Morrison & Foerster Quarterly News Volume 3, No. 4 January 2011

TaxTalk

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Editor's Note

This latest issue of TaxTalk comes to you with a slight delay. The benefit of this delay is that we can provide a timely update on the most recent federal income tax developments. Both Congress and the Internal Revenue Service ("IRS") have been busy passing legislation and issuing regulations and other guidance. On the Congressional front, the Bush tax cuts were extended at the last possible moment and a new law modernizing the tax rules applicable to regulated investment companies ("RICs") was enacted. The IRS also had a busy holiday season and came out with proposed regulations expanding the scope of the "publicly traded" definition and issued guidance applicable to real estate investment trusts ("REITs") in connection with the modification of mortgage loans. We also discuss the framework of the tax system overhaul that the National Commission on Fiscal Responsibility and Reform put forward in its draft report as well as a few additional items. Due to the blizzard of current events, this issue does not include our otherwise regular feature "The Classroom," which is scheduled to return next quarter.

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2010 Tax Relief Act

On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act") into law. The Tax Relief Act extends the Bush era tax rates for individuals and introduces 100% "bonus depreciation" for businesses.[1]

Tax Rate Extensions and Alternative Minimum Tax Relief for Individuals

The Bush era tax rates with respect to income, capital gains and dividends for individuals were scheduled to expire at the end of 2010. The Tax Relief Act, however, extends these rates for an additional two years. As a result, through 2012:

- the marginal tax rates applicable to an individual's regular income will be 10%, 15%, 25%, 28%, 33%, and 35%;[2] and
- the capital gains and dividend tax rates for individuals below the 25% bracket will be 0% and for those in the 25% bracket and above will be 15%.[3]

The Tax Relief Act further includes alternative minimum tax ("AMT") relief for individuals for taxable years beginning in 2010 and 2011. It increases the AMT exemption amounts for 2010 to $72,450 (married individuals filing jointly), $47,450 (unmarried individuals), and $36,225 (married individuals filing separately), and increases the AMT exemption amounts for 2011 to $74,450 (married individuals filing jointly), $48,450 (unmarried individuals), and $37,225 (married individuals filing separately).[4]

Temporary Employee Payroll Tax Cut

The Tax Relief Act also provides that for calendar year 2011, the employee FICA tax, which applies up to the taxable wage base of $106,800, is reduced to 4.2% from 6.2%. The employer FICA tax remains 6.2%. Consistent with these changes, the self-employment tax rate (which also applies up to the taxable wage base of $106,800) is reduced for 2011 to 10.4% from 12.4%.[5]

Bonus Depreciation for Businesses

The Tax Relief Act provides 100% "bonus depreciation" for "qualified property" acquired after September 8, 2010, but before 2012, and 50% "bonus depreciation" for "qualified property" acquired during 2012. Thus, under the Tax Relief Act, businesses would be able to deduct the full cost of their 2011 investments in qualified property and half the cost of their 2012 investments in such property. Qualified property generally includes most equipment and software, but not most real property (e.g., buildings). More specifically, qualified property includes tangible property with a depreciation period of 20 years or less, certain water utility property, certain computer software, and certain leasehold improvement property (generally, certain interior improvements).[6]

Readers may find the following of interest. In our earlier client alert on the new bonus depreciation provisions, we stated that, to qualify for 100% bonus depreciation, qualified property had to be acquired after September 8, 2010, but not pursuant to a binding contract entered into before that date. We based this conclusion on the fact that the statute provides that rules "similar" to those applicable to the previous bonus depreciation provisions for property "acquired" after December 31, 2007 would apply to determine when property had been "acquired" after September 8, 2010. Among those previous provisions was the requirement that property be acquired after December 31, 2007, but not pursuant to a binding contract entered into before that date. Notwithstanding our preliminary reading of the new statute, the explanation of the Tax Relief Act provided by the Joint Committee on Taxation contained a statement that property acquired after September 8, 2010 would qualify for 100% depreciation as long as any binding contract was entered into after December 31, 2007 (as opposed to September 8, 2010). Conversations with the Committee have confirmed the reference to December 31, 2007 was intentional, although the Committee candidly acknowledged this may not have been the natural reading of the statute. Taxpayers are not likely to complain about an expansive reading in their favor. If and when the Treasury Department or IRS issue guidance on the subject, we hope such guidance confirms the Committee's understanding.

1. For a more detailed discussion of these and other provisions of the Tax Relief Act, please see our client alert at http://www.mofo.com/files/Uploads/Images/101217-2010-Tax-Relief-Act.pdf.
2. Upon expiration, the marginal tax rates become 15%, 28%, 31%, 36%, and 39.6%.
3. Upon expiration, the capital gains rates become 10% and 20%, respectively, and dividends will be subject to tax at ordinary income rates. Further, capital gain rates applicable to certain specified categories, for example, collectibles gain, are not affected by the Tax Relief Act and remain unchanged.
4. Further the Tax Relief Act repeals the personal exemption phase-out and the itemized deduction limitation and extends the marriage penalty relief for the standard deduction and the 15% bracket, all for an additional two years through 2012.
5. The Medicare hospital insurance tax rates equal to 1.45% (for the employee and for the employer) and 2.9% (for self-employed), respectively, on covered wages remain unchanged.
6. See our prior client alert for more details on the specific requirements to qualify for bonus depreciation at http://www.mofo.com/files/Uploads/Images/101213-Job-Creation-Act-Provides-100-Percent-Bonus-Depreciation.pdf.

Knock-Out Option Treated as Direct Ownership of Underlying

On November 12, 2010, the IRS released an advice memorandum—AM 2010-005, dated October 15, 2010—in which it concluded that a contract styled as an option should in substance be characterized for federal income tax purposes as direct ownership of the underlying property.[1]

Facts

Taxpayer, a hedge fund ("HF") without any employees, was organized as a Delaware limited partnership and managed by its general partner ("GP"). HF entered into a call option contract ("Contract") with a foreign bank ("FB") on a basket of securities ("Reference Basket") held in an account administered by FB. The Reference Basket was funded with $1x, the premium paid by HF to FB, and $9x paid by FB.[2] Pursuant to the terms of the Contract, HF had the right to terminate the Contract at any time during its two-year term upon which it would

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Knock-Out Option Treated

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receive the "Cash Settlement Amount." This amount equaled the greater of (i) zero, or (ii) the reimbursement of the $1x premium, plus "Basket Gain" or less "Basket Loss." Basket Gain or Loss equaled (i) trading gains, unrealized gains, interest, dividends, or other current income, less (ii) trading losses, unrealized losses, interest, dividends, or other current expenses, less (iii) commissions and other trading costs incurred in acquiring or disposing of the securities and positions, and less (iv) financing charges on the $9x provided by FB. The terms of the Contract included a "knock-out" provision, pursuant to which the Contract would automatically terminate at any time the Basket Loss reached 10%, and gave FB the right to require HF to enter into risk-reducing trades.

FB entered into an investment management agreement with GP setting forth certain investment guidelines and pursuant to which GP conducted trading of the securities included in the Reference Basket.[3] In addition, GP had the power to make corporate action decisions with respect to the Reference Basket securities.[4] Pursuant to the investment management agreement, FB paid GP a fixed annual fee of less than 0.1% of $10x.[5]

IRS Analysis—Contract Not an Option

The IRS concluded that the terms of the Contract, and in particular the Cash Settlement Amount, ensured one of two outcomes: (i) HF would exercise if the Reference Basket increased in value, or decreased by less than 10%, in order to recoup at least a portion of its premium, or (ii) the Reference Basket would fall in value by 10% and the knock-out provision would terminate the Contract and HF would receive nothing. As a result, in the IRS's view, the Contract imposed on HF costs similar to those of an obligated buyer and precluded any possibility of lapse and therefore lacked the requisite characteristics of an option.[6]

Further, the IRS concluded that the Contract did not function like an option because HF (through GP acting on its behalf) actively traded the securities included in the Reference Basket, whereas an option on property allows the holder to accept an offer to buy or sell specified property at a defined price.[7]

IRS Analysis Continued—Ownership of Reference Basket

Citing case law,[8] the IRS concluded that HF should be treated as the owner of the Reference Basket for federal income tax purposes because HF had (i) opportunity for full trading gain and current income, (ii) substantially all of the risk of loss related to the Reference Basket, and (iii) complete dominion and control of the Reference Basket.

In concluding that HF bore substantially all of the risk of loss related to the Reference Basket, the IRS acknowledged that FB could suffer a loss if a Basket Loss were incurred that would breach the knock-out level and FB would not be able to timely liquidate the Reference Basket to limit the loss to 10%. The IRS, however, noted that this possibility was remote and that FB also had rights to force HF into risk-reducing trades under the investment guidelines.

Similar Cases

Finally, the IRS noted that it considers the nature of the above-described transaction particularly aggressive and it encourages its agents to develop cases with respect to this and similar transactions. In addition, the IRS stated that it may be appropriate to argue that changes in a contract's reference basket cause a taxable exchange of either the contractual rights within the reference basket or of the contract itself.

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1. Also see our prior client alert at http://www.mofo.com//files//Uploads/Images/101115-Knock-Out-Option.pdf.
2. According to the IRS memorandum, the amount of the premium was not determined using option-pricing standards.
3. GP selected the initial securities to be included in the Reference Basket and GP conducted the trading by instructing FB to execute its trading decisions.
4. For example, addressing tender offers, mergers, and other decisions offering a choice of considerations of cash or shares.
5. The IRS memorandum indicates that GP was compensated by the investors in HF through a fee structure equal to 2% of the net asset value of the Reference Basket and 20% of specified levels of Basket Gain.
6. In addition, the IRS noted that the premium was a fixed percentage of the Reference Basket and was not based on an option-pricing formula (e.g., the Black-Scholes model). The IRS therefore considered the premium more akin to collateral for a nonrecourse margin loan.
7. Importantly, the IRS noted that HF could be viewed as having a series of separate contractual rights for each security included in the Reference Basket with the result that each trade executed by HF would cause a taxable sale or exchange. However, because the IRS concluded that HF owned the securities included in the Reference Basket for federal income tax purposes, it did not have to (and did not) address this issue.
8. Among other cases, the IRS cites Anschutz v. Commissioner, 135 T.C. 5 (2010) and Calloway v. Commissioner, 135 T.C. 3 (2010). For a discussion of these cases please see our prior client alert and MoFo Tax Talk at http://www.mofo.com/files/Uploads/Images/100723TaxCourt.pdf and http://www.mofo.com/files/Uploads/Images/100716TaxTalk.pdf.

Tax System Overhaul Recommended by Deficit Reduction Commission

The National Commission on Fiscal Responsibility and Reform released a draft report entitled "The Moment of Truth" in December. Appointed by President Obama on February 18, 2010, the bipartisan commission's charge was to come up with a plan to balance the federal budget, excluding interest on the debt, by 2015. The commission's draft proposed a six part plan to "put our nation back on a path to fiscal health, promote economic growth, and protect the most vulnerable among us." Among other things, the draft recommended a major overhaul of the U.S. federal tax system. The fundamental tax reform would include:

Individuals

- A maximum 23-28% tax rate for individuals
- Repeal of the alternative minimum tax
- Elimination of itemized deductions and replacement with a standard deduction for all individuals
- Taxation of capital gains and dividends at ordinary income rates
- Elimination of the mortgage interest deduction and replacement with

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Tax System

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12% non-refundable tax credit for interest on mortgages up to $500,000, applicable only to primary residences

- Cap on exclusion for employer provided health insurance
- Replacement of charitable contribution deduction with 12% non-refundable tax credit available to the extent gifts exceed 2% of adjusted gross income
- Elimination of exclusion for tax exempt interest for newly issued state and municipal bonds
- Consolidation of retirement accounts, cap on tax preferred contributions to lower of $20,000 or 20% of income, expansion of saver's credit
- Elimination of nearly all other income tax expenditures.

Corporations

- Single corporate income tax rate between 23-29%
- Elimination of tax expenditures for business
- Elimination of the inventory method of accounting
- Move towards a territorial tax system where income earned in foreign subsidiaries and branches would not be taxed in U.S.
- Retention of current taxation of passive income from foreign subsidiaries

The draft also recommends a "failsafe" law that would automatically scale back deductions or tax expenditures if Congress does not enact legislation by 2013 that meets certain specified revenue targets.

Unfortunately, "The Moment of Truth" came and went on December 3, 2010 when the 18 member commission fell 3 votes short of the 14 votes necessary to issue the report. The good news, however, is that the commission will live on, perhaps forever because the Presidential order that created the commission provides that the commission shall terminate 30 days "after submitting its final report."[1]

1. Also, some of the proposals may appear in the Administration's 2012 budget, due out in mid-February.

Proposed Regulations Clarify and Expand Scope of "Publicly Traded"

The IRS released proposed regulations ("Proposed Regulations") on January 6, 2011, which clarify and expand the circumstances that cause property to be "publicly traded" for purposes of determining the issue price of a debt instrument. The Proposed Regulations were issued in response to commentary from practitioners regarding the current meaning of such term in the Treasury Regulations. If the Proposed Regulations are adopted in a form substantially similar to the proposed form, they would make debt instruments purchased and sold in current financial markets more easily characterized as "publicly traded." This characterization could have significant consequences for creditors and debtors that engage in debt modifications that result in a deemed exchange of the old debt obligation for a new modified obligation.[1]

Background

The issue price of a debt instrument that is issued in exchange for property that is traded on an established market, or publicly traded, is equal to the fair market value of the publicly traded property.[2] Pursuant to existing Treasury Regulations, property is considered to be traded on an established market for this purpose if it is listed on (1) a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934 (the "Act"), (2) an "interdealer quotation system sponsored by a national securities association registered" under Section 15A of the Act (e.g., NASDAQ), or (3) a foreign exchange or board of trade recognized by the Treasury Regulations or the IRS. Property also qualifies if it is traded on an interbank market or on a board of trade designated as a contract market by the Commodities Futures Trading Commission. Property is traded on an established market if it appears on a "quotation medium," which is defined as "a system of general circulation… that provides a reasonable basis to determine fair market value by disseminating either recent price quotations… of one or more identified brokers, dealers, or traders or actual prices… of recent sales transactions."[3] In addition, subject to certain limitations, property is also traded on an established market if price quotations are "readily available" from brokers, dealers, or traders.[4]

Practitioners have criticized the definition of an established market under the current Treasury Regulations, asserting that comparatively little debt is listed on an exchange described in the Regulations. Practitioners also have raised issues regarding the meaning of what constitutes a "quotation medium." The vast majority of debt instruments are currently purchased and sold over-the-counter for a price negotiated between a financial entity (such as a securities dealer or broker) and a customer. Almost all pricing services provide quotes or valuations rather than actual trading prices. Practitioners have struggled to characterize the debt instruments exchanged in such transactions as appearing on a quotation medium. Moreover, practitioners have found too restrictive the exclusions to the general rule that treat a debt instrument as publicly traded if price quotations are readily available from dealers, brokers, or traders. Thus, it has been unclear whether debt instruments sold in financial markets through current trading mechanisms would be considered publicly traded for purposes of determining the issue price.

Proposed Treasury Regulations

According to the preamble, the Treasury and the IRS generally believe that the "traded on an established market" standard under Section 1273(b)(3)[5] should be interpreted broadly, and that accurate pricing information, to the extent it exists, should be the basis for the issue price determination under Section 1273(b)(3). To address concerns with the current rules, the Proposed Regulations simplify and clarify the determination of when property is traded on an established market, identifying four situations in which property is considered to be so traded: (1) the property

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Proposed Regulations

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is listed on an exchange; (2) the sales price for property is reasonably available; (3) a "firm" price quote to buy or sell the property is available; or (4) a price quote (i.e., an indicative quote) is provided by a dealer, broker, or pricing service. The Proposed Regulations provide that the fair market value of such property will be presumed to be equal to its trading price, sales price, or quoted price, whichever is applicable. If more than one price quote exists, taxpayers can reconcile the competing prices in a "reasonable manner." In the case of an indicative quote, however, if the taxpayer determines that the quote materially misrepresents fair market value, then the taxpayer is entitled to use a reasonable method to determine fair market value.

The Proposed Regulations, which will be effective for debt issued on or after the date that the regulations are finalized, provide significantly greater clarity than the current Regulations with respect to when a debt instrument is publicly traded. Since price quotes, either firm or soft, are available for a substantial amount of debt obligations, the Proposed Regulations would have the effect of significantly increasing the number of debt obligations that are publicly traded. Thus, the issue price of such instruments will generally be the fair market value (presumed equal to its trading, sales, or quoted price) as opposed to the face value. However, further guidance would be helpful. The Proposed Regulations, for example, do not clarify whether debt obligations purchased in a government-sponsored auction would be considered to be "publicly traded."

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1. For a more detailed discussion of the Proposed Regulations, please see our client alert at http://www.mofo.com/files/Uploads/Images/110110-Proposed-Treasury-Regulations.pdf.
2. Treasury Regulations issued in 1994 address when property is considered to be "traded on an established market" at any time during the 60-day period ending 30 days after the issue date.
4. Treas. Reg. § 1.1273-2(f)(4).
5. Treas. Reg. § 1.1273-2(f)(5).
6. Unless otherwise indicated, Section references are to the Internal Revenue Code of 1986, as amended ("Code").

Short Form HIRE Act Protocol

As discussed in our prior issue of MoFo Tax Talk,[1] the International Swaps and Derivatives Association ("ISDA") released a protocol ("Original Protocol") amending its standard equity swaps documentation to address the "dividend equivalent" provisions introduced by the Hiring Incentives to Restore Employment Act. Following release of the Original Protocol, foreign counterparties have resisted these provisions. As a result, including or not including all or some of the provisions included in the Original Protocol was the subject of case-by-case negotiation. To address the concerns raised following the release of the Original Protocol, in November 2010, ISDA released a second protocol ("Short Form Protocol") which deleted the representation related to the new 30% FATCA withholding tax and deleted the additional termination rights. Further, the Short Form Protocol includes provisions addressing transactions in which one of the non-U.S. parties is a dealer in derivatives. If the parties to a swap have adhered to both the Original Protocol and the Short Form Protocol, the terms of the Short Form Protocol provide that that protocol will supersede the Original Protocol in all respects. More information on the protocols, including a list of adhering parties, can be found on ISDA's website.[2]

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1. See MoFo Tax Talk Volume 3, No. 3.
2. For the Original Protocol: http://www.isda.org/isda2010hireactprot/hireactprot.html and for the Short Form Protocol: http://www.isda.org/isda2010shortformhireactprot/shortformhireactprot.html.

Repatriation Holiday on the Horizon?

Passed in 2004 as part of the American Jobs Creation Act, the Homeland Investment Act provided a one-year tax holiday for the repatriation of foreign earnings by U.S. corporations from foreign corporate subsidiaries. Not surprisingly, as the amount of cash held offshore by U.S. corporations purports to reach the $1 trillion mark, and as Congress and the IRS have acted to curb certain prominent repatriation strategies, calls for another tax holiday have grown louder.[1]

Reflected in Section 965, the Homeland Investment Act allowed corporations to deduct 85% of extraordinary cash dividends received from their foreign subsidiaries from their income, resulting in an effective tax rate of 5.25% on such earnings (i.e., the remaining 15% multiplied by a 35% tax rate). Repatriated earnings only qualified for the deduction if, among other things, such earnings were reinvested in the United States pursuant to a domestic reinvestment plan prepared by the repatriating corporation. Qualified reinvestments included worker hiring and training, infrastructure, research and development, capital investments, the financial stabilization of the corporation for the purposes of job retention or creation and certain business acquisitions (generally, to the extent the assets of the acquired business constituted qualified investments); disqualified investments included executive compensation, intercompany transactions, dividends and other shareholder distributions, stock redemptions, portfolio investments, debt instruments and tax payments.[2]

Presumably any new tax holiday would look to the Homeland Investment Act, and its successes and failures, for inspiration. In 2005, approximately $300 billion—an increase from an average of about $62 billion per year from 2000 to 2004—was repatriated under the Homeland Investment Act.

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1. According to the financial press, U.S. corporate executives raised the issue when they met with President Obama in mid-December. See, e.g., Jesse Drucker, "Dodging Repatriation Tax Lets U.S. Companies Bring Home Cash," Bloomberg, December 28, 2010, available at http://www.bloomberg.com/news/2010-12-29/dodging-repatriation-tax-lets-u-s-companies-bring-home-cash.html.
2. Notice 2005-10, 2005-1 CB 474, supplemented by Notice 2005-38, 2005-22 IRB 1100 and Notice 2005-64, 2005-36 IRB.

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RIC Modernization Provisions

The Regulated Investment Company Modernization Act of 2010 (the "RIC Act") was enacted on December 22, 2010.[1] The RIC Act contains a number of provisions addressing the tax treatment of RICs. Although a discussion of all of the provisions included in the RIC Act is beyond the scope of this publication, below we have highlighted a few of the most important changes.
The RIC Act introduces new intermediate sanctions (in lieu of disqualification) for RICs that inadvertently fail the RIC qualification tests due to reasonable cause (and not willful neglect). Any failures will generally be curable through monetary penalties (similar to the intermediate sanctions that are currently applicable to REITs) instead of resulting in loss of RIC status for federal income tax purposes. The new law also changes the capital loss carryover rules that apply to RICs. Whereas, under prior law, capital loss carryforwards were limited to eight years, the RIC Act provides that such losses may be carried forward indefinitely and retain their character as short-term or long-term losses. Further, the new law repeals the preferential dividend rules for publicly offered RICs. Under those rules, a RIC had to make distributions to shareholders on a strictly pro rata basis, subject to limited and detailed exceptions, or it was unable to claim a dividends-paid deduction with respect to the distribution. Also in connection with distributions, the RIC Act allows a RIC fund of funds to pass through tax-exempt interest and foreign tax credits if certain requirements are met (before the new law was enacted, a RIC fund of funds could not pass through these items). As an offset, the RIC Act increases the required annual capital gain distribution from 98% to 98.2% in order to avoid the excise tax (the required distribution percentage with respect to a RIC's ordinary income remained unchanged at 98%). Finally, we note that certain provisions that were included in earlier drafts of the new law did not make it into the enacted version of the RIC Act. Specifically, the provision allowing RICs to directly invest in commodities was not included.

1. For coverage of the RIC Act in proposed form, see MoFo Tax Talk Vol. 2 Issue 4.

Modification of Mortgage Loans—New REIT Safe Harbor

Acknowledging that the widespread decline in real estate values could adversely affect the ability of a REIT to maintain its status for federal income tax purposes, the IRS issued Revenue Procedure 2011-16 (the "Rev. Proc.") on January 5, 2011 to provide REITs with relief from potential violations of the REIT qualification requirements that are due to certain modifications of mortgage loans.[1]

Background

In order to qualify as a REIT, an entity must meet two annual income tests (among other requirements). One of these tests requires that at least 75% of the entity's gross income must consist of real estate related income, including, in particular, rents from real property and mortgage interest (the "75% income test"). A REIT must also meet an asset test each quarter. Thus, at the close of each quarter of an entity's taxable year, at least 75% of the value of the entity's total assets must consist of "real estate assets," cash and cash items (including receivables) and Government securities (the "75% asset test").[2]

If a mortgage loan is secured by both real property and other property, an apportionment test is used to determine how much of the interest on such loan is treated as "good" real estate related interest for purposes of the 75% income test. Under this apportionment test, the "loan value of the real property" is compared to the "amount of the loan."[3] If the loan value of the real property is equal to or exceeds the amount of the loan, then all of the interest income from the loan is apportioned to the real property. If the amount of the loan exceeds the loan value of the real property, the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan. The interest income apportioned to the other property is the excess of the total interest income over the interest income apportioned to the real property.[4]

In addition, a REIT is subject to a 100% tax on net income derived from prohibited transactions, generally defined as a sale or other disposition of property described in Section 1221(a)(1) (*i.e.*, property held primarily for sale to customers in the ordinary course of a trade or business, commonly referred to as "dealer property"), which is not foreclosure property.[5]

A substantial modification of a debt instrument for federal income tax purposes can result in a deemed issuance of a new loan for federal income tax purposes.[6] The fear was that the new loan would have to be retested under the REIT income test (*i.e.*, running a new apportionment test) and the REIT asset test at a time when the real property securing the loan was worth much less than the loan face amount. There was also concern that the deemed exchange of the old loan for a new loan could result in a 100% prohibited transactions tax.

Revenue Procedure 2011-16

The Rev. Proc. provides that for purposes of the REIT's income tests, "qualifying" modifications of mortgage loans (i) may be treated as not being new commitments to make or purchase a loan for purposes of ascertaining the "loan value of the real property" and (ii) will not be treated as prohibited transactions.

Qualifying mortgage loan modifications include modifications that (A) were occasioned by default or (B) based on all the facts and circumstances, (1) the REIT (or servicer of the loan) reasonably believes that there is a significant risk of default of the unmodified loan, and (2) the REIT (or servicer of the loan) reasonably believes that the modified loan presents a substantially reduced risk of default (as compared to the unmodified loan). For purposes of determining whether the REIT reasonably believes there is a significant risk of default (i) the reasonable belief may be based on credible written factual representations made by the loan issuer (so long as the REIT does not know, or have reason to believe, they are false), (ii) the default may be at maturity or at an earlier date, (iii) there is no maximum period after which default is *per se* not foreseeable (*e.g.*, the foreseen default may be more than one

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Modification of Mortgage

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year in the future), and (iv) the REIT may reasonably believe there is a significant risk of default even if the loan is performing. This new standard follows similar guidance issued in 2009 with respect to real estate mortgage investment conduits.[7]

In addition, the Rev. Proc. provides that the IRS will not challenge a REIT's treatment of a loan as being part of a "real estate asset" for purposes of the 75% asset test if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of (i) the market value of the loan (if quotations are readily available for such loan) or the fair value of the loan (as determined in good faith by the REIT's trustees) or (ii) the loan value of the real property securing the loan as determined under the apportionment test described above.

The favorable rules in the Rev. Proc. do not apply to a REIT that buys the loan after the real estate securing the loan has declined in value. An example in the Rev. Proc. makes clear that the purchasing REIT must retest the loan at the time of its acquisition for purposes of the income and asset tests. Moreover, if the purchasing REIT buys the loan at a substantial discount because the underlying real estate has depreciated, the example makes it clear that the retest could result in a significant amount of income not qualifying under the 75% income test.[8]

Acknowledging the extreme duress that the real estate market has been under for several years, the Rev. Proc. is effective for all calendar quarters and all taxable years.

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1. For a more detailed discussion of Rev. Proc. 2011-16, please see our client alert at http://www.mofo.com/files/Uploads/Images/110106-REIT-Safe-Harbor.pdf.
2. The term "real estate assets" includes real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.
3. The "amount of the loan" is the highest principal amount of the loan outstanding during the taxable year.
4. For purposes of the apportionment test, the "loan value of real property" that secures a loan is the fair market value of the real property, determined as of the date on which a commitment became binding on the REIT either to make or to purchase the loan.
5. In general, foreclosure property is any real property (including interests in real property), and any personal property incident to such real property, acquired by a REIT as the result of such REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property or on an indebtedness which such property secured.
6. Section 1001; Treas. Reg. § 1.1001-3.
7. See Rev. Proc. 2009-45, 2009-40 I.R.B. 471.
8. Thus, in the example, the purchasing REIT buys a $100 face amount mortgage for $60 at a time when the underlying real estate is worth $55. The interest apportioned to the real estate is 55/100 or 55% of the total interest. The remainder of the interest is apportioned to the other property.

IRS Reporting Obligations for Corporate Actions

The new year brings with it new tax reporting obligations with respect to certain corporate actions affecting tax basis. Although the new reporting obligations were enacted as part of the Energy Improvement and Extension Act of 2008, they became effective as of January 1, 2011, and the IRS only recently issued final regulations.

The tax reporting rules provide that any domestic or foreign corporation (or entity treated as a corporation for federal income tax purposes) must file an information return with the IRS or publish on its website certain information if an organizational action (such as a stock split, a merger or an acquisition) affects the tax basis of any "specified security."[1] A "specified security" generally includes any share of stock (including any American Depositary Receipt).[2] The required information includes, among other things, the type or nature of the organizational action and the quantitative effect of the organizational action on the basis of the security in the hands of a U.S. taxpayer as an adjustment per share or as a percentage of the old tax basis (including a description of the calculation, the applicable Internal Revenue Code provision upon which the tax treatment is based, the data supporting the calculation such as the market values of securities and valuation dates, any other information necessary to implement the adjustment including the reportable taxable year, and whether any resulting loss may be recognized).[3]

The information return must be filed by the corporation, or the information must be published on its website, on or before the 45th day following the organizational action or, if earlier, January 15 of the year following the calendar year of the organization action. If the information is made available on its website, the corporation must keep the information accessible to the public for 10 years. No reporting is required if all holders of the securities affected are exempt recipients which generally includes, but is not limited to, corporations (or entities treated as corporations for federal income tax purposes), foreign holders, and tax-exempt organizations. These reporting rules are effective with respect to organizational actions occurring on or after January 1, 2011 or, in the case of regulated investment companies, on or after January 1, 2012. The IRS has not yet made a form available in connection with this return requirement.

Our clients should note that the reporting obligations apply to public and privately held domestic and foreign corporations. For example, a foreign corporation not engaged in a U.S. trade or business but that has U.S. shareholders would be required to file a return. The penalties for failure to comply are (i) $50 for each information return (with a calendar year maximum penalty amount of $250,000) or $100 if the failure to file is a result of intentional disregard of the filing requirement without a maximum penalty amount, and (ii) $50 for each holder or nominee return (with a calendar year maximum penalty amount of $100,000) or $100 if the failure to file is a result of intentional disregard of the filing requirement without a maximum penalty amount.

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1. See Section 6045B.
2. The definition of "specified security" also includes, for example, any note, bond, debenture, or other evidence of indebtedness. Reporting with respect to securities other than stock, however, is not required with respect to organizational actions occurring before January 1, 2013 (or such later date as determined in Treasury Regulations).
3. In addition, the corporation must, on or before January 15 of the year following the calendar year of the organizational action, furnish a written statement with the same information to each holder of record of the security or to the holder's nominee. In this respect, a corporation is deemed to furnish such a holder or nominee statement if it satisfies the above-described public reporting requirement.

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Press Corner

Various news outlets reported on the "plain writing law" that was passed last year. In an effort to improve the "effectiveness and accountability of Federal agencies to the public," President Obama signed into law the Plain Writing Act of 2010 (the "Plain Writing Act") on October 13, 2010.[1] The Plain Writing Act requires that, beginning one year after its enactment, federal documents must be written in "plain writing," which is defined as "writing that is clear, concise, well-organized, and follows other best practices appropriate to the subject or field and intended audience." This requirement covers tax returns and other IRS publications and guidance, but does not cover Treasury Regulations. Under the Plain Writing Act, each federal agency must designate a senior official to oversee that agency's implementation of the Plain Writing Act. Each federal agency must also publish annual reports on compliance, which reports are to be posted on the agency's website. However, there does not appear to be any penalty for failure to comply with the Plain Writing Act. While it is possible that tax professionals may become obsolete if the IRS adopts "plain writing" we were relieved to see that Treasury Regulations are not covered by the Plain Writing Act.

1. Pub. L. No. 111-274.

MoFo in the News

On October 5, 2010, the Structured Products Association presented a Structured Products Update at Morrison & Foerster LLP. Anna Pinedo and a group of panelists discussed new developments impacting the structured products industry, focusing on emerging regulatory guidance on nomenclature; the proposed fiduciary standard and how it impacts structured products; the Dodd-Frank Act and its impact on hedging structured products; a discussion on the implications of the recent Basel III talks; and how regulatory activity in other jurisdictions will affect the marketing of Structured Investments in North America.

On October 7-8, 2010, in a session organized by Risk Magazine, Peter Green of Morrison & Foerster LLP's London office joined a panel to discuss central counterparties and the shifting landscape of regulatory reform.

Morrison & Foerster LLP's Mark Edelstein, Jerry Marlatt and Anna Pinedo, together with Moody's Investors Service and NERA Economic Consulting, presented on commercial real estate and covered bonds on October 12, 2010. Panelists discussed the proposed U.S. legislation, and why it would be beneficial for U.S. issuers; why covered bonds might be attractive to investors and issuers; covered bonds compared to CMBS; keys to access the U.S. market; and what every commercial real estate lender needs to know about covered bonds.

On October 13, 2010, Peter Green, Jeremy Jennings-Mares and Kevin Roberts of Morrison & Foerster LLP's London office provided an update on EU and U.S. Regulation of OTC Derivatives. OTC derivatives have been at the forefront of regulatory debate since the outbreak of the subprime crisis in 2007. This is due to the enormous market size, the perceived complexity and opacity of some of the instruments involved, and the counterparty exposures among interconnected financial institutions. Panelists discussed proposed EU regulation on OTC derivatives, central counterparties and trade repositories; relevant aspects of the new U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; industry response to the regulatory proposals and the likely impact of the new regulatory landscape on both financial and non-financial entities; anticipated changes as well as trends in the standardisation of OTC derivatives contracts and product structuring in the market; and recent derivatives related litigation.

On October 18, 2010, during the Structured Products Association Autumn Expo 2010, Anna Pinedo joined a legal and compliance panel discussion on the structured products industry. The following day, David Kaufman joined a panel discussion of new trade reporting obligations, position limits, swap data repositories, and securities law provisions applicable to security-based swaps as part of PLI's Advanced Swaps & Other Derivatives 2010.

As part of IMN 2nd Annual Covered Bonds: the Americas Conference held on October 20, 2010, Jerry Marlatt joined a panel to discuss legislative developments in the U.S., including what the framework might look like, a potential timeline, and the benefits of establishing a specific covered bonds legislative framework vs. applying structured finance technology to covered bonds. The following day, as part of SNL Financial's Securitization and Structured Finance, Jerry Marlatt spoke about how regulatory reform will affect securitization.

On October 22, 2010, Morrison & Foerster LLP organized "Roundtable Lunch Session: Transactions with Affiliates" during which Barbara Mendelson held a working session to delve into a detailed analysis of legal and practical issues arising in connection with the Dodd-Frank Act and transactions with affiliates. She focused on Section 23A/23B limitations, changes effected by the Act, implications for derivatives and securities lending, collateral requirements, and other considerations. On the same day, Anna Pinedo spoke about asset recognition and mark-to-market valuation in connection with NYC Bar's Accounting for Lawyers Beyond the Balance Sheet: Recognizing the Red Flags of Fraud 2010.

In another Roundtable Lunch Session organized by Morrison & Foerster LLP ("Lincoln "Push Out"") on October 27, 2010, David Kaufman held a working session to delve into a detailed analysis of legal and practical issues arising in connection with the Dodd-Frank Act and the Lincoln swaps push-out provisions. He focused on the derivatives activities excluded from the application of the Lincoln provision, the concept of federal assistance, the entities subject to the prohibition, excluded activities, and the timeline for implementation.

During the FMA 2010 Legal and Legislative Conference over a two-day period on October 27-28, 2010, Jerry Marlatt joined a panel to discuss securitization and the capital markets. Panelists focused the

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potential impact of the Dodd-Frank Act, recent developments related to covered bonds, and the potential impact of the Volcker Rule.

On November 18, 2010, Morrison & Foerster LLP's Peter Green and Jeremy Jennings-Mares together with Timothy Hailes, Chairman of the Joint Associations Committee on Retail Structured Products, presented Developments in the Structured Product Markets. In the aftermath of the subprime crisis, Lehman's bankruptcy and the ensuing global financial crisis, structured products, particularly those marketed to retail investors (such as PRIPs and UCITS) and private funds, have come under close scrutiny. Regulators, politicians and industry associations have produced a number of consultations and initiatives for reform, which are designed to help speed the revival of confidence in the structured products markets, by addressing the perceived shortcomings in structured products. Their proposals involve, among others, enhanced disclosure, reforms of the structuring, marketing and transparency of certain structured products and proposed homogenization of regulations affecting retail investment products contained in different "wrappers." Panelists discussed key regulatory and industry developments, including an update on the work of the Joint Associations Committee on Retail Structured Products, as well as the likely impact of the proposed changes on future structured products.

Morrison & Foerster LLP's Kenneth E. Kohler and James R. Tanenbaum presented as part of a PLI Webcast on November 8, 2010 and titled "Dodd-Frank Act and the Effect on Nonbanks." The Dodd-Frank legislation introduces fundamental and overarching changes in the U.S. financial regulatory structure. The legislation not only substantially restructures the oversight framework for the U.S. financial system, but also imposes significant new restrictions with respect to regulatory capital requirements, consumer protection, derivatives regulation, securitization and corporate governance. While many of the new restrictions will apply to banks and nonbanks alike, large banking institutions are often singled out for the most restrictive of the new rules. Although additional rulemaking is required for implementation to begin, market participants should not wait to assess their businesses and operations to identify new strategic opportunities that may be presented by Dodd-Frank. Many of these companies may find that the legislation results in opportunities that have not existed for them in over a decade, if ever.

On November 16, 2010, Hillel T. Cohn and Anna T. Pinedo of Morrison & Foerster LLP presented in connection with the ALI-ABA Webcast: A Fiduciary Duty for Broker-Dealers?

The SEC is studying the existing standards of care for broker-dealers offering personalized investment advice to retail investors. Comments have been flowing into the SEC identifying a number of the issues that would be raised by the imposition of a fiduciary duty standard on broker-dealers. By early 2011, the SEC will have completed its study and may have proposed new rules for broker-dealers. Topics included: duties currently owed by broker-dealers to their customers; standards applicable to investment advisers; common law fiduciary duty principles; practical issues raised by the imposition of a fiduciary duty on broker-dealers, including those related to trading on a principal basis, offering proprietary products, obtaining required consents, etc; how the imposition of a fiduciary duty may affect certain markets, including IPOs; and action items for compliance personnel.

Two days later, on November 18, 2010, Anna Pinedo spoke for the Global Association of Risk Professionals in connection with Basel III: The Future of Banking, Risk Management and Risk Managers. The Basel III framework strengthens risk-based capital regulation, regulatory supervision principles and risk management practices in the banking sector. While maintaining the micro-prudential regulatory toolkit introduced in the previous Basel Accords that ensure the safe, sound and prudent operations of banks, Basel III seeks to address the effects of systemic risks that globally interconnected financial institutes propagate. On the eve of the G-20 meetings in South Korea that are to ratify this new international framework, the members of the distinguished panel discuss the implications this new macro-prudential regulatory regime has on the future of banking, risk management, and risk managers.

On November 30, 2010, Morrison & Foerster LLP's Peter Green and Jeremy Jennings-Mares together with Janet Wood of Bank of America Merrill Lynch spoke at an IFLR Web Seminar titled "EU Regulation of OTC Derivatives." Since the financial crisis, regulators have been working to address the perceived gaps in OTC derivatives regulation. They have focused on improving the transparency and safety of the market through centralized clearing and transaction reporting. In September, the EU Commission published the proposed draft of the EU Regulation on OTC derivatives, central counterparties and trade repositories. But many important details remain to be clarified, and as the European Parliament deliberates on the proposals, more amendments are expected before its introduction by the end of 2012. Panelists discussed the proposals, compared them with relevant provisions of the recent Dodd-Frank legislation in the U.S., and assessed their likely impact on the OTC derivatives market in the EU and internationally.

Jerry Marlatt spoke on November 30, 2010 at a West Legalworks Webinar titled "The Covered Bond Market in the U.S. and Abroad." Covered bond markets have been very active this year. This webinar reviewed recent developments in the covered bond markets in Europe and the US, including the opening of the U.S. market this year by Canadian and European issuers. There have also been several developments toward enactment of legislation for covered bonds in the US. The current draft of the statute and prospects for enactment by the next Congress were also discussed.

On December 1, 2010, Thomas A. Humphreys and Anna T. Pinedo presented on Contingent Capital during a West Legalworks Webinar. Contingent capital products have been hailed as a possible solution to bolstering regulatory capital levels for financial institutions. Generically, a contingent capital instrument is a hybrid security (having certain equity-like and certain debt-like features), which can serve to provide permanent capital for the financial institution issuer during stress scenarios. Thus far, we have seen two issuances of contingent capital, one in an exchange offer by Lloyds and another in an offering by Rabobank. This webinar addressed the current regulatory capital developments (in Dodd-Frank and in the

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Basell III framework) that have stimulated the debate about contingent capital, as well as the securities, tax and other structuring considerations.

Morrison & Foerster LLP's David H. Kaufman spoke at a Roundtable Lunch Session during a session titled "Crystal Clear? More About Clearing" on December 2, 2010. A prominent element of regulatory reform in the US and in Europe is the movement of OTC derivatives to centralized clearing. The use of clearinghouses has been advanced as a panacea; however, many questions remain to be answered. The roundtable session focused on the clearing requirements under the Dodd-Frank Act, issues raised in dealing with CCPs, and related questions for dealers and for end-users.

At a PLI Webcast titled "Dodd-Frank Act and the Effect on Foreign Banks" on December 3, 2010, Anna T. Pinedo presented. There are quite a number of provisions of the regulatory reforms that are broadly worded so that they may have extraterritorial application. In addition, there are a number of provisions that are intended to affect foreign institutions doing business in the U.S. Topics included: the categorization of institutions as "systemically important financial institutions;" application of the new resolution mechanism to the U.S. operations of a foreign bank ; Volcker Rule restrictions; the effect of regulations relating to OTC derivatives; regulations affecting regulatory capital, which would affect U.S. intermediate bank holding companies of international banks; foreign fund exception to the private fund registration rule; executive compensation and governance requirements applicable to foreign issuers.

On December 7, 2010, Peter Green and Jeremy Jennings-Mares gave a presentation titled "Update on Banking Regulation in the UK and EU." As panic begins to recede and the world gradually regains confidence, regulators are increasingly shifting their focus to longer-term reforms in order to seek to reduce the likelihood and severity of another financial crisis and to ensure that banks and other financial institutions are better able to endure one. Speakers discussed the regulatory proposals in relation to capital and liquidity, including update on Basel reform proposals and amendments to the EU Capital Requirements Directive; UK proposals to revamp its financial regulatory structure; changes to the EU financial supervisory architecture; and living wills, bank levies and other specific proposals.

"Risk and Reward: Compensation in a Post-Financial Crisis World" was the title of a presentation at Morrison & Foerster LLP by Michael T. Frank, David M. Lynn, and Anna T. Pinedo on December 9, 2010. In the aftermath of the financial crisis, financial regulators have become increasingly focused on how compensation plans can or should be structured in order to better align the interests of executives with those of shareholders. With the advent of TARP and now the Dodd-Frank Act, the focus is on how compensation structures may encourage more prudent behavior that is in alignment with the long term performance, rather than rewarding executives and other employees for achieving short-term gains. Our panel discussed the regulatory guidelines and best practices that have developed, as well as alternatives for public companies, including financial institutions, to consider. Topics also included: what we learned from the TARP; the interagency statement on sound compensation policies for financial institutions; Basel III and compensation matters; implementation of the Dodd-Frank provisions regarding incentive compensation; bonus taxes and other regulatory measures; innovative compensation structures; conducting a pay risk assessment; disclosure related issues; and say-on-pay and other governance matters. ■

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