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MoFo Tax Talk

Distressed Debt Buybacks and Restructurings – It's Easy, Unless It's Not

General

The credit crisis continues to take its toll on virtually all economic activity. As it sweeps the globe, it has left many companies financially weakened, if not crippled. In some situations, the fair market value of corporate debt has fallen significantly below face amount. As a result, some companies may be forced to restructure their debt and others may wish to take advantage of this "opportunity" to repurchase their debt at a discount. Interesting tax issues arise in this context.

A corporation is generally subject to tax on cancellation of indebtedness ("COD") income. COD income may arise in several situations, including forgiveness of debt by the debtholder, the repurchase of debt by the issuer at a discount, the exchange of one debt instrument of the issuer for another, significant modification of debt, the exchange of debt for equity of the issuer, and the acquisition of debt by a person related to the issuer. COD income, however, generally is not included in gross income with respect to a taxpayer that is insolvent or in a title 11 bankruptcy proceeding. However, tax attributes of such a taxpayer (*e.g.*, its net operating losses, tax credits or adjusted tax basis in property) are reduced by the amount of COD income that is excluded from gross income. In addition, and as described below under "The Stimulus Bill – An Executive Summary," the American Recovery and Reinvestment Act of 2009 ("ARRA") provides some relief for taxpayers that are not insolvent or in a title 11 bankruptcy proceeding. Pursuant to ARRA the recognition of COD income in connection with certain repurchases, modifications and exchanges of debt instruments can be deferred for a period of four or five years upon election by the taxpayer. With respect to financial institutions, an added benefit is that COD income, less an amount in respect of deferred tax liability, increases such institutions' Tier 1 Ratio.

Contingent Convertible Debt Instruments

U.S. corporations have raised billions of dollars of funding by issuing so-called contingent convertible debt instruments ("CoCos"). CoCos are debt instruments convertible into stock of the issuer that provide for the

payment of "contingent interest." For example, a typical CoCo may provide that the amount of interest payable equals the amount of the dividends paid on the underlying stock or if the CoCo's price exceeds a percentage (*e.g.*, 120%) of its adjusted issue price. As a result of the contingent interest feature, CoCos are treated as "contingent payment debt instruments" for U.S. federal income tax purposes, and the issuer, as well as the holder, are subject to the "noncontingent bond method" rules provided for in the Treasury regulations. Under this method, the holder is required to include interest or "original issue discount" ("OID") in income over the term of the CoCo based upon the comparable yield of the issuer. The issuer takes a corresponding interest deduction. The "adjusted issue price" of the CoCo increases by the amount of interest that is deemed to accrue, and any differences between taxable income included and cash received are reconciled when a contingent payment is made (which, often, is not until maturity or upon conversion of the CoCo into stock of the issuer).

Upon a restructuring or repurchase of a CoCo prior to maturity, the issuer's COD income is not determined by reference to the CoCo's face amount but rather by reference to its accreted adjusted issue price. For example, a CoCo issued ten years ago with a face amount of $1000x by an issuer with a comparable yield at the time equal to 5%, currently has an adjusted issue price equal to approximately $1,600x. As a result, a repurchase of the CoCo by the issuer prior to maturity for its face amount would result in COD income to the issuer equal to $600x. As noted above, the impact on the issuer may be softened by ARRA because the issuer may be permitted in certain situations to elect to defer the recognition of the COD income. Even absent a repurchase or modification of the CoCo, the issuer faces the same situation upon maturity of the instrument. If the CoCo is retired, upon maturity, for its face amount, the issuer would have to include $600x in income. Issuers of CoCos can be expected to carefully weigh all available options as alternatives that have substantially the same economic result may not necessarily have substantially the same tax result.

On the other hand, holders of CoCos would likely welcome a repurchase or modification as the holders would then be able to reverse prior OID inclusions. Where the tax treatment of the holders upon a repurchase is relatively straightforward, a significant modification of these debt instruments can produce a host of complex and technical tax rules if the modified debt instrument is not considered "publicly traded" under U.S. federal income tax principles. For example, stellar hedge fund performance during prior years have resulted in several financial institutions' offering their clients tailored structured notes, the payout on which is linked to the performance of hedge funds. Unfortunately, it would seem that many of these structured notes are currently under water. Restructurings and workouts of these instruments, and other debt instruments that are not publicly traded, can result in the restructured debt instrument being "split" into two components for U.S. federal income tax purposes: a non-contingent component and a contingent component under current regulations. The application of these rules can be extremely complex and both issuers and holders that participate in debt restructurings and workouts would be well advised to discuss their particular situations with tax counsel.

Foreign Holders

Foreign holders, such as foreign investment funds, especially those that have a presence in the United States, need to take great care with regard to restructurings of debt that they hold in order to avoid getting entangled in the U.S. tax web. These foreign investment funds generally take the position that they are not engaged in a U.S. trade or business within the United States pursuant to a "securities trading safe harbor" which provides that a foreign person trading for its own account is not engaged in a U.S. trade or business, even if it has a fixed place of business within the U.S. A foreign investment fund, however, that is in the "lending business" cannot rely on the securities trading safe harbor. As a result, such a fund can purchase debt on the secondary market through its U.S. office without being regarded as having a U.S. trade or business, but it cannot regularly and continuously "originate" loans. Can a foreign investment fund participate in restructuring debt instruments without being considered to be engaged in a U.S. trade or business? The answer to this question is unfortunately unclear. Several interested parties have commented on this issue. In May, 2007, the New York City Bar published a report proposing various safe harbors for certain lending activities conducted within the United States. In addition, last April, the Managed Funds Association, an advocacy group for the alternative investment industry, appealed to Treasury to publish guidance to clarify that the securities trading safe harbor extends to situations in which debt instruments are being restructured and includes restructuring negotiations, collection, servicing and similar activities undertaken in

connection with the debt instruments. Treasury has thus far not responded with published guidance and the Managed Funds Association has indicated that capital held by foreign investment funds will not flow into the United States without further clarification. However, the Internal Revenue Service ("IRS") indicated during a Federal Bar Association Conference, held on March 6, 2009 in Washington D.C., that it is addressing these issues and indicated that investments in distressed debt coupled with aiding in the management of the issuer with the intent to realize a capital gain may be viewed as passive activities not resulting in a U.S. trade or business.[1]

For more information on debt restructurings, please see our client alert "Temporary Deferral of Cancellation-of-Indebtedness Income Under the Recovery and Reinvestment Act of 2009."

The Obama Budget

On February 26, 2009, the Office of Management and Budget ("OMB")[2] released "A New Era of Responsibility: the 2010 Budget," the new Administration's first budget proposal. The 2010 budget proposal resonates with President Obama's initiatives emphasized during his campaign for the presidency. For a discussion of those campaign initiatives, see our last issue, "MoFo Tax Talk, Volume 1, Issue 4."

The President has announced his intention to cut the budget deficit by more than one-half to $533 million by 2013 through a combination of tax hikes and spending cuts. The 2010 plan would increase taxes on high-income earners and businesses and decrease spending in certain areas. It appears that "high income" earners would include single filing taxpayers who earn more than $200,000 and joint filers who report income of more than $250,000. For the most part, the tax hikes will not take effect until 2011. While precise details have not yet been released (and are expected in late March or April), noteworthy provisions in the 2010 plan include the following:

Individuals

Increase in marginal rates for high-income earners. The plan would allow the Bush tax cuts to expire as scheduled. Accordingly, the top two income tax brackets will revert in 2011 to 39.6% and 36% from 35% and 33%, respectively. OMB estimates that the proposal will raise approximately $339 billion through 2019.

Increase in capital gains rate for high-income earners. Currently, long-term capital gains and qualifying dividends are generally taxed at a preferential 15% rate. For high income earners, the plan would increase the rate to 20%. OMB estimates that the proposal will raise approximately $118 billion through 2019.

Reduce value of certain deductions. Under current law, if an individual is entitled to a deduction, the deduction generally reduces federal income tax liability by an amount equal to the individual's marginal tax rate multiplied by the amount of the deduction. The plan proposes to limit the rate at which itemized deductions (which generally include mortgage interest deductions and charitable donations) reduce federal income tax liability for high-income earners by capping the rate at 28%. Charitable institutions are concerned that the change in law may impair charitable contributions. OMB justifies the provision on fairness grounds, arguing that a low-income taxpayer at a 15% marginal rate who makes a charitable contribution of, say, $1,000 receives a $150 tax benefit but, absent a change of law, a high-income taxpayer taxed at a 35% marginal rate making the same $1,000 contribution receives a $350 benefit. The proposal would limit the benefit of the deduction for high-income earners to $280 ($1000 x 28%). Opponents contend that the fairness argument is dubious. The high-income earner would have to pay tax on "phantom" income equal to the product of the $1,000 contribution and the difference between the highest marginal rate (in this example, 35%) and 28%. Stated differently, to give away $1000 earned in the current year, the high-income earner would, from one point of view, have to pay Uncle Sam $70. OMB estimates that the proposal will raise approximately $318 billion through 2019.

[1] Tax Analysts, *IRS Examining Foreign Hedge Fund Debt Investment Issues*, 2009 TNT 43-5 (March 9, 2009).
[2] OMB is a division of the Executive Office of the President of the United States and assists the President in implementing and overseeing the federal budget.

Restore personal exemption phaseout and itemized deduction phaseout for high-income earners. In recent years, the phaseout limitations on the personal exemption and itemized deductions, which phases out a taxpayer's ability to take the full value of otherwise allowable deductions as a taxpayer's income increases, has been reduced or eliminated. The proposal would reinstate these two phaseout limitations on high-income earners. OMB estimates that this would raise $180 billion over 10 years.

Make Making Work Pay credit permanent. ARRA contained a "Making Work Pay" credit, which provided a temporary tax credit for tax years 2009 and 2010 for lower-income taxpayers. The credit equals 6.2% of a taxpayer's earned income, up to a cap of $400 for singles and $800 for joint filers. The exemption is subject to a phaseout. The proposal would make this credit permanent at a cost of approximately $537 billion through 2019 according to the OMB.

Businesses

Tax carried interest as ordinary income. In typical private equity and hedge fund arrangements, a fund is structured as a partnership for tax purposes. Passive investors typically contribute 99% of capital to the partnership and become limited partners. Managers, who manage the investments of the partnership, contribute the remaining capital and become general partners. In return for running the fund, managers typically receive a management fee equal to 2% of invested capital and an additional 20% "profits interest" in the partnership (the "carried interest"). The carried interest is a right to receive 20% of the profits of the partnership without the obligation to contribute capital. The management fee is treated as compensation for services rendered and taxed at ordinary rates for federal income tax purposes. However, if the partnership has profits from the sale of long-term capital assets (*e.g.*, stock held for more than one year), the profits pass-through to the partners and are taxed at the preferential long-term capital gain rate (currently 15%). The proposal will tax profits from the carried interest at ordinary rates. The proposal will raise approximately $24 billion through 2019 according to OMB.

Implement international enforcement, reform deferral, and other tax reform policies. The plan intends to reform international taxation with respect to enforcement, deferral (presumably addressing the provisions of current law that permit U.S. taxpayers that operate offshore to defer payment of taxes in the United States), and other policies, which would raise revenue by an estimated $210 billion through 2019. The administration has left the contours of the proposed reform vague.

Codify Economic Substance Doctrine. The plan would codify the economic substance doctrine (historically, a judicial doctrine that polices the boundaries beyond which transactions are treated as generating impermissible tax benefits). The proposal would raise approximately $5 billion through 2019 according to OMB.

Expand net operating loss carryback. The plan would extend carrybacks of NOLs to 5 years, which would cost taxpayers an estimated $28 billion in 2009 and $36 billion in 2010.

A Note on APB 14-1 (Converts)

On May 9, 2008, the Federal Accounting Standards Board ("FASB") issued APB 14-1, a Staff Position on "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)," which requires that an issuer separately account for the liability and equity components of convertible debt on a bifurcated basis and in a manner that reflects the issuer's borrowing rate on non-convertible debt.[3] The new rule generally applies for fiscal years that begin after December 15, 2008. As a result of APB-14, issuers now are required to recognize a non-cash interest expense in respect of convertible debt that reflects the rate the issuer would have had to pay if the instrument did not have the conversion feature. The increased interest expense will result in a lower reported earnings per share for affected issuers. Issuers will need to update their public disclosures to reflect APB-14 and earnings releases will need to adjust for the additional non-cash expense.

[3] For more information, please see our client alert "New FASB Accounting Rules on Convertible Debt."

See, *e.g.*, http://idea.sec.gov/Archives/edgar/data/917520/000136231009000738/c79841e8vk.htm, a Form 8-K filed by Integra Lifesciences Holdings Corporation on January 28, 2009 discussing the impact of APB 14-1.

This new accounting approach draws some parallels with current tax rules applicable to convertible instruments. Indeed, as a response to objections that issuers may not be able to comply with the new bifurcation rules, the FSP mentions that issuers already may be required to determine their nonconvertible borrowing rate to adequately support their income tax positions. For example, certain convertible debt instruments containing contingent interest provisions are characterized, for tax purposes, as contingent debt obligations. An issuer of a contingent debt obligation generally is required to compute its nonconvertible borrowing rate and is permitted an income tax deduction based on that rate. In addition, many issuers of other convertible debt securities acquire call options on their own stock concurrently with the issuance of the securities (sometimes as part of a call spread). Under those circumstances, the convertible debt security and the call options may be integrated for tax purposes, resulting, the APB claims, in an overall tax deduction that is similar to the issuers' nonconvertible debt borrowing rates.

The Stimulus Bill – An Executive Summary

ARRA was passed by Congress on February 13, 2009 and signed into law by the President on February 17. ARRA includes a package of more than 40 tax provisions directed towards individuals, business, energy, and infrastructure. Of these, roughly 10 provisions affect individuals, 10 provisions affect business, 9 provisions affect infrastructure, and 14 provisions are directed towards energy. Please see "Tax Provisions of the Stimulus Bill" for an executive summary of some of ARRA's more significant tax related provisions.

ARRA provides tax cuts estimated to cost U.S. taxpayers approximately $301 billion over a ten-year horizon according to the Joint Committee on Taxation ("JCT").[4] Of the $301 billion, approximately $232 billion is expected to benefit individuals and families, approximately $20 billion is in incentives for energy investment, approximately $25 billion is geared towards infrastructure, and an estimated $6 billion of relief is provided for businesses. The following is a summary of the key tax provisions that affect businesses.

Cancellation of Indebtedness Relief

As noted above, COD income arises if a taxpayer incurs debt but is ultimately relieved from having to pay back the full amount.

ARRA adds new Section 108(i), which allows a corporation to reacquire (*e.g.*, through repurchase, modification or exchange) outstanding debt instruments in 2009 and 2010 and elect to defer recognition of any COD income incurred for an initial deferral period (5 years if reacquired in 2009, 4 years if reacquired in 2010). After the deferral period, the corporation must include the deferred COD income ratably over the next five years. The new rules accelerate recognition of deferred COD income on the occurrence of certain events including bankruptcy of the issuer. If an issuer exchanges or is deemed to exchange (*e.g.*, through modification of existing debt) a debt instrument for a debt instrument that has OID, to match the timing of OID and COD income, the issuer is required to defer OID deductions during the initial deferral period to the extent of the COD deferral, and is then allowed to ratably take OID deductions over the next 5 years. For a more detailed discussion on new Section 108(i), including the special rules that apply to partnerships and pass-through entities, see our prior client alert "Temporary Deferral of Cancellation-of-Indebtedness Income Under the Recovery and Reinvestment Act of 2009."

[4] The JCT is a nonpartisan committee of the United States Congress (chaired on a rotating basis by the Chair of the Senate Finance Committee and the Chair of the House Ways and Means Committee) that is involved in all stages of the tax legislative process and also provides analyses of new tax legislation, including revenue effects.

AHYDO Relief

An "applicable high yield discount obligation" ("AHYDO") is a debt instrument with a maturity in excess of 5 years, which has a yield that equals or exceeds the sum of the "applicable federal rate"[5] plus 5 percentage points, and which has "significant original issue discount."[6] The issuer of an AHYDO is denied a deduction for a portion (the "disqualified portion") of OID.[7] In addition, the non-disqualified portion of OID is deductible only when paid.

ARRA provides that the AHYDO rules will not apply to exchanges of existing debt for new debt of the same issuer if (i) the new debt is issued between August 31, 2008 and January 1, 2010; (ii) the existing debt is not an AHYDO; and (iii) the new debt is not issued to a related party. ARRA also grants the Treasury the authority to extend the suspension. In practice, what this means is that a corporation may roll over its debt with new debt, with interest deductions on the new debt not subject to otherwise applicable limitations under the AHYDO rules.

JCT estimates that the COD and AHYDO provisions will cost taxpayers $12.1 billion for 2009, $22.8 billion for 2010, $7.5 billion for 2011, and only $1.6 billion over a ten-year horizon (as the COD income is included in later years).

Section 382

In general, Section 382 of the Internal Revenue Code of 1986, as amended ("Code"), is designed to police the trafficking of corporate tax attributes (*e.g.*, net operating losses ("NOLs") and unrecognized built-in losses) through the sale of significant ownership interests in loss corporations. ARRA provides that Section 382 will not apply in the case of an ownership change if a corporation is required to restructure pursuant to a loan or credit line received from the Treasury under the Economic Stabilization Act of 2008 and the restructuring plan is intended to rationalize costs and expenses. However, the exception will not apply if any person owns 50% or more of the stock of the new loss corporation by vote or value after the ownership change. The relief ARRA provides with respect to the potential application of Section 382 of the Code appears targeted at General Motors and Chrysler. Late last year, the Treasury provided General Motors and Chrysler with emergency loans to keep the two automakers afloat. This relief is estimated to cost $3.1 billion over a ten year horizon.

Repeal of Notice 2008-83

As we reported in Tax Talk Volume 1, Issue 4, certain members of the U.S. Congress were not particularly pleased with IRS Notice 2008-83, released in September 2008, which relaxed Section 382's limitation on the prospective use of built-in losses of a troubled bank (including unrealized losses on toxic assets) in the event of its acquisition. The point of the Notice was to encourage the acquisition of troubled banks by healthy banks. ARRA repeals Notice 2008-83 prospectively for ownership changes occurring after January 16, 2009. For Notice 2008-83 to have the force and effect of law for transactions entered into on or before January 16, 2009 but which have yet to close, a written binding contract must have been entered into on or before January 16, 2009 or a written agreement must have been entered on or before January 16, 2009 and the agreement must have been described on or before such date in a public announcement or in a filing with the SEC.

The new statutory provision memorializes Congress's displeasure with Notice 2008-83, finding as follows: (1) the delegation of authority to the Secretary of the Treasury under Section 382 does not authorize the Secretary to provide exemptions or special rules that are restricted to particular industries or classes of taxpayers; (2) Notice 2008-83 is inconsistent with the congressional intent behind Section 382; (3) the legal authority to prescribe

[5] The "applicable federal rates" are interest rates published monthly by the U.S. Treasury for purposes of applying various provisions of the Internal Revenue Code.
[6] Under Section 165(i)(2), OID is significant if, immediately before the close of any accrual period ending more than five years after issue, the aggregate amount that has been included in gross income with respect to such instrument exceeds the sum of actual interest payments plus an amount equal to the product of the debt instrument's issue price and yield to maturity.
[7] Under Section 165(e)(5), the disqualified portion of OID is the lesser of (i) all OID or (ii) the product of (a) the sum of OID and stated interest on the instrument and (b) the ratio of (X) an amount by which the yield to maturity exceeds 6% plus the AFR to (Y) the yield to maturity.

Notice 2008-83 is doubtful; and (4) as taxpayers should generally be able to rely on guidance issued by the Secretary of the Treasury, legislation is necessary to clarify the force and effect of Notice 2008-83 and restore the proper application under the Internal Revenue Code of the limitation on built-in losses following an ownership change of a bank.

JCT projects that the provision will save taxpayer's approximately $7 billion over the next 10 years.

NOL Carrybacks

A corporation's NOL is generally calculated as the excess of deductions over gross income. If a corporation has an NOL, it may "carryback" the NOL to offset income earned during the prior 2 years and "carryforward" the NOL to offset income earned during the next 20 years. ARRA extends the carryback period from 2 years to 5 years. However, the relief is available only to small businesses, generally defined as those that have $15 million or less in annual gross receipts. JCT estimates that this provision will cost U.S. taxpayers $4.7 billion for the 2009 tax year and $947 million over a 10 year horizon.

Madoff Matters – What Tax Relief?

The current economic downturn has uncovered several rather ugly situations, including the alleged Ponzi scheme run by prominent investment manager Bernard Madoff. It seems, however, that Madoff's victims might be able to soften the effects of their economic losses courtesy of Uncle Sam. The Code generally allows taxpayers to deduct losses, including theft losses, sustained during a taxable year to offset taxable ordinary income. However, the loss may not be otherwise compensated for, *e.g.*, by insurance, in order to be deductible. This is important as some of Madoff's victims may (partly) be entitled to a reimbursement from the Securities Investor Protection Corporation under the Securities Investor Protection Act.

In the case of individual investors, the amount of loss that may be deducted for U.S. federal income tax purposes depends on whether the loss was incurred in a transaction entered into for profit (though not connected with a trade or business). If an investment with Madoff were not a transaction entered into for profit (and not connected with a trade or business), then a theft loss is allowed only to the extent such loss exceeds 10% of the taxpayer's adjusted gross income. This limitation does not apply to losses incurred in a transaction entered into for profit. However, it seems that, in the past, the IRS has taken the position that theft losses are always subject to the aforementioned limitation. This would mean that Madoff's victims would only be able to claim a deduction for the amount of their losses exceeding 10% of their adjusted gross income.

Further, given the nature of the alleged ponzi scheme, investors may have included fictitious income, such as interest, dividends and capital gains, on their tax returns in amounts reported on IRS information reporting forms (*e.g.*, Forms 1099) received from Madoff or the feeder funds through which they invested with Madoff. Alternatively, by filing protective amended returns, taxpayers conceivably could seek refunds from the IRS of the taxes paid on any such fictitious income. Taxpayers can generally seek refunds with respect to tax returns filed within three years of the date of the refund claim. Thus, this remedy is fairly limited for those victims who have been with Madoff for a relatively longer time. Those taxpayers could consider taking the position that the amounts of fictitious income included on prior year tax returns should subsequently be taken into account as a theft loss. It is thus far unclear what the IRS's position is with respect to these issues.

The Learning Annex – A Primer on Debt Reopenings

Debt issues are often "reopened," meaning that an issuer issues an additional tranche of notes ("additional notes") at some point after original issue ("original notes"). 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. One benefit of fungibility is that it adds

liquidity to the market for the notes. Reopening a debt issue can cause significant tax consequences, particularly where the additional notes are issued with 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 is generally not currently taxable 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 would generally prefer the original notes and the additional notes to be fungible from a tax standpoint, so that the additional notes (like the new 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 additional notes and the new 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 new 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.

To be fungible from a tax standpoint, the reopening must satisfy one of three tests: the original notes and the additional notes must be issued within 13 days of the original note (the "13 day rule"), 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.

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 6 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.

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 provide 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 a 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.

As a practical matter, if neither the original notes nor the additional notes would be viewed as being issued with OID (each tested on a separate basis), the requirement that the original notes be publicly traded, even though required by the text of the regulations, may be irrelevant. Thus, even though such a reopening may not qualify as a "qualified reopening" within the meaning of the regulations, the original notes and the new notes may, nonetheless, be fungible for tax purposes. In those circumstances, the note issue may be reopened without adverse tax consequences to a holder.

MoFo in the News

On January 26-28, 2009, MoFo sponsored "Finance IQ Insurance-Linked Securities Summit" at the Millennium Broadway Hotel in New York City. Panelists included MoFo partner Chiahua Pan. The panel examined the impact of the global financial crisis on insurance-linked securities and discussed new investment strategies for catastrophe bonds, longevity risks, catastrophic mortality, and life settlements.

On February 11, 2009, MoFo partners Anna T. Pinedo and James R. Tanenbaum presented a comprehensive lecture on "Rights Offerings" at MoFo's New York office. A rights offering – an offering of rights to an issuer's existing shareholders to purchase a *pro rata* portion of additional shares of issuer stock at a specified price ("subscription warrants") – is an alternative to an outright common stock offering for companies looking to raise capital. Typically, the issuer does not pay an underwriter fee for a rights offering. In a typical common stock offering, on the other hand, an issuer sells shares through an investment bank (the underwriter). The investment bank then places the stock with public investors. In return, the bank earns underwriting fees, which can be in the 7% range. From the holder's perspective, a rights offering is attractive because the rights are generally set at a discount (which may be substantial) to the trading price of the stock. For example, last September, Fortis, to fund the take over of ABN-Amro, was reported to offer additional shares at a 43.7% discount in a public rights offering. Ms. Pinedo and Mr. Tanenbaum gave an introduction to rights offerings, discussed holder and issuer considerations for rights offerings from an economic, corporate and securities law perspective, and also discussed current structures and documentation issues with respect to rights offerings.

On February 24, 2009, members of the MoFo state and local tax and federal tax groups presented a four hour CLE to the Tax Executives Institute Atlanta Chapter in Atlanta, Georgia. Partners Thomas A. Humphreys, Stephen Feldman, and Robert A. Cudd summarized the federal income tax developments of 2008, among other things. Topics included, in part, legislative and regulatory developments relating to Section 382, NOLs, COD income, debt workouts, captive insurance companies, repatriation and Subpart F blockers, inversion transactions, tax preparer regulations, and tax accrual workpapers. Partners Hollis Hyans and Andres Vallejo and counsel Gregory Roberts discussed recent developments on the state and local tax front.

On February 25, 2009, MoFo hosted "XBRL: What Companies and In-House Lawyers Need to Know" at MoFo's New York offices. XBRL stands for eXtensible Business Reporting Language. The SEC has issued a final rule requiring companies to provide financial statement information in a form that is intended to improve its usefulness to investors. That form is XBRL, which is an interactive data format that investors can download directly into spreadsheets or other software and which is intended to provide standardization for reporting. MoFo partner

David Lynn discussed the preparation and submission of XBRL tagged disclosures, audit and attestation implications, liability, due diligence and other related considerations.

On March 3, 2009, MoFo hosted "TARP and Government Intervention in 2009" at MoFo's New York offices. Panelists included Dr. Elaine Buckberg and Dr. Ronald I. Miller, both with NERA Economic Consulting, and MoFo's Oliver I. Ireland and Amy M. Baumgardner. The panel addressed the new administration's commitment for transparency in the Troubled Asset Relief Program spending and discussed new initiatives taken by the new administration to prevent foreclosures for responsible borrowers having difficulty paying their mortgages. The panel also discussed the economic impact on the U.S. economy of the TARP and other initiatives.

On March 5, 2009, MoFo hosted "Financial Institutions, Government Programs and the Ratings Outlook" at MoFo's New York offices. Tanya Azarchs and Scott Sprinzen (Standard & Poor's), Barbara Havlicek and Craig Emrick (Moody's Investors Service), and Thomas A. Humphreys and Anna T. Pinedo (MoFo) discussed the debt markets, downgrades and defaults, capital ratios, performance of hybrid instruments during the downturn, ratings on government guaranteed debt and ratings outlook for financial institutions.

On March 11, 2009, MoFo will host "IFLR Web Seminar: Debt Hangover: Addressing Liability Management." Panelists include partners Thomas A. Humphreys and Anna T. Pinedo. Mr. Humphreys and Ms. Pinedo will address the structuring, documentation, securities law and tax consequences of open market debt repurchases, debt tender offers and exchange offers, non-convertible investment grade debt tenders, consent solicitations, repurchases and tenders for convertible and exchangeable debt securities, and debt for equity swaps.

Press Corner

- Hybrid and Tier 1 securities were all the rage until the tidal waves of the credit crunch reached a crescendo during the second half of 2008, with U.S. financial institutions issuing hundreds of billions of dollars of various types of instruments, including long-term subordinated debt, equity units (typically consisting of remarketable debt or trust preferred securities coupled with a forward contract on the issuer's common or preferred stock) and convertible preferred stock or noncumulative perpetual preferred stock. Foreign financial institutions added many more billions of euros of instruments, including the very popular perpetual bond offerings. Many of these instruments were structured to qualify as Tier 1 capital, to receive high equity credit from ratings agencies and, to the extent possible, to be tax deductible as well. Bankers designed innovative structures that maximized the benefits to the issuer and produced an attractive enhanced yield to investors for taking on what was then perceived to be a manageable dose of additional risk. Clearly, few counted on the credit crunch to be as severe as it turned out to be, and the instruments are in the news again, only this time the coverage is not entirely positive. In the United States, prices on many hybrids have fallen to distressed levels, with some fearing that the very equity features that made the securities attractive for issuers may now haunt investors. For example, long-term hybrid debt securities typically contain a provision that permits the issuer to defer payments of interest. Investors worry that exercise of these deferral rights, once viewed as remote, is now all too real. Other hybrids permit issuers to keep securities outstanding in perpetuity. Investors worry that banks may elect not to call, or may be forced by regulators not to call, their hybrids, resulting in investor exposure to perpetual securities of banks on shaky ground. Rumblings of nationalization of banks in the U.S. and Great Britain have not helped. As of last month, some hybrids issued by some of the largest financial institutions left standing had lost more than half their value.
- U.S. tax laws are complex. Compliance can be difficult, time-consuming and confusing. The result of noncompliance can result in penalties and interest charges. And, noncompliance may have collateral effects, such as derailing an executive branch nomination or two. As has been widely reported in the press, President Obama's appointees have not been immune to these risks.

  Reportage of tax troubles began with Tim Geithner, now Secretary of the Treasury. Geithner worked at the International Monetary Fund from 2001 to 2003 as a policy director. The IMF apparently does not withhold U.S. payroll taxes, so U.S. employees are required to comply with their payroll tax obligations on their own.

In the U.S., payroll taxes include Social Security and Medicare. For 2008, the Social Security tax was assessed at 12.4% capped at the first $102,000 of income and Medicare taxes were assessed at 2.9% with no cap. Employees and employers are responsible for one-half each. The self-employed pay the full amount. If amounts are not withheld, taxpayers must add the payroll taxes to their quarterly estimated tax payments. Geithner was audited in 2006, found to be in noncompliance, amended his 2003 and 2004 tax returns, and paid back taxes for those years. A 3-year statute of limitations prevents the IRS from collecting back taxes on his 2001 and 2002 returns. Geithner did not pay those taxes until after he was nominated. Geithner was nominated and sworn in on January 26, 2009 despite his tax problems.

Then came Tom Daschle. After he left the Senate in 2004, Daschle worked as an independent consultant for a private company. He was provided with the use of a limo and chauffeur. After his nomination, he disclosed that he had used the perk 80% for personal use and 20% for business use. The personal use portion constitutes income in the United States. Even after he corrected the error, Daschle further admitted that he had failed to pay about $6,000 in self-employment tax on the perk. He failed to report more than $255,000 in income over three years. News of Daschle's problems broke on January 30, 2009. President Obama stated on February 2 that he had full faith in his nominee. However, on February 3, 2009, Daschle withdrew. President Obama later said: "I screwed up."

In our prior issue (Q3, 2008), we reported that Charles Rangel, Chairman of the House Ways and Means Committee, had been in the news for failing to report $75,000 in rental income on a beach property. Apparently, Rangel has not paid penalties for back taxes owed. Congressman John Carter (R-TX) has since introduced HR 735 (the "Rangel Rule Act"), which would give all taxpayers the right to waive IRS interest and penalties on back taxes if they simply write "Rangel Rule" on their tax return when paying back taxes. The following is the text of the bill:

> SEC. 7529. UNITED STATES CITIZENS EXEMPT FROM PENALTIES AND INTEREST.
>
> "Any individual who is a citizen of the United States and who writes "Rangel Rule" on the top of the first page of the return of tax imposed … for any taxable year shall be exempt from any requirement to pay interest, and from any penalty, addition to tax, or additional amount, with respect to such return."

The future of this bill is uncertain as of press time.

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