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MoFo Tax Talk
News Bulletin

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Note from the Editors

The best thing we can say about this edition of Tax Talk is that, from the standpoint of the global capital markets, things are not as bad as they were a year ago. When we published our Q4, 2008 issue, the financial world, it seemed, stood at the edge of economic collapse. Governments around the world scrambled to deploy billions in coordinated attempts to save the global banking system. Wall Street and Main Street alike were paralyzed with fear. Looking forward into 2009 was extremely difficult, with near zero visibility. Now, a year later, things seem improved. Investor confidence and risk appetites on Wall Street are slowly coming back. While Main Street is still hurting and we're not out of the woods yet, visibility for 2010 seems less murky. Against this backdrop, our last issue of 2009 focuses less on reporting instances of an extraordinary mobilization of the tax laws to help ease the impact of the Crash of 2008, and more on developments that are, as a general matter, unconnected to the crisis. Of particular note, we report on the Foreign Account Tax Compliance Act of 2009 and the Tax Extenders Act of 2009 that had significant ripple effects in the bearer bond market and global capital markets generally; we discuss an Internal Revenue Service ("IRS") pronouncement that rattled hedge funds involved in cross-border lending activities; and we provide a general discussion of a recent development that has received significant coverage and scrutiny, so-called contingent capital securities. And in our regular feature, The Classroom, building on past issues discussing structured notes, we discuss the boundaries of the class of structured notes that may properly qualify as "variable rate debt instruments."

Happy New Year! ■

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Tax Extenders Act of 2009 Includes FATCA

In late October, Senator Max Baucus (D-Montana) and Representative Charles Rangel (D-New York), chairmen of the Congressional tax writing committees, unveiled the Foreign Account Tax Compliance Act of 2009 ("FATCA"). The FATCA provisions, introducing a new 30% U.S. withholding tax on "withholdable payments" made to foreign financial institutions that fail to comply with specified reporting requirements, and proposing to repeal the U.S. bearer bond exception, had significant ripple effects in the global capital markets. On December 7, 2009, Representative Rangel introduced H.R. 4213, the Tax Extenders Act of 2009 (the "Bill") which was passed by the House on December 9. As its name suggests, the Bill is aimed at extending certain tax provisions set to expire at the end of the year. Importantly, the Bill also includes the FATCA, with certain modifications, many of which are intended to address issues raised by market participants relating to provisions of the original FATCA. The FATCA provisions stem from Congressional concerns about U.S. tax avoidance apparently triggered by the recent disclosures about substantial numbers of U.S. taxpayers with "undisclosed" foreign accounts. At least so far, Congress is apparently less concerned about possible negative impacts on foreign investors' willingness to buy U.S. securities or about foreign countries imposing similar requirements on U.S. financial institutions. We summarize below the Bill's provisions that are of importance to capital markets transactions.

PROPOSED REPEAL OF U.S. BEARER BOND EXCEPTION

Background

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

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

Many U.S. issuers have European medium-term note or other foreign-targeted programs under which they issue bearer notes to non-U.S. investors. These issuances comply with the TEFRA regulations and, as such, the instruments are not subject to the sanctions described above or to U.S.

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withholding tax. In addition, many non-U.S. issuers include TEFRA restrictions in their debt offerings outside the U.S. to ensure that these offerings are not subject to the TEFRA excise tax.

The Bill

- The Bill would end the practice of selling bearer bonds to foreign investors under TEFRA C and TEFRA D. Thus, with respect to issuers of foreign targeted bearer bonds, the Bill would deny an interest deduction for interest on bearer bonds. In addition, interest paid on such bonds would no longer qualify for treatment as portfolio interest, thereby subjecting such interest to a 30% U.S. withholding tax, and any gain realized by a holder of such bonds would be treated as ordinary income. In an odd twist, the Bill would effectively retain TEFRA restrictions for foreign issuers. Thus, issuers of debt in purely foreign-to-foreign transactions could avoid any excise tax risk by complying with existing TEFRA procedures.
- The Bill proposes to codify IRS Notice 2006-99. Accordingly, debt obligations held in dematerialized book-entry systems (such as JASDEC in Japan) would be treated as being issued in registered form. U.S. issuers using such a system would be required to comply with the certification provisions applicable to registered debt (e.g., by obtaining IRS Form W-8s from holders) in order to tap the portfolio interest exception for their debt issuances.
- The Bill includes a provision giving Treasury the authority to determine that certification (required under current law) as to non-U.S. beneficial ownership (e.g., IRS Form W-8BEN) is not required to qualify for the portfolio interest exemption from withholding tax on payments of interest on certain registered debt obligations. It is not clear under what circumstances Treasury would use this authority.
- Under the Bill, the repeal of the bearer bond exception would apply to debt obligations issued after the date which is two years after the enactment of the Bill. This grandfather provision, eighteen months longer than originally proposed, would give issuers substantial time to adapt to the new rules.

PROPOSED 30% U.S. WITHHOLDING TAX ON "WITHHOLDABLE PAYMENTS"

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

Rather than agreeing with Treasury to act as a withholding agent in respect of reportable payments, an FFI may wash its hands of any withholding responsibility by electing to give the withholding agents from which it receives payments the information necessary for the "upstream" withholding agent to implement the new withholding tax (generally, information that discloses the extent to which payments made to the electing FFI are allocable to accounts subject to the 30% U.S. withholding tax).

The term "financial institution" would include banks, brokers and investment funds, including private equity funds and hedge funds. A "withholdable payment" generally would include any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations,

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emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the U.S. It also includes gross proceeds from the sale of property that is of a type which can produce U.S. source dividends or interest, such as stock or debt issued by domestic corporations. A "financial account" would include bank accounts, brokerage accounts and other custodial accounts. A "specified U.S. person" is any U.S. person other than certain categories of entities such as publicly-traded corporations and their affiliates, banks, mutual funds, real estate investment trusts and charitable trusts. A "U.S.-owned foreign entity" for this purpose would be any entity that has one or more "substantial U.S. owners," which generally means (i) in the case of a corporation, if a specified U.S. person, directly or indirectly, owns more than 10% of the stock, by vote or value, (ii) in the case of a partnership, if a specified U.S. person, directly or indirectly, owns more than 10% of the profits or capital interests, or (iii) in the case of a trust, if a specified U.S. person is treated as an owner of any portion of the trust under the grantor trust rules.

Impact on Foreign Non-Financial Institutions

The Bill would also impose a 30% withholding tax on any withholdable payment made to a non-financial foreign entity, unless the non-financial foreign entity provides the withholding agent with either (i) a certification that it does not have a substantial U.S. owner, or (ii) the name, address, and taxpayer identification number of each substantial U.S. owner. This provision would not apply to payments made to a publicly-traded non-financial foreign entity, or any of its affiliates.

Treaty Relief, Credits and Refunds

If the beneficial owner of a payment is entitled to treaty benefits, the withholding tax rate imposed on any withholdable payment may be reduced or eliminated by the provisions of an applicable tax treaty and such beneficial owner would be entitled to a partial or full refund or credit. In addition, even if a treaty is not available, the beneficial owner of a withholdable payment on which the 30% tax is withheld may otherwise be entitled to a full refund or credit of the tax (e.g., because payments are eligible for the portfolio interest exemption or represent gross proceeds from the sale of a capital asset). In such a case, a non-U.S. person would have to file a U.S. tax return to obtain a full or partial refund or credit. Similarly, a U.S. person with a foreign bank account on which it receives payments that are withheld on, presumably would have to claim a refund or credit on its U.S. tax return.

Effective Date

These provisions generally would apply to payments made after December 31, 2012. However, the provisions would not apply to payments made on debt obligations outstanding on the date which is two years after enactment of the Bill. This latter grandfather should serve to calm foreign markets, which in early December were shut to U.S. issuers of debt over concern about the earlier version of the provision.

Unfortunately, the impact of the FATCA bearer bond and withholdable payment provisions on the purchase of U.S. securities by foreign investors will not be known until they take effect (if they are enacted), and then it may be too late to do anything. The U.S. Senate has not yet acted on the Bill.

"DIVIDEND WASHING"

Under current law, the source of any payments made pursuant to a notional principal contract (or swap) is determined by reference to the residence of the person receiving the payment. Accordingly, payments (including any amounts determined by reference to dividends) received by a foreign person that enters into a swap with respect to an underlying U.S. stock are treated as foreign source payments not subject to U.S. tax. By contrast, a direct distribution to the

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foreign person of a dividend generally would be subject to a 30% withholding tax (unless reduced by an applicable treaty). Further, although substitute dividend payments made under a stock lending agreement are sourced in the same manner as the dividends with respect to the underlying stock (and would therefore be U.S. source if made with respect to stock of a U.S. corporation), transactions involving stock lending rely on a decade old IRS Notice to avoid U.S. dividend withholding tax.[2]

Beginning in 2007, Congress investigated certain transactions where brokers would enter into swaps on U.S. equities for foreign customers. After a Wall Street Journal article[3] and a Congressional hearing[4], it was apparent that "dividend washing" was in the Congressional sights even after one of the perceived culprits, Lehman Brothers, Inc., went bankrupt. The Bill would treat as a U.S.-source dividend any "dividend equivalent" for purposes of U.S. withholding tax provisions. A "dividend equivalent" would be (i) any substitute dividend, (ii) any amount paid pursuant to a "specified notional principal contract" and that is contingent on, or determined by reference to, the payment of a U.S.-source dividend, and (iii) any amount that the Treasury determines is substantially similar to a payment described in (i) and (ii).

A specified notional principal contract is any notional principal contract if (i) in connection with entering into the contract, any long party (i.e., the party entitled to receive the dividend related payment) transfers the underlying security, (ii) in connection with the termination of the contract, any short party (i.e., any party that is not a long party) transfers the underlying securities to any long party, (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral, or (v) the Treasury identifies the contract as a specified notional principal contact. 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 more than two years after the date of enactment will be a specified notional principal contract.

To address the concern with respect to the cascading effect of such a dividend withholding tax, the Bill includes a provision pursuant to which the Treasury may reduce the tax if one or more of the dividend equivalents is subject to tax and to the extent the taxpayer establishes that the tax has been paid on another dividend equivalent in the chain. For purposes of this provision, an actual dividend payment is treated as a dividend equivalent.

This provision would apply to payments made on or after the 90th day after enactment of the Bill. Therefore, if enacted, it would apply to existing swaps. The provision would have no effect, positive or negative, on payments before said date. ■

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1 Unless such bonds (i) are issued by a natural person, (ii) mature in one year or less, or (iii) are not of a type offered to the public.

2 Notice 97-66, 1997-48 I.R.B. (1997). The notice addressed the concern expressed by practitioners with respect to the "cascading effect" of a dividend withholding tax if the same U.S. securities are the subject of multiple stock lending transactions and therefore multiple substitute dividend payments.

3 See Anita Raghavan, "Happy Returns: How Lehman Sold Plan To Sidestep Tax Man—Hedge Funds Use Swaps To Avoid Dividend Hit; IRS Seeks Information," The Wall Street Journal, September 17, 2007.

4 See, Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends, Staff Report, Permanent Subcommittee on Investigations, United States Senate, September 11, 2008, available at http://levin.senate.gov/newsroom/supporting/2008/091108DividendTaxAbuse.pdf.

IRS Memorandum: Loan Origination by Foreign Entity Through U.S. Intermediary Subject To U.S. Tax

On September 22, 2009, the Office of Chief Counsel of the IRS released a generic legal advice memorandum, AM 2009-010 ("Memorandum"), concluding that interest income earned by a foreign corporation with respect to loans originated by an agent in the U.S., whether dependent or independent, is subject to net income tax in the U.S. as income "effectively connected" with the conduct of a U.S. trade or business. The Memorandum is significant in that a literal reading indicates that it appears the IRS is prepared to argue against strategies developed by offshore funds and lenders that use intermediaries to originate loans in the U.S. without subjecting income derived from those activities to U.S. tax. An expansive view of the Memorandum indicates that the IRS might also challenge situations in which an intermediary acquires or services loans pursuant to a management agreement.

The Memorandum addresses the following fact pattern: Foreign Corporation ("FCo") is a corporation organized outside the U.S. in a country that does not have a bilateral income tax treaty with the U.S. and is wholly owned by shareholders who are not U.S. persons. FCo makes loans to U.S. borrowers within the U.S., but FCo has no office or employees in the U.S. To originate loans to U.S. borrowers, FCo outsources the origination activities to a U.S. corporation ("Origination Co"). Under a service agreement between FCo and Origination Co, the activities performed by Origination Co include the solicitation of U.S. borrowers, the negotiation of the terms of the loans, the performance of the credit analyses with respect to U.S. borrowers, and all other activities relating to loan origination other than the final approval and signing of the loan documents. Origination Co conducts these activities on a considerable, continuous, and regular basis. Under the service agreement, FCo pays Origination Co an arm's-length fee for its services. Origination Co performs the origination activities from an office in the U.S., and Origination Co is subject to U.S. federal net income taxation. Although Origination Co performs all of the origination activities on behalf of FCo, Origination Co is not authorized to conclude contracts on behalf of FCo. FCo's employees, who work in an office outside of the U.S., give final approval for the loans and physically sign the loan documents on behalf of FCo.

If a foreign corporation is engaged in a U.S. trade or business, it will generally be subject to U.S. federal income tax on its net income that is "effectively connected" with its U.S. trade or business.

The U.S. federal income taxation of a foreign corporation depends on whether the foreign corporation is engaged in a trade or business and, if so, whether that trade or business is carried on in the U.S. The existence of a trade or business in any given tax year and the determination

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whether the trade or business is in the U.S. is based on all the facts and circumstances, including the presence or absence of a profit motive; the continuity, regularity, and substantiality of the activities; and the nature of the activities. If a foreign corporation is engaged in a U.S. trade or business, it will generally be subject to U.S. federal income tax on its net income that is "effectively connected" with its U.S. trade or business.

The IRS concludes in the Memorandum that FCo is engaged in a trade or business in the U.S. In arriving at this conclusion, the IRS found that Origination Co is an agent, the activities of which are attributable to FCo, the principal:

Although Origination Co. acts on behalf of [FCo] pursuant to a service contract and does not have authority to conclude contracts, Origination Co. performs activities that are a component of [FCo]'s lending activities, such as the solicitation of customers, the negotiation of contractual terms and the performance of credit analyses. In similar circumstances, courts have found an agency relationship to exist in fact and have attributed the activities of the U.S. agent to the foreign principal in determining whether the foreign principal conducted considerable, continuous, and regular activity within the U.S. […] Because the lending activities of [FCo], which were carried on by Origination Co., were considerable, continuous, and regular, [FCo] is engaged in a U.S. trade or business.

The IRS concludes in the Memorandum that FCo is engaged in a trade or business in the U.S.

In coming to its conclusions, the Memorandum does not indicate whether Origination Co is related to FCo, nor does it state whether Origination Co acts only on behalf of FCo or acts in the ordinary course on behalf of other unrelated parties. It also does not indicate that it would regard the status of an agent as dependent or independent as affecting whether the acts of the agent should be attributed to an offshore taxpayer. Further, it does not indicate whether FCo had any tax avoidance motives. In light of these omissions, an expansive view of the Memorandum would conclude that the IRS is prepared to take the stance that these distinctions do not matter. In particular, the IRS may be prepared to take the stance that the acts of an independent agent that has no power to conclude contracts in the U.S. on the principal's behalf can put the principal in a U.S. trade or business.

The Memorandum is generic legal advice issued by the Office of the Associate Chief Counsel (International), is not binding on the IRS, and is not taxpayer specific. Rather, it is intended to provide assistance to IRS field agents administering industry-wide programs or programs that give rise to issues that apply across classes of taxpayers. The Memorandum is nonetheless significant because it indicates clearly that the IRS stands ready to challenge foreign persons that in the IRS' view have originated loans in the U.S. through the strategy described in the Memorandum as well as "other strategies," leaving open the scope of any future guidance in this area. Since the publication of the Memorandum the IRS has indicated, in the course of making comments to practitioners at industry events, that the Memorandum should not be read broadly as providing guidance on when and under what circumstances lending gives rise to a U.S. trade or business. These statements, coupled with the Memorandum, have created substantial confusion about whether or when a foreign person acting through a U.S. intermediary to originate loans in the U.S. is engaged in a U.S. trade or business. ■

Fed Eyes Contingent Capital

In the wake of the near collapse of the American banking system, much attention has been given to how to prevent a recurrence. One of the things that U.S. (as well as non-U.S.) banking regulators are talking about is "contingent capital." For example, last month, William Dudley, president of the Federal Reserve Bank of New York stated that the Fed was "extremely interested" in the contingent capital idea.[1]

What is contingent capital? Broadly speaking, contingent capital is a hybrid security, the purpose of which would be to provide a financial institution leverage in good times, but provide a buffer in bad times. For example, the instrument, in good times, would act like debt and provide leverage to the institution. In bad times, when the issuer finds it difficult to raise capital, it would act as equity, and provide a cushion to convince depositors and other creditors that their money is safe.

So what might contingent capital be? The most straight-forward contingent capital instrument would be mandatorily convertible debt. In this structure, the issuer would issue a debt instrument to investors. Upon certain events (e.g., a decline in its tangible common equity, Tier 1 capital, or other regulatory events) the debt instrument would automatically convert into a predetermined amount of the issuer's equity. A more complicated structure is one in which the issuer creates a separate entity, which raises proceeds by issuing securities to investors and then purchases securities from, and enters into financial contracts with, the issuer. This entity would be structured to be a pass-through entity for tax purposes. For example, the proceeds raised from investors could be invested in short-term highly liquid debt instruments. In addition, the separate entity could enter into a contract with the issuer. Under the terms of the contract, the issuer would have the right to sell its equity to the separate entity at any time. In addition, under the contract, there could be automatic triggers, such as the ones described above. Under this structure, the notion is that the entity's short-term assets will be available to invest in the issuer's stock when the contract is exercised.

Broadly speaking, contingent capital is a hybrid security, the purpose of which would be to provide a financial institution leverage in good times, but provide a buffer in bad times.

In November, a Lloyds Banking Group affiliate issued £9 billion in a form of contingent capital called "enhanced capital notes" to existing Tier 1 and Upper Tier 2 security holders. The purpose of the offering was to allow Lloyds to avoid the need for further support from the U.K. government. The enhanced capital notes have a ten year term and pay fixed, non-deferrable interest. They are convertible into a fixed number of Lloyds ordinary shares if Lloyds' consolidated core Tier 1 ratio falls below five percent.

Earlier this month, the U.S. House of Representatives passed the "Wall Street Reform and Consumer Protection Act

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of 2009" (H.R. 4173), which contains a section on "contingent capital." That section would authorize the Federal Reserve Board of Governors to issue regulations "that require a financial holding company to maintain a minimum amount of long-term hybrid debt that is convertible into equity when--(1) a specified financial company fails to meet prudential standards…and (2) the [agency] has determined that threats to United States financial system stability make such conversion necessary."

In the U.S. the exact form a contingent capital security will take, if any, is not clear. From a federal income tax standpoint, however, a mandatory convertible type security a la Lloyd's enhanced capital notes raises serious federal income tax issues if the issuer intends to claim a deduction for interest on the security. For example, creditors rights are an important, if not essential, element of debt treatment for U.S. federal income tax purposes. Whether a holder of a mandatory convertible has creditors rights is unclear and will depend on the "trigger" built into the instrument. Thus, under

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The Classroom: Exploring the Boundaries of Variable Rate Debt Instruments

A complication that arises for floating rate-linked notes within the Type 1 category (i.e., principal protected notes treated as debt for U.S. federal income tax purposes) where the rate is expressed by reference to an index that does not measure borrowing rates (e.g., LIBOR or EURIBOR) is whether the expressed rate is treated as an objective rate within the meaning of the applicable regulations. This question is important because if a rate qualifies as an objective rate, the note generally is treated as a variable rate debt instrument ("VRDI") for tax purposes. If the rate fails to qualify as an objective rate, the note generally is treated as a contingent payment debt instrument ("CPDI") for tax purposes. In most cases, VRDIs are preferable to CPDIs for investors. In the case of a VRDI, an investor's taxable income inclusions generally match up squarely with the cash that is paid out, so there is no "phantom income," unlike a CPDI. In addition, if an investor recognizes any gain on sale, it generally is capital gain in the case of a VRDI, versus ordinary income for CPDIs.

For most rate linked structured notes in the market, to qualify for VRDI status, the expressed interest rate must either be a qualified floating rate ("QFR") or an objective rate. QFRs include "plain vanilla" rates that measure contemporaneous variations in the cost of borrowing money (e.g., rates expressed by reference to LIBOR or EURIBOR). When an objective rate is involved, under regulations, the instrument must provide for a single objective rate (generally, a rate that is determined using a single fixed formula that is based on objective financial information). Examples are rates determined by reference to inflation, or rates that are linked to the difference between two rates (e.g., the "curve steepener," a popular structured note product discussed below).

Two special rules apply in limiting the scope of the objective rate universe. First, a rate is not an objective rate if "it is reasonably expected that the average value of the rate during the first half of the instrument's term will either be significantly less than or significantly greater than the average value of the rate during the final half of the instrument's term." The other special rule is the following: If interest on a debt instrument is stated at a fixed rate for an initial period of one year or less followed by a variable rate that is an objective rate for a subsequent period, and the value of the variable rate on the issue

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the formulation in H.R. 4173 a holder would have creditors rights so long as the issuer's distress does not coincide with "threats to United States financial system stability". Is that sufficient to give the holder creditors rights? Also, depending on the circumstances, the actual conversion of a contingent capital security into equity may be unlikely to occur so that the expectation is that a holder will be paid in full on its debt claim. Should that be taken into account, and if so, what is the standard, a reasonable expectation of repayment? Other tax issues arise under section 163(l) which disallows an interest deduction for corporate debt payable in the issuer's equity. Should that section apply to a contingent capital instrument? If contingent capital is to become a reality in the U.S. and issuers demand an interest deduction for interest on the security, these questions and others will have to be answered by counsel, if possible, or, in a perfect world, by the Treasury. ■

[1] See, e.g., Emily Barrett, "Fed's Dudley: Fed Extremely Interested In Contingent Capital," WSJ Online, November 13, 2009.

U.S. Continues to Extend and Expand Relief Through the Tax Code

FIRST-TIME HOME BUYER TAX CREDIT

The *Housing and Economic Recovery Act of 2008* provided a new refundable tax credit generally available for qualifying first-time homebuyers of a principal residence in the U.S. For 2008, the credit applies to a principal residence purchased by the taxpayer after April 8, 2008, and on or before December 31, 2008. Qualifying homebuyers are allowed a one-time credit of up to $7,500, subject to a phase out for taxpayers with modified adjusted gross income between $75,000–$95,000 ($150,000–$170,000 for joint filers). The credit, however, must be repaid over a 15-year period, effectively giving the taxpayer the benefit of an interest free loan.

In order to stimulate the housing market further, the *American Recovery and Reinvestment Act of 2009* made changes to the credit for purchases made in 2009. For qualifying first-time homebuyers who buy a principal residence after December 31, 2008, the credit amount is increased to up to $8,000, and, of most importance, the taxpayer does not have to repay the credit, provided the home remains the taxpayer's principal residence for 36 months after the purchase date.

As the credit was to expire, the Worker, Homeownership and Business Assistance Act of 2009 was signed into law on November 6, 2009. This Act (i) extends the deadline for qualifying purchases from November 30, 2009 to April 30, 2010 (and up to June 30, 2010, if a buyer enters into a binding contract by April 30, 2010); (ii) increases the phase out limit to $125,000 to $145,000 ($225,000 to $245,000 for joint filers); and (iii) provides a smaller credit of up to $6,500 for existing homeowners (generally including a homeowner who has used the same home as a principal residence for at least five consecutive years during an eight-year period ending on the date of purchase).

NET OPERATING LOSS CARRYBACK

A corporation's net operating loss ("NOL") is generally calculated as the excess of deductions over gross income. If a corporation has an NOL, it may "carry back" the NOL to offset income earned during the prior two years and "carry forward" the NOL to offset income earned during the next 20 years. To stimulate small

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businesses, the American Recovery and Reinvestment Tax Act of 2009 extended the carryback period from two years to up to five years for small businesses (generally defined as those that have $15 million or less in annual gross receipts) for NOLs arising in 2008. When the law was being passed, there was some debate as to whether to extend the relief to medium and large businesses.

The Worker, Homeownership and Business Assistance Act of 2009 extends the NOL carryback relief for an additional year and expands the credit to medium and large businesses. NOLs incurred in 2008 or 2009 can be used to recover taxes paid up to the prior five years, at the election of the taxpayer (specifically, the new law allows a taxpayer to elect to carry back an applicable NOL for a period of three, four, or five years to offset taxable income in those preceding years; an applicable NOL means the taxpayer's NOL for a taxable year ending after December 31, 2007, and beginning before January 1, 2010). However, if the taxpayer elects to carry back the NOL to the fifth taxable year, the amount of offset is limited to 50% of the taxable income for the carryback taxable year. Another important limitation to note is that the extended carryback relief is not available to TARP recipients. Accordingly, the major U.S. banks (which have received TARP assistance) are not eligible for the expanded carryback. On November 20, 2009, the IRS published Rev. Proc. 2009-52, which principally discusses when and how to make the NOL carryback election.

EXTENSION OF TEMPORARY SUSPENSION OF AHYDO RULES

Section 163(e)(5) prevents a corporation from deducting the "disqualified portion" of the OID on an "applicable high yield discount obligation" ("AHYDO"), and the corporation's deduction for the remaining portion of OID is deferred until paid. As discussed in our previous issue (see MoFo Tax Talk, Volume 2, Issue 1), the American Recovery and Reinvestment Tax Act of 2009 temporarily suspended the AHYDO rules with respect 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. The Act also granted the Treasury the authority to extend the suspension if deemed appropriate. Notice 2010-11, issued on December 24, 2009, extends the suspension of the AHYDO rules to December 31, 2010 for qualified obligations (as defined under the Notice). ■

The Classroom

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date is intended to approximate the fixed rate, the fixed rate and the variable rate together constitute a single qualified floating rate or objective rate. A fixed rate and a variable rate is conclusively presumed to meet the requirements of the preceding sentence if the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than .25 percentage points (25 basis points).

Here's a real life example of a structured note where these rules are applied, the so-called curve steepener. Consider a note that has a 10 year term and an issue price of $10 per note. During the first four quarterly interest periods, interest on the notes accrues at a rate of 10.00% per annum. During each subsequent quarterly interest period, interest on the notes accrues at a rate per annum equal to the product of

(a) 10, and

(b) the amount by which the 30-year U.S. Dollar Constant Maturity Swap Rate ("CMS30") exceeds the 2-year U.S. Dollar Constant Maturity Swap Rate ("CMS2") on the applicable interest determination date. The rate is subject to a 10% cap. CMS30 and CMS2 are "constant maturity swap rates" that measure the fixed rate of interest payable on a hypothetical fixed-for-floating U.S.

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The Classroom

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dollar interest rate swap transaction with a maturity of 30 years and two years, respectively.

Applying the rules described above, the expressed rate is not a QFR. Since the fixed rate is in effect for one year or less, the analysis must measure the difference between the initial fixed rate and the value of the expressed variable rate. For example, suppose that on the issue date, the spread between the CMS30 and the CMS2 is 2%. Plugging that into the formula (and taking into account the cap) results in a value that is exactly equal to the fixed rate. Thus, applying the 25 bps rule, you would say that there is a conclusive presumption that the expressed rate results in a single objective rate. But that is not the end of the analysis. There is one last hurdle: the note would not qualify as a VRDI unless it is reasonably expected that the average value of the rate during the first half of the instrument's term will not either be significantly less than or significantly greater than the average value of the rate during the final half of the instrument's term. This is a factual question the resolution to which typically requires a market-based analysis, one that generally requires input from the business desk that prices the note. ■

Proposed Bill Seeks to Modernize Tax Treatment of RICs

Earlier this month, House Ways and Means Committee chairman, Charles Rangel (D-New York) introduced the Regulated Investment Company Modernization Act of 2009 ("Act"). As its name suggests, the Act would modernize the U.S. federal income tax rules that apply to regulated investment companies ("RICs," e.g., mutual funds). Two of the Act's provisions are discussed below.

As its name suggests, the Act would modernize the U.S. federal income tax rules that apply to regulated investment companies.

COMMODITIES PRODUCE QUALIFYING INCOME

A RIC must derive at least 90% of its gross income from certain enumerated sources (the "Income Test"). Under current law, direct investments in commodities do not generate qualifying income for purposes of the Income Test. In addition, the IRS ruled a few years ago that derivative contracts providing for a total return exposure to a commodity index also do not generate qualifying income for purposes of the Income Test.

The Act would provide that a RIC's gains from the sale or other disposition of commodities and other income derived with respect to its business of investing in commodities would be qualifying income for purposes of the Income Test.

REPEAL OF PREFERENTIAL DIVIDEND RULE

A RIC is permitted to take a deduction for dividends paid to its shareholders. However, "preferential dividends" are not deductible. A dividend is considered a "preferential dividend" unless it is distributed pro rata to the RIC's shareholders and with no preference to any share of stock as compared with other shares of the same class and with no preference to one class of stock as compared with another class except to the extent that the class is entitled to such preference. The intricacies of the preferential dividend rule have bedeviled tax practitioners for decades.

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Proposed Bill Seeks

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The Act would provide that a RIC's gains from the sale or other disposition of commodities and other income derived with respect to its business of investing in commodities would be qualifying income for purposes of the Income Test.

The Act would repeal the preferential dividend rule for "publicly offered" RICs. A RIC is considered to be "publicly offered" if its shares are (i) continuously offered pursuant to a public offering, (ii) regularly traded on an established securities market, or (iii) held by or for no fewer than 500 persons at all times during the taxable year. ■

Press Corner

The New York Times reported that Bradley C. Birkenfeld, an ex-UBS banker, is seeking at least several billions from the U.S. government for blowing the whistle on UBS. See Lynnley Browning, "Ex-UBS Banker Seeks Billions for Blowing Whistle", New York Times, November 26, 2009, available at http://www.nytimes.com/2009/11/27/business/27whistle.html. Under federal law, a whistleblower could receive as an award an amount in a range from 15% to 30% of the collected proceeds resulting from an action brought by the IRS based on information provided by the whistleblower. Birkenfeld blew the whistle on the Swiss bank UBS. In the process, he was sentenced to 40 months in prison for his crimes; he is currently seeking to postpone serving his sentence which is scheduled to start January 8, 2010. Elsewhere in the press, it was reported that children as young as four years old received first time home buyer tax credits, to the dismay of the IRS. See Dawn Kopecki, "Four-Year-Olds Got Homebuyer Tax Credits, U.S. Says," Bloomberg, October 22, 2009, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a9LAMoJC2sQQ. It was reported that the IRS identified over 70,000 questionable claims totaling over $500 million, and the IRS also found that 582 minors claimed almost $4 million in tax credits. A representative for the IRS stated that it is and will continue to vigorously pursue any cases of tax fraud. (In the latest version of the credit, there is an express age requirement to obtain the credit: the buyer must be 18 years of age.) ■

Bradley C. Birkenfeld, an ex-UBS banker, is seeking at least several billions from the U.S. government for blowing the whistle on UBS.

MoFo in the News

ON OCTOBER 13, 2009, MORRISON & FOERSTER LLP PRESENTED "HOW WILL REGULATORY AND ACCOUNTING REFORM CHANGE SECURITIZATION?" IN THE NEW YORK OFFICE.

Tom Humphreys and Jerry Marlatt of Morrison & Foerster LLP, and Thomas Rees of FTI Consulting Inc., discussed the rise and collapse of securitizations, the problems identified with respect to securitizations by the Administration's white paper on financial regulatory reform, the white paper's proposals for reform, and various accounting changes and their effect on the securitization market, including FAS 166 and 167.

ON OCTOBER 22, 2009, MORRISON & FOERSTER LLP PRESENTED "OTC DERIVATIVES REGULATION" IN THE NEW YORK OFFICE.

David Kaufman and David Trapani of Morrison & Foerster LLP discussed recent U.S. legislative proposals to regulate OTC derivatives, including the OTC Derivatives Market Act of 2009. The bill, among other things, would generally require all standardized swap transactions between dealers and large market participants to be cleared and traded on an exchange and would generally divide regulatory authority over OTC derivatives between the Commodity Futures Trading Commission and the Securities and Exchange Commission.

ON OCTOBER 27, 2009, MORRISON & FOERSTER LLP PRESENTED "DEVELOPMENTS IN LIFE SETTLEMENTS" IN THE NEW YORK OFFICE.

Panelists included Robert Cudd and Chiahua Pan of Morrison & Foerster LLP, Craig Seitel of Abacus Settlements, LLC, and Bob Thompson of Eimi Holdings. The term life settlement refers to the sale of life insurance policies to third parties. The purchaser often securitizes the policies in a life settlement securitization. The panel discussed the structure of life settlements, applicable state regulation of life settlements, recent IRS revenue rulings applicable to life settlements, and the methodologies undertaken by life settlement providers in assembling a securitization portfolio. They also identified the issues raised by life settlement securitization, the techniques used in prior life insurance securitizations, and the concerns raised by the SEC.

ON NOVEMBER 5, 2009, INTERNATIONAL FINANCIAL LAW REVIEW PRESENTED A WEBINAR ON "MORTGAGE REITS."

Anna Pinedo and Tom Humphreys of Morrison & Foerster LLP and Halle Bennet of UBS Securities LLC discussed the recent resurgence of mortgage REITs in the market, the advantages of REITs over comparable investment vehicles, the formation and organization of REITs, tax requirements of REITs, and ongoing financing strategies for mortgage REITs. For a further discussion, see our prior client alert, "Mortgage REITs are Back (Again)."

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ON NOVEMBER 12, 2009, MORRISON & FOERSTER LLP PRESENTED "PIPES AND REGISTERED DIRECT OFFERINGS."

MoFo partners Anna Pinedo and Jim Tannenbaum discussed the advantages and disadvantages of PIPE transactions (i.e., private investments in public equity in which a fixed number of securities are sold to accredited institutional investors) and registered direct offerings (i.e., fully registered transactions sold to select institutional investors) as potential capital raising alternatives, and the corporate and securities law aspects of such offerings, including shelf registrations and Rule 144A.

ON DECEMBER 1, 2009, INTERNATIONAL TAX REVIEW PRESENTED A WEBINAR ON "BEARER BONDS."

Tom Humphreys and Anna Pinedo of Morrison & Foerster LLP discussed the implications of the Foreign Account Tax Compliance Act of 2009 on both US and foreign issuers and the possible effects on the capital markets, including the proposed repeal of the bearer bond exception under TEFRA and the proposed withholding tax on withholdable payments to foreign financial institutions.

ON DECEMBER 8, 2009, MORRISON & FOERSTER LLP PRESENTED "REGULATORY CAPITAL DEVELOPMENTS" IN THE NEW YORK OFFICE.

Panelists included Tom Humphreys and Oliver Ireland of Morrison & Foerster LLP and Barbara Havlicek and Allen Tischer from Moody's Investor Service. The panel discussed recent events affecting financial institutions and regulatory capital requirements; liability management transactions by financial institutions and whether these transactions have been successful in delevering their balance sheets and boosting regulatory capital levels; recent issuances of hybrid securities in the U.S. and U.K. and the outlook for hybrid securities issuances in light of rating agency and E.C.B. actions; contingent capital instruments; standby capital arrangements; tangible common equity and other measures; potential changes to regulatory capital requirements; and the ratings outlook for financial institutions. ■

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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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