agreement Implementation, each increase the estimated tax payments of corporations with assets greater than \$1 billion, with equal decreases in the following quarters. The free trade agreements include the following increases: (i) the U.S.-Colombia agreement provides the amount of installment payments of corporate estimated tax which is due in July, August or September of 2016 shall be increased by 0.50 percent; (ii) the U.S.-Panama agreement provides the amount of installment payments of corporate estimated tax which is due in July, August or September of 2012 shall be increased by 0.25 percent and amounts due in July, August or September of 2016 shall be increased by 0.25 percent; and (iii) the U.S.-Korea agreement provides the amount of installment payments of corporate estimated tax which is due in

July, August or September of 2012 shall be increased by 0.25 percent and amounts due in July, August or September of 2016 shall be increased by 2.75 percent. In total, the three free trade agreements provide for an increase of 0.50 percent for payments in 2012 and an increase of 3.5 percent of payments in 2016. All of the free trade agreements provide a reversal of the increase in the following quarter. The bills all passed Congress and were sent to President Obama on October 13, 2011.

## Tanning Tax: Was it Worth it?

Included in the controversial Patient Protection and Affordable Care Act of 2010 was an excise tax on indoor tanning services equal to 10 percent of the amount paid for such services (now codified as section 5000B). The Joint Committee on Taxation originally estimated the tax would raise approximately \$200 million in fiscal 2011. However, in its September 22, 2011 report, the Treasury Inspector General for Tax Administration (the "TIGTA") stated the tanning tax has raised less than one-fifth of its expected revenue (the IRS has thus far collected only \$36.6 million for fiscal year 2011). The TIGTA also stated the number of taxpayers filing tanning services excise tax returns is much lower than expected.

The recommendations provided in the report were as follows: that the IRS (i) perform further analyses of the data on tanning businesses, (ii) monitor the results from notices sent to taxpayers who could potentially owe the tanning tax, and (iii) update Publication 510, *Excise Taxes (Including Fuel Tax Credits and Refunds)*, to include information related to the tanning tax. The IRS agreed with all three recommendations.

## GOP Presidential Candidates' Tax Positions

With the non-stop press coverage of the GOP Presidential candidates, we figured a summary of the candidates' tax positions would be helpful to our readers.<sup>18</sup> Most of the GOP candidates promise (some have even pledged) not to raise taxes. The following chart takes a look at their proposed income, corporate, capital gains and sales tax positions.

<sup>18</sup> The candidates' own websites typically contain little information about specific tax provisions so this information came from <http://www.mainstreet.com/slideshow/moneyinvesting/taxes/what-gop-candidates-will-do-your-taxes>.

Candidate	Income Tax	Corporate Tax	Capital Gains Tax	Sales Tax
Michele Bachman	Suggested eliminating federal taxes for one full year	Lower, if not eliminate, corporate tax rate	Eliminate tax completely	National sales tax
Herman Cain	Flat individual tax rate of 9%	One corporate tax rate of 9%	Eliminate tax completely	9% national sales tax
Newt Gingrich	Optional flat tax of 15%	Lower maximum corporate rate to 12.5%	Eliminate tax completely	NA
Jon Huntsman	Create three tax rates of 8%, 14% and 23% and eliminate all deductions	Lower maximum corporate rate to 25%	Eliminate tax completely	NA
Ron Paul	Eliminate income tax completely	NA	Eliminate tax completely	National sales tax
Rick Perry*	Proposed a flat tax with one rate or a fair tax based on a national retail sales tax	Possibly eliminate the corporate tax	NA	NA
Mitt Romney	Move closer to a single tax rate	Lower maximum corporate rate to 25%	Eliminate tax for taxpayers earning less than \$200,000 annually	NA
Rick Santorum	Reduce taxes for all	Eliminate corporate tax for all manufacturers and lower rate for others	Permanent extension of current tax (maximum rate of 15%)	NA

\* On October 19, 2011, Rick Perry proposed a flat tax; he intends to introduce an economic plan the week of October 24 that will include details related to his flat tax proposal.

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# The Classroom – Integrating a Debt Instrument with a Hedge into a Synthetic Debt Instrument

Both issuers and holders of debt instruments may enter into hedging transactions in an effort to minimize or manage risk on such debt. As a general matter, separate financial instruments are taken into account separately for federal income tax purposes. Current Treasury regulations, however, permit the integration of certain debt instruments (“qualifying debt instruments”) and certain hedges (“section 1.1275-6 hedges”) provided specified requirements are satisfied. This integration permits “a more appropriate determination of the character and timing of income, deductions, gains or losses than would be permitted by separate treatment of the components.”<sup>19</sup> The integrated transaction is subsequently taken into account for federal income tax purposes, rather than the separate components of the transaction. The integration regulations affect only the taxpayer who holds or issues the qualifying debt instrument and enters into the 1.1275-6 hedge.

In order for a qualifying debt instrument and 1.1275-6 hedge to be integrated for tax purposes, certain requirements must be satisfied. A qualifying debt instrument is any debt instrument, including a synthetic debt instrument arising from an integrated transaction, other than (i) a tax-exempt obligation; (ii) a debt instrument subject to certain original issue discount rules based on possible acceleration of principal; or (iii) a contingent debt instrument issued for nonpublicly traded property. A 1.1275-6 hedge is any financial instrument or combination of financial instruments (including a forward or futures contract, an option, a notional principal contract, a debt

instrument but not stock) if the combined cash flows of the financial instrument and qualifying debt instrument permit the calculation of a yield to maturity, or the right to the combined cash flows would qualify as a variable rate debt instrument<sup>20</sup> that pays interest at a qualified floating rate or rates. A taxpayer may only integrate a qualifying debt instrument and a 1.1275-6 hedge if the following requirements are satisfied:

1. Certain identification requirements must be satisfied on or before the date the taxpayer enters into the 1.1275-6 hedge, including entering and retaining the following information in the taxpayer’s books and records: (a) the date the qualifying debt instrument was issued or acquired and the date the 1.1275-6 hedge was entered into; (b) a description of the qualifying debt instrument and the 1.1275-6 hedge; and (c) a summary of cash flows and accruals resulting from the integrated transaction;
2. No parties to the 1.1275-6 can be related (or, if the parties are related, the party providing the hedge must use mark-to-market accounting for the hedge and all similar or related transactions);
3. Both the qualifying debt instrument and the 1.1275-6 hedge are entered into by the same individual, partnership, trust, estate, or corporation;
4. If the taxpayer is a foreign person engaged in a U.S. trade or business and issues or acquires the qualifying debt instrument or enters into the 1.1275-6 hedge through such trade or business, all items of income and expense associated with the qualifying debt instrument or hedge would have been effectively connected with the U.S. trade or business throughout the term of the qualifying debt instrument;
5. Neither the qualifying debt instrument nor the 1.1275-6 hedge can have been part of an integrated transaction that was terminated by the taxpayer under the legging out rules (discussed below)

within 30 days immediately preceding the issue date of the synthetic debt instrument;

6. The qualifying debt instrument must be issued or acquired on or before the date of the first payment on the 1.1275-6 hedge or issued or acquired after, but substantially contemporaneously with, the date of the first payment on the 1.1275-6 hedge; and
7. Neither the 1.1275-6 hedge nor the qualifying debt instrument can be part of a straddle prior to the issue date of the synthetic debt instrument.

Assuming a qualifying debt instrument and section 1.1275-6 hedge qualify for integration for federal income tax purposes, the resulting “synthetic debt instrument” has the same cash flows as the combined cash flows of the two instruments. Regardless of the aforementioned integration requirements, the Treasury regulations include an anti-abuse provision that authorizes the IRS to treat a qualifying debt instrument and a financial instrument as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a 1.1275-6 hedge.

Once a qualifying debt instrument and 1.1275-6 hedge are integrated, the resulting synthetic debt instrument is treated as a single instrument and, as noted above, neither the qualifying debt instrument nor the 1.1275-6 hedge are subject to the Internal Revenue Code or Treasury regulations that would apply on a separate basis.

## MoFo in the News

On August 2, 2011, MoFo Partners Oliver Ireland and Dwight Smith spoke on a teleconference panel titled “The New Regulatory Framework for Thrift Institutions.” On July 21, 2011, all thrift institutions lost their regulator and gained

<sup>19</sup> Treasury Regulation section 1.1275-6(a).

<sup>20</sup> See [MoFo Tax Talk Volume 2, No. 4](#) for a discussion of the boundaries of variable rate debt instruments.

# MoFo

## In the News

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two new ones. The panel discussed changes likely to result from this new regulatory structure, with special emphasis on the authority of the Federal Reserve Board over thrift holding companies

The Business Law Section gathered at the ABA Annual Meeting in Toronto, on August 5-8, 2011. Over 50 CLE programs were offered and more than 200 committee meetings focusing on an array of business law practice areas covering the latest developments in business law took place. Senior Of Counsel Jerry Marlatt joined a panel titled "Everything Old Is New Again: Covered Bonds Come (Back) To The U.S. and Canada."

PLI sponsored a webcast titled "A Role for Mortgage REITs in the Emerging Mortgage Finance Market," on August 9, 2011. Partner Thomas A. Humphreys and Senior Of Counsel Kenneth E. Kohler explored the advantages and disadvantages of mortgage REITs in the post-crisis legal and regulatory environment, and addressed the legal steps required to form and operate a mortgage REIT and protect it in the next financial downturn.

Peter Green moderated a panel at the GARP London Regulatory Forum on September 20, 2011. The Capital Requirements Directive continues to be refined, reflecting Basel III framework requirements for new capital measurements, leverage and liquidity requirements, and at the same time strengthening regulation, supervision and risk management of the entire global financial system. Although much of the rule making process is complete, the challenge of implementation still lies ahead. This one-day intensive forum presented a comprehensive assessment within a global regulatory context and a discussion of these policy initiatives. Mr. Green moderated a panel on MiFID.

On September 28, 2011, Charles Horn and David Lynn hosted a webcast titled "Protiviti

Webcast: Incentive Compensation." In the aftermath of the financial crisis, financial regulators have become increasingly focused on how compensation plans can or should be structured in order to better align the interests of executives with those of shareholders. In the aftermath of TARP and now the implementation of the Dodd-Frank Act, the focus is on how compensation structures may encourage more prudent behavior that is in alignment with an organization's long-term performance, rather than rewarding executives and other employees for achieving short-term gains.

MoFo partners Lloyd Harmetz and Anna Pinedo participated in a PLI-sponsored webcast titled "Removal of Credit Ratings from SEC Rules – Changes and Proposed Changes" on October 3, 2011. Section 939A of the Dodd-Frank Act requires federal agencies to review how existing regulations rely on credit ratings and remove such references from their rules and replace them with standards of creditworthiness as each agency deems appropriate. On July 27, 2011, the SEC unanimously adopted rules to remove references to credit ratings in rules and forms promulgated under the Securities Act of 1933 and the Securities Exchange Act of 1934. The amendments will become effective 30 days after publication in the Federal Register, except for the rescission of Form F-9, which is to become effective December 31, 2012.

Morrison & Foerster's London office hosted an in-house CLE on October 6, 2011 titled "Dodd-Frank for Non-U.S. Banks: What Will it Mean for You?" The U.S. bank and securities regulators' jurisdiction and mission has expanded under the Dodd-Frank reforms. Panelists included MoFo partners Anna Pinedo, Oliver Ireland, and Elana Hahn. The seminar was followed by a Protiviti Demo.

Also on October 6, 2011, Jerry Marlatt participated in the IMN Covered Bonds Americas conference. The 3rd Annual Covered Bonds – The Americas Conference was held in New York City. The covered bonds product enjoys a strong reputation in Europe, having originated in Germany as a funding tool some 300 years ago. Covered bonds, some have argued, are a safer investment alternative

owing to its on-balance sheet nature which means issuers of these bonds retain some skin in the game (a current criticism of its sister funding tool, securitization which is off-balance sheet funding.) The question remains as to whether or not the world's largest and deepest mortgage market, the U.S., will develop its own covered bonds market.

Jerry Marlatt also led an in-house CLE on October 7, 2011 titled "Accessing the Covered Bond Market Through 3(a)(2) or Other Exempt Offerings."

On October 11, 2011, Oliver Ireland and Anna Pinedo participated at the GARP New York Regulatory Forum. The Dodd-Frank Act represents a comprehensive overhaul to the U.S. regulatory system. As we enter the next phase of the process, understanding the evolving requirements and provisions of the Act becomes essential. This intensive one-day forum addresses some of the most complex provisions of the Act and covers derivatives trading, proprietary trading (Volcker-rule), structured products, regulatory oversight, and investor protections. Mr. Ireland led a presentation on the Volcker Rule and Ms. Pinedo moderated a panel discussion on "Too Big to Fail."

Barbara Mendelson spoke at the Institute of International Bankers Seminar on Risk Management and Regulatory Examination/ Compliance Issues Affecting International Banks on October 17, 2011. This once-a-year program is well recognized by the regulatory community as providing definitive and timely information on key examination and supervision issues and best practices. It provided an excellent opportunity for experienced officers to be thoroughly updated on new developments and gain practical insights in preparing for examinations. It also offered new officers a solid introduction to the U.S. regulatory system and compliance requirements.

Anna Pinedo will participate on a panel at the SIFMA Conference on October 24, 2011. The program, "Dodd-Frank Wall Street Reform and Consumer Protection Act," discussed auditing in the wake of Dodd-Frank Legislation.

On October 25, 2011, David Kaufman will

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join the GARP Derivatives Webcast to discuss derivatives regulation.

On November 9, 2011, Oliver Ireland will participate at The Clearing House First Annual Business Meeting & Conference.

The conference consists of in depth panel discussions on the following topics, as well as keynote speakers with expertise in commercial banking regulation, banking finance and payments, the unbanked and under-banked, cyber and data security, bank capital and liquidity, consumer financial issues and the CFPB, the future of payments and payments innovation, SEC and PCAOB accounting developments, systemic risk, bank litigation

and enforcement, a special pre-conference UNC lecture series event, bringing together academic, industry and government leaders to debate the concept of “Too Big to Fail.”

Oliver Ireland will join the “Protiviti Webcast: Accessing Capital” on November 30, 2011.

## Announcing Federal Taxation of Partnerships & Partners

Part of the CCH® Expert Treatise Library, *Federal Taxation of Partnerships & Partners* provides up-to-date, comprehensive expert guidance for complex tax issues affecting partners and partnerships.

Written by experts in the field, including Morrison & Foerster partner Thomas A. Humphreys, the treatise offers numerous examples and expert guidance to give you practical insights and planning advice.

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