Morrison & Foerster Quarterly News Volume 3, No. 2 July 2010

TaxTalk

IN THIS ISSUE

2 The Dodd-Frank Act – Trust Preferreds, Covered Bonds, and Section 1256 Contracts

3 Proposed Regulations Clarify Ambiguity in Debt Modification Regulations

3 *Summitt v. Comm'r* – Foreign Currency Options Are Not Section 1256 Contracts

4 *Calloway v. Comm'r* – Purported Stock Loan Treated as Sale

5 Tax Patents – Update on *In Re Bilski*

6 From Extender's Act to American Jobs and Closing Tax Loopholes Act to Nowhere

6 The Classroom – RICs and Commodity Linked Structured Notes

7 Press Corner

7 MoFo in the News

Authored and Edited By

Thomas A. Humphreys

Anna T. Pinedo

Stephen L. Feldman

Armin M. Gharagozlou

Arthur Man

Remmelt A. Reigersman

Editor's Note

The biggest news in the U.S. capital markets in the second quarter 2010 was the conference agreement on the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act passed the U.S. House of Representatives on June 30, 2010, and passed the Senate on July 15, 2010. While tax had little to do with the Dodd-Frank Act, the Dodd-Frank Act will have an impact on "trust preferred" offerings. The Dodd-Frank Act may also be remembered for what it didn't do with regard to the taxation of derivatives and covered bonds.

In other news, the Internal Revenue Service (the "IRS") released taxpayer friendly proposed regulations clarifying ambiguities in the debt modification regulations, providing that deterioration in the financial condition of an issuer will generally be ignored in determining whether a modified debt is not debt for U.S. federal income tax purposes. Also, the Tax Court in *Summitt v. Comm'r*, 134. T.C. No. 12 (May 20, 2010) released a decision holding that over-the-counter foreign currency options are not Section 1256 contracts, confirming the IRS's position on this issue and the Tax Court in *Calloway v. Comm'r*, 135 TC No. 3 (July 8, 2010) held that a purported non-recourse loan equal to 90% of the value of a stock position held by a taxpayer was, in substance, a sale for U.S. federal income tax purposes.

(Continued on page 2)

Editor's Note

(Continued from Page 1)

In this issue of MoFo Tax Talk, we also provide an update on *In re Bilski* and tax patents, and we discuss the Tax Extenders Act of 2009 (and subsequent versions of this bill), on which Congress has thus far failed to reach agreement. Finally, in our regular feature, The Classroom, we discuss mutual funds and the tax law rules applicable to investing in commodity linked derivatives.

The Dodd-Frank Act

Hybrids are Dead, Long Live Hybrids. Since 1996, the U.S. Federal Reserve has allowed U.S. bank holding companies ("BHCs") to count "trust preferred" as Tier 1 capital. As the name suggests, a "trust preferred" is a preferred interest in a state law trust. The trust's common securities are held by the bank holding company. The trust preferred securities are issued to investors for cash. The trust then lends this cash to the bank holding company taking in return a long-term junior subordinated note. The junior subordinated note typically provides for interest deferral of at least five years. Such securities, if structured properly, permit the bank holding company to deduct interest on the subordinated note in an amount equal to distributions on the trust preferred securities. The result: tax deductible equity.

Beginning in 2005, BHCs began to issue enhanced trust preferreds that garnered more rating agency credit as quasi-equity. One such instrument was the subject of a favorable IRS Chief Counsel Memorandum (CCM 200932-0496) issued in 2009. While the Federal Reserve permitted trust preferreds to count as Tier 1 capital, U.S. bank regulators, *e.g.*, the Federal Deposit Insurance Corporation, did not. The Dodd-Frank Act reforms the regulatory capital requirements for bank holding companies. One of these changes will eliminate trust preferred securities as Tier 1 capital for BHCs.

The Dodd-Frank Act requires that the Board of Governors of the Federal Reserve set a maximum debt to equity (leverage) ratio of 15 to 1. The leverage limit applies to bank holding companies that can threaten systemic stability (*i.e.*, those with total consolidated assets of $50 billion or more, excluding any Federal home loan bank). Section 171 of the Act also provides for a minimum Tier 1 capital to average total assets ratio, which is to be established by Federal bank regulators for insured depository institutions, depository institution holding companies (defined as a bank or savings and loan holding company), and nonbank financial companies under the supervision of the Board of Governors. The Board of Governors is likewise ordered to establish minimum risk-based capital requirements, setting a minimum ratio of regulatory capital to risk-weighted assets. Both of these requirements are to be no less stringent than generally applicable requirements, which are to be set up as floor values, and no less stringent than requirements previously in place for banks (or insured depository institutions, as they are called in the actual legislative language) under the prompt corrective action provisions of the Federal Deposit Insurance Act.

The Dodd-Frank Act reforms the regulatory capital requirements for bank holding companies. One of these changes will eliminate trust preferred securities as Tier 1 capital for BHCs.

Because bank holding companies will now be subject to the same regulations as banks, bank holding companies will no longer be permitted to count trust preferred securities as Tier 1 capital. Intermediate bank holding companies of foreign banks will be subject to the same regulations as U.S. BHCs, but the foreign organization itself will be exempted, as the legislation does not include such organizations in the definition of a depository institution holding company.

The requirements set forth in Section 171 are to become effective immediately for all debt or equity instruments (presumably referring especially to trust preferred securities) issued on May 19, 2010 and afterward. Trust preferred securities issued before this date will be phased out as Tier 1 capital for bank holding companies and nonbank financial companies over a 3-year period, starting at the beginning of 2013. Notably, small bank holding companies (*i.e.*, those with total consolidated assets of $15 billion or less as of December 31, 2009) will be exempted from these capital requirements. Both bank holding companies not previously under the supervision of the Federal Reserve and bank holding company subsidiaries of foreign banks will see the requirements of the section phased in over a period of 5 years from the signing of the bill.

The section goes on to mandate a report by the Comptroller General (the GAO) on the extent to which smaller bank holding companies (total consolidated assets under $5 billion) have access to capital. Two other studies are mandated later (in Section 174): one on the use of hybrid capital instruments (trust preferred securities) as Tier 1 capital and the impact of prohibiting such use; the other on the treatment of intermediate holding companies of foreign banks with regard to capital requirements.

The Dodd-Frank Act also directs the Financial Stability Oversight Council to study contingent capital. Some have referred to contingent capital as the "super hybrid." As discussed in our previous articles on contingent capital (see, *e.g.*, our last issue of MoFo Tax Talk), substantial tax roadblocks in the U.S. must be overcome before the promise of that label is realized.

Section 1256 Contracts. The final title (Title XVI) of the Dodd-Frank Act excludes from the definition of "Section 1256 contract" under Section 1256 of the Code (a) securities futures contracts or options on such contracts unless the contract is a dealer securities futures contract, and (b) interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, credit default swaps or similar agreements. Section 1256 provides that "Section 1256 contracts" such as regulated futures contracts are marked to market annually. Also, gains and losses on such contracts are 60% long-term and 40% short-term capital gains and losses. The amendment was necessary to clarify that increased exchange trading of derivatives

The Dodd-Frank Act

(Continued from Page 2)

would not mean such derivatives were subject to taxation under Section 1256 of the Code. Gains and losses on such contracts will continue to be governed by existing rules, which in some cases remain unclear.

Covered Bonds. Lawmakers had considered including provisions that would facilitate the operation of a United States "covered bond" market in the Dodd-Frank Act. The final conference bill, however, did not include the covered bond provisions so legislation will have to wait for another day. Nevertheless, we wanted to point out that the latest draft of the proposed covered bond legislation (the "United States Covered Bond Act of 2010"—for a discussion of this proposed legislation, see our client alert "Covered Bond Legislation: Is the Fourth Time the Charm?) includes various provisions designed to integrate covered bonds into the U.S. tax system. Among other things, these provisions provide that an estate created under the legislation (*i.e.*, upon an issuer default prior to receivership or bankruptcy) is not taxable as a separate entity nor is the creation of the estate a taxable event. This means income and deductions from the cover pool will continue to belong to the covered bond issuer. The draft legislation also would make it clear that a foreign person who acquires a covered bond is not thereby engaged in a U.S. trade or business. This would make it possible for foreign investors to purchase such instruments upon original issuance without fear that they would be considered to be engaged in a "lending" business for U.S. tax purposes. Finally, a covered bond secured by residential or commercial mortgages would be a qualified mortgage for REMIC and REIT purposes. This would encourage REITs to invest in covered bonds and would allow covered bonds to be used as part of a REMIC pool; for example, covered bonds issued by a number of small issuers could be combined in one REMIC.

Proposed Regulations Clarify Ambiguity

As discussed in prior editions of MoFo Tax Talk,[1] an exchange of property for other property differing materially either in kind or in extent is generally treated as a taxable exchange for U.S. federal income tax purposes. Special rules govern whether a modification of the terms of a debt instrument results in a taxable exchange. These rules apply to any modification of a debt instrument, regardless of the form of the modification. For example, the rules apply to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. A modification of a debt instrument results in a taxable exchange of the original debt instrument for the modified debt instrument if the modification is a "significant modification." Whether a modification of a debt instrument is a "significant modification" and therefore results in a taxable exchange is important to both the issuer and the holder since the modification may result in cancellation of indebtedness income to the issuer or a gain or loss to the holder.

With respect to modifications of a debt instrument, Treasury Regulations provide that an "alteration that results in an instrument or property right that is not debt for federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer." In addition, Treasury Regulations provide that "a modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification" and that, for those purposes, any deterioration in the financial condition of the issuer between the issue date of the unmodified debt instrument and the modification date (as it relates to the issuer's obligation to repay the debt instrument) is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor. There has been some uncertainty as to the scope of the reference to the deterioration in the financial condition of the issuer—specifically, whether this should be applied only to determine whether the modification was "significant" or whether the rule was broader in scope so as to apply in determining whether the modified debt was debt for U.S. federal income tax purposes. Proposed regulations issued by the IRS on June 3, 2010 attempt to clarify this ambiguity.

The proposed regulations generally require an analysis of all of the factors relevant to a debt or non-debt determination of the modified instrument at the time of an alteration or modification. However, in making this determination, the proposed regulations clarify that any deterioration in the financial condition of the issuer between the debt instrument's issue date and the date of the alteration or modification (as it relates to the issuer's ability to repay the debt instrument) will not be taken into account, unless there is a substitution of a new obligor or the addition or removal of a co-obligor. For example, under the proposed regulations, any decline in the fair market value of a debt instrument (whether or not publicly traded) between the debt instrument's issue date and the date of the alteration or modification is not taken into account to the extent that the decline in fair market value is attributable to the deterioration in the financial condition of the issuer and not to a modification of the terms of the instrument. However, any portion of the increased yield that is not attributable to a deterioration in the financial condition of the issuer, such as a change in market interest rates, is taken into account.

The proposed regulations will apply to alterations of the terms of a debt instrument on or after the date final regulations are published in the Federal Register. However, taxpayers may also rely on the proposed regulations for alterations to the terms of a debt instrument occurring before that date.

Summit v. Comm'r

In *Summitt v. Comm'r*, 134 T.C. No. 12 (May 20, 2010) the Tax Court held that an over-the-counter foreign currency option was not a contract subject to Section 1256 of the Code, and accordingly, the taxpayer could not trigger the loss on a "major/

Summit v. Comm'r

(Continued from Page 3)

minor currency" transaction by marking the foreign currency contract to market under Section 1256 of the Code. The holding confirms the IRS's position on this issue, which it set forth in Notice 2007-71. In that notice, the IRS explained that it believes that foreign currency options are not contracts subject to Section 1256 of the Code, regardless of whether the underlying currency is one in which positions are traded through regulated futures contracts.

The Court rejected the taxpayer's arguments and held that foreign currency options are not foreign currency contracts within the meaning of Section 1256 of the Code, thereby confirming the IRS's position in Notice 2007-71.

Summitt v. Comm'r dealt with a major/minor currency transaction,[2] flagged by the IRS in Notice 2003-81 as a listed transaction. The transaction at issue in *Summitt v. Comm'r* can be summarized as follows: (i) the taxpayer was a 10% shareholder in an S corporation; (ii) the corporation paid premiums to purchase reciprocal offsetting put and call options (the purchased options) on a foreign currency in which positions are traded through regulated futures contracts (the "major currency"—here, the euro); (iii) the corporation received premiums for writing reciprocal offsetting put and call options (the written options) on a different foreign currency in which positions are not traded through regulated futures contracts (the "minor currency"—here, the Danish krone); (iv) the net premiums paid and received substantially offset one another and the values of the two currencies underlying the purchased and written options historically demonstrated a very high positive correlation with one another; (v) the corporation assigned to a charity the purchased option that had a loss and the charity also assumed the corporation's obligation under the offsetting written option that had a gain; and (vi) the taxpayer, as shareholder of the S corporation, took the position that the purchased option assigned to the charity is a contract subject to Section 1256 of the Code, marked the purchased option to market under Section 1256 of the Code and claimed a loss.

Section 1256 of the Code requires taxpayers to mark certain financial contracts ("Section 1256 Contracts") to market at the end of each year thereby causing taxpayers to recognize income or loss at the end of each taxable year. Section 1256 Contracts include as a "foreign currency contract" a contract (i) which requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts, (ii) which is traded in the interbank market, and (iii) which is entered into at arm's length at a price determined by reference to the price in the interbank market.

The substantive issue addressed in *Summitt v. Comm'r* was whether the major currency option was a "foreign currency contract" within the meaning of Section 1256 of the Code—and hence, subject to marking to market. The taxpayer argued that the plain meaning of the statute was broad enough to cover major currency options, and supported its position by arguing that (i) the words "any foreign currency contract" used in Section 1256 of the Code should be construed broadly because a "contract" is a broad term and an option is a unilateral contract; (ii) no Treasury regulations limit the definition of a "foreign currency contract" and that the application of Section 1256 of the Code to various types of contracts has been expanded over time; (iii) there are generally no significant economic differences among foreign currency forwards, futures, and options; and (iv) if the Tax Court finds that an option is a contract, the option value depends on the value of the currency, the currency is a major foreign currency traded on the interbank market, and the option was entered into at arm's length and with a price coinciding with the interbank market price for such options, then Section 1256 of the Code compels the conclusion that the option should be marked to market. The IRS, also invoking the plain meaning of the statute, noted that a foreign currency contract requires delivery of a foreign currency at a future date at an agreed price. On the other hand, an option does not require any "delivery." The IRS further argued that the addition of the words "or the settlement of which depends on the value of" was included to address any uncertainty as to whether cash-settled forward contracts were covered by Section 1256 of the Code and not to expand the scope to also include option contracts.

The Court rejected the taxpayer's arguments and held that foreign currency options are not foreign currency contracts within the meaning of Section 1256 of the Code, thereby confirming the IRS's position in Notice 2007-71. The Tax Court stated that the legal distinction between a forward contract and an option is not insignificant, emphasizing that a forward contract is a bilateral contract requiring an obligation to perform whereas an option is a unilateral contract where performance is left to the discretion of one of the parties.

Calloway v. Comm'r

Calloway v. Comm'r, decided on July 8, 2010, in the Tax Court, held (i) that a purported non-recourse loan equal to 90% of the value of stock held by a taxpayer was, in substance, a sale for U.S. federal income tax purposes, and (ii) that the transaction was not a securities lending arrangement under Section 1058 of the Code. The lender was Derivium Capital, LLC ("Derivium"), which operated a 90%-stock-loan program and seems to have entered into approximately 1,700 similar transactions over the course of a 5-year period. It filed for bankruptcy a few years ago. A number of cases are docketed in the Tax Court. It is hard to imagine, however, that their facts could be worse than *Calloway's*.

Those facts can be briefly summarized as follows: (i) the taxpayer entered into an agreement with Derivium whereby the taxpayer transferred 990 shares of IBM common stock in exchange for a cash payment equal to 90% of the fair market value of the stock at that time; (ii) the terms of the agreement, including supporting documentation, characterized the transaction as a 3-year nonrecourse bullet loan accruing interest at 10.5% compounded annually; (iii) at maturity, the

Calloway v. Comm'r

(Continued from Page 4)

taxpayer had the option of (a) paying the balance due and having the stock returned to the taxpayer, (b) renewing or refinancing the transaction, or (c) surrendering the stock and walking away without paying any balance due; (iv) upon the initial transfer of the stock, Derivium had the right to sell, and did in fact sell, the stock (although the taxpayer claimed he didn't know about the sale); (v) at maturity, taxpayer surrendered the stock extinguishing the loan; and (vi) upon initial transfer of the stock, the taxpayer did not treat the transaction as a sale of the stock for tax reporting purposes. Interestingly, the taxpayer did not report the transaction on his tax return when the transaction was terminated.

It is hard to imagine, however, that their facts could be worse than Calloway's.

In determining whether the purported loan was, in substance, a sale for U.S. federal income tax purposes, the Tax Court analyzed whether the benefits and burdens of ownership of the stock passed to Derivium. Upon applying a multi-factor test (including, *e.g.*, whether legal title passes, how the parties treat the transaction, whether an equity interest in the property is acquired, whether the right of possession is vested in the purchaser, who bears risk of loss on the transferred property, who receives the profits from the operation and sale of the property), the Tax Court concluded that the benefits and burdens of ownership did, in fact, pass to Derivium. For example, according to the Court, Derivium had the right, and did sell, the stock immediately upon transfer; the parties treated the transaction as a sale (*e.g.*, the taxpayer did not report dividends throughout the term of the transaction, and did not report any discharge of indebtedness upon termination of the transaction); and the taxpayer did not bear any risk of loss with respect to the stock following the transfer to Derivium but only retained the option for gain if the stock appreciated beyond what was due at maturity.

The Court also concluded that the arrangement was not a securities lending arrangement under Section 1058 of the Code. If a securities lending agreement meets several requirements under Section 1058, then a taxpayer does not recognize any gain or loss upon a transfer of securities pursuant to the agreement. One of the requirements a securities lending agreement must meet in order to so qualify is that it must not reduce the lender's risk of loss or opportunity for gain in the securities loaned. In this case, since the taxpayer did not have the right to reacquire the stock on demand, but only upon maturity, the Tax Court held that this requirement was not met (*i.e.*, the taxpayer did not retain all of the benefits and burdens of ownership of the stock and the right to terminate the lending agreement upon demand).

Calloway reminds us that we are still awaiting the Tax Court's decision in *Anschutz v. Comm'r*, a case that involves a variable prepaid forward coupled with a stock loan. There were three sets of Tax Court judges that wrote opinions in *Calloway* and it appears that the Tax Court is somewhat split about the correct legal standard for determining whether a taxpayer has sold publicly traded stock. This issue is at the heart of the dispute in *Anschutz*. Eleven of the *Calloway* judges adopted an eight factor "benefits and burdens" test derived from a 1981 case (*Grodt & McKay Realty, Inc. v. Comm'r,* 77 T.C. 1221) involving a sale of cattle. Judge Halpern concurred in the result but said the multifactor, economic risk-reward analysis used by the eleven was only appropriate for determining ownership of non-fungible assets (such as cattle). Judge Halpern would only ask two questions: whether legal title and the power to dispose are joined in the supposed owner, if so that person owns the stock. Judge Holmes's opinion decides the case on narrow grounds: Regs. Section 1.1001-2(a)(4)(i) which provides that the sale of property that secures a non-recourse loan discharges the loan.

Tax Patents - Update on *In Re Bilski*

In prior issues of MoFo Tax Talk,[3] we discussed *In re Bilski*, No. 2007-1130 (Fed. Cir. Oct. 30, 2008) and tax patents. *Bilski* held that a method of hedging risk associated with volatile commodity prices by entering into swaps was not patentable because the claim was a "non-transformative process that encompasses a purely mental process of performing requisite calculations without the aid of a computer or any other device" and, as a result, it did not meet the court's test of being tied to a particular machine or apparatus or transforming a particular article into a different state of things in order to be patent eligible. This test was at odds with an earlier decision in State *Street & Trust Co. v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998), which held that a business method is patent eligible as long as it produces a "useful, concrete, and tangible result." On June 1, 2009, the U.S. Supreme Court granted certiorari for *Bilski*, and on June 28, 2010, the Supreme Court officially weighed in (*Bernard L. Bilski et al. v. David J. Kappos*, No. 08-964), affirming the Federal Circuit's decision that Bilski's particular business method for hedging consumption risk was not eligible for a patent. The Supreme Court, however, rejected the machine-or-transformation test as the "sole test" for patent eligibility. The Supreme Court also expressly stated that business methods are not categorically excluded from patent eligibility, instead opting for a more flexible approach. Accordingly, it appears the controversy surrounding tax patents will continue. For a discussion of the decision of the Supreme Court in *Bilski*, please see our client alert "Business Method Patents Survive *Bilski*."

From Extender's Act to American Jobs

Representative Charles Rangel (D – New York) introduced the Tax Extenders Act of 2009 (the "Bill") on December 7, 2009. The Bill was intended to provide individuals and businesses with over $30 billion in tax relief by, as its name suggested, extending over forty different expiring tax provisions. Specific provisions include renewals of the research credit, new markets credit, the 15-year straight-line cost recovery period for qualified leasehold improvements, restaurant buildings and improvements, and retail improvements, the state and local sales tax deduction, as well as tax relief provisions that encourage charitable contributions, provide community development incentives, and support the deployment of alternative vehicles and alternative fuels. Other extenders target disaster recovery efforts in the Gulf region and New York City. To help pay for these provisions, the original bill proposed to offset its cost by, among other things, tightening enforcement on non-compliant taxpayers using foreign accounts and by taxing income from "carried interests" as ordinary income rather than as capital gains.

As is the case with many bills, the Bill has been through many revisions and iterations while working its way through both the Senate and the House.

The Senate's original substitute amendment to the Bill (which renamed it the American Workers, State and Business Relief Act) was passed by the Senate in March 2010. Among some of the differences between Congressman Rangel's original version and the Senate's amended version are that the latter added longer term extensions of unemployment insurance benefits, subsidies to help displaced workers continue their employer-provided health insurance, and other provisions as well as removal of the provision aimed at tightening enforcement on non-compliant taxpayers using foreign accounts as those provisions were enacted into law on March 18, 2010 as "pay fors" in the Hiring Incentives to Restore Employment Act. The Senate's version also deleted the "carried interest" provision.

The House responded with its own amendment (renaming it the American Jobs and Closing Tax Loopholes Act of 2010) and voted to pass the amendment in May 2010. The House was pressured to reduce drastically the size of the Bill and to cut billions of dollars in spending programs by eliminating a proposed extension of the 65% COBRA premium tax subsidy. It also added back a revised version of the carried interest provision, in a compromise approach, specifying a portion of income from a carried interest to be treated as ordinary income and another portion to be treated as capital gain.

In the past two months alone, in an attempt to push the Bill through the Senate, the Bill has been amended three more times, with each amended version aimed at reducing its cost. However, on June 24, 2010, the Senate was unable to get sufficient "aye" votes to prevent a filibuster and the Bill died. Its fate remains uncertain.

The Classroom

A regulated investment company ("RIC") is a tax-favored vehicle that receives the benefit of avoiding an entity level tax through a dividends paid deduction if several requirements are met. These requirements include a gross income test. Under the gross income test, 90% of the RIC's gross income must be "qualifying income." Qualifying income is defined as "dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities (as defined in . . . the Investment Company Act of 1940) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC's] business of investing in such stock, securities, or currencies."

Historically, RICs entered into derivative contracts with respect to commodities to obtain the desired commodities exposure. These funds took the position that income and gain from such derivatives constituted "qualifying income."

In December 2005, the IRS released Revenue Ruling 2006-1, which held that income from a derivative contract with respect to a commodity index is not qualifying income for RICs under the aforementioned gross income test. After citing legislative history, the IRS concluded in the ruling that Congress did not intend for the cross-reference to the Investment Company Act of 1940 to expand the term "securities" to include derivative contracts providing for a total return exposure to a commodity index. The IRS also stated that the fund in the ruling did not enter into the derivative contract to "reduce or hedge the level of risk in a business of investing in stock, securities or currencies;" therefore, the income from those contracts could not be considered qualifying income through the "other income" provision. In addition, the ruling provided that the holding would not be applied adversely to income that a RIC would recognize on or before June 30, 2006.

Desperate to give their shareholders commodities exposure, RICs besieged Congress and the IRS to get relief. The IRS's response was Private Letter Ruling 200628001 (commonly referred to as the "Rydex Ruling"). The Rydex Ruling analyzed whether a structured note that provided exposure to a commodities index generates "qualifying income" for purposes of the RIC rules. The Rydex Ruling was premised on four representations made by the mutual fund requesting the ruling: (i) the issuer of the note will receive payment in full of the purchase price of the note substantially contemporaneously with the delivery of the note; (ii) the mutual fund, while holding the note, will not be required to make any payment to the issuer in addition to the purchase price paid for the note, whether as margin, settlement payment, or otherwise, during the life of the note or at maturity; (iii) the issuer of the note is not subject by the terms of the instrument to mark-to-market margining requirements of the Commodities Exchange Act ("CEA"); and (iv) the note is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to the CEA. The Rydex Ruling concluded that income and gain arising from the note constitute qualifying income because the note was a hybrid instrument that is "predominantly a security" within the meaning of the CEA.

On the basis of the Rydex Ruling, it seems that mutual funds may obtain commodity exposure by investing in a properly structured note without the risk of running afoul of the "gross income test." However, since private letter rulings can only be

The Classroom

(Continued from Page 6)

relied on by the taxpayer who sought the ruling, many mutual funds have sought and obtained their own private letter rulings. It appears that the IRS adopted the standards set forth above so that the note most closely resembles a debt instrument for federal income tax purposes, even if the rulings do not conclude that the instrument is, in fact, indebtedness for federal income tax purposes. For example, a typical structured note of this ilk provides for 3x leveraged exposure (both on the upside and on the downside) to the commodity index but knocks out at 15% index depreciation. Assuming the knock-out works perfectly, the note holder will get 55% of its investment back. We suspect this was designed so that one could say more than 50% of the note's issue price is not contingent (even though there is no absolute legal protection) leading one to conclude that the instrument is predominantly debt. Also, the IRS has limited the rulings to notes whose return is based on an index, rather than on a single commodity.

On the basis of the Rydex Ruling, it seems that mutual funds may obtain commodity exposure by investing in a properly structured note without the risk of running afoul of the "gross income test."

Press Corner

The press reported that the Swiss parliament finally approved a deal with the United States that allows for UBS to transfer data on thousands of its clients to the U.S. See Lehmann, "Swiss parliament approves bank data deal with US," AFP, available at http://news.yahoo.com/s/afp/20100617/bs_afp/switzerlanduspoliticstaxregulatebankingcompanyubs(June 17, 2010). Last year, UBS was accused of aiding and abetting offshore tax evasion by U.S. citizens. UBS settled two U.S. lawsuits against it, agreeing to pay a $780 million fine and also agreeing to turn over account records to U.S. authorities. However, a Swiss court decision blocked the transfer of account records to U.S. authorities due to bank secrecy laws, and parliamentary approval apparently was required.

Earlier this year, as previously discussed in our prior issue of MoFo Tax Talk, the press reported that Bradley C. Birkenfeld, an ex-UBS banker, is seeking at least several billions of dollars from the U.S. government for blowing the whistle on UBS. Under federal law, a whistleblower who blows the whistle against tax cheats (for example—their employers) 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. The problem for whistleblowers is that it may take several years to receive any payment, and they may be unemployed during the interim period. The private sector apparently is filling the gap. Hedge funds are making upfront payments in exchange for sharing in the reward expected from the IRS, according to the New York Times. See David Kocieniewski, "Whistle-Blowers Become Option for Hedge Funds," New York Times, available at http://www.nytimes.com/2010/05/20/business/20whistleblower.html (May 19, 2010).

According to the National Association of Realtors, sales of homes fell in May compared to April, but, compared to last year, sales are much better. See "May Shows a Continued Strong Pace for Existing-Home Sales," National Association of Realtors, available at http://www.realtor.org/press_room/news_releases/2010/06/may_strong_pace (June 22, 2010). The Homebuyer Tax Credit, which provides a credit worth up to $8,000 for certain homebuyers, expired at the end of June (those buyers who have entered into a binding contract to purchase a home by April 30, 2010 had until June 30, 2010 to close the transaction in order to qualify), worrying some as to whether the housing market will decline now that the credit expired. Congress recently passed a bill to extend the deadline to September 30, as it was reported that a substantial number of first time homebuyers were likely to miss the deadline to close the transaction due to third-party delays.

To the dismay of smokers in New York, on June 21, 2010, New York Governor David Paterson (D) approved a $1.60 tax increase on a pack of cigarettes, which raises the state tax to $4.35 per pack, making the state's tax the highest in the nation, according to Tax Analysts. Those purchasing cigarettes in New York City pay an additional $1.50-per-pack local tax on cigarettes, and accordingly, the total tax in New York City will increase to $5.85 per pack, meaning that cigarettes may cost more than $11 per pack in NYC. See Nicola M. White, "New York Governor Approves Highest Cigarette Tax in Nation," 2010 STT 120-28 (June 23, 2010).

On the softer side of news, one man claims that taxes saved his life. How, you may wonder? The press reported that a Kentucky man credited a state revenue employee with saving his life after he had a heart attack during a phone call about his income taxes and she called an ambulance. See "Phone call about taxes a life-saver for Ky. Man," Associated Press, available at http://news.yahoo.com/s/ap/20100619/ap_on_fe_st/us_odd_revenue_rescue (June 19, 2010).

MoFo in the News

On April 19, 2010, West Legalworks presented a webinar on "PIPEs and Registered Direct Offerings." Anna Pinedo and James Tanenbaum of Morrison & Foerster LLP discussed the advantages and disadvantages of PIPE transactions (*i.e.*, private investments in public equity in which a fixed number of securities are 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 SEC Rule 144A.

On April 21 through April 23, 2010, the Financial Markets Association hosted a "Securities Compliance Seminar" at the Washington Marriott Hotel in Washington, D.C. David Lynn of Morrison & Foerster LLP chaired the event, and Anna Pinedo

MoFo in the News

(Continued from Page 7)

of Morrison & Foerster LLP joined a panel with Richard T. Burrow from E*TRADE Securities LLC. They discussed current developments affecting securities broker-dealers and commercial banks, including legislative/regulatory initiatives, pertinent court decisions, and a regulatory reform update.

On April 22 through April 24, 2010, the American Bar Association hosted its 2010 Spring Meeting in Denver, CO. Anna Pinedo of Morrison & Foerster LLP joined a panel, chaired by Kenneth Kohler of Morrison & Foerster LLP, with Michael Krimminger of the FDIC, Stephen Kudenholdt of Sonnenschein Nath & Rosenthal LLP and James Mountain of Deloitte & Touche LLP. The panel discussed recent legislative, regulatory, accounting, and rating agency proposals and changes affecting securitizations, such as current legislative proposals, the administration's "white paper" on securitization reform, and FASB 166 (*Accounting for Transfers of Financial Assets*) and 167 (*Amendments to FASB Interpretation No. 46(R)*), which would, in general, among other things, bring securitizations back onto the balance sheet of many issuers.

On April 27, 2010, Morrison & Foerster LLP hosted a CLE in the New York office titled "Trading in Restricted Securities" with Citigroup and NasdaqOMX. Anna Pinedo of Morrison & Foerster LLP, Karin McKinnell of NASDAQ OMX Group Inc. and Eric Wooley of Citi discussed SEC Rule 144A private offerings and provided details on the current operation of the PORTAL Alliance platform and its role in the current private placement market. Rule 144A offerings are private offerings by issuers to sophisticated parties ("qualified institutional buyers") which do not require public registration. The PORTAL Alliance platform is a platform, founded by the major financial institutions, such as Bank of America Merrill Lynch, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, J.P. Morgan, Morgan Stanley, and NASDAQ OMX Group Inc., intended to enhance the liquidity and transparency of 144A securities by standardizing the process for trading, shareholder tracking and settlement of 144A securities.

On April 28 through April 29, 2010, International Financial Law Review hosted a forum on "European Capital Markets" in London, England. Peter Green of Morrison & Foerster LLP discussed the new realities of finance and Basel III, which proposes to alter capital requirements of financial institutions.

On May 4, 2010, Morrison & Foerster LLP hosted a teleconference on the new provisions of the Foreign Account Tax Compliance Act ("FATCA"). Morrison & Foerster LLP partners Thomas A. Humphreys and Trevor James discussed the new FATCA provisions, such as: the 30% tax on "withholdable payments" such as interest, dividends and securities sales proceeds made to non-U.S. banks and brokers unless they agree to information report on their U.S. account holders beginning January 1, 2013; extension of the U.S. 30% withholding tax to "dividend equivalent" payments made on certain cross border swaps and other transactions which takes effect September 14, 2010; and the repeal of the U.S. "bearer bond" exception for obligations targeted to non-U.S. markets, effective for obligations issued after March 18, 2012. For a discussion of these new provisions, please see our prior issue of MoFo Tax Talk and our prior client alert "FATCA Provisions Enacted Into Law."

On May 4, 2010, West Legalworks presented a webinar titled "U.S. IPOs: Is the Window Open?" David Lynn and Anna Pinedo of Morrison & Foerster LLP discussed current IPO market activity, such as which sectors are most active, structure of IPOs in registration (primary and secondary), maturity of IPO issuers, sponsor backing, alternatives to IPOs, whether to decide to pursue an IPO, keys to a successful IPO, accounting, tax and other concerns, and public company reporting and Sarbanes-Oxley and other corporate governance issues.

On May 5, 2010, Morrison & Foerster LLP hosted "The 43rd Annual Uniform Commercial Code Institute of Penn State Dickinson School of Law: The Securitization Market and Proposed Reforms: A Look into the Future of Housing Finance" in the New York office. Panelists included Jerry Marlatt and Anna Pinedo of Morrison & Foerster LLP, professor Louis F. Del Duca of Penn State Dickinson School of Law, Yehudah Forster of Moody's Investors Service, Mercy Jimenez of Covered Bond Investor LLC, Stephen Kudenholdt of Sonnenschein Nath & Rosenthal LLP, James Mountain of Deloitte & Touche LLP, and Faten Sabry of NERA Economic Consulting. The panel discussed the current state of the market and a review of securitization reforms, recent proposed legislation, accounting changes, mortgage modification efforts, tax impediments to mortgage modifications, and the future of housing finance and potential alternative approaches.

On May 10, 2010, Practising Law Institute presented a webcast titled "Legal and Market Considerations in Covered Bonds." Jerry Marlatt of Morrison & Foerster LLP discussed covered bonds in the United States and recent developments. Covered bonds are debt instruments of an issuer (*e.g.*, a bank) in which an investor in the bonds has recourse against the issuer and a specified pool of collateral (the "cover pool"), which, in general, consist of high quality assets of the issuer. These instruments are a form of on-balance sheet financing and provide a possible source of alternative financing by banks in lieu of securitization. For a further discussion on covered bonds, *see, e.g.*, Anna Pinedo, "Covered Bonds in the U.S.," *Practical Law The Journal*, February 2010.

On May 11, 2010, Morrison & Foerster LLP, in conjunction with Donohoe Advisory Associates LLC, hosted a CLE titled "The 20% Rule and Structuring Issues" in the New York office. James Tanenbaum of Morrison & Foerster LLP and David A. Donohoe, Jr., of Donohoe Advisory Associates LLC discussed the 20% rule that provides that a listed company is required to obtain shareholder approval in connection with certain transactions. The rule affects, among other things, the structuring of private placements and PIPE transactions, financings in connection with an acquisition, financings that may result in a change of control, and financings involving related parties. The panel discussed common structuring approaches, as well as new guidance and interpretive advice.

On May 11, 2010, International Financial Law Review hosted a web seminar on "The Impact of Basel III." The new Basel framework proposes that banks raise their regulatory capital levels, provide greater transparency and account for

MoFo in the News

(Continued from Page 8)

derivatives and securitization. The panel included Tom Young, editor of International Financial Law Review, and Anna Pinedo and Oliver Ireland of Morrison & Foerster LLP, who discussed the proposed framework and key changes of Basel III, such as the new definitions of tier one and tier two capital; the proposed regulatory adjustments, including deferred tax assets; the proposed treatment of derivatives, repo activities and securitizations; the effect on funding costs, the hybrid securities market, and capital structure; and the interplay with other pending regulatory reforms.

On May 20, 2010, International Tax Review presented a webinar titled the "U.S. Foreign Account Tax Compliance Act." Thomas A. Humphreys of Morrison & Foerster LLP discussed the new provisions of FATCA such as the new withholding tax on withholdable payments, the repeal of the bearer bond exception, and the tax treatment of dividend equivalent payments.

Contacts

United States Federal Income Tax Law

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

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

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

Stephen L. Feldman
(212) 336-8470
sfeldman@mofo.com

Arthur Man
(212)-336-4113
aman@mofo.com

Corporate + Securities Law

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

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

About Morrison & Foerster

We are Morrison & Foerster — a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, Fortune 100 companies, investment banks and technology and life science companies. Our clients count on us for innovative and business-minded solutions. Our commitment to serving client needs has resulted in enduring relationships and a record of high achievement. For the last six years, we've been included on The American Lawyer's A-List. Fortune named us one of the "100 Best Companies to Work For." Our lawyers share a commitment to achieving results for our clients, while preserving the differences that make us stronger. This is MoFo.

[1] See e.g., MoFo Tax Talk, Volume 2, Issue 2.
[2] In this context, a "major currency" refers to a currency in which positions are traded through regulated futures contracts and a "minor currency" refers to a currency in which positions are not traded on a qualified board or exchange.
[3] See, e.g., MoFo Tax Talk, Volume 1, Issue 4.

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.

©2010 Morrison & Foerster LLP