Morrison & Foerster Quarterly News
Volume 4, No. 2 July 2011

TaxTalk

IN THIS ISSUE

Editor's Note

Just as we were going to press bemoaning the impending January 1, 2013 effective date of the Foreign Account Tax Compliance Act ("FATCA"), the Internal Revenue Service ("IRS") and Treasury Department ("Treasury") announced an extension of the new provisions' withholding and reporting requirements. We cover this "breaking news" in this issue along with other recent FATCA guidance. In other breaking news, we provide a brief summary of the tax provisions of the so-called "Gang of Six" deficit reduction plan. We also cover *Merck & Co., Inc. v. U.S.*, in which the U.S. Court of Appeals for the Third Circuit ("Third Circuit") affirmed the U.S. District Court's denial of a refund claim with respect to the taxpayer's assignment of interest rate swaps to its foreign subsidiaries in exchange for lump sum payments. Further, we cover the IRS's temporary suspension of information reporting requirements enacted under the Hiring Incentives to Restore Employment Act (the "HIRE Act"). Finally, our regular features – Press Corner and MoFo in the News – are also included.

Authored and Edited By

Thomas A. Humphreys

Anna T. Pinedo

Stephen L. Feldman

Arthur Man

Remmelt A. Reigersman

Jared B. Goldberger

(Continued on page 2)

IRS Announces Phased Implementation of FATCA

The IRS and Treasury announced a phase-in schedule that effectively delays implementation of FATCA[1] for one year, and in some cases, until 2015. Notice 2011-53[2] will likely be welcomed by foreign financial institutions ("FFIs"); however, it does not change the basic structure of the FATCA regime, which is designed to enlist FFIs in the hunt for non-compliant U.S. taxpayers.

Participating FFIs

FATCA is constructed around the FFI Agreement, which requires an FFI to provide the IRS with information about its U.S. account holders. Notice 2011-53 announces that the IRS will begin accepting applications for FFI Agreements from FFIs through its electronic submissions process no later than January 1, 2013. In order to avoid potential withholding tax when FATCA withholding begins on January 1, 2014 (under the one-year delay in the Notice), an FFI Agreement must be entered into by June 30, 2013. The June 30, 2013 deadline is designed to make sure there is enough time to allow the relevant FFI to be identified as a "participating FFI" by January 1, 2014. FFIs applying after June 30, 2013, are not assured they will be "in the system" as of January 1, 2014, and therefore may be subject to FATCA withholding when it is initially implemented. Notice 2011-53 also provides that the effective date of an FFI Agreement entered into any time before July 1, 2013, will be July 1, 2013, and that the effective date of an FFI Agreement entered into on or after July 1, 2013, will be the date the FFI enters into the FFI Agreement. Among other things, the effective date is relevant for the application of the due diligence procedures described in the following paragraph.

In previous published guidance, due diligence procedures[3] were provided in order for FFIs to identify U.S. accounts. Notice 2011-53 provides a phased implementation for these due diligence procedures based on the type of account at issue. For all accounts (i) that were opened prior to the effective date of the FFI's FFI Agreement, (ii) that are associated with a private banking relationship, and (iii) that have a balance/value of at least $500,000 as of the FFI Agreement's effective date, a participating FFI is required to have completed the due diligence procedures within one year of its FFI Agreement's effective date. A participating FFI has until December 31, 2014, or one year following its FFI Agreement's effective date, to implement due diligence procedures for those private banking accounts with a balance/value of less than $500,000 as of the FFI Agreement's effective date. For all other preexisting accounts, a participating FFI has two years from its FFI Agreement's effective date to implement due diligence procedures. Thus, rather than requiring due diligence procedures to be effective on January 1, 2013, as many FFIs initially feared, Notice 2011-53 grants participating FFIs additional time to implement such procedures in order to properly, and effectively, identify U.S. accounts.

Reporting

FATCA's main focus is on information reporting between FFIs and the IRS. While prior guidance provided information reporting procedures,[4] Notice 2011-53 acknowledges the challenges ahead for FFIs and loosens the information reporting requirements for a participating FFI's initial year of reporting. For those accounts for which a participating FFI has received a Form W-9 from the account holder by June 30, 2014, such account must be reported to the IRS as a "U.S. account" by September 30, 2014. A participating FFI is only required to report the following information for the initial year of reporting: (i) the name, address, and U.S. TIN of each specified U.S. person who is an account holder, and in the case of any account holder that is a U.S.-owned foreign entity, the name, address, and U.S. TIN of each substantial U.S. owner of such entity; (ii) the account balance as of December 31, 2013 (or, if the account was closed after the FFI Agreement's effective date, the account balance immediately before its closure); and (iii) the account number.

Withholding

To the surprise of many, rather than requiring withholding procedures to commence on FATCA's January 1, 2013 effective date, Notice 2011-53 states that regulations will implement such withholding procedures in a delayed, two-phase approach. In phase one, withholding agents (including domestic, foreign, and participating FFIs) will be required to withhold *only* on U.S. source FDAP[5] payments made on or after January 1, 2014. In phase two, withholding agents will be required to withhold on *all* withholdable payments made on or after January 1, 2015, including "gross proceeds," e.g., proceeds from sales of securities. Also, participating FFIs will not be required to withhold with respect to passthru payments[6] made before January 1, 2015. Thus, Notice 2011-53 provides participating FFIs and withholding agents an additional one to two years, depending on the source of the payment, to commence withholding.

"Grandfathered Obligations"

Unrelated to the phased implementation of FATCA, Notice 2011-53 also discusses "grandfathered obligations."[7] Numerous comments and questions have been raised

1 FATCA was included in the HIRE Act. See our prior client alert discussing the FATCA provisions at http://www.mofo.com//files//Uploads/Images/100322FATCA.pdf.

2 See our prior client alert discussing Notice 2011-53 at http://www.mofo.com/files/Uploads/Images/110719-IRS-Announces-Phased-Implementation-of-FATCA.pdf.

3 Procedures are described in Step 3 of Section 1.A.2 of Notice 2011-34.

4 A participating FFI has the option to elect into the reporting requirements under section 1471(c)(2). All "section" references are to the Internal Revenue Code of 1986, as amended (the "IRC"), and Treasury Department regulations promulgated thereunder.

5 "FDAP" stands for "fixed, determinable, annual, or periodical" income or payments and includes interest and dividends.

6 As explained in Notice 2011-34, passthru payments include (i) any withholdable payment and (ii) other payments to the extent attributable to a withholdable payment.

7 The HIRE Act provided that there shall not be any amount deducted or withheld from any payment under any obligation outstanding on March 18, 2012, or from the gross proceeds of any disposition of such an obligation.

(Continued on Page 3)

Phased Implementation of FATCA

(Continued from Page 2)

regarding "obligations" and the Notice states that the term "obligation" will be clarified in future regulations as meaning any legal agreement that produces or could produce passthru payments (including withholdable payments), but not including any instrument treated as equity for U.S. tax purposes, or any legal agreement that lacks a definitive expiration or term. The Notice clarifies that a withholdable payment does, in fact, include passthru payments.

Next Steps

The Notice provides that proposed regulations incorporating guidance provided in Notice 2010-60, Notice 2011-34, and Notice 2011-53 will be published prior to the end of 2012. Final regulations are currently planned to be published in the summer of 2012, along with an FFI Agreement and reporting forms for use by withholding agents and participating FFIs.

The Gang of Six

The Gang of Six (Democratic Senators Mark Warner (VA), Dick Durbin (IL), and Kent Conrad (ND); and Republican Senators Saxby Chambliss (GA), Mike Crapo (ID) and Tom Coburn (OK)) has been meeting in secret since the spring on a "large plan" to reduce the federal deficit and reform federal finance. Building on the findings of the Simpson Bowles Report,[8] an outline of the Gang of Six Plan has been circulating in Washington. On July 19, President Obama endorsed the Gang of Six plan. The federal income tax elements of the plan would require the Senate Finance Committee to report tax reform within six months that would "deliver real deficit savings by broadening the tax base, lowering tax rates, and generating economic growth" as follows:

- Simplify the tax code by reducing the number of tax expenditures and reducing individual tax rates, by establishing three tax brackets with rates of 8–12 percent, 14–22 percent, and 23–29 percent.
- Permanently repeal the $1.7 trillion Alternative Minimum Tax.
- Reform, not eliminate, tax expenditures for health, charitable giving, homeownership, and retirement, and retain support for low-income workers and families.
- Retain the Earned Income Tax Credit and the Child Tax Credit, or provide at least the same level of support for qualified beneficiaries.
- Maintain or improve the progressivity of the tax code.
- Establish a single corporate tax rate between 23 percent and 29 percent, raise as much revenue as the current corporate tax system, and move to a competitive territorial tax system.

Of course, tax bills must originate in the House of Representatives and it remains to be seen how the House will react to the Gang of Six Plan or whether any part of the Gang of Six Plan will become part of a deal on the Federal budget limit.

[8] See MoFo Tax Talk Volume 3, No. 4.

IRS Issues Supplemental Guidance on FATCA Reporting and Withholding Requirements

Prior to the issuance of Notice 2011-53, the IRS and Treasury issued supplemental FATCA reporting and withholding guidance in Notice 2011-34.[9] Notice 2011-34 addresses seven areas of concern with respect to FFIs, including (1) the procedures to be followed by FFIs in identifying U.S. accounts among their preexisting individual accounts, (2) the definition of the term "passthru payment," (3) certain categories of FFIs that will be deemed compliant, (4) reporting obligations on U.S. accounts, (5) requirements for FFIs that are Qualified Intermediaries ("QIs"), (6) the requirements for expanded affiliated groups of FFIs, and (7) the effective date of FFI Agreements.

Preexisting Individual Accounts

In the case of "preexisting individual accounts,"[10] the FFI is required to determine whether such accounts are to be treated as (1) U.S. accounts, (2) accounts of recalcitrant account holders ("recalcitrant accounts"), or (3) accounts that are other than U.S. accounts ("non-U.S. accounts"). Notice 2011-34 provides six procedures to assist the FFI in this determination. The steps to be taken in this process are as follows:

Step 1: Account holders documented as U.S. persons for other U.S. tax purposes will be treated as holding U.S. accounts. However, unless the FFI elects otherwise, an account is a non-U.S. account if (i) the account is a depository account; (ii) each holder is a natural person; and (iii) the balance at the end of the year preceding the FFI Agreement's effective date does not exceed $50,000 (or the equivalent foreign currency).

Step 2: Accounts not identified as U.S. accounts pursuant to Step 1 may be treated as a non-U.S. account if the balance at the end of the year preceding the FFI Agreement's effective date does not exceed $50,000 (or the equivalent foreign currency). The FFI may elect out of applying this step.

Step 3: Notice 2011-34 provides detailed

[9] The IRS and Treasury had previously published preliminary guidance in Notice 2010-60, issued on August 27, 2010, regarding (1) the grandfather provision, (2) the definition of an FFI, (3) the scope of required information collection and identification of persons by FFIs, and (4) the manner and type of information that FFIs must provide to the IRS with respect to U.S. accounts. See our prior client alert discussing Notice 2010-60 at http://www.mofo.com/files/Uploads/Images/100910FACTA.pdf.

[10] A "preexisting individual account" is defined as any financial account held by an individual as of the date that an FFI Agreement becomes effective.

(Continued on Page 4)

Supplemental FATCA Guidance

(Continued from Page 3)

guidelines with respect to private banking accounts[11] maintained by the FFI that are not categorized as a U.S. or non-U.S. account pursuant to Step 1 or 2. The Notice gives relationship managers at private banks the responsibility of finding indicia of U.S. accounts.

Step 4: If an account has not yet been identified as a U.S. account, non-U.S. account, or private banking account pursuant to Steps 1 through 3, the FFI must determine whether an account has specified U.S. indicia from electronically maintained information. For those accounts that contain U.S. indicia, the FFI is required within one year of the effective date of its FFI Agreement to request certain documentation to establish whether such account is a U.S. account.

Step 5: The FFI must review high value accounts (accounts with a balance of $500,000 or more at the end of the year preceding the effective date of the FFI Agreement) with respect to accounts that have not been categorized under Steps 1 through 4. To the extent such accounts contain U.S. indicia, the FFI must obtain certain documentation within two years following the effective date of its FFI Agreement. Account holders that do not provide appropriate documentation will be classified as "recalcitrant account holders."

Step 6: For those accounts that did not previously meet the requirements to be treated as high value accounts but would have been treated as high value accounts based on the account balance on the last day of the preceding year, the FFI is required to apply the high value account procedure annually, commencing the third year following the effective date of its FFI Agreement. Those accounts identified as high value accounts under this retesting process will be treated as recalcitrant if required documentation is not provided by the end of the identified year.[12]

Passthru Payments

Notice 2011-34 provides guidance regarding the obligation of an FFI to withhold on a passthru payment. An FFI is required to deduct and withhold 30 percent of any passthru payment made to a recalcitrant account holder or non-participating FFI. As previously mentioned, a passthru payment includes (i) any withholdable payment, and (ii) other payments to the extent attributable to a withholdable payment. The purpose of this rule is to encourage FFIs to enter into FFI Agreements (without such a rule, it may be possible for non-participating FFIs to hold indirect U.S. investments through participating FFIs without being subject to a withholding tax while avoiding entering into an FFI Agreement).

Deemed-Compliant Status for Certain FFIs

Notice 2011-34 provides that certain categories of FFIs will be deemed compliant with the requirements of FATCA. An FFI that is deemed compliant must (i) apply for deemed-compliant status with the IRS, (ii) obtain an FFI identification number from the IRS, and (iii) certify every three years that it meets the requirements for deemed-compliant treatment. The IRS and Treasury intend to issue regulations addressing deemed-compliant FFIs in an expanded affiliated group.[13]

Reporting on U.S. Accounts

Notice 2010-60 provided preliminary guidance regarding the manner and type of information FFIs would be required to report with respect to their U.S. accounts. Notice 2011-34 indicates that the IRS and Treasury intend to issue regulations limiting FFIs' account balance reporting obligations to year-end account balances or values, and that an FFI must annually report the following information with respect to a U.S. account: (i) the gross amount of dividends paid or credited to such account, (ii) the gross amount of interest paid or credited to such account, (iii) other income paid or credited to such account, and (iv) gross proceeds from the sale or redemption of property paid or credited to such account with respect to which the FFI acted as custodian, broker, nominee, or otherwise as an agreement for the account holder. As discussed above, Notice 2011-53 mitigates certain FFI reporting requirements for a participating FFI's initial year of reporting.

In the case of a U.S. account that is an equity or debt interest in the FFI, the FFI will be required to report with respect to such interest, the gross amount of: (i) all distributions, interest, and similar amounts credited during the year, and (ii) each redemption payment made during the year. The IRS and Treasury intend to issue additional guidance with respect to reporting tax basis information for FFIs that are not U.S. payors and branch and affiliate reporting for FFIs that do not elect branch-by-branch reporting.

Requirements for QIs

Since QIs that are FFIs will be subject to the FATCA requirements in addition to the existing reporting and other requirements imposed on QIs, the IRS and Treasury intend to issue guidance requiring all FFIs currently acting as QIs to consent to include in their QI agreements the requirement to become participating FFIs (unless it is deemed-compliant).

Withholding, Reporting, and Other Requirements Regarding Expanded Affiliated Groups of FFIs

FATCA provides that the withholding, reporting, and other requirements imposed on an FFI shall apply with respect to U.S. accounts maintained by the FFI,

(Continued on Page 5)

11 These are generally accounts maintained or serviced by an FFI's private banking department.

12 Completion of annual retesting (i.e., Step 6) is not required to be certified to the IRS by the chief compliance officer.

13 Defined as "an 'affiliated group' as defined by section 1504(a), determined by substituting 'more than 50 percent' for 'at least 80 percent' in each place it appears in section 1504(a) and without regard to paragraphs (2) and (3) of section 1504(b)." A partnership or any other entity (other than a corporation) is treated as a member of an expanded affiliated group if such entity is controlled (within the meaning of section 954(d)(3)) by members of such group (including any entity treated as a member of such group by reason of this rule).

Supplemental FATCA Guidance

(Continued from Page 4)

including U.S. accounts maintained by each other FFI that is a member of the same expanded affiliated group that includes the FFI. The IRS and Treasury intend to issue regulations requiring each FFI included in the affiliated group to be either a participating or deemed-compliant FFI. This would be achieved through a coordinated application, rather than individual, process. The FFI affiliated group will designate a "lead FFI" to execute the FFI agreement for all participating FFIs and certifications for deemed-compliant FFIs.

Effective Date of FFI Agreements

Notice 2011-34 provides that FFI Agreements will become effective on the later of (i) the date they are executed, or (ii) January 1, 2013. However, as discussed above, Notice 2011-53 extends that deadline.

IRS Temporarily Suspends Information Reporting Requirements

Apart from FATCA, the HIRE Act added two information reporting requirements under sections 6038D and 1298(f). Section 6038D, which addresses information reporting requirements with respect to Foreign Financial Assets, applies to taxable years beginning after March 18, 2010. Any individual who, during the taxable year, holds an interest in any "specified foreign financial asset" is required to attach to his income tax return for the taxable year certain required information with respect to each specified foreign financial asset if the aggregate value of all of the individual's specified foreign financial assets exceeds $50,000.[14] Section 1298(f), also effective as of March 18, 2010, requires U.S. persons who are shareholders of a passive foreign investment company ("PFIC") to file an annual report containing information as required by Treasury.

On June 21, 2011, the IRS issued guidance (Notice 2011-55) suspending information reporting requirements under sections 6038D and 1298(f) for tax years beginning after March 17, 2010, until the IRS releases Form 8938, "Statement of Foreign Financial Assets," and revises Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund." In addition, the IRS and Treasury intend to issue regulations under sections 6038D and 1298(f). Both Forms 8938 and 8621 will be issued/revised to reflect the requirements of the respective IRC sections. An individual required to report an interest in one or more specified foreign financial assets under section 6038D will be required to attach Form 8938 to the individual's income tax return for the taxable year to report the required information. A PFIC shareholder required to report information under section 1298(f) will be required to attach the revised Form 8621 to the PFIC shareholder's income tax return or information return for the taxable year to report the required information.

As individuals with reporting requirements under sections 6038D and 1298(f) may have to file an income tax return for a taxable year prior to the IRS releasing Form 8938 or revised Form 8621, Notice 2011-55 suspends the reporting requirement to attach either Form to an income tax return before Form 8938 or revised Form 8621 are released. Following the release of Form 8938 or revised Form 8621, individuals and PFIC shareholders for whom the filing of Form 8938 or revised Form 8621 has been suspended under Notice 2011-55 for a taxable year will be required to attach Form 8938, Form 8621, or both, as appropriate, for the suspended taxable year to their next income tax or information return required to be filed with the IRS.

[14] Section 6038D(a).

Third Circuit Affirms *Schering-Plough Corp.* Ruling in *Merck & Co., Inc. v. U.S*

In *Schering-Plough Corp. v. United States*,[15] the U.S. District Court for the District of New Jersey ("District Court") denied Schering-Plough Corp. ("Schering") a refund claim of nearly $500 million in taxes and interest with respect to its assignment of interest rate swaps to its foreign subsidiaries in exchange for lump sum payments.[16] On June 20, 2011, the Third Circuit affirmed the District Court's decision in *Merck & Co., Inc. v. U.S.*[17]

Background

In 1991 and 1992, Schering, an international pharmaceutical company, entered into two 20-year interest rate swap transactions with Algemene Bank Nederland, N.V. ("ABN"), a Dutch bank. Under the swaps, Schering and ABN agreed to make periodic payments based on different floating rate interest rate indices with respect to a specified notional amount. To hedge their exposure, both ABN and Schering entered into "mirror swaps" with an investment bank. After entering into the swaps, Schering assigned the majority of its rights to receive payments from ABN with respect to years 6 – 20 to two of its foreign subsidiaries in exchange for lump-sum payments, totaling approximately $690 million. Relying on Notice 89-21, advice of outside counsel, its financial advisors, and accountants, Schering amortized the lump-sum payments received over the period to which the future income streams had been assigned (i.e., over 15 years),

[15] *Schering-Plough Corp. v. United States*, 651 F.Supp.2d 219 (D.N.J. Aug. 28, 2009).

[16] See MoFo Tax Talk Volume 2, No. 3 for a detailed discussion of the district court case.

[17] *Merck & Co. Inc. v. United States*, No. 10-2775, 3d Cir. June 20, 2011. During the course of the action, Schering purchased Merck, Inc., and the combined entity is currently known as Merck. For the sake of consistency, we shall continue to refer to the petitioner as Schering.

(Continued on Page 6)

Schering-Plough Corp. Ruling

(Continued from Page 5)

thereby deferring its income tax liability with respect to those payments to that extent. Economically, Schering had repatriated approximately $690 million from its two foreign subsidiaries to the United States. Had Schering received either a dividend or a loan from its foreign subsidiaries, Schering would have had to include the amount of such dividend or loan in its taxable income when received. Section 956 of the Code generally requires the U.S. parent of a controlled foreign corporation ("CFC") to include in its gross income the amount of a loan from the CFC to the parent to the extent of the CFC's earnings and profits.

District Court

In the District Court, the IRS argued that the "swap-and-assign" transactions (the "transactions") were in substance loans and that Schering should include the appropriate amount in its income in the years it entered into the transactions instead of amortizing its income inclusions over 15 years. The District Court agreed with the IRS and applied the substance-over-form doctrine, concluding that the transactions, in substance, constituted loans by the foreign subsidiaries to Schering. The District Court compared the transactions, where the amounts of the lump-sum payments were determined by reference to the present value of the future income streams, to home mortgage loans, in which the lender makes an upfront payment in return for periodic principal and interest payments. The District Court also determined that the transactions lacked economic substance.

Third Circuit

On appeal, Schering argued, as it did in the District Court, that the transactions were not loans, in substance, and the reporting of the transactions complied with Notice 89-21 – therefore, the lump sum payments it received from its foreign subsidiaries did not currently constitute taxable income but could be amortized into income over the life of the contract. To determine whether he District Court accurately characterized the transactions as loans, resulting in the inapplicability of Notice 89-21, the Third Circuit first applied the substance-over-form doctrine, analyzing both the objective characteristics of the transactions and the parties' intentions. The Third Circuit found that Schering, along with other parties involved in the transactions, treated the transactions as loans. The Third Circuit stated that "there is meaningful indirect evidence that the parties knew they were creating a loan and thus seeking to evade taxation on the repatriated funds."[18] The more difficult question addressed by the Third Circuit was whether the transactions had the objective economic attributes of loans. In determining whether there was an "unconditional obligation" on Schering's part to repay the amount the Swiss subsidiaries advanced, the Third Circuit found that the transactions were planned to provide ultimate repayment to the subsidiaries.[19] It discounted (some would say ignored) the fact that, had the Federal Funds rate dropped precipitously over the swap term, Schering's foreign subsidiary would not have received back the entire amount advanced.[20] Moreover, it quickly dispatched Schering's argument that third-party involvement prevented the transactions from being characterized as loans. The Third Circuit affirmed the District Court's ruling, holding that the transactions were in substance loans. However, it did not reach the District Court's alternative conclusion that the transactions lacked economic substance. Thus, the case can now be added to the few authorities holding that a transaction can be a loan even though there is no legal obligation to repay the principal amount. Unfortunately, the court paid so much attention to bad facts (basically that Schering entered into the transaction predominately for tax avoidance reasons) that it is hard to tell whether this conclusion can or should be applied in a broader context.

[18] *Id.*

[19] Both Schering's assistant treasurer and expert testified at trial that Schering had expected the subsidiaries to recover their principal.

[20] Evidence was presented that, had the Fed Funds rate gone below 2.93 percent, the advance would not have been repaid. Right now, the Fed Funds rate is 0.10 percent.

Temporary and Proposed Regulations Issued on Transfer and Assignment of Derivative Contracts

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), certain books of derivative contracts must be transferred to other dealers. For federal income tax purposes, gain or loss is recognized upon the exchange of property for other property differing materially either in kind or extent. Therefore, the nonassigning counterparty to any derivative contracts subject to a transfer may be treated as recognizing gain or loss. Since existing Treasury regulations only address the transfer and assignment of derivatives that qualify as "notional principal contracts" for federal income tax purposes, many in the public commented that such regulations were too narrowly drawn, especially for the post-Dodd Frank world. In response to these comments, the IRS has expanded the regulations by issuing temporary and proposed regulations addressing the transfer and assignment of a broader set of derivative contracts.[21]

The newly issued temporary and proposed Treasury regulations expand the current regulations by providing that there is no exchange to the nonassigning counterparty for federal income tax purposes, provided (i) both the transferring or assigning party and the party to which the rights and obligations are transferred or assigned are either a dealer or a clearinghouse, (ii) the terms of the derivative contract permit the transfer or assignment of the contract (whether or not the consent of the nonassigning counterparty is required for the transfer or assignment to be effective), and (iii) the terms of the derivative contract

[21] Treasury regulation section 1.1001-4T.

(Continued on Page 7)

Temporary Regulations

(Continued from Page 6)

are not otherwise modified in a manner that results in a taxable exchange. The definition of derivative contract has been expanded to not only include notional principal contracts but also an interest in, or a derivative financial instrument in, stock, a partnership, note, bond, other evidence of debt or certain hedges. In addition, if any consideration passes between the assignor and assignee in connection with the transfer or assignment, this will not affect the treatment of the nonassigning counterparty.

Press Corner

The tax distinction between debt and equity has been a fundamental feature of the U.S. corporate tax system since its inception. Interest on debt is deductible, dividends on stock are not. In Washington, D.C., circa 2011, everything is on the table and this spring the media reported that legislators are examining whether the debt/equity distinction still makes sense. A joint hearing to discuss the IRC's treatment of debt versus equity, which commenced on July 13, included a presentation by the Joint Committee on Taxation on the tax treatment of both individual and corporate debt. House Ways and Means Committee Chairman Dave Camp (R-MI) and Senate Finance Committee Chairman Max Baucus (D-MT) said they will be interested in analyzing the differences between debt-financed and equity-financed investments, and their related tax consequences, in an effort to encourage job creation as Congress discusses overall tax reform legislation.[22]

Will the choice of a business entity become an easier decision in the near future? As Congress confronts the daunting task of reducing the federal deficit, Senator Baucus said that Congress will have to consider whether to tax at least certain passthru entities as corporations. "We're going to maybe have to look at [passthrus] – say they've got to be treated as corporations if they earn above a certain income. It's one possibility," Senator Baucus said on May 4, 2011. While a dollar threshold has been mentioned, Senator Baucus did not specifically discuss one (some lobbyists have suggested Treasury is discussing treating passthru entities with revenue of $50 million or more as corporations).

The taxation of passthru entities is not the only potential revenue-raiser being discussed. A document obtained by *Transportation Weekly* outlined the government's proposal to create a "Surface Transportation Revenue Alternatives Office" that would essentially study how much revenue the government could raise if motorists were taxed based on the amount they drive, sometimes called a VMT tax (taxing motorists based on "vehicle miles traveled"). The Obama Administration said it does not support the idea of a VMT tax. "This was an early working draft proposal that was never formally circulated within the administration, does not [take] into account the advice of the [p]resident's [senior advisors], economic team or Cabinet officials, and does not represent the views of the president."[23]

However, others in government are looking to cut taxes. Several House Republicans introduced legislation to repeal the 10 percent tax on tanning services that was levied to help pay for the new health-care law. The group of Republicans, lead by Reps. Michael Grimm (R-NY), Phil Roe (R-TN), and Pat Tiberi (R-OH), say "the tax slaps an onerous burden on thousands of small businesses and threatens the livelihood of their employees."[24]

The U.S. is not the only country where the introduction of new tax legislation is causing concern. Sweden has contemplated raising taxes on fat and unhealthy foods in an effort to address its obesity problem. The use of taxes in Sweden is a common way for government to combat problems, including tobacco, alcohol, and carbon dioxide. The Expert Group on Public Economics ("ESO"), a state-run organization that produces analyses for fiscal policy and socio-economic challenges in Sweden, acknowledged that the proportion of the population that is overweight, according to the World Health Organization definition, has doubled in the past 20 years. The Swedish government can fight this problem with the introduction of a tax on bakery products, added sugars, and saturated fats, according to an ESO study. We will have to wait and see whether such a tax is ever introduced in Sweden.[25]

MoFo in the News

Morrison & Foerster has been shortlisted with four other firms for the 2011 *Derivatives Week* Law Firm of the Year. We are recognized for our "wide-ranging transactional capabilities." The winner will be announced at an awards ceremony in London on September 27, 2011.

On April 12, 2011, MoFo partners Peter Green, Thomas A. Humphreys, and Anna Pinedo presented an in-house CLE titled "Bail-In Capital and Contingent Capital." Speakers discussed Basel III guidance on bail-in capital; interaction with various proposed resolution schemes; national guidance on bail-in capital; contingent capital products; market experience; tax considerations, ratings considerations, corporate governance, and other considerations relating to contingent capital; investor perspective; competitive issues arising in connection with contingent capital; SIFIs and GSIFIs, and contingent capital.

Kenneth Kohler presented at the IFLR European Capital Markets Forum 2011, on April 13 – 14, 2011. Ken sat on the securitization panel on the second day of the conference.

Alexandra Steinberg Barrage, Peter Green and Dwight Smith spoke in a teleconference about resolution authority on April 21, 2011. Speakers discussed resolution authority in the U.S. and EU.

On April 25, 2011, David Lynn and Anna Pinedo spoke at PLI's Global Capital Markets and the U.S. Securities Laws 2011: Strategies for the Changing Regulatory Environment conference. This program gave securities lawyers up-to-date information on international regulatory and market developments, bringing together a

[22] *See* "Hearing Scheduled on Debt-Equity Issues in Tax Code," 131 DTR G-12, Daily Tax Report, BNA (July 8, 2011).

[23] *See* "A Mileage Tax? Who Said Anything About A Mileage Tax?," by Joseph B. White, The Wall Street Journal, May 20, 2011.

[24] *See* "'Tan Tax' Might be Toast," by Patrick O'Connor, The Wall Street Journal, June 3, 2011.

[25] *See* "Does Sweden Have the Stomach for a Fat-Tax?," by Sven Grundberg, The Wall Street Journal, May 13, 2011.

(Continued on Page 8)

MoFo In the News

(Continued from Page 7)

lively mix of expert practitioners and senior regulators for an in-depth look at how the U.S. securities laws work in a global context, and the new environment of domestic and international financial reform.

David Lynn and Anna Pinedo also presented at PLI's Private Placements and Other Financing Alternatives 2011 conference on April 26, 2011. David and Anna analyzed current developments in private placements and hybrid financing transactions, including Private Investments in Public Equity (PIPEs), registered direct offerings, wall-crossed offerings, change-of-control transactions, and 144A offerings. They discussed the basics of private placements and other exempt offerings, as well as recent related regulatory reform and SEC developments involving exempt offerings. They discussed recent changes to Regulation D effected by the Dodd-Frank Act and more.

On April 26, 2011, May 10, 2011, and July 8, 2011, Lloyd Harmetz, Charles Horn, and Jerry Marlatt spoke at a West Legalworks webinar titled "Foreign Banks Financing in the United States." The presenters discussed how foreign banks are increasingly seeking to diversify their financing opportunities. With careful planning, foreign banks may access U.S. investors without subjecting themselves to the securities registration requirements applicable to public offerings and to ongoing disclosure and governance requirements applicable to U.S. reporting companies.

Kenneth Kohler presented at an ABA webinar titled "Securitization Reform: Dodd-Frank Changes the Rules," on April 27, 2011. The panel discussed a number of changes to securitization practice that Congress included in the Dodd-Frank Act to try to address perceived abuses and the regulations implementing these changes, including new rules requiring securitizers to retain a portion of the risk of losses on the financial assets (the so-called "skin-in-the-game" rule), conduct pre-offering reviews of the financial assets, and disclose to investors information revealed by such reviews. The panel also reviewed additional disclosures to investors regarding the characteristics of the financial assets and the representations and warranties on those assets provided by the ABS transaction documents, new disclosures with respect to demands for repurchases of financial assets relating to breaches of representations and warranties, and ongoing reporting requirements.

Peter Green, Jeremy Jennings-Mares, and David Trapani led a teleconference on the regulation of OTC derivatives on May 4, 2011. Speakers discussed regulations affecting OTC derivatives in both the U.S. and the EU.

Elana Hahn, Kenneth Kohler, and Jerry Marlatt led a teleconference on May 11, 2011, on regulations affecting the securitization market. Speakers discussed regulations affecting securitization in both the U.S. and the EU.

On May 16, 2011, Thomas A. Humphreys and Anna Pinedo led a West Legalworks webinar titled "Financing and Liability Management Developments for Financial Institutions." The webinar discussed how financial regulatory reform legislation requires federal banking agencies to establish minimum leverage and risk-based capital requirements. The legislation will effect a number of important changes for insured depository institutions and bank holding companies. Financial institutions also are evaluating the impact of the proposed Basel III framework on regulatory capital requirements. These changes will affect funding costs for financial institutions going forward. Banks should begin planning now and will be required to consider a number of alternatives.

Charles Horn, Jerry Marlatt, and Barbara Mendelson spoke at an Institute of International Bankers breakfast briefing on covered bond programs on May 24, 2011. The briefing provided practical advice on how foreign banks can access U.S. investors through section 3(a)(2) and rule 144A issuances of covered bonds.

On June 6, 2011, Thomas A. Humphreys, Kenneth Kohler, and Anna Pinedo presented at PLI's Financing and Liability Management Developments for Financial Institutions conference. The conference discussed how financial regulatory reform legislation requires federal banking agencies to establish minimum leverage and risk-based capital requirements. The legislation will effect a number of important changes for insured depository institutions and bank holding companies. Financial institutions also are evaluating the impact of the proposed Basel III framework on regulatory capital requirements. These changes will affect funding costs for financial institutions going forward. Banks should begin planning now and will be required to consider a number of alternatives.

Alexandra Steinberg Barrage, Barbara Mendelson, Larren Nashelsky, and Dwight Smith provided an in-house CLE on June 8, 2011, titled "Living Wills: A Blueprint for Action." The presenters discussed the living will requirements under the Dodd-Frank Act and a proposed rule from the Federal Reserve and the FDIC.

Peter Green, Jeremy Jennings-Mares, and Remmelt Reigersman led a teleconference on changes affecting U.S. issuers offering securities into the EU on June 9, 2011. Speakers gave an overview of recent and proposed changes to the regulatory framework in the EU that will have a major impact on the operation of the financial markets, including (i) the EU Commission's recent consultation paper proposing far reaching changes to the Market in Financial Instruments Directive ("MiFID"), (ii) the EU Commission's consultation paper in relation to packaged retail investment products ("PRIPS") which aims to provide consistency to the precontractual disclosure and point of sale regime for structured retail products, however they are structured, and (iii) recent amendments to the Prospectus Directive relating to securities offerings.

David Lynn joined a regulatory innovation roundtable on June 13, 2011. The keynote speaker was Eddy Wymeersch, winner of the Burton Morrison & Foerster 2011 Regulatory Innovation Award. Mr. Wymeersch was central to the formation of ESMA, the first pan-European regulatory authority. Following the keynote address, a panel of experts discussed global regulatory initiatives and harmonization efforts.

(Continued on Page 9)

MoFo In the News

(Continued from Page 8)

On June 27, 2011, MoFo partners Peter Green and Jeremy Jennings-Mares led a teleconference on bank regulatory developments in the EU. Speakers discussed recent developments, including new capital requirements, bail-ins and recovery/resolution, EU passporting issues in relation to bank branches within the EU, EU proposals to implement Basel III under CRD IV, the recent UK ICB report, and tax levies (in individual Member States and possibly in a pan-European regime).

Thomas A. Humphreys and Anna Pinedo also presented "Financing and Liability Management Developments for Financial Institutions" (see description above) at an IFLR webinar on June 29, 2011.

On June 30, 2011, Joel Haims, David Kaufman, and David Lynn spoke at Fordham Law School on recent developments in U.S. law, focusing on financial regulatory reform. Panel topics included executive compensation for financial institutions, asset management regulation, OTC derivatives, and developments in private securities litigation.

Morrison & Foerster hosted two half-day seminars to mark the anniversary of the Dodd-Frank Act. Day one, July 7, 2011, covered the Volcker Rule and other banking rules, ratings developments, capital issues, and what the new regulatory environment means for financial institutions. Day two, July 21, 2011, covered derivatives, compensation for financial institutions, and the Dodd-Frank Act and foreign banks.

On July 27, 2011, MoFo partners Peter Green and Jeremy Jennings-Mares led a teleconference titled "Regulatory Initiatives Affecting Structured Products." Topics discussed included key regulatory developments that may affect the U.S. and the EU market for structured products, including FINRA guidance in the United States relating to structured products; know-your-customer issues; suitability and fiduciary duty issues; disclosure considerations; the potential impact of the Dodd-Frank Act on structured products; the importance of the Key Information Document; PRIPs initiative; the FSA's Product Intervention paper in the UK; and other emerging issues.

The Burton Award

The Burton Awards honor excellence in legal writing and are annually presented in association with the Library of Congress, which hosted this year's reception on June 13 in Washington, D.C.

Morrison & Foerster tax partner Thomas A. Humphreys and capital markets partner Anna Pinedo received the 2011 Legal Writing Award for their article titled "Is it a bird? A plane? Exploring contingent capital," published by *Butterworths Journal of International Banking and Financial Law*. The article discusses a new financial product: contingent capital. Contingent capital has been endorsed by regulators as a form of high quality regulatory capital for financial institutions. Mr. Humphreys and Ms. Pinedo both work with financial institutions on the design of financial products, including contingent capital and other hybrids.

Ms. Pinedo and capital markets partner James Tanenbaum won this year's Burton Association of Legal Administrators Award for Best Law Firm Encyclopedic Handbook. Their *Covered Bonds Handbook* (Volumes 1 & 2), published by Practising Law Institute, is the first comprehensive guide to covered bonds. The treatise addresses regulatory and legal issues across a number of jurisdictions and discusses the incipient covered bond market in the United States, where covered bonds are seen as a housing finance solution.

Contacts

United States Federal Income Tax Law

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

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

Jared B. Goldberger
(212) 336-4441
jgoldberger@mofo.com

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

Remmelt A. Reigersman
(212) 336-4259
rreigersman@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. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for eight straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.