MORRISON | FOERSTER

News Bulletin September 30, 2008 Volume 1, Issue 3

MoFo Tax Talk

Bailout Bill Tax Provisions

Over several frantic days leading up to a failed congressional vote on September 29, 2008, the Bush Administration and congressional leaders negotiated and agreed on a bill aimed at preventing a potential economic meltdown. The bill would have given the United States Treasury authority to purchase troubled assets from financial institutions with significant U.S. operations. The bill authorized expenditures in several stages up to $700 billion in the aggregate. Troubled assets would either have been purchased by Treasury directly or through an auction process. The bill included limits on executive compensation and "golden parachutes" for financial institutions that took advantage of its provisions. In addition, under the bill, Treasury would have received ownership interests in financial institutions participating in the program.

The bill included a few specific tax provisions. First, the bill would have provided that any gain or loss suffered by banks and savings and loan associations on Fannie Mae or Freddie Mac preferred stock would be treated as ordinary gain or loss. To qualify, the preferred stock must have been held on September 6, 2008 or disposed of on or after January 1, 2008 and before September 7, 2008. Second, financial institutions that sold more than $300 million in troubled assets to Treasury through an auction process would have been denied a tax deduction for compensation in excess of $500,000 and for any "golden parachute payments" to a CEO, CFO or any employee who is one of the three most highly compensated officers of a participating entity. Third, the 2007 provision excluding from taxable income the first $2 million of discharge of mortgage debt relating to a taxpayer's primary residence would have been extended through the end of 2012.

Borrower's Default on Securities Loan Doesn't Trigger Taxable Event to Lender

Under a securities loan agreement, a borrower typically borrows securities from a lender and posts collateral to secure its obligation to return identical securities. The initial transfer of securities to the borrower and the return of identical securities to the lender upon termination of the securities lending agreement generally do not result in any gain or loss to the lender for U.S. federal income tax purposes, provided the loan agreement meets certain specified requirements under Section 1058.[1] If, upon a borrower default, the lender applies the collateral to purchase securities that are identical to the securities borrowed, the lender would be required to realize gain, if any. In most situations, losses would be expected to be disallowed as a result of the application of the wash sale rules. On September 29, 2008, the IRS published Revenue Procedure 2008-63 to preserve non-recognition treatment and restore symmetrical results in the case of gains and losses. The Revenue Procedure, effective for taxable years ending on or after January 1, 2008, provides that if a borrower defaults under a securities loan agreement as a direct or indirect result of its bankruptcy (or the bankruptcy of an affiliate) and the lender applies the collateral to purchase identical securities as soon as is commercially practicable after the default (but not more than 30 days following the default), then the transaction will not be a recognition event for U.S. federal income tax purposes to the lender.

Credit Crunch Results in Suspension of AHYDO Rules

On August 8, 2008, the IRS issued Revenue Procedure 2008-51 in yet another demonstration that it is willing to surgically and temporarily freeze the application of tax laws in order to help shepherd the economy through the credit crisis. The Revenue Procedure grants temporary and limited relief from rules that defer and, in some cases, deny an issuer an interest deduction on so-called "AHYDO" debt instruments. In general, issuers of debt with original issue discount ("OID") are permitted a deduction for the OID. Harking back to the go-go days of unbridled LBOs and corporate takeovers, the AHYDO rules impose a limitation on the availability of a deduction for OID in the case of debt instruments that are perceived to be in no man's land on the debt/equity border. The AHYDO rules patrol that border by imposing strict limitations on the ability of an issuer of high yield obligations to defer cash interest payments. An issuer of a high yield debt instrument that by its terms requires or permits a deferral of cash interest payments beyond these limits is required under the AHYDO rules to defer or, in extreme cases, lose all or a portion of a deduction for the deferred interest.

The Revenue Procedure notes that, in unanticipated fashion, the recent crisis in the markets has resulted in significant dislocations between the time at which a corporation arranges for the issuance of debt pursuant to a binding financing commitment and the time at which the corporation calls upon the lender to perform on the commitment by advancing cash to the issuer and on-selling the issuer's debt instruments in the market. This can result in situations in which the issue price of a debt instrument (generally, the price paid by the public) is significantly less than the amount of money actually received by the corporation from the lender, raising the yield on the instrument. The resulting OID may have the effect of forcing the debt over the AHYDO border, raising the after-tax cost to the issuer of issuing the debt due to the deferred or foregone interest deductions, and potentially affecting the willingness of borrowers and lenders to enter into financing commitments. Acknowledging these problems, the Revenue Procedure suspends the application of the AHYDO rules in this situation and two other specified situations.

Section 1032 Disallows Subsidiary Loss on Forward Contract Involving Parent Stock

Section 1032 generally provides that a corporation does not recognize gain or loss on the receipt of cash or property in exchange for stock of the corporation. The provision, in some cases, has been interpreted broadly to apply to forward contracts, whether or not stock is physically transferred, so long as gain or loss is determined by reference to the value of a taxpayer's own stock. The IRS recently issued private guidance that prevents a taxpayer from recognizing losses in respect of forward contracts on stock of an affiliate following a merger. Chief Counsel Advisory Letter 200832002 (April 23, 2008) involves a corporation (Corp A) that entered into an equity forward

[1] Unless otherwise specified, section references are to the Internal Revenue Code of 1986, as amended.

contract to repurchase an amount of its own shares on a future settlement date. The forward contract could be physically settled, or could be settled on a net equity basis using either cash or stock. If the contract was net equity-settled, Corp A would be required to deliver to the counterparty shares or cash having an equivalent value if the market price of Corp A shares was less than the forward price on the settlement date. Prior to settlement, Corp A merged into Corp S, a controlled subsidiary of Corp P, in a tax-free reorganization. Under the terms of the equity forward contract, Corp A shares due on the forward contract would be replaced by an equivalent value of Corp P shares as of the date of the merger. Thus, the value of Corp A stock on the merger date was used to determine the number of substitute shares of Corp P deliverable on the settlement date. Subsequently, Corp S cash settled the forward contract and was required to make a cash payment to the counterparty. Corp S reported a capital loss in the amount of the payment, claiming that Section 1032 did not apply because it did not acquire its own stock. The IRS disagreed.

Previously, the IRS held in Revenue Ruling 70-305 that Section 1032 does not apply to a transfer of stock of a taxpayer's parent or subsidiary. Thus, Rev. Rul. 70-305 would appear to permit Corp S to recognize its loss because settlement of the forward contract did not involve Corp S stock, but rather stock of its parent. However, in the new guidance the IRS states that Congress did not intend Section 1032 to be elective or to be avoided by transactions that are economically equivalent to a transaction by a corporation in respect of its own stock. The IRS points out that Corp A survived in modified corporate form following the merger and, further, that Corp S's loss is calculated based on the value of Corp A stock on the merger date, which was embedded in the forward contract post-merger. Thus, according to the IRS the loss did not lose its "origin" despite a change in the underlying stock to be delivered. As private guidance, a Chief Counsel Advisory Letter cannot be relied on by other taxpayers, *e.g.*, where the forward is settled at a gain. It signals, however, an expansive reading of Section 1032 by the IRS.

Foreign Tax Credit Regulations

Proposed regulations addressing foreign tax credit generator transactions were issued on March 29, 2007. On July 16, 2008, the IRS issued temporary regulations that adopt and modify certain provisions of the proposed regulations. The former proposed regulations set forth six characteristics, or conditions, that determine whether parties would be able to take a foreign tax credit against their U.S. tax. The temporary regulations retain the structure of the six conditions, but modify certain requirements related to structured passive investment arrangements ("SPIAs"). For example, while the proposed regulations would treat all foreign entities in which a U.S. party has an 80% (direct or indirect) interest as a single taxpayer, the temporary regulations abandon this rule. Another difference between the temporary and proposed regulations is the treatment of foreign tax payments. The former rule required that the foreign tax payments be substantially greater than the amount of foreign tax credit taken for the proportionate share of the special purpose vehicle's ("SPV") assets (the "direct interest test"). While the proposed regulations looked to the aggregate amount of foreign payment, the temporary regulations look to a proportionate share of such payments. The modification is intended to achieve appropriate results where the equity interest in the SPV is owned by more than one person.

Another change involves the requirement of a foreign tax benefit. Under the proposed regulations, an arrangement must be reasonably expected to result in a tax benefit (under foreign laws) to a counterparty (a person regarded as owning an interest in, or assets of, the SPV under the tax laws of a foreign country). The temporary regulations clarify that the tax benefit only requires reasonable expectation of a foreign tax benefit, regardless of whether the tax benefit is actually intended or obtained. In addition, the temporary regulations hold that a foreign tax benefit only exists if it corresponds to at least 10% of the U.S. party's share of the foreign payment attributable to the SPV. The modification is in line with the policy that the foreign tax credit rules will not apply where no duplicative tax benefits exist.

Legislative Changes Affect REITs

In an effort to help stabilize the deteriorating housing market, Congress enacted the American Housing Rescue and Foreclosure Prevention Act of 2008 and liberalized the REIT rules. A REIT is an entity that is otherwise subject to tax as a domestic corporation, but has elected to be taxed under a preferential regime in which dividends distributed to REIT shareholders are generally deductible by the REIT. As a result, a qualifying REIT escapes the corporate level tax. To maintain REIT status, an entity is required to meet certain income and asset tests that are designed to ensure that a REIT primarily generates passive real estate related income and holds assets that primarily consist of real property. In addition, a REIT is subject to a 100% tax on its net income from the sale of property held primarily for sale to customers in the ordinary course of business ("prohibited transaction sales"), unless a sale qualifies for a safe harbor under which, among other requirements, the REIT must satisfy a four-year holding period requirement for the sold property as well as a requirement that the REIT does not sell more than seven properties during any taxable year or that the aggregate basis of real property sold during the year does not exceed 10% of the aggregate basis of all of the REIT's assets.

The new legislation reduces the holding period requirement under the prohibited transaction safe harbor from four years to two years and amends the 10% limitation to allow calculation of the limitation by reference either to tax basis or fair market value of property. The new legislation contains several additional favorable amendments. The new REIT rules are permanent (i.e., there is no "sunset" provision) and are generally effective for tax years beginning after July 30, 2008. For more information on the new rules, please see our client alert: Congress Enacts New Laws Affecting REITs, available at http://www.mofo.com/news/updates/files/14245.html.

Senate Targets Dividend Withholding Tax Abuse

The U.S. Senate Permanent Subcommittee on Investigations published a report on September 11, 2008 entitled "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends." The report is the result of a year-long investigation by the staff of the subcommittee and is part of a series of reports on offshore tax abuse. The report primarily focuses on two transactions – equity swaps and stock lending transactions – which are used by foreign investors – primarily offshore hedge funds, in some cases with the help of U.S. financial institutions – to avoid the 30% U.S. withholding tax on U.S. source dividend payments. Under U.S. tax rules, dividend-equivalent payments made by a U.S. financial institution to an offshore hedge fund on an equity swap are not subject to a 30% U.S. withholding tax. On the other hand, an in-lieu of payment made under a stock loan reflecting dividends paid in respect of stock underlying the stock loan generally is subject to a 30% U.S. withholding tax, but the IRS has issued a notice (Notice 97-66, the "Notice," further discussed below) that adds some gloss to the general rule.

The report describes the following stock lending transaction that attempts to arbitrage these rules. An offshore corporation, owned and controlled by a U.S. financial institution, borrows stock from an offshore hedge fund before a dividend payment on that stock is made. The offshore corporation sells the stock and enters into an equity swap with its parent, the U.S. financial institution. Under the equity swap, the offshore corporation receives a dividend equivalent payment (not subject to U.S. withholding tax). In turn, the offshore corporation makes a substitute payment under the stock loan agreement to the offshore hedge fund. As discussed, this substitute payment generally is subject to a 30% U.S. withholding tax. However, relying on the Notice the offshore corporation takes the position that the substitute payment is not subject to U.S. withholding tax.

The report specifically zeroes in on equity swap transactions where an offshore hedge fund holding U.S. stock disposes of the stock a few days prior to the record date of dividend payments on the stock while entering into total return swaps with a U.S. financial institution to avoid the 30% U.S. withholding tax on dividends, all the while keeping 100% of the economic exposure to the stock. Because it is clear that the payments under the total return swaps are generally not subject to U.S. withholding tax, the IRS would have to attack these transactions by arguing that they are sham transactions or otherwise lack economic substance. With respect to the stock lending transactions, the report focuses on the impact of the Notice, which was issued to address the concern that taxing substitute payments could result in too much U.S. taxes withheld if the same stock is the subject of multiple stock loans. The report, however, points out that certain practitioners believe that there should be a showing of actual tax withheld before one can rely on the Notice. Presumably, the concern is that the Notice otherwise opens up avenues for abuse.

The report identifies several "red flags" that could signal a potentially abusive equity swap transaction or stock loan, including: a transaction that occurs over a short period of time; dividend-equivalent payments in excess of 70% of the gross dividend; fees tied to tax savings; whether shares of the dividend paying stock are sold and then reacquired after the dividend is paid; sham market sales; coordination of stock sales to minimize risk; use of an offshore company as an intermediary in stock loans; and whether a U.S. financial institution party to a transaction considers not withholding U.S. taxes a tax risk and sets a limit on its exposure.

The report recommends that legislation be enacted to make dividends, dividend equivalent payments, and substitute dividend payments equally taxable as dividends, and that the IRS take action against taxpayers engaging in abusive transactions such as the ones described in the report. The report further recommends that Treasury issue new regulations providing that dividend-equivalent payments under a swap are taxable to the same extent as dividends and to issue new regulations addressing the impact of the Notice.

MoFo in the News

On September 11, 2008, Morrison & Foerster hosted a seminar on covered bonds entitled "Up Next: Covered Bonds." Speakers from across the industry discussed the breakdown of the loan origination and securitization model, and whether and how "covered bonds" have made headway as an alternative for the mortgage industry. In general, a covered bond is an instrument, backed by a senior loan obligation, that has recourse both to the issuing entity and a cover pool of mortgages. Morrison & Foerster partner Anna Pinedo discussed the importance of a contractual framework for creating high quality, transparent vehicles for the issuance of covered bonds in the United States, given that a statutory framework currently does not exist. Aaron Palmer from Blake, Cassels & Graydon LLP discussed structural issues and regulatory hurdles that Canadian banks have encountered in tapping the covered bonds market in Europe. Partner Oliver Ireland from Morrison & Foerster discussed bank regulatory issues, including the impact of the new interim-final FDIC policy statement permitting expedited access to collateral as well as the Treasury best practices suggesting parameters with which covered bond structures should comply. Huxley Somerville from Fitch Ratings provided a synopsis of the methodology used in rating covered bonds, including accounting for the issuer's default rating and a discussion of discontinuity factor compositions, including elements such as asset segregation, liquidity gaps and oversight issues. From a federal income tax standpoint partner Thomas Humphreys of Morrison & Foerster described the covered bonds structure as a simple back-to-basics model. High quality mortgages remain on balance sheet thus avoiding the perceived defect in the securitization model, where mortgages are shifted off-balance sheet and consequently dilute issuer accountability. A covered bond issuer (typically a trust) is treated as a transparent entity for tax purposes and holders of the covered bonds (otherwise, the owners of the trust) are treated as owning their pro rata share of the trust's assets and pick up income as the trust assets make payments.

On September 4 and 5, the New York Society of Security Analysts hosted a program entitled "Concentrated Stock Management Workshop: Making Order Out of Complexity." The program covered various issues that arise when managing the risk of a client's concentrated stock position, including: taxation of financial instruments, securities law, margin rules, contract law, derivatives risk modeling, and behavioral finance. In attendance were numerous wealth and portfolio managers, chief investment officers, risk management professionals, accountants, and lawyers. The program was led by Thomas J. Boczar, a co-managing partner of Hallmark Capital, who emphasized best practices that would allow professional advisers to create the most advantageous strategy for a particular client while satisfying their fiduciary duties. Panelists during the program included partner Thomas Humphreys from Morrison & Foerster who addressed the application of the tax treatment of derivatives to various monetization and hedging strategies, including options, forward contracts and convertible securities strategies, among many others.

On September 22 and 23, Morrison & Foerster co-sponsored Structured Products West Coast USA 2008, a two-day conference held in San Francisco. The conference addressed a wide range of issues relating to the design and marketing of structured products with a special emphasis on legal and regulatory issues. Speakers evaluated industry-wide developments, addressed structured fund products and platforms for issuing exchange traded structured products, and highlighted the issues that arise in the design of tax-efficient products. The target audience included distributors of products, compliance officers, financial advisors, and attorneys. Lecturers included Morrison & Foerster partners Thomas Humphreys and Shamir Merali, who ran an extended boot camp on tax considerations related to structured products. The presentation provided insight into the tax classification of structured products and a critical look at design parameters that affect the characterization and proper tax treatment of structured products. Mr. Humphreys and Mr. Merali also explored the tax differences between structured notes and comparable alternative investments and examined current developments relating to ETNs, ETFs, prepaid forwards contracts, mutual funds and fund linked products.

The Learning Annex: Options Pricing and the Taxation of Derivatives

Abusive derivatives strategies employed to deliver or eliminate economic exposure to an underlying asset without acquiring or disposing of ownership of the asset for tax purposes were substantially curtailed by the enactment of Section 1259 (discussed below) and Section 1260 in the late 1990s (for coverage of Section 1260, see MoFo Tax Talk Volume 1, Issue 2). These anti-abuse provisions are triggered by strategies that deliver or eliminate “substantially all” of the economic exposure with respect to an underlying financial asset. What constitutes “substantially all” for tax purposes, and how to measure it? Where options pricing is an available technique (*e.g.*, in the case of publicly traded stock), it provides one accepted methodology for measuring when a strategy runs afoul of the tax laws.

Suppose that a taxpayer owns Google common stock (ticker: GOOG) with a low basis. Taxpayer now is bearish on the stock and wishes to eliminate exposure to the stock to the maximum extent possible without triggering a taxable gain. One way to do this is to enter into the following options strategy: sell a call option and simultaneously acquire a put option on the shares. Taxpayer would entirely eliminate exposure by selling an at-the-money call option and buying an at-the-money put option. In that event, however, Section 1259 would undoubtedly apply because that strategy results in a “constructive sale” of the Google stock (generally, a derivatives strategy that eliminates “substantially all” of a taxpayer’s risk of loss and opportunity for gain). As an alternative, therefore, the taxpayer instead sells an out-of-the-money call option and buys an out-of-the-money put option. How, though, to set the strikes in a manner that would avoid application of Section 1259?

An illustration of one options pricing approach initially suggested by the New York State Bar Association in its report addressing Section 1259, a measure of the aggregate opportunity for gain with respect to the Google stock is measured by the premium of an at-the-money call option on the stock; a measure of the aggregate risk of loss with respect to the stock is the premium of an at-the-money put option; and a measure of the total economic exposure with respect to the stock is the sum of the two. Further, a measure of the upside exposure retained by selling an out-of-the-money call option rather than an at-the-money call option is the difference between the premium of the at-the-money call option and the out-of-the-money call option. Finally, a measure of the retained risk of loss by buying an out-of-the-money put option rather than an at-the-money put option is the difference between the premium of the at-the-money put option and the premium of the out-of-the-money put option. Generally, if the value of the sum of the retained opportunity for gain and the retained risk of loss represents more than 20% of the total economic exposure (i.e., the sum of the premiums of an at-the-money call and put option with the same exercise price and date), many practitioners conclude that the taxpayer has not eliminated “substantially all” of the opportunity for gain and risk of loss with respect to the stock and, accordingly, that Section 1259 should not apply to the strategy.

In late September, GOOG was trading at approximately $430. January 2010 options on GOOG were trading as follows: the $430 call was priced at approximately $95; the $430 put at $70; the $470 call at $70; and the $390 put at $50. Under the options pricing approach, a taxpayer that sold the $470 call and acquired the $390 put would have retained opportunity for gain and risk of loss equal to the sum of ($95 – $70) and ($70 - $50) or $45. The measure of total economic exposure is ($95 + $70) or $165. Thus the ratio of retained economic exposure to total economic exposure is roughly 27%. Under the options pricing approach discussed above, Section 1259 should not apply to this strategy.

Reporting Discharges of Debt

During the coming months borrowers and lenders may be expected to work out troubled loans that lie at the heart of the credit market turmoil, including cancelling or discharging loans in whole or in part. Certain cancellations and discharges may result in reporting obligations under U.S. federal income tax law. A cancellation or discharge is generally required to be reported on IRS Form 1099-C by a financial institution or any organization that is engaged in the business of lending money. However, a reporting obligation exists only upon occurrence of an "identifiable event." An identifiable event includes discharge of indebtedness in a bankruptcy proceeding; cancellation of debt that renders the debt unenforceable in a receivership, foreclosure, or probate proceeding; cancellation of debt upon the expiration of the statute of limitations for collection or pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection; discharge of debt pursuant to an agreement between lender and debtor to discharge debt at less than full consideration, or pursuant to a decision by a creditor to discontinue collection. Absent the occurrence of an identifiable event, no reporting obligation exists. Further, where reporting is required, only the discharge of stated principal must be reported. This rule, one of administrative convenience, was enacted because lenders generally do not track interest, penalties, fees, administrative costs and fines once debt is written off on the books of the lender.

Interesting issues arise with respect to the discharge or cancellation of non-recourse debt and with respect to modifications of debt. If a borrower abandons property that secures his non-recourse loan, the borrower is treated as having sold or exchanged the property for an amount equal to the amount of the non-recourse debt. Query, then, whether, even though the abandonment is treated as a sale or exchange for tax purposes, the financial institution nonetheless has a reporting obligation. The IRS seems to think that there is no difference between recourse and non-recourse debt and that reporting should be required. Also, certain modifications of debt instruments may result in a deemed taxable exchange of the debt instruments for U.S. federal income tax purposes. Consequently, a modification of a debt instrument may result in a discharge of indebtedness. Should such a modification be reported on Form 1099-C? It seems that the market has taken the position that no reporting is necessary in the case of modification of debt instruments. However, given the potentially high level of loan modifications, it is not impossible that the IRS may give the issue some attention in the foreseeable future.

Focus on Withholding

On August 7, 2008, the IRS provided guidance to IRS agents on conducting audits of U.S. withholding agents in a chapter added to the Internal Revenue Manual entitled "U.S. Withholding Agent Examinations – Form 1042." Generally, a withholding agent is any person, U.S. or foreign, that has control or custody over an item of income of a foreign person subject to withholding. Form 1042 is used by a withholding agent to report any taxes withheld. The new guidance does not address audits of "qualified intermediaries" (generally persons that have entered into an agreement with the IRS governing their withholding obligations and procedures). However, it does instruct IRS agents to focus on both financial institutions and on non-financial institutions that are withholding agents. The IRS identifies the following areas for particular scrutiny: REITs; original issue discount; securities loans; repurchase agreements; notional principal contracts; syndicated loans; portfolio interest; foreign targeted bearer obligations, and registered debt obligations. The guidance advises IRS agents to begin their audits with a review of written procedures and training manuals including summaries of withholding tax systems, system flow charts covering payments made to account holders, internal control and audit reports, manuals relating to procedures for opening accounts, validation procedures for IRS Forms W-8, procedures for classifying undocumented accounts, and the application of certain presumption rules contained in applicable withholding regulations. The IRS has stated it aims to achieve 100% audit coverage with respect to all filers of Form 1042. Finally, the guidance advises IRS agents to review domestic backup withholding practices if they encounter problems with respect to foreign withholding obligations. It is therefore more critical than ever that withholding agents be aware of their obligations under the U.S. federal income tax laws, have adequate internal systems in place, and fully comply with all withholding obligations. Chances of an audit on these issues are on the rise.

MORRISON | FOERSTER

Press Corner

The auction rate market all but froze earlier this year and the legal fallout continues. As widely reported in the financial press, federal and state regulatory investigations into whether Wall Street banks misstated the stability of the auction rate market to its investors, who were not forewarned about the risk that the auction rate market could become illiquid, have led to civil and criminal actions. UBS, Morgan Stanley, and Citigroup have agreed to pay out of court settlements to avoid further probes. Merrill Lynch has offered to preemptively buy back the failed securities from retail customers during a period beginning as early as October 1, 2008. It is worth pointing out that some banks may end up losing less than the amount of their settlement on an after-tax basis. Under current tax rules, a taxpayer is allowed to deduct the cost of paying investors that have suffered losses. A recent piece in the tax press ("Settlements With Banks Raise Deductibility Questions," Tax Notes Today August 22, 2008) suggests that payments to municipal investors on auction rate securities may be deductible, pointing out that businesses in the past have argued certain penalties are "remedial" in nature rather than "punitive" and thus deductible. Some muse that there is a prejudice in the tax rules in favor of a deduction because most anything a business does is in the ordinary course of business.

Also in the news, recent developments that demonstrate that even tax legislators can get it wrong. Congressman Charles B. Rangel, the Chair of the House Ways and Means Committee and writer of many a piece of tax legislation, confirmed that he had failed to report as much as $75,000 in rental income related to a beach house investment in the Dominican Republic. The investment was such that the rental income would defray the mortgage payments made on the villa, with no cash rental proceeds provided to Mr. Rangel. Under general tax rules, Mr. Rangel is required to report the rental proceeds as being paid to Mr. Rangel, and in turn used to pay off the mortgage. Because the villa is considered investment property, rather than a vacation home, an interesting question arises as to whether Mr. Rangel is able to deduct depreciation on the property. The tax law limits deductions of expenses related to the rental of a dwelling unit that is also used as a residence during the tax year. A taxpayer uses a dwelling unit as a residence if it is used for personal purposes for a number of days exceeding the greater of 14 days or 10% of the days in which the dwelling unit is rented at fair value. Mr. Rangel has stated that he did not realize he had to declare the money as income and was unaware of the rental payments, given that villa-resort sent income statements intermittently. The House Committee on Standards of Official Conduct is investigating the matter.

Contacts

United States Federal Income Tax Law

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

Shamir Merali
(212) 336-4149
smerali@mofo.com

Corporate and Securities Law

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

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

About Morrison & Foerster

With more than 1000 lawyers in 17 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.