



## Note from the Editors

While the consensus appears to be that the world has stepped away from the abyss that threatened global financial markets and economies alike, the Internal Revenue Service (“IRS”) and the U.S. Treasury Department (“Treasury”) continue to be in crisis-response mode, addressing tax issues that arise from various stabilizing initiatives adopted by the U.S. government. Since the last issue of this publication, the IRS released Revenue Procedure 2009-37, which provides guidance on the Section 108(i)<sup>1</sup> election that defers recognition of cancellation of indebtedness (“COD”) income. The government also released Revenue Procedure 2009-38 and Revenue Procedure 2009-42, each of which addresses aspects of the Public-Private Investment Program (“PPIP”). In addition, the IRS provided favorable guidance on modifications of securitized commercial mortgage loans. This issue reports on these developments. We also report on developments unrelated to the credit crisis. The IRS released a favorable Chief Counsel Advice that addresses the taxation of trust preferred securities. In *Schering-Plough Corp. v. United States*, a U.S. district court disallowed perceived abusive tax benefits arising from an assignment of interest rate swaps by a domestic corporation to its foreign subsidiaries. And, responding to concerns that the oil markets are in part driven by speculation, Senator

Wyden proposed a bill that would affect the taxation of certain actively traded oil and natural gas positions. Next, in a development that is in part driven by the global economic recovery that is believed currently to be underway, we have detected of late increasing activity on Wall Street relating to business development companies (“BDCs”) and mortgage real estate investment trusts (“REITs”), each of which represents a structure for pooling capital to invest in targeted asset classes, including troubled businesses and distressed financial assets. In this issue, we compare and contrast the appeal and limitations of these two structures. Finally, in our regular feature, the Learning Annex, we provide a primer on the taxation of foreign-currency linked structured notes, a fast-growing segment of the structured products market. ■

<sup>1</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

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## New Section 108(i) Guidance – An Executive Summary

Section 108(i) was enacted on February 17, 2009.<sup>1</sup> Where available, Section 108(i) permits taxpayers to elect to defer for a period of up to five years the recognition of COD income arising from repurchases, exchanges or modifications (“reacquisitions”) of outstanding debt (“applicable debt instruments”) that occur during 2009 and 2010. Under Section 108(i), if a debt instrument having original issue discount (“OID”) is issued in exchange for an applicable debt instrument, deductions for the OID on the new instrument are disallowed during the deferral period to the extent such OID does not exceed the COD income realized but deferred in the exchange. After the expiration of the deferral period, the deferred OID deductions may be claimed ratably over the five-year period during which the COD income must be included.

On August 17, 2009, the IRS issued Revenue Procedure 2009-37, which, in addition to providing detailed administrative procedures for making the Section 108(i) election, clarifies certain ambiguities in the statute. Significantly, it also permits “partial elections” as discussed below. Here we provide a summary of some

of the more important aspects of the new guidance.

*Partial Elections.* The revenue procedure makes clear that a taxpayer may make an election for all or any portion of COD income realized from the reacquisition of any applicable debt instrument. Thus, for example, if a taxpayer realizes \$100 of COD income from the reacquisition of an applicable debt instrument, the taxpayer may elect to defer only \$40 of the \$100 of COD income. The remaining portion may be excluded under other Section 108 exceptions (e.g., the insolvency exception), if applicable. The procedure also clarifies that a taxpayer may make an election in respect of different portions of COD income arising from different applicable debt instruments (whether or not part of the same issue). In addition, a partnership that makes a partial election may specifically allocate the deferred amount to specific partners, allowing the partnership flexibility in tax planning for each partner.<sup>2</sup>

*Pass-Through Entities.* Under Section 108(i), certain events accelerate the deferral of COD income. These events include the death of, liquidation of,

or other similar event with respect to, a taxpayer. In addition, certain dispositions of interests in partnerships, S corporations, or other “pass-through” entities cause acceleration. Importantly, clarifying an ambiguity in the statute, the revenue procedure provides that regulated investment companies (“RICs”) and REITs are not pass-through entities for purposes of Section 108(i).

*Impact on Earnings and Profits.* The revenue procedure provides that the IRS intends to issue regulations that generally will provide that deferred COD income increases earnings and profits in the taxable year that it is realized and not in the taxable year or years that the deferred COD income is includible in gross income. OID deductions deferred under Section 108 generally will decrease earnings and profits in the taxable year or years in which the deduction would be allowed without regard to Section 108(i). However, in the case of RICs and REITs, COD income deferred under Section 108(i) generally increases earnings and profits in the taxable year or years in which the deferred COD income is includible in gross income and not in the year that the deferred

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## New Section 108(i)

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COD income is realized and OID deductions deferred under Section 108(i) generally decrease earnings and profits in the taxable year or years that the deferred OID deductions are taken into account.

*Transition Rules.* A previous election that does not comply with the revenue procedure will not be effective unless the taxpayer files an amended return that complies with the requirements of the revenue procedure on or before November 16, 2009. In addition, a taxpayer that filed a Section 108(i) election on or before September 16, 2009 may modify that election by filing an amended return on or before November 16, 2009. ■

<sup>1</sup> See our prior client alert at [Temporary Deferral of Cancellation-of-Indebtedness Income Under the Recovery and Reinvestment Act of 2009](#) for a detailed discussion.

<sup>2</sup> In the case of an entity classified for tax purposes as a partnership, COD income is recognized at the partnership level, but any applicable COD exclusions must be determined at the partner level.

## IRS Lends Public-Private Investment Program a Helping Hand

PPIP, unveiled on March 23, 2009, was designed to encourage the creation of markets for so-called “toxic assets” that were at the center of the credit crisis. It represents an effort to encourage the creation of investment funds, capitalized in part by the U.S. government and in part by private investors, to take toxic assets off the balance sheets of ailing financial institutions. The IRS has recently released favorable revenue procedures addressing two potential tax complications that funds, operating under PPIP, may face. The first prevents application of a rule that could impose an entity level tax on PPIP funds, and the second provides a favorable “look through” rule for testing whether a RIC that invests in such funds is adequately diversified for federal income tax purposes.

Revenue Procedure 2009-38, released on August 27, 2009, provides that the IRS will not assert that funds that invest in toxic assets under PPIP are “taxable mortgage pools” (“TMPs”). A TMP, treated as a corporation for federal income tax purposes that is subject to an entity level tax, generally is defined as any entity (other than a real estate mortgage investment conduit (“REMIC”)) (i) substantially

all of the assets of which consist of debt obligations and more than 50% of those assets are real estate mortgages, and (ii) that has issued multiple classes of debt, where the payments made on the debt issued are related to the payments received by the entity on its assets. The revenue procedure generally applies to a fund or portion of a fund that holds securities pursuant to PPIP, provided that the government owns a significant equity interest in the fund, and to any entity or portion of an entity that directly or indirectly owns equity interests in such a fund.

Revenue Procedure 2009-42, released on September 9, 2009, provides that, for purposes of meeting prescribed statutory asset diversification requirements,<sup>2</sup> a RIC will be treated as if it directly invested in the assets held by the PPIP in which it invests (as determined in accordance with the RIC’s percentage of ownership of the capital interests in the PPIP). The rule is favorable because the RIC gets to count the PPIP assets as separate assets for purposes of testing diversification. The procedure is available if the RIC

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## IRS Lends

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invests at least 70% of its original assets (including seed capital and net proceeds from an initial public offering) as a partner in one or more PPIPs that hold PPIP toxic assets and that are treated as partnerships for federal income tax purposes and if the entity's allocable share of each item of the PPIP's income, gain, loss, deduction, and credit for federal income tax purposes is proportionate to its percentage of ownership of the capital interests in the PPIP. ■

<sup>1</sup> For more information on PPIP, see our prior client alert "[Worth the Wait? Treasury Announces the Public-Private Investment Program.](#)"

<sup>2</sup> To qualify as a RIC, a corporation's assets must be adequately diversified at the close of each quarter of the taxable year under each of two tests. First, at least 50% of the value of its total assets must generally be represented by cash, government securities, securities of other RICs, and other securities that, with respect to any one issuer, do not represent more than 5% of the value of the RIC's total assets or more than 10% of the voting securities of such issuer. Second, not more than 25% of the value of its total assets may generally be invested in securities (other than government securities or the securities of other RICs) of any one issuer, securities (other than the securities of other RICs) of two or more issuers which it controls and which are determined to be engaged in the same or similar trades or businesses or related trades or businesses, or securities of one or more "qualified publicly traded partnerships."

## Permissive Guidance on Commercial Mortgage Loan Modifications

On September 15, 2009, the IRS and the Treasury issued final regulations addressing permitted modifications of commercial mortgage loans held by a REMIC and Revenue Procedure 2009-45, describing the conditions under which modifications to mortgage loans will not cause the IRS to challenge the tax status or treatment of securitization vehicles that hold the loans.<sup>1</sup> The guidance is aimed at providing greater flexibility in working out securitized commercial loans. Below we highlight the important aspects of the guidance.

*Final Regulations.* Under the REMIC rules, only specified modifications to loans are permitted without triggering adverse tax consequences for the REMIC. The new regulations, effective on or after September 16, 2009, finalize proposed regulations released on November 9, 2007. The new rules expand the list of permitted modifications to include (i) release of a lien on real property that secures a mortgage, (ii) release, substitution, addition or other alteration to the collateral for, a guarantee on, or other form of credit enhancement for a loan, and (iii) a change to a loan from recourse to nonrecourse or from nonrecourse to recourse;

provided in each case that the loan continues to be "principally secured" by real property after giving effect to the modification. Under the final regulations, the "principally secured" test generally is met if (i) the fair market value of the real property that secures the loan equals at least 80% of the amount of the loan, or (ii) the fair market value of the real property that secures the loan immediately after the modification equals or exceeds the fair market value of the real property that secured the loan immediately before the modification. Clause (ii) was not a provision that was in the proposed regulations but was added in the final regulations and is generally intended to provide a more flexible standard.

*Revenue Procedure 2009-45.* Under regulations, if a modification to the terms of a loan is "occasioned by default or reasonably foreseeable default," the modification is a permitted modification. The revenue procedure, in general, provides additional guidance for commercial mortgages. Where requirements of the revenue procedure are met, the IRS will not challenge a securitization vehicle's favorable tax status or tax treatment as a result of loan

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## Permissive Guidance

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modifications (including exchanges) even if the modifications would otherwise be impermissible. The key requirement that must be met is that, based on all the facts and circumstances, the holder or servicer of the loan must reasonably believe that there is a significant risk of default on the loan prior to modification. This belief must be based on a “diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the holder or servicer neither knows nor has reason to know that such representations are false.” While factors include how far in the future the possible default is, and whether the loan is performing, there is no maximum period after which default is *per se* not foreseeable, and a holder or servicer may reasonably believe that there is a significant risk of default even if the loan is performing. The revenue procedure applies to loan modifications effected on or after January 1, 2008. ■

<sup>1</sup> It also issued Notice 2009-79, soliciting comments on additional guidance, if any, that may be needed regarding modifications of commercial mortgage loans held by investment trusts.

## Schering-Plough Corp. v. United States

In a 91-page opinion,<sup>1</sup> a federal district court denied a refund claim by *Schering-Plough Corp.* (“Schering”) with respect to two transactions it had entered into almost two decades ago. In 1991 and 1992, Schering, an international pharmaceutical company, entered into two 20-year interest rate swap transactions with Algemene Bank Nederland, N.V. (“ABN”), a Dutch bank. Under the swaps, Schering and ABN agreed to make periodic interest payments based on different interest rate indices with respect to a specified notional amount. To hedge their exposure, both ABN and Schering entered into “mirror swaps” with an investment bank. After entering into the swaps, Schering assigned the majority of its rights to receive payments from ABN with respect to years 6-20 to two of its foreign subsidiaries in exchange for lump-sum payments, totaling approximately \$690 million. Relying on an IRS Notice, advice of outside counsel, its financial advisors, and accountants, Schering amortized the lump-sum payments received over the period in which the future income streams had been assigned (*i.e.*, over 15 years), thereby deferring its income tax liability with respect to those payments to that extent.

Economically, Schering had repatriated approximately \$690 million from its two foreign subsidiaries to the United

States. Had Schering received either a dividend or a loan from its foreign subsidiaries, Schering would have had to include the amount of such dividend or loan in its taxable income when received. The IRS argued that the “swap-and-assign” transactions were in substance loans and that Schering should include the appropriate amount in income in the years it entered into the transactions instead of amortizing its income inclusions over 15 years.

The court agreed with the IRS and concluded that the transactions, in substance, constituted loans by the foreign subsidiaries to Schering. The court compared the transactions, where the amounts of the lump-sum payments were determined by reference to the present value of the future income streams, to home mortgage loans, in which the lender makes an upfront payment in return for periodic principal and interest payments. In applying its substance-over-form analysis, the court (i) looked to Schering’s intent (certain transaction documents of both Schering and ABN referred to loans); (ii) examined the objective indicia of the transaction (the court found that the difference between gross amounts paid to the subsidiaries and the lump sum payments was equivalent to interest; the swap payment legs constituted a repayment schedule; no formal loan

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## Schering-Plough Corp.

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documentation was required between the parties; and that because the risk of any Schering default was negligible, no loan collateral was necessary); and (iii) concluded that ABN was merely a conduit (Schering and its subsidiaries had agreed to enter into a transaction prior to involving ABN; ABN's participation was limited to facilitating the swap transactions; ABN's risk with respect to the transactions was *de minimis*; and there was no non-tax business purpose to ABN's participation).

In addition to its substance-over-form analysis, the court provided an *encore* by also determining that the transactions lacked economic substance. It held that the transactions lacked (i) objective economic substance (Schering's interest rate risk was manufactured, and it was willing to incur significant costs to enter into the transactions without a profit potential); and (ii) subjective business motivation (arguments regarding financial reporting, cash management and balance sheet motivations were rejected by the court). ■

<sup>1</sup> *Schering-Plough Corp. v. United States* (D.C. N.J. August 28, 2009).

## “Enhanced” Trust Preferred Securities: A-Ok?

On August 7, 2009, the IRS released Chief Counsel Memorandum 200932049 (the “Memorandum”), addressing the treatment of “trust preferred securities.” Trust preferred securities, treated as debt for tax purposes, are hybrid instruments that have features typically associated with debt instruments as well as some features that arguably are equity flavored.

In a typical structure, a trust, set up by an issuer that wishes to access the capital markets, issues “preferred securities” to investors and uses the proceeds to purchase unsecured, junior subordinated debt obligations (“notes”) issued by the issuer. The trust is structured as a grantor trust – a complete pass-through entity, not subject to an entity-level tax – and investors are treated as owning their *pro rata* share of the trust's assets (*i.e.*, the notes). In a plain vanilla, traditional structure (to be contrasted with the “enhanced” variation discussed below), under the terms of the notes, the issuer may elect to defer payments of interest for a specified number of years (typically five years), and the notes typically have a term of 30 – 49 years. For federal income tax purposes, the issuer receives an interest deduction on the interest it pays on the notes.

“Enhanced” trust preferred securities are a form of trust preferred securities.

These instruments have additional features not found in the basic trust preferred structure. For example, interest may be deferred for periods in excess of five years, deferred interest may be subject to “caps” in bankruptcy (*i.e.*, the investor could lose its claim on a portion of deferred interest payments in excess of a specified cap in bankruptcy), and the notes may have a term in excess of 49 years.

The enhanced features can result in significant benefits from ratings agencies, which give more or less “equity credit” depending on which of the features are included in any particular security. The primary competing consideration is the federal income tax treatment of the notes. If pushed too far, tax practitioners worry that the notes may lose their debt treatment, resulting in a denial of interest deductions for the issuer.

The facts of the Memorandum, while redacted, address enhanced trust preferred securities. The terms of the notes described include optional deferral of interest, mandatory deferral of interest during any period when the issuer is not in compliance with specified financial tests, caps on recovery of deferred interest in bankruptcy, and a term, one may

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## Trust Preferred Securities

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reasonably hazard, significantly in excess of 49 years.

In determining whether the notes constitute debt or equity for federal income tax purposes, the Memorandum recommended that the issuer's characterization of the notes as debt should not be challenged. In arriving at this conclusion, the Memorandum placed a great deal of emphasis on the economic reality in which the notes were issued. In particular, it emphasized the issuer's status as a long-standing and financially sound company, the remote likelihood that the issuer would voluntarily suspend payments of interest or that it would be forced to do so, and the fact that the interest rate borne by the notes suggested that the market did not consider the long maturity of the instruments to be a significant risk.

Enhanced trust preferred securities have been in the market for nearly four years. The Memorandum, which is internal government guidance that cannot be relied on, generally confirms the consensus among practitioners that, for the right issuer in the right economic context, the enhanced features described above should not push an instrument so far along the debt-equity continuum that it loses its debt characterization. ■

## Senator Ron Wyden's "Oil Bill"

On August 6, 2009, Senator Ron Wyden (D-Oregon) introduced the "Stop Tax-breaks for Oil Profiteering Act" in the Senate, which is intended to temporarily curb excessive speculative trading in the oil and gas futures markets by eliminating the preferential tax treatment of direct and certain derivative interests in oil and natural gas. Under current law, direct or derivative interests in oil and natural gas generally are treated as capital assets and, as such, give rise to capital gains or losses. Long-term capital gains recognized by an individual are generally subject to tax at a preferential rate, whereas short-term capital gains are generally subject to tax at ordinary income rates.

The Wyden bill would generally treat all gain or loss from the sale or exchange of any "applicable commodity" which would otherwise be treated as long-term capital gain or loss, as short-term capital gain or loss. An applicable commodity generally includes direct or derivative interests in (i) actively traded oil or natural gas or any primary product of oil or natural gas (such as diesel fuel and gasoline), or (ii) an index, a "substantial portion" of which is based on actively traded oil or natural gas or any primary product of oil or natural gas.

The bill would also affect partnerships and tax-exempt organizations. The

bill would treat any gain or loss recognized upon the sale or exchange of a partnership interest (such as an interest in a hedge fund or investment partnership) as short-term capital gain or loss to the extent a portion of such gain or loss is attributable to unrecognized gain or loss with respect to any applicable commodity. It would also treat any income, gain or loss derived by a tax-exempt organization with respect to any applicable commodity as unrelated business taxable income, subjecting the income to tax at corporate rates. In addition, if a tax-exempt organization holds an interest in a foreign corporation, it would be required to take into account, on a current basis without regard to whether there was an actual distribution from the corporation to the organization, its *pro rata* share of any income, gain or loss of such foreign corporation with respect to any applicable commodity as if the tax-exempt organization held such commodities directly.

In its current form, the bill raises a number of issues and questions. First, it is unclear what portion of an index must be based on actively traded oil or natural gas for it to be "substantial" within the meaning of the proposed legislation. Second, the bill can be expected to have far-reaching consequences for any tax-exempt

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## “Oil Bill”

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organization holding stock in a foreign corporation that has income, gain or loss from any applicable commodity. Such corporations could include widely held international oil and gas companies. It is interesting to note that an exempt organization investing in a domestic oil company would not be subject to the same rules. Third, whether intended or not, it would appear that an applicable commodity would include exchange-traded notes or other structured notes that are linked to oil, natural gas, or an oil or gas index. Finally, the bill would affect the taxation of an investment in exchange-traded funds holding an applicable commodity whether or not they are treated as partnerships for federal income tax purposes. All or a portion of the gain from an investment in applicable commodities through exchange traded funds likely would lose its preferential treatment if the bill is enacted into law.

The bill, if enacted, would apply to any applicable commodity acquired after August 31, 2009 and before January 1, 2014. For a more detailed discussion of the bill, see our prior alert [“Stop Tax-breaks for Oil Profiteering Act: Proposed Tax Legislation Intended to Reduce Excessive Speculative Trading in Oil and Natural Gas.”](#) ■

## A Summary Comparison of BDCs and REITs

As we have discussed in our prior client alerts,<sup>1</sup> BDCs and REITs have witnessed a resurgence of late. Below, we provide our observations and a brief comparison of the two investment vehicles.

### BDCS

A BDC is a special investment vehicle designed to facilitate capital formation for small companies. Its regulatory advantages include exemptions from many of the restrictions imposed by the Investment Company Act of 1940 (“1940 Act”). A BDC is defined under the 1940 Act to mean a domestic closed-end company that operates for the purpose of making investments in certain securities and, with limited exceptions, makes available “significant managerial assistance” with respect to the issuers of such securities.

Under the 1940 Act, a BDC generally must have at least 70% of its total assets in the following investments: (i) privately issued securities purchased from issuers that are “eligible portfolio companies”;<sup>2</sup> (ii) securities of eligible portfolio companies that are controlled by a BDC and of which an affiliated person of the BDC is a director; (iii) privately

issued securities of companies subject to a bankruptcy proceeding, reorganization, insolvency or similar proceeding or otherwise unable to meet its obligations without material assistance; (iv) cash, cash items, government securities, or high quality debt securities maturing in one year or less; and (v) office furniture and equipment, interests in real estate and leasehold improvements and facilities maintained to conduct the business of the BDC.

BDCs typically are organized as limited partnerships and taxed as partnerships in order to obtain pass-through tax treatment. More recently, some BDCs have been organized as corporations and have opted to be treated as RICs for federal income tax purposes thereby avoiding an entity-level tax. A RIC must meet certain income, asset, diversification, and distribution tests to receive preferential tax treatment. For example, at least 90% of its gross income must be derived from certain passive sources (*e.g.*, interest and dividends and gain from stock, securities or foreign currencies), and at the close of each quarter of its tax year its assets must be adequately diversified. To avoid an entity-level

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## BDCs and REITs

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tax, RICs generally distribute all or substantially all of their income by the end of each taxable year.

In general, a BDC would file a registration statement on Securities and Exchange Commission (“SEC”) Form N-2. If treated as a partnership for federal income tax purposes, the BDC would file a federal income tax return on IRS Form 1065 and send its investors, annually, Schedules K-1, reporting their shares of partnership income. If, however, the BDC is treated as a RIC for federal income tax purposes, it would file a federal income tax return on IRS Form 1120-RIC and send its investors, annually, IRS Forms 1099, reporting their RIC distributions.

### REITS

A REIT is an investment vehicle designed to allow investors to pool capital to invest in real estate assets. Its regulatory advantages include an exemption under the 1940 Act, which is available for entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. This exemption generally is available if at least 55% of the REIT’s assets are comprised of qualifying

assets and at least 80% of its assets are comprised of qualifying assets and real estate-related assets. For these purposes, qualifying assets generally include mortgage loans and other assets which are the functional equivalent of mortgage loans.

### A REIT is subject to normal corporate tax on any income that it retains.

For federal income tax purposes, a REIT is a corporation<sup>3</sup> that receives special tax treatment. The special tax treatment is an exemption from federal income tax at the corporate level to the extent the REIT distributes its income annually. A REIT is subject to normal corporate tax on any income that it retains. In order to qualify as a REIT for federal income tax purposes, substantially all of the entity’s assets must be held in real estate related investments. It also must earn, each year, at least 95% of its gross income from passive sources and at least 75% of its gross income from real estate related sources. Real estate mortgages qualify as good REIT investments under the asset test and produce good income for both the 95% and 75% tests.

A REIT is subject to a 100% penalty tax on income from sales of “dealer property” (generally, property held as inventory or primarily for sale to customers in the ordinary course of its trade or business, excluding certain foreclosure property), a rule that limits the REIT’s activities. However, a REIT can own a taxable REIT subsidiary (“TRS”), which is subject to a corporate level tax and may engage in activities that would be impermissible for the REIT itself; its investment in TRSs cannot exceed 25% of its total gross assets.

In general, a REIT would file a registration statement on SEC Form S-11. A REIT must file its federal income tax return on IRS Form 1120-REIT and send its investors, annually, IRS Forms 1099. ■

<sup>1</sup> See “[An Alternative for Private Equity: BDCs](#)” and “[Mortgage REITs are Back \(Again\)](#).”

<sup>2</sup> An eligible portfolio company means a domestic issuer that either (1) does not have any class of securities listed on a national securities exchange; or (2) has a class of equity securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than \$250 million and, in each case, (A) is not, with limited exceptions, a registered or unregistered investment company; or (B) either: (i) does not have a class of securities that are “margin securities,” (ii) is controlled by a BDC and has an affiliated person of the BDC as a director, or (iii) has total assets of not more than \$4 million, and capital and surplus (shareholders’ equity less retained earnings) of not less than \$2 million, or (3) has a class of securities listed on a national securities exchange.

<sup>3</sup> It must be a corporation for federal income tax purposes but can be a trust or limited liability company, for example, under local law.

## Learning Annex – A Primer on Foreign-Currency Linked Structured Notes

Foreign-currency linked structured notes are a fast-growing segment of the structured products market. The federal income tax treatment of such a note depends on its specific terms. Foreign-currency linked structured notes typically do not bear a current coupon and are, consequently, treated as either “Type 1” notes (principal-protected, treated as debt for tax purposes) or “Type 2” notes (non-principal-protected, with a tax treatment that depends on the specific terms of the note).<sup>1</sup> This difference is significant as it will determine whether a holder should include income currently or can adopt “wait and see” taxation (*i.e.*, no current inclusion of income). In addition, special rules address the federal income tax treatment of transactions in which the taxpayer is entitled to receive an amount determined by reference to the value of one or more nonfunctional currencies (a “Section 988 Transaction”). Any gain or loss from a Section 988 Transaction is generally treated as ordinary instead of capital in nature. Below, we discuss three examples of foreign-currency linked structured notes

that have recently been offered on a regular basis by various issuers.

**Any gain or loss from a Section 988 Transaction is generally treated as ordinary instead of capital in nature.**

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*Example 1.* Under the terms of a note, investor pays \$100 to the issuer at inception, at which time \$100 equals €75, in exchange for the payment at maturity of a U.S. dollar equivalent amount (determined at maturity) of the sum of (1) €75; and (2) a euro-based compounded rate of return applied to €75, less a certain fee. Investor’s functional currency is the U.S. dollar.

The IRS addressed the federal income tax treatment of the note described in Example 1 in Revenue Ruling 2008-1 (“Ruling”). In the Ruling, the IRS held that, even though there

is a significant possibility that the payment at maturity as determined in U.S. dollars may be significantly less than the payment at inception as determined in U.S. dollars, the note is a euro-denominated debt instrument for federal income tax purposes (*i.e.*, a Type 1 note) and that such characterization is not affected by whether the note is privately offered, publicly offered or traded on an exchange. As a result, the interest accruing on the note is taxable to the investor on a current basis, and any income realized by the investor is taxed as ordinary income to the extent such income is attributable to accrued interest or foreign currency gain.

*Example 2.* Investor purchases a two-year note at original issue for \$100. The note pays interest in U.S. dollars at the rate of 4% compounded semi-annually. At maturity, the investor is entitled to an amount equal to \$100 plus the equivalent of the excess, if any, of (a) the value of the FTSE 100 index determined and translated into U.S. dollars on the last business day prior to the maturity date, over (b) £2,150, the “stated value” of the FTSE 100 index, which is equal to 110% of the average value of the index for the six months prior to the issue date, translated at the

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## Learning Annex

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exchange rate of £1 = \$1.50. Investor's functional currency is the U.S. dollar.

The note described in Example 2 is "principal protected" as determined in U.S. dollars and is, therefore, treated as a debt instrument for federal income tax purposes (*i.e.*, a Type 1 note). Further, because the contingent payment at maturity is determined by reference to the FTSE 100 index and not by reference to the value of a nonfunctional currency, an investment in the note is not a Section 988 Transaction. Nevertheless, because the note is subject to the rules governing "contingent payment debt instruments," any gain realized by the on a sale investor is treated as ordinary income and not capital gain.

*Example 3.* Pursuant to the terms of a note, investor pays \$100 to the issuer at inception, at which time one euro equals 130 Japanese yen and 2.6 Brazilian reals. At maturity, after a term of three years, the issuer will pay the investor \$100 plus or minus \$100 times the average change in the exchange rates, since the inception date, between (i) the euro and the Japanese yen; and (ii) the euro and the Brazilian real.

Because the payment at maturity on the note described in Example 3 is not determined by reference to a single nonfunctional currency, there is, depending on the term of the note and the volatility of the relevant exchange rates, a significant possibility that the payment at maturity may be significantly less than the payment at inception as determined in either U.S. dollars, euros or Brazilian reals. As a result, the note is not principal protected in any currency and is not treated as a debt instrument for federal income tax purposes (*i.e.*, the note is treated as a Type 2 note). The investor therefore is not required to include income on a current basis. Because the amount of the payment at maturity is determined by reference to the value of nonfunctional currencies, the transaction is considered a Section 988 Transaction with the result that any gain or loss with respect to the note is treated as ordinary rather than capital. However, the special rules under Section 988 include a provision pursuant to which a taxpayer may elect capital treatment with respect to certain Section 988 Transactions. Although not clear, an investor in a note as described in Example

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3, may be entitled to elect capital treatment with respect to any gain or loss realized. Such an election must be made by the investor by clearly identifying the investment in the notes on his books and records on the date he acquires the note as being subject to the election and by meeting certain other requirements set forth in applicable U.S. Treasury regulations under Section 988. ■

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<sup>1</sup> For a detailed discussion of the types of structured notes, see [MoFo Tax Talk Volume 1, Issue 1, The Learning Annex: A Taxonomy for Structured Notes – Type 1, Type 2 and Type 3 Notes](#).

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## Press Corner

As the economy begins to recover from the financial crisis, mortgage REITs filings have exploded. Since the spring, over a dozen REITs have filed registration statements or updated

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prospectuses seeking to raise capital. In addition, there have been at least six mortgage REIT offerings that have raised proceeds of over \$1.7 billion. However, several REITs have cut their expected initial public offerings. See, e.g., Miles Weiss, "[Apollo, Colony Mortgage REITs Cut Stock Sales by Half](#)", **Bloomberg (September 23, 2009)**. For additional discussion on mortgage REITs, see the section in this issue on BDCs and REITs above. For a brief history of mortgage REITs, further insights, and links to prospectuses, see our prior article "[Mortgage REITs are Back \(Again\)](#)." ■

## MoFo in the News

On June 17, 2009, International Financial Law Review presented a webinar on "U.S. Rights Offerings." A rights offering is 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). It is an alternative to an outright common stock offering for companies looking to raise capital. MoFo partner Anna Pinedo discussed the advantages of rights offerings, the documentation of a rights offering, considerations for issuers and bankers in a rights offering, applicable SEC regulations and other requirements of a rights offering, and current market news on such offerings.

On June 23, 2009, West Legalworks presented a webinar on "Hybrid Offerings, Overnights, and Targeted Public Offerings." MoFo partner Anna Pinedo discussed the various reasons why larger and more seasoned issuers are considering PIPE transactions (*i.e.*, private investments in public equity in which a fixed number of securities are sold to accredited institutional investors) and

hybrid offerings (such as registered direct offerings to select institutional investors) as potential capital raising alternatives, corporate and securities law aspects of such offerings, and why issuers are premarketing public deals prior to public announcement. Ms. Pinedo also discussed best practices in connection with such marketing approaches.

On June 30, 2009, West Legalworks presented a webinar on "Distressed Debt Buybacks and Restructuring." MoFo partners Tom Humphreys and Anna Pinedo discussed various legal and tax aspects of distressed debt buybacks and restructurings, including applicable disclosure requirements, issues relating to material nonpublic information, such as disclosure obligations under Reg FD with respect to when an issuer discloses material nonpublic information to market professionals or holders of its securities who may trade on the basis of such information, the tender offer rules, rating agency considerations, accounting considerations, and tax considerations such as the

*Continued on Page 13*

## Mofo in the News

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potential for cancellation of indebtedness income.

On July 13, 2009, West Legalworks presented a webinar on “Regulatory Reform and Securitization.”

MoFo partners Anna Pinedo, Tom Humphreys, and Ken Kohler discussed various aspects of the Obama Administration’s White Paper “Financial Regulatory Reform: A New Foundation,” which proposes fundamental reforms to the financial regulatory system, including reforms that would affect the regulation of mortgages and the secondary mortgage market (such as the creation of a Consumer

Financial Protection Agency), reforms affecting the future of the government sponsored entities, reforms affecting securitizations, and reforms affecting applicable disclosure requirements of asset-backed securities offerings.

On July 16, 2009, MoFo presented, in conjunction with NERA Economic Consulting, “Regulatory Reform,” in its New York office. MoFo partners David Kaufman and Anna Pinedo discussed the various proposals to restructure the regulation of financial institutions, securitizations, and over-the-counter derivatives. The panel, which

included Dr. Elaine Buckberg, and Dr. Ronald I. Miller from NERA Economic Consulting, also discussed the policy and economic impact of the proposals for reform.

On August 26, 2009, Financial Research Associates presented a webinar on “Debt Repurchases, Exchanges and Tenders.” MoFo partners Tom Humphreys and Anna Pinedo discussed various issues arising from debt repurchases, exchanges, and tenders, including their corporate, securities, and tax aspects. ■

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Because of the generality of this newsletter, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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