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# MoFo Tax Talk



## First Thing's First:

*HAPPY HOLIDAYS!*
From Morrison & Foerster LLP

## Tax Law and the Credit Crunch – An Executive Summary

This past year has been described as historic and unprecedented. As governments continue to react to calm the markets and the global economy, investors, corporations and workers remain on edge, hoping that the effects of recent events are contained. Governments have put on the table every fiscal, monetary and political tool available to help stem the crisis. One such tool is the formulation and implementation of tax policy and a targeted implementation of that policy through legislation and administration of the tax laws. In the United States, Congress, the Treasury and the IRS have reacted, in some cases quite aggressively, to the deepening crisis. The following is a summary that broadly traces legislative and administrative responses by the United States government from the first days of the crisis.

1. December 6, 2007 – Revenue Procedure 2007-72 In tandem with the Paulson-Jackson plan aimed at stemming foreclosures by freezing adjustable rate mortgages subject to reset, the IRS issued Rev. Proc. 2007-72, which provided that, under certain conditions, the IRS will not challenge a REMIC's status for U.S. federal income tax purposes in connection with "fast track modifications" of certain subprime mortgage loans under a framework recommended by the American Securitization Forum. A fast-track modification program is a program that permits servicers to modify eligible troubled mortgage loans subject to certain broad parameters. Specifically, the IRS stated that: (i) it will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the loan modifications are not permitted under the REMIC rules; (ii) it will not contend that the loan modifications are prohibited transactions under the REMIC rules; and (iii) it will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the loan modifications resulted in a deemed reissuance of the REMIC regular interests. The Rev. Proc. was issued in an effort by the Treasury and the IRS to stem foreclosures by

removing barriers imposed by tax laws, arguably too restrictive in light of prevailing economic and market circumstances, to broad-based mortgage modification plans.

2. December 20, 2007 – Debt Relief Act of 2007 The Act excludes cancellation of indebtedness from gross income if the indebtedness is "qualified principal residence indebtedness" (meaning, generally, indebtedness with respect to the taxpayer's principal residence) that is discharged, initially, before January 1, 2010 (this provision was later extended in the Emergency Economic Stabilization Act, described below, through the end of 2012). The legislation was enacted to provide relief to troubled borrowers at risk of losing their homes as a result of the credit crisis. These borrowers would otherwise be subject to tax if lenders forgave a portion of their mortgages as part of a refinancing or to avoid foreclosure. The Debt Relief Act imposes a $2 million limit (or $1 million in the case of married taxpayers filing separately) on the amount of cancelled debt that may be excluded from income.

3. February 19, 2008 – Notice 2008-27 & March 25, 2008 – Notice 2008-41 In general, interest on auction-rate tax-exempt bonds may be exempt from U.S. federal income taxation provided certain requirements are met at issuance. Tax-exempt bond issuers may obtain credit enhancement on the bonds they issue from municipal bond insurers (e.g., MBIA and Ambac). Accordingly, if a rating agency downgrades municipal bond insurers, such downgrades may affect the tax-exempt bonds, including the interest rates payable on the bonds. In addition, if the auctions at which the interest rates on the bonds are reset fail, interest rates reset to a specified maximum (or penalty) rate. Auction failures may also cause severe liquidity issues and investors may be unable to sell their notes at par under these circumstances. In these situations, a bond issuer may seek to convert auction-rate bonds into standard fixed or floating-rate bonds. Alternatively, the issuer may seek to provide additional liquidity through other measures by, for example, temporarily repurchasing the bonds. However, under current U.S. federal income tax law, debt may be considered to be "reissued" if a debt instrument is significantly modified; a reissuance, in turn, could cause significant adverse tax consequences, including a redetermination of whether the instruments qualify as tax-exempt bonds. A repurchase treated as a retirement would cause similar issues. Notice 2008-27 and Notice 2008-41 were issued primarily in response to rating agency downgrades of municipal bond insurers and auction failures in the tax-exempt bond market. In general, for purposes of determining whether bonds qualify for tax-exempt status, Notice 2008-41 provides that bonds issued as auction rate securities but converted by the issuer into fixed or floating-rate bonds for their remaining term will not be treated as having been significantly modified (and thus reissued). In addition, in order to provide liquidity in the tax-exempt bond market, the Notice permits issuers to repurchase bonds on a temporary basis without causing a retirement of the bonds for U.S. federal income tax purposes. The exemption applies to bonds purchased before October 1, 2008 and held for not more than 180 days after purchase.

4. May 12, 2008 – Revenue Procedure 2008-26 A U.S. shareholder that owns 10% or more of the voting stock of a controlled foreign corporation ("CFC") is generally required to include "subpart F income" on a current basis if the CFC invests in "U.S. property," which includes certain obligations of United States persons (e.g., mortgage-backed securities) unless the obligations are "readily marketable." The Rev. Proc. provides that the IRS will not question whether a security is "readily marketable" in determining whether the security constitutes U.S. property if the security is of a type that was readily marketable at any time within three years before May 5, 2008. The Rev. Proc. is aimed at addressing the effect of market dislocations in respect of securities that likely would be marketable under "normal" market conditions.

5. May 16, 2008 – Revenue Procedure 2008-28 Similar to Rev. Proc. 2007-72, Rev. Proc. 2008-28 provides that if mortgage loans are modified in accordance with certain specified conditions (including limits on the size of the underlying residences, a condition that the underlying properties be owner-occupied, and that there be a reasonable belief that there is a significant risk of foreclosure under the original loans) the IRS will not seek to challenge the status of a REMIC securitization. This Rev. Proc. expanded Rev. Proc. 2007-72 to permit additional fast-track loan modifications.

6. June 13, 2008 – Notice 2008-55 Notice 2008-55 provides that the IRS will not challenge the equity characterization of auction-rate securities ("ARS") for federal income tax purposes if certain liquidity facility agreements are put in place that permit holders of the ARS to sell their ARS to a liquidity provider upon a failed auction. Thus, payments on the ARS would continue to be characterized as exempt-interest dividends (to the extent of the issuer's exempt interest). If the ARS were instead characterized as debt, payments would be treated as taxable interest for the ARS holders. In general, the Notice only applies if, among other requirements, the ARS are issued by closed-end funds that are RICs and that invest exclusively in taxable or tax-exempt bonds, the ARS were outstanding on February 12, 2008 (or issued after that date to refinance ARS that were outstanding on that date) and the liquidity provider is unrelated to the issuer. The Notice was issued to provide some relief for closed end funds that sought to restructure their ARS amid a seizure of the ARS markets.

7. July 8, 2008 – Revenue Procedure 2008-47 Rev. Proc. 2008-47 provides that the IRS will not challenge the tax status of a REMIC or assert that a REMIC engaged in a "prohibited transaction" when certain mortgage loans – primarily adjustable rate mortgages with teaser rates – held by a REMIC are modified by freezing rates prior to their reset in accordance with the American Securitization Forum's "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans" (which was issued on July 8, 2008). The Rev. Proc. amplifies and supersedes Rev. Proc. 2007-72.

8. July 30, 2008 – Housing and Economic Recovery Act of 2008 In response to a deepening housing crisis and speculation regarding the failure of Fannie Mae and Freddie Mac, the Act (i) granted the United States Treasury the ability to place Fannie and Freddie into conservatorship, (ii) increased regulatory oversight over the GSEs, (iii) increased the conforming loan limits of the GSEs to $625,000 from $417,000 (to provide liquidity in the mortgage market by allowing the GSEs to purchase additional mortgages and to decrease interest rates on such mortgages over time), (iv) created a temporary program within the Federal Housing Administration ("FHA") that would insure up to $300 billion in mortgages available to distressed borrowers looking to refinance their mortgages and (v) provided certain tax credits, including a refundable first time homebuyer credit that works like an interest-free loan for first-time home buyers of up to $7,500 to be repaid over 15 years in equal installments as a surcharge on the homeowner's tax returns.

9. August 8, 2008 – Revenue Procedure 2008-51 The crisis in the credit markets resulted, in some cases, in significant dislocations between the time at which a corporation arranged for the issuance of debt pursuant to a binding financing commitment and the time at which the corporation called upon the lender to perform on the commitment by advancing cash to the issuer and selling the issuer's debt instruments in the market. This can result in situations in which the issue price of a debt instrument (generally, the price paid by the public) is significantly less than the amount of money actually received by the corporation from the lender. The resulting original issue discount ("OID") may cause the debt to be treated as an applicable high yield discount obligation ("AHYDO"), resulting in an increased after-tax funding cost to the issuer due to deferred or foregone interest deductions, and may potentially affect the willingness of borrowers and lenders to enter into financing commitments. Acknowledging these problems, the Rev. Proc. suspends the application of the AHYDO rules in this and certain other situations in order to ameliorate the affects of the credit crisis on corporate issuers.

10. September 8, 2008 – Notice 2008-76 The Housing and Economic Recovery Act of 2008 authorized the Treasury to purchase obligations of, or securities issued by, Fannie Mae and Freddie Mac where necessary to stabilize the financial markets. After the Treasury placed Fannie and Freddie into conservatorship, the IRS issued Notice 2008-76, which provided that the IRS and the Treasury will issue new regulations providing that the application of Section 382 will be suspended in situations where Treasury acquires stock or options to acquire stock pursuant to the Housing Act. Section 382 is a section in the Internal Revenue Code that is aimed at policing the trafficking of corporate tax attributes, including operating losses and built-in losses, via the sale of significant ownership interests in loss corporations. The Notice is aimed at preserving Fannie Mae's and Freddie Mac's tax attributes in the event of what would otherwise be an impermissible "ownership change" resulting from the Treasury's acquisition of ownership interests.

11. September 12, 2008 – Notice 2008-77 In general, under regulations finalized in 2006, widely held fixed investment trusts ("WHFITs") must satisfy certain reporting requirements. The requirements first applied for the 2007 calendar year, but the preamble to the final regulations stated that the IRS would not impose any penalties for 2007 where the trustee or middleman was unable to change its information reporting systems to comply with the regulations. Notice 2008-77 extends this deadline for an additional year. The Notice also states in the case of widely held mortgage trusts ("WHMTs") that, pending future published guidance, under certain circumstances, modifications of mortgages held by a WHMT that has entered into a guarantee arrangement that compensates the trust or all the trust interest holders for any shortfalls from such modifications are not required to be reported under the WHFIT reporting rules.

12. September 24, 2008 – Notice 2008-81 In response to the credit crisis that threatened the ability of money market funds to maintain a $1 per share net asset value ("breaking the buck"), the United States Treasury established a temporary guarantee program for the U.S. money market mutual fund industry. Under this program, the Treasury will insure, in return for a fee, the holdings of any publicly offered eligible money market mutual funds. The Treasury will make available as necessary the assets of the Exchange Stabilization Fund (an emergency fund originally established in 1934 to manage exchange rates), up to a limit of $50 billion. (For more information on this program, consult our prior Client Alert "First Look at Treasury Plan; Money Market Fund Bailout" at http://www.mofo.com/news/updates/files/080921FirstLook.pdf.) In general, the tax law frowns on federal guarantees of tax-exempt bonds and interest on such bonds would lose their tax-exempt status. Also, under current law a mutual fund that owns tax-exempt bonds that have an aggregate value of at least 50 percent of the fund's total assets is permitted to pay tax-exempt dividends to its shareholders. Notice 2008-81 clarifies that the Treasury money market guarantee program will not violate the restrictions against federal guarantees of tax-exempt bonds held by tax-exempt money market funds. In addition, the IRS will not assert that the program impairs the ability of a money market fund to designate and distribute tax-exempt dividends.

13. September 24, 2008 – Revenue Procedure 2008-58 Rev. Proc. 2008-58 addresses holders of ARS who, amid failing auctions, accept settlement offers from brokers for claims that the brokers acted improperly in the sale and distribution of the ARS. The Rev. Proc. addresses agreements pursuant to which holders who acquired ARS prior to February 12, 2008 are given the right during a specified period of time (not to extend beyond December 31, 2012) to sell the ARS to the brokers at par. The Rev. Proc. provides that the IRS will not challenge (i) that the taxpayer continues to own the ARS upon accepting (or "opting into") the settlement offer; (ii) that the taxpayer does not realize any income as a result of accepting the settlement offer and does not reduce the basis of ARS from its original purchase price; and (iii) that the taxpayer's amount realized from the sale of ARS to the party offering the settlement is the full amount of the cash proceeds received from that party.

14. September 26, 2008 – Revenue Procedure 2008-63 Rev. Proc. 2008-63, effective for taxable years ending on or after January 1, 2008, provides that if a borrower defaults under a Section 1058 compliant securities loan agreement (generally a securities loan agreement that requires the borrower to return identical securities borrowed to the lender, requires the borrower to pay interest and dividend equivalent amounts to the lender, and does not reduce the lender's risk of loss or opportunity for gain) as a direct or indirect result of its bankruptcy (or the bankruptcy of an affiliate) and the lender applies the collateral to purchase identical securities as soon as is commercially practicable after the default (but not more than 30 days following the default), the lender will not recognize any gain or loss for U.S. federal income tax purposes as a result of the transaction.

15. September 26, 2008 – Notice 2008-78 As the credit crisis deepened, companies that had already raised significant amounts of capital needed to raise even more. Additionally, investors that had recently invested in such companies experienced a significant decline in the value of those investments in a very short period of time. Prior to Notice 2008-78, the rules under Section 382 generally presumed that capital contributions made within a two-year period prior to the date on which a Section 382 ownership change

occurs are part of a tax-avoidance plan. A capital contribution, if counted, has the effect of increasing the Section 382 limitation by increasing the value of the stock immediately before an ownership change. The tax avoidance presumption excludes such capital contributions in determining the Section 382 limitation. The Notice announced that the IRS intends to issue regulations waiving this tax avoidance presumption. Notice 2008-78 instead provides a facts and circumstances test to determine whether the contribution is made for tax avoidance. It also provides four safe harbors under which a contribution will not be treated as having a tax avoidance motive, signaling a marked shift in the way the IRS intends to view capital contributions in the context of Section 382.

16. September 26, 2008 – Notice 2008-84 Under Section 382, each date on which a corporation is required to determine whether an ownership change has occurred that may limit the future use of the corporation's operating or built-in losses is called a "testing date." After the U.S. government effectively nationalized AIG, the largest insurance company in the world, the IRS issued Notice 2008-84. The Notice announced that the IRS and the Treasury will issue regulations under Section 382 providing that the term "testing date" does not include any date as of the close of which the United States directly or indirectly owns a more than 50 percent interest in the loss corporation. In effect this means that the acquisition of a loss corporation by the United States government does not result in an ownership change that would limit the use of the loss corporation's net operating losses in subsequent years (but only so long as the United States continues to own a more than 50 percent interest in the corporation).

17. September 30, 2008 – Notice 2008-83 The failures of some of the largest financial institutions in the United States caused systemic risk to the entire global banking system. Notice 2008-83 demonstrated the IRS's willingness to go to great lengths to relieve some of that stress. Notice 2008-83 generally provides that if a bank undergoes an ownership change, losses and deductions attributable to loans that are otherwise allowable will not be treated as built-in losses or deductions attributable to a pre-change period for purposes of Section 382. In practice, this means that if an acquirer acquires a target troubled bank in which a Section 382 ownership change occurs, the target's use of its net unrealized built-in losses attributable to underwater loans (including underwater mortgages) will not be limited by Section 382. The full amount of the loss attributable to the underwater loans, when recognized after a Section 382 ownership change, could be used to offset the acquiror's and target's future taxable income. The apparent policy behind Notice 2008-83 appears to be to ease the credit crisis by unlocking significant value in troubled banks and by encouraging acquisitions of troubled banks by stronger financial institutions. Consider the events around the time of the Notice. On Monday, September 29, 2008, Citigroup announced it would acquire Wachovia for approximately $2 billion (with help from the FDIC). The next day, the IRS issued Notice 2008-83 and, three days later, Wells Fargo announced that it would acquire Wachovia for approximately $15 billion (without FDIC help). It is widely speculated that Notice 2008-83 contributed to the change in the value of Wachovia as a target.

18. October 1, 2008 – Notice 2008-88 As the credit crisis continued to take its toll on the municipal bond market, through Notice 2008-88 the IRS extended relief initially provided in Notice 2008-41 by expanding covered securities to include qualified tender bonds (e.g., seven-day variable rate bonds with seven-day put options) and tax-exempt commercial paper. In addition, the Notice extends the period during which relief is available to December 31, 2009 (extended from October 1, 2008).

19. October 3, 2008 – Emergency Economic Stabilization Act of 2008 On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008 ("EESA"). EESA allocated in the aggregate $700 billion to the Treasury under the Troubled Asset Relief Program ("TARP") and authorized the Treasury to purchase "troubled assets" from eligible "financial institutions." The EESA contained significant tax provisions, including allowing qualified financial institutions to treat losses on Fannie Mae and Freddie Mac preferred stock as ordinary losses, rather than capital losses, and providing new limitations on the deductibility of executive compensation for those that participate in the program. (For an executive summary of the tax provisions of the EESA, consult our prior Client Alert "Bailout Bill Tax Provisions – An Executive Summary" at http://www.mofo.com/news/updates/files/14546.html.)

 

20. October 6, 2008 – Notice 2008-91 As a result of the recent liquidity crisis, the IRS issued Notice 2008-91, which relaxed the standards set forth in Notice 88-108, issued on September 16, 1988. In general, a U.S. shareholder that owns 10% or more of the voting stock of a CFC must include in Subpart F income certain amounts invested in U.S. property, which includes loans by the CFC to its U.S. shareholders. Under Notice 88-108, loans that are collected within 30 days from the time they are incurred (the "30-day rule") are excluded from the definition of United States property, thereby providing short-term lending to a parent company. The exclusion did not apply if the CFC held obligations that would be U.S. property without regard to the 30-day rule for more than 60 days in a calendar year. Notice 2008-91 temporarily extends the two limits of Notice 88-108 to 60 days and 180 days, respectively. The Notice only applies for the CFC's first two taxable years ending after October 3, 2008. However, the Notice does not apply to taxable years of a foreign corporation beginning after December 31, 2009. The Notice is designed to provide short-term liquidity to U.S. corporations from their foreign subsidiaries without triggering adverse tax consequences.

21. October 7, 2008 – Notice 2008-92 On October 7, 2008, the Treasury and the IRS issued Notice 2008-92, which clarified that the Treasury and the IRS will not assert that participation in the Treasury's temporary guarantee program by an "insurance-dedicated money market fund" (generally a money market fund available only to insurance company segregated accounts) causes a violation of required diversification requirements (described below) or that participation in the program causes the holder of a variable insurance policy that invests in the fund through a segregated account to be treated as an owner of the fund for tax purposes. Under current law, if a life insurance policy is properly structured and respected for federal income tax purposes, income from the investments underlying the policy are permitted to accumulate tax-free and, if held until death of the insured, the entire death benefit paid is not subject to tax. However, these benefits are lost if the segregated account is not adequately diversified or if the policy holder is deemed to own the underlying investments directly because the holder violates the "investor control" doctrine. To be adequately diversified, the segregated account is subject to specified concentration limits, restricting it from holding too many securities or obligations of any one issuer. For this purpose and in the case of government securities (generally securities issued or guaranteed by the United States or any instrumentality thereof), each government agency or instrumentality is treated as a separate issuer. In addition, the holder of a policy generally may be treated as an owner of the underlying investments if the holder exercises sufficient control over the assets to be deemed the owner for tax purposes or if the investments are not available exclusively through the purchase of a life insurance contract. Prior to the Notice, practitioners had expressed concern that participation in the Treasury's temporary guarantee program by insurance-dedicated money market funds may raise both diversification issues (presumably because the underlying guarantee may be viewed as concentrating an account's investments in one government issuer) and investor control issues (presumably because the guarantee was made available to money market funds available to investors outside of insurance company segregated accounts). The Notice states that it was issued to provide "administrative relief in furtherance of public policy to promote stability in the market for money market funds."

22. October 14, 2008 – Notice 2008-100 Notice 2008-100 generally provides, among other things, that (i) preferred stock acquired by the Treasury pursuant to the TARP Capital Purchase Program is not treated as "stock" for purposes of Section 382 and, consequently, will not trigger a Section 382 ownership change; (ii) for purposes of testing for Section 382 ownership changes on or after the date that stock held by the Treasury is redeemed, the redeemed shares will be treated as if they were never outstanding; and (iii) any capital contribution made by the Treasury pursuant to the TARP Capital Purchase Program will not be considered to have been made as part of a tax-avoidance plan. In effect, Notice 2008-100 removes any potential disincentive resulting from participation by a bank in the TARP Capital Purchase Program by clarifying generally that a Treasury purchase of capital would not by itself trigger application of the limitations of Section 382 on the use of the bank's losses going forward.

23. October 14, 2008 – Notice 2008-101 When the Treasury injects capital into financial institutions, a question arises as to whether such amounts would constitute "federal financial assistance" within the

meaning of Section 597, which would cause those amounts to be includable as income to the recipient institution and, if received in connection with certain acquisitions, could wipe out all of the favorable tax attributes of the target. Notice 2008-101 provides that, until future guidance is issued, no amount furnished by the Treasury to a financial institution under TARP will be treated as federal financial assistance for purposes of Section 597.

## 101 Events that Rocked the World – A Timeline of Significant Market Events

2008 changed the global economic landscape. Unexpected events occurring in compressed time destabilized many Wall Street institutions. On Main Street, jobs were lost and small businesses stalled. And across the globe, stock markets retrenched as increasingly interconnected economies braced for a deep recession. As we reflect today on what the future holds, it is instructive to also reflect on the events that brought us to where we are now. The following is a summary of 101 critical market events that have defined the crisis thus far and supplements our prior timeline (located at http://www.mofo.com/docs/pdf/081118CrisisTimeline.pdf). The arc of these events clearly demonstrates how quickly, widely and deeply the credit contagion spread.

### *2007 – The Clouds Gather*

1. January 5 Ownit Mortgage Solutions, a California based subprime lender, filed for bankruptcy.

2. February 5 Mortgage Lenders Network USA, another subprime lender in California, filed for bankruptcy. Mortgage Lenders was the fifteenth largest subprime lender.

3. February 8 HSBC announced it would increase its reserves for loan losses because of its exposure to U.S. mortgages.

4. February 13 ResMae Mortgage, a large U.S. subprime lender, filed for bankruptcy.

5. March 4 HSBC announced write downs of $11 billion from U.S. mortgages, marking the beginning of a parade of write downs linked to the valuation of mortgages.

6. March 20 People's Choice Home Loan, another California subprime lender, filed for bankruptcy.

7. April 3 New Century Financial, another California subprime lender, declared bankruptcy. New Century was the second largest U.S. subprime lender.

8. April 12 SouthStar, another subprime lender, filed for bankruptcy.

9. June 23 Bear Stearns bailed out one of its hedge funds by pledging $3.2 billion in loans, marking the largest bailout of a hedge fund since Long Term Capital Management in 1998. The hedge fund ran into trouble because of exposure to U.S. subprime mortgages.

10. July 16 Alliance Bancorp declared bankruptcy. Alliance Bancorp specialized in Alt-A mortgages.

11. July 31 Two Bear Stearns hedge funds filed for bankruptcy.

12. August 6 American Home Mortgage, reported at one time to be the tenth largest retail mortgage lender in the U.S., filed for bankruptcy, adding concern that the credit crisis had hit non-subprime borrowers.

13. August 10 Homebanc, another mortgage lender, filed for bankruptcy.

14. August 14 Goldman Sachs and investors injected $3 billion in the firm's Global Equity Opportunities Fund, about $2 billion of which was provided by Goldman.

15. August 17 The Fed cut the discount rate by 25 basis points to 5.75% from 6.00%. The discount rate is the rate at which the Fed lends to commercial banks and other depositary institutions for short periods of time in order to provide short-term liquidity.

16. September 14 The Bank of England extended emergency funding to Northern Rock, a large U.K. mortgage lender. The mortgage crisis had crossed the borders of the United States.

17. September 18 The Fed cut the discount rate and the federal funds rate by 50 basis points to 5.25% and 4.75%, respectively. The federal funds rate is the interest rate at which depository institutions lend balances at the Fed to other depository institutions overnight.

18. October 1 UBS announced write downs of $3.4 billion.

19. October 15 Citigroup announced write downs of $5.9 billion.

20. October 24 Merrill announced a loss from its loan portfolio (primarily CDOs) of $7.9 billion.

21. October 31 Deutsche Bank announced write downs of $3 billion.

22. October 31 The Fed cut the discount rate and the federal funds rate each by 25 basis points to 5.00% and 4.50%, respectively.

23. November 1 Credit Suisse announced write downs of $1 billion.

24. November 7 Morgan Stanley announced write downs of $3.7 billion.

25. November 9 Wachovia announced write downs of $1.1 billion.

26. November 13 Bank of America announced write downs of $3 billion.

27. November 27 Citigroup raised capital by issuing mandatory convertible securities to Abu Dhabi Investment Authority. The securities had a yield of 11%.

28. December 5 Fannie Mae announced it would raise $7 billion in capital and reduce dividends paid to its shareholders.

29. December 6 The Paulson-Jackson plan was announced, which froze mortgage rates on subprime adjustable rate mortgages for a period of five years for eligible participants. To be eligible, in general, the subprime adjustable rate mortgage must have been originated between January 2005 and July 2007, and the interest rate must be reset at a higher rate. The plan was limited to owner occupied properties. In addition, in general, the borrower must be current in payments, must prove that he/she cannot afford a higher payment, and must have some equity in the home.

30. December 10 UBS announced write downs of an additional $10 billion.

31. December 11 The Fed cut the discount rate and the federal funds rate by 25 basis points to 4.75% and 4.25%, respectively.

32. December 20 Congress enacted the Debt Relief Act of 2007, designed to provide relief to borrowers in foreclosure by excluding mortgage debt forgiven by a lender from gross income.

***2008 – The Perfect Storm***

33. January 11 Bank of America announced it would acquire Countrywide, the largest U.S. mortgage lender, for $4 billion. Countrywide was on the verge of bankruptcy.

34. January 15 Citigroup announced a loss of $9.8 billion and write downs of $18 billion.

35. January 17 Merrill announced a loss of $7.8 billion and write downs of $14.1 billion.

36. January 22 The Fed cut the discount rate and the federal funds rate each by an unexpected 75 basis points to 4.00% and 3.50%, respectively.

37. January 24 A $150 billion U.S. economic stimulus plan was unveiled in which eligible taxpayers would receive tax refunds ranging from $300 to $1,200, subject to a phase-out for high-income earners.

38. January 30 The Fed cut the discount rate and the federal funds rate by an additional 50 basis points to 3.50% and 3.00%, respectively.

39. February 12 Auctions of auction rate securities, reported to be a $330 billion market, began to fail, causing liquidity issues and borrowing costs for issuers of ARS to spike.

40. February 17 The U.K. nationalized Northern Rock.

41. February 28 AIG announced write downs of approximately $11 billion from its credit default swap portfolio.

42. March 3 HSBC announced write downs of $17.2 billion from U.S. mortgage exposure.

43. March 6 Peloton Capital, an asset-backed security fund, failed after it could not make interest payments on borrowings it used to purchase assets.

44. March 11 The Fed injected $200 billion of liquidity in the capital markets by increasing lending to financial institutions through its new Term Securities Lending Facility. (For more information on this program, consult our prior Client Alert "TARP and the Various Tent Poles: Will it be Enough?" at http://www.mofo.com/news/updates/files/081015TARP.pdf.)

45. March 16 Bear Stearns, then the fifth largest investment bank, on the verge of bankruptcy, was sold to JPMorgan Chase for $2 per share with Fed assistance of approximately $30 billion.

46. March 18 The Fed cut the discount rate and the federal funds rate each by an additional 75 basis points to 2.50% and 2.25%, respectively.

47. March 25 The purchase price of the Bear Stearns acquisition was renegotiated to $10 per share with Fed assistance of approximately $29 billion.

48. April 1 UBS announced write downs of $19 billion.

49. April 1 Deutsche Bank announced write downs of $3.9 billion.

 

50. April 8 Washington Mutual Inc. raised $7 billion of capital by issuing common shares and convertible preferred shares.

51. April 8 The FDIC issued its Covered Bond Policy Statement, in which it addressed creditor issues in the event that the issuing insured depository institution fails. (For more information, consult our prior Client Alert "Covered Bonds and U.S. Regulators" at http://www.mofo.com/news/updates/files/CoveredBondsUSregulator.pdf.)

52. April 14 Wachovia announced it would raise $7 billion in offering of common stock and convertible preferred shares.

53. April 17 Merrill announced another $4.5 billion in write downs.

54. April 18 Citigroup announced a loss of $5.11 billion and write downs of $12 billion.

55. April 30 The Fed cut the discount rate and the federal funds rate each by an additional 25 basis points to 2.25% and 2.00%, respectively.

56. May 6 Swiss Reinsurance Co., the world's biggest reinsurer, announced write downs of $782 million with respect to its credit default swap portfolio.

57. May 9 AIG reported a $7.8 billion loss and write downs of $9.11 billion from its credit default swap portfolio.

58. May 29 JPMorgan Chase completed its acquisition of Bear Stearns.

59. June 2 S&P cut Merrill's, Lehman's, and Morgan Stanley's ratings by one level to A, A, and A+, respectively.

60. June 4 Moody's announced it would cut the AAA ratings of Ambac and MBIA, two of the largest bond insurers.

61. June 19 Two former Bear Stearns hedge fund managers were indicted for fraud, marking the first criminal indictments with respect to the subprime crisis.

62. July 7 Freddie Mac and Fannie Mae shares plummet on reports that a government bailout would be necessary to keep the institutions afloat.

63. July 11 IndyMac Bank failed, which then was the second largest thrift failure in U.S. history. It was also the first bank to fail as a result of the subprime crisis. That same day, oil hit a record $147 per barrel, as commodities prices continued to skyrocket.

64. July 15 The FDIC issued its Final Policy Statement on covered bonds, in which it addressed creditor concerns with respect to a failed financial institution that had issued covered bonds. (For more information, consult our prior Client Alert "FDIC Offers Certainty on Covered Bonds" at http://www.mofo.com/docs/pdf/Client_Alert_FDIC.pdf.)

65. July 17 Merrill announced write downs of $9.4 billion.

66. July 28 The Treasury announced the Best Practices Guide for covered bonds, marking a push for alternative sources of mortgage financing as the securitization market remained frozen. Treasury Secretary Paulson stated that "covered bonds have the potential to increase mortgage financing,

 

improve underwriting standards, and strengthen U.S. financial institutions by providing a new funding source that will diversify their overall portfolio." (For more information, consult our prior Client Alert "Treasury Announces Best Practices for Covered Bonds" at http://www.mofo.com/news/updates/files/080729TreasuryAnnounces.pdf.)

67. July 30 Congress enacted the Housing and Economic Recovery Act, aimed at reforming the mortgage market and granting to the Treasury the ability to bailout Fannie Mae and Freddie Mac, if necessary.

68. August 8 Citigroup, UBS and Merrill agreed to buy back $36 billion of auction-rate securities, after New York Attorney General Andrew Cuomo threatened litigation. Other firms soon entered into settlement agreements for ARS repurchases.

69. August 27 Bloomberg released a summary of write downs (since the beginning of 2007) and capital raises (since July 2007) at more than 100 of the largest financial institutions. Bloomberg reported $506.1 billion in write downs by financial institutions and a corresponding $352.6 billion in capital raises.

70. September 7 The U.S. placed Fannie and Freddie into conservatorship, wiping out the value of the stock of its shareholders, including those who only months prior had made significant investments in preferred stock.

71. September 15 Lehman filed for bankruptcy, which was the largest bankruptcy in U.S. history, after the Fed refused to step in. That same day, Bank of America announced it would acquire Merrill, then the third largest investment bank.

72. September 16 AIG, the largest insurance company in the world, on the brink of bankruptcy, was bailed out by the Fed, with the full support of the Treasury. The Fed provided a two-year $85 billion loan to AIG and received in return an equity stake representing 79.9% ownership.

73. September 17 Shares of Goldman Sachs and Morgan Stanley plunged as the market lost confidence in investment banks. Credit default swap spreads on financial institutions spiked to unprecedented levels. For example, spreads on Washington Mutual reached approximately 4800 basis points. Two years earlier, such spreads were at approximately 20 basis points. LIBOR spreads over the federal funds rate also widened to unprecedented levels, meaning that banks were afraid to lend to one another for fear that the borrower bank would fail overnight.

74. September 19 The Treasury announced a temporary guarantee program for money market funds in danger of "breaking the buck" pursuant to which it will insure the holdings of any publicly offered eligible money market mutual fund that pays a fee to participate in the program. (For more information, consult our prior Client Alert "First Look at Treasury Plan; Money Market Fund Bailout" at http://www.mofo.com/news/updates/files/080921FirstLook.pdf.)

75. September 22 Goldman Sachs, the largest investment bank, and Morgan Stanley, the second largest investment bank, elected to become banks, marking an end to the large investment banking era.

76. September 25 Washington Mutual, a thrift, failed (the largest banking failure in U.S. history), and its assets were sold to JPMorgan Chase for $1.88 billion. JPMorgan assumed the deposit liabilities and covered bonds of Washington Mutual.

77. September 29 Citigroup announced it would acquire Wachovia, which was on the verge of failure, for approximately $2 billion with FDIC help. Under the agreement, Citigroup would have absorbed up to the first $42 billion of losses on a $312 billion pool of loans. The FDIC would have absorbed losses

 

beyond that. Citigroup would have granted the FDIC $12 billion in preferred stock and warrants to compensate the FDIC for bearing this risk.

78. October 2 As the commercial paper market froze, General Electric announced its plan to raise $15 billion in capital by issuing common stock.

79. October 3 Wells Fargo announced it would acquire Wachovia for $15 billion without FDIC help. That same day, Congress passed the Emergency Economic Stabilization Act, providing $700 billion to the Treasury to purchase troubled assets from eligible financial institutions under the Troubled Asset Relief Program ("TARP").

80. October 7 The Fed announced a temporary Commercial Paper Funding Facility ("CPFF"), aimed at unfreezing the commercial paper market. The CPFF provides a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle ("SPV") that will purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers. The SPV will cease purchasing commercial paper on April 30, 2009, unless the Fed extends the facility. (For more information, consult our prior Client Alert "TARP and the Various Tent Poles: Will it be Enough?" at http://www.mofo.com/news/updates/files/081015TARP.pdf.)

81. October 8 As failures (and near failures) hit Europe, the Fed and the European Central Bank announced a coordinated interest rate cut. The Fed cut the discount rate and the federal funds rate each by an additional 50 basis points to 1.75% and 1.50%, respectively.

82. October 13 The United Kingdom announced it would inject £37 billion in three of the country's largest banks, including RBS, Lloyds TSB and HBOS.

83. October 14 The Treasury announced the TARP Capital Purchase Program, a plan to directly inject capital into eligible financial institutions. Originally, nine banks received $125 billion. These banks included Citigroup ($25 billion), JPMorgan Chase ($25 billion), Wells Fargo ($25 billion), Bank of America ($12.5 billion), Merrill ($12.5 billion), Goldman Sachs ($10 billion), Morgan Stanley ($10 billion), Bank of New York Mellon ($3 billion), and State Street ($2 billion). (For more information, consult our prior Client Alert "New Liquidity and Capital Alternatives for Financial Institutions: Treasury's TARP Capital Purchase Program; FDIC's Temporary Liquidity Guarantee Program" at http://www.mofo.com/news/updates/files/081016NewLiquidity.pdf.)

84. October 14 The FDIC announced the Temporary Liquidity Guarantee Program, a plan to guarantee newly issued bank debt for three years in return for a fee. (For more information, consult our prior Client Alert "New Liquidity and Capital Alternatives for Financial Institutions: Treasury's TARP Capital Purchase Program; FDIC's Temporary Liquidity Guarantee Program" at http://www.mofo.com/news/updates/files/081016NewLiquidity.pdf.)

85. October 21 The Fed announced the creation of the Money Market Investor Funding Facility ("MMIFF"), which is designed to provide additional liquidity to U.S. money market investors. (For more information, consult our prior Client Alert "Federal Reserve Announces Creation of Money Market Investor Funding Facility" at http://www.mofo.com/news/updates/files/081021FederalReserve.pdf.)

86. October 24 PNC announced it would acquire National City for $5.2 billion in PNC stock, after it received approval for a $7.7 billion capital injection under the TARP Capital Purchase Program. This deal caused controversy as critics thought the funds provided under the program should be used for lending, not acquisitions.

87. October 29 The Fed cut the discount rate and the federal funds rate each by an additional 50 basis points to 1.25% and 1.00%, respectively.

88. November 4 Brazilian banks Itau and Unibanco merged to create Itau-Unibanco, Brazil's largest bank, in an effort to weather the financial crisis. Brazil's financial system was battered by steep currency declines and tightening credit.

89. November 10 American Express elected to become a bank.

90. November 10 Circuit City declared bankruptcy, as the credit crisis took its toll on Main Street.

91. November 10 The terms of the AIG bailout were revised, as the U.S. government announced it would provide in the aggregate $150 billion to AIG. AIG reported a loss of $24.5 billion for the third quarter, a significant amount of which was from its credit default swap portfolio.

92. November 12 Treasury Secretary Paulson announced that remaining TARP funds would not be used to purchase troubled assets, but rather would be used to relieve pressure on consumers, as the banking system stabilized (including a significant decrease in credit default swap and LIBOR spreads). The market was spooked and shares of all major financial institutions plunged on the news.

93. November 17 Congress scheduled a debate on whether to bail out the U.S. big-three automakers (GM, Ford and Chrysler) by providing $25 billion in emergency aid. The big-three had seen car sales significantly decline over the prior two years due to a weakening economy, tightening credit, and previous skyrocketing oil and commodities prices.

94. November 21 Goldman Sachs and Citigroup announced they would issue debt under the FDIC temporary guarantee liquidity program. Other big banks, including JPMorgan Chase and Bank of America, would also announce their intent to issue notes through such program.

95. November 24 The U.S. bailed out Citigroup by providing an additional $20 billion in capital and a $306 billion guarantee on its risky assets.

96. November 25 The Fed announced the Term Asset-Backed Securities Loan Facility ("TALF"), a facility aimed at relieving stress on the student loan, auto loan, credit card loan, and small business loan market. Under the TALF, the Fed would lend up to $200 billion on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans. (For more information, consult our prior Client Alert "TARP's Term Asset-Backed Securities Loan Facility: Can Wall Street Help Main Street?" at http://www.mofo.com/news/updates/files/081126TermAsset.pdf.)

97. December 4 It was reported that Harvard University's endowment lost 22% in value (approximately $8 billion).

98. December 4 Capital One agreed to acquire Chevy Chase Bank for $520 billion in cash and stock.

99. December 4 The European Central Bank cut interest rates by 75 basis points to 2.50%, the Bank of England cut interest rates by 100 basis points to 2.00%, and Sweden's central bank cut interest rates by 175 basis points to 2.00%.

100. December 5 The U.S. nonfarm payroll jobs report indicated a loss of 533,000 jobs in the month of November, indicating that the United States was in a deep recession. The market had expected job losses of approximately 350,000. U.S. companies cut jobs at the fastest pace since the 1970s.

101. December 16 The Fed cut the discount rate by 75 basis points to 0.50% and established a target range for the federal funds rate of 0.00% to 0.25%.

## The Temporary Liquidity Guarantee Program and Bearer Debt

The FDIC announced the TLGP on October 14, 2008 in response to the current market crisis. Under the TLGP, newly-issued senior unsecured debt issued by participating "eligible institutions" will be guaranteed by the FDIC and backed by the full faith and credit of the United States. Pursuant to the TLGP, the FDIC will guarantee debt issued through June 30, 2009 and the debt will be covered by the guarantee through June 30, 2012.

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act ("TEFRA") which restricts the issuance of debt instruments in bearer form. Under TEFRA, issuers of bearer debt generally are denied deductions for U.S. federal income tax purposes for interest paid on the bearer debt and are subject to an excise tax. However, the issuer sanctions do not apply in the case of bearer debt instruments that are issued under arrangements reasonably designed to ensure that they will not be sold to United States persons. These arrangements include an issuance of bearer debt instruments that complies with Treasury regulations referred to as "TEFRA D." For example, many U.S. issuers have European Medium-Term Note or other programs under which they issue bearer notes to non-U.S. investors. These issuances comply with TEFRA D and, as such, the instruments do not trigger the sanctions described above.

The ban on bearer U.S. government guaranteed debt dates back to 1984. Shortly after the U.S. withholding tax was repealed for "portfolio" interest, various investment banks stripped U.S. Treasury bonds by contributing the bonds to a trust and taking back bearer trust certificates. The bearer trust certificates were sold to foreign investors in compliance with TEFRA. In response, then-Secretary of the Treasury Donald Regan issued a news release announcing that regulations would be promulgated that prohibited U.S. Treasury bonds and other instruments guaranteed by the U.S. government from being issued in bearer form. The regulations subsequently promulgated under TEFRA generally provide that an obligation guaranteed by a United States Government-owned agency cannot satisfy requirements for exemption from the sanctions described above. Consequently, it appears that issuers of bearer debt instruments covered by an FDIC guarantee under TLGP would generally be subject to the sanctions described above.

Rather than bearer debt, an issuer of FDIC-guaranteed debt may, conceivably, issue debt that complies with rules that apply to "foreign targeted registered obligations" which permit the issuance of properly structured registered debt into foreign markets without requiring that the issuer obtain tax certifications from each investor. These rules, however, are in flux. In Notice 2006-99, the IRS announced its intention to issue regulations providing that tax certifications would be required for foreign targeted registered obligations issued after 2006, except for debt instruments issued before January 1, 2009 with a stated maturity of no more than 10 years. To date, no such regulations have been issued.

It is possible that the Treasury Department could issue guidance addressing the U.S. tax consequences of issuing bearer debt instruments under TLGP as part of the ongoing effort to minimize impediments on liquidity in the credit markets. To date, however, no such guidance has been issued.

## The New Administration's Tax Plan – What to Expect

On November 4, 2008, the nation elected Barack Obama as its 44th president. Below, we briefly summarize tax policy initiatives that his campaign emphasized on the road to the White House. Of course, the particulars of the tax policy initiatives are not known. In addition, we do not know whether the President-elect will continue to support these initiatives in light of a continuously changing economic landscape.

1. *Increase marginal tax rate on high income earners up to 39.6%.* The highest marginal tax rate on high income earners currently stands at 35%. Obama's campaign indicated he would support increasing the marginal rates to levels of the Clinton era rates for high income earners.

2. *Increase long-term capital gains and dividend rate from 15% to 20% for high income earners only.* The campaign indicated that Obama would support a tax increase on capital gains and dividends for high income earners. It is not clear whether Obama would seek an increase through legislative action in 2009 or through expiration of the Bush tax cuts in 2010.

3. *Increase FICA tax (colloquially known as the payroll tax) by 2% to 4% for high income earners effective in 2018.* The payroll tax funds Social Security and Medicare. In general, the United States imposes a payroll tax of 6.2% on wages up to the first $102,000 of wages earned per year in addition to United States federal income tax. Obama's campaign has suggested that he would support lifting the cap on the payroll tax for an aggregate increase of between 2% to 4% on high income earners effective in 2018.

4. *Tax carried interest as ordinary income.* Currently, private equity funds (e.g., leveraged buyout funds), are generally structured as partnerships. A fund manager generally receives a 2% management fee and a 20% profits interest in the partnership. In general, under current law, the 20% profits interest is not be taxed as compensation at ordinary rates. Instead, it is taxed at 15% in the case of long-term gains. Obama's campaign indicated he would support taxing such income at ordinary rates.

5. *Codify economic substance doctrine.* Obama may support codification of the economic substance doctrine. The economic substance doctrine is a common-law doctrine developed by courts in the United States to police tax shelters and operates in some cases to disregard the form of a transaction and tax the transaction instead based on its substance (or disregard all or a portion of a transaction) if the taxpayer can provide no justification for entering into the transaction other than tax avoidance.

6. *Significantly expand refundable tax credits.* In pursuit of a goal to reduce taxes for 95% of Americans (to be distinguished from 95% of taxpayers), Obama has indicated his support for significantly expanding refundable tax credits. A refundable tax credit is one in which a taxpayer may still receive a tax credit even if the taxpayer does not owe tax. Obama's campaign suggested that these refundable tax credits would favor middle-class and low-income taxpayers.

7. *Windfall profits tax on oil and gas companies.* Obama has indicated his support for taxing windfall profits of oil and gas companies. This initiative is in response to the record profits by oil and gas companies over the last few years and the record oil prices in the first half of 2008. However, as oil prices plummeted from $147 per barrel to under $45 per barrel, it has been reported that Obama may no longer push for such an initiative.

8. *Eliminate income tax for seniors making less than $50,000 per year.* Obama's campaign has indicated support for elimination of income taxes for seniors making less than $50,000 per year.

9. *Other initiatives related to credit crisis.* As the credit crisis deepened towards the end of his campaign, in late October 2008, Obama indicated he would support the following initiatives: (i) the elimination of the income tax on unemployment insurance for 2008 and 2009; (ii) allowing penalty-free withdrawals of up to 15 percent (but no more than $10,000) from retirement accounts**;** (iii) providing a refundable $3,000 credit to businesses for each new full-time job they create; (iv) the elimination all capital gains taxes on investments in small and start-up firms; and (v) the lowering of corporate tax rates for companies that expand or start operations in the United States.

## In re Bilski – The End of Patenting Tax Strategies?

In recent years, the United States Patent and Trademark Office ("USPTO") and the Federal Circuit have struggled with the proper standard for patent-eligibility of so-called business method inventions, which generally are thought to include tax strategies. Even though pursuant to statute "any new and useful process, machine, manufacture, or composition of matter" are patent-eligible subject matters, the courts had excluded any "business process" until the decision in *State Street Bank & Trust Co. v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998). In that case, the court held that a business method was patent-eligible as long as it produced a "useful, concrete, and tangible result." The *State Street* decision opened the gates to applications for patents covering tax strategies – many have been filed with the USPTO and some interesting tax patents have been granted (for one example see The Learning Annex below). It now seems, however, that the Federal Circuit may have closed the door with its decision in *In re Bilski*, No. 2007-1130 (Fed. Cir. Oct. 30, 2008).

*Bilski* claimed a method of hedging risk associated with volatile commodity prices by entering into swaps to smooth out price fluctuations. The Federal Circuit, addressing whether the claim involved patent-eligible subject matter (the first prong discussed below in the Learning Annex), however, determined that the claim involved a "non-transformative process that encompasses a purely mental process of performing requisite calculations without the aid of a computer or any other device." As a result, it did not meet the court's test of being tied to a particular machine or apparatus or transforming a particular article into a different state of things. The holding in *Bilski* would seem to apply equally to tax strategies that involve only mental processes and that are not sufficiently physically tied to the use of a computer or other apparatus. The *Bilski* court did not say that all business methods (and by extension tax strategies) are not patent-eligible per se. Quite the contrary. Thus, it will be interesting to see just how the patent examiners at the USPTO will apply *Bilski* to applications for tax strategies and what the effect of the new decision will be on business method and tax strategy patents that have already been granted.

## The Learning Annex: Tax Patents Explained

Article I, Section 8 of the United States Constitution grants Congress the power "To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." In the United States, patent protection is granted by statute under the Patent Act, Section 101 of which provides: "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvements thereof, may obtain a patent, subject to the conditions and requirements of this title."

The principal conditions and requirements for obtaining a patent are that the invention must be (a) "statutory" (i.e., covered by a statutory category expressly protected, and not excepted as a law of nature, natural phenomenon or an abstract idea, none of which are patent-eligible), (b) "novel" (meaning the invention must be new), (c) "useful" (the invention must have a useful purpose and, in the case of a machine or process, must operate to perform the intended purpose) and (d) "nonobvious" (meaning the invention must be an improvement over the state of the art (the "prior art") that would not be obvious to one of ordinary skill in the art).

If granted, a patent gives the holder the right to exclude all others from commercially exploiting the invention for a limited time (generally 20 years) from the date the application is filed, even if an infringer independently develops the same invention. Infringement of a patent is any unauthorized use of the invention within the United States during the specified term of the patent. If a patent is infringed, the patent holder may sue for relief and ask for an injunction to prevent continued infringement and for monetary damages.

Tax patents may fall under the broader class of patents: business methods. *State Street* held that a method of doing business was not excluded subject matter and is patent-eligible. The test, at least until the *Bilski* case (discussed above) was that a process for doing business must produce a "concrete, useful and tangible" result in order to be patentable.

In August 2001, an application was filed that contained, among others, the following claim for a patent to protect: A method performed with respect to a stock company, shares of stock of the company trading at a price, the method further performed with respect to a holder of a financial instrument, the instrument having a market price, the method comprising the steps of:

a. issuing the financial instrument indicative of a principal amount at maturity and receiving an issue price therefore;

b. contractually agreeing, pursuant to the financial instrument, to repay said principal upon predetermined conditions and according to a predetermined term;

c. contractually agreeing, pursuant to the financial instrument, to convert the instrument into a number of shares of stock of the company;

d. contractually agreeing, pursuant to the financial instrument, to make a payment to the holder with respect to a contingency, the contingency a function of the market price of the instrument or the market price of the stock, wherein the payment is made with respect to passage of a time interval in the event the market price of the instrument or the market price of the stock is in a predetermined relationship to a principal amount;

e. converting the instrument upon request into shares of stock of the company, based upon said conditions of the contractual agreement to repay, of the contractual agreement to convert, and the contractual agreement to make payment; and

f. taking a tax deduction based upon a yield at which the issuer would issue a fixed-rate, nonconvertible debt instrument comparable to the financial instrument.

The patent was granted on May 15, 2007. To those familiar with financial products, the instrument just described is the so-called "contingent convertible" debt instrument. We leave it to *Bilski* and other courts to determine the validity of these and similar patents. In the meantime, interested readers may themselves reflect on the anatomy of this patent claim in light of each of the requirements discussed above. The patent is publicly available at www.USPTO.com.

Quite apart from their future in light of *Bilski*, tax patents raise interesting policy issues which have been addressed by the Internal Revenue Service, the American Bar Association, the American Institute of Certified Public Accountants and interested parties in the United States Congress. We leave discussion of policy, however, to a future issue of MoFo Tax Talk.

## MoFo in the News

On October 15, 2008, Morrison & Foerster hosted a seminar at our New York offices entitled "Briefing on the Emergency Economic Stabilization Act and Related Initiatives." Speakers on the panel included Dr. Elaine Buckberg and Dr. Ronald I. Miller, each from NERA Economic Consulting, and Morrison & Foerster partners Barbara Mendelson, Thomas A. Humphreys, and James R. Tanenbaum. The panel focused on the powers and roles of the Federal Reserve, the FDIC and Treasury and how action by each has been (and may in the future be) necessary to help stem the crisis. The panel also discussed recent tax developments relating to the credit crisis, including controversial Notice 2008-83 and its impact on bank mergers.

On October 19 through October 22, 2008, Morrison & Foerster co-sponsored ABS East 2008 in Florida, a conference addressing distressed debt pricing and valuation in the face of illiquidity, product transparency, the critical task of rebuilding investor confidence and updates on the legal and regulatory landscape affecting asset-backed securities. Morrison & Foerster partner Thomas A. Humphreys, a participant at the conference, discussed recent changes in the securitization market, including updates in accounting and tax standards.

On October 21, Morrison & Foerster sponsored "Covered Bonds—the Americas," a conference held in Florida addressing covered bond developments in the United States. The panel included Morrison & Foerster partners Anna T. Pinedo, Oliver I. Ireland, and James R. Tanenbaum. The Morrison & Foerster team discussed the structure of covered bonds in the United States market, including cash flow considerations, default events, swap agreements, and guaranteed investment contracts. The Morrison & Foerster team also discussed legislative and regulatory issues concerning covered bonds, including recent initiatives by the FDIC and the Treasury.

On November 11 through November 12, 2008, Morrison & Foerster sponsored a seminar on European structured products in London, England, entitled "Structured Products Europe," which was hosted by Structured Products magazine. Morrison & Foerster partners Peter J. Green, Trevor James, and Jeremy C. Jennings-Mares led two structured products workshops, one on structured products "wrappers," and the other on the changing landscape of structured products. The team also spoke on two panels: an overview of the European structured products market and an update on the evolving European regulatory environment, as the credit crisis continues to reshape the regulatory world.

On November 18, Morrison & Foerster hosted a seminar on private equity investments in financial institutions, entitled "Private Investment in Financial Institutions and Financial Assets." Speakers at the event included Morrison & Foerster partners Anna T. Pinedo, Thomas A. Humphreys, Oliver I. Ireland, Larry Engel, and Brett H. Miller. The panel discussed the impact of the Treasury bailout and related measures on private equity investment, including the Capital Purchase Program and tax relief; the regulation of private investment in financial institutions; considerations in structuring private equity investments in the financial services sector; and strategies for acquisitions of financial assets from troubled financial institutions, including issues related to FDIC receivership and bankruptcy procedures.

On November 21, Thomas A. Humphreys gave a talk entitled "The New, New Mortgage" on a number of plans that have been proposed to reform the U.S. mortgage system. The talk covered the Soros Plan (modeled after the Danish system where mortgages are repackaged into standardized covered bonds that the homeowner can repurchase in order to defease his or her loan), the Alpert "Freedom Recovery Plan" (where homeowners in financial distress would give up their deeds, rent the home back and pay tax deductible rent), the Patrick-Taylor Plan, proposed by the former Merrill Lynch CFO, Tom Patrick (where the government would refinance all securitized mortgages with the proceeds being used to repay existing mortgages and "collapse" all legacy securitization vehicles), and shared appreciation mortgages (being proposed by the Brookings Institute and professors in the NYU Graduate Tax Program).

On December 4, Morrison & Foerster and the Structured Products Association hosted a seminar entitled "Year in Review," in which the panelists discussed the effects of the credit crunch over the last year on legal and regulatory aspects of securities filings and credit default swaps, including domestic and foreign regulatory issues and other reform proposals in the pipeline. Partner Anna T. Pinedo moderated the discussion and spoke on issues related to the aftermath of the collapse of Lehman, including its effects on Lehman structured products.

Morrison & Foerster is slated to write "Structured Products – The Book" to be published by the International Financial Law Review ("IFLR"). The text will explore, in plain English, a framework for understanding structured products, including corporate, securities and tax law aspects of issuing and investing in structured products in domestic and international contexts. Morrison & Foerster partners James R. Tanenbaum, Anna T. Pinedo, and Lloyd S. Harmetz will address the U.S. corporate and securities law aspects, while Thomas A. Humphreys and Shamir Merali will take the lead on U.S. federal income tax considerations. Partners Peter J. Green, Trevor James, and Jeremy C. Jennings-Mares will discuss international aspects. The text is expected to be published in 2009.

## Press Corner

On September 25, 2008, JPMorgan acquired Washington Mutual in a transaction facilitated by the FDIC. JPMorgan purchased all of the assets of Washington Mutual for $1.88 billion and assumed Washington Mutual's deposit liabilities and debt (including covered bond obligations). While general creditors and equity holders of Washington Mutual were largely wiped out, the deal with JPMorgan protected depositors from losses and relieved the FDIC from any deposit insurance liability with respect to those deposits. On September 26, the bank holding company, Washington Mutual, Inc., and its remaining subsidiary, WMI Investment Corp., filed for Chapter 11 bankruptcy. On October 24, the bank holding company filed a motion in bankruptcy court to protect its interests in the company's tax losses. The losses, which could be carried back two years for a refund of taxes paid in those prior years, total $20 billion by some accounts and have a cash value, therefore, of up to $7 billion. On October 30, JPMorgan Chase filed a motion in bankruptcy court to protect its claim on "tax attributes not properly allocable to the debtors' estate," such as tax attributes relating to its acquisition of Washington Mutual, including any right to receive any tax refund attributable to all or a portion of the losses mentioned above, to the extent not properly allocable to the debtors' estate. In light of the fact that the deal was a weekend shot-gun wedding brokered by the government, it is hard to imagine that the parties had time to adequately negotiate all aspects of the deal, including, for example, provisions concerning any tax attributes generated by the transaction itself.

As discussed elsewhere in this issue, on September 30, 2008, the IRS issued Notice 2008-83, which relaxed Section 382's limitation on built-in loan losses of a troubled bank to help ease the systemic risk posed by collapsing financial institutions by facilitating the acquisitions of troubled banks by stronger financial institutions. There are some who argue that the Notice effectively turned off an explicit statutory provision and, therefore, that the IRS exceeded its authority in issuing it. Exacerbating the controversy, the cost of the Notice to the Treasury could very well exceed one hundred billion dollars, according to some estimates. Among those upset are Senate Finance Committee ranking member Chuck Grassley, R-Iowa, who has questioned the legality of the Notice and asked for an investigation into the process behind its issuance. A representative in Treasury's Office of Inspector General ("OIG") (which reports to the Secretary of the Treasury and is charged with providing independent and objective reviews of Treasury's operations) stated that the office would review issues raised by the Notice. Finally, two separate bills have been introduced in Congress to repeal Notice 2008-83 by legislative action.

## A Word on Sources

In creating this newsletter, we have used and relied on factual information widely available in the press and other public sources, including the U.S. Treasury (www.treasury.gov); the Internal Revenue Service (www.irs.gov); The Wall Street Journal (www.wsj.com); Bloomberg (www.bloomberg.com); the BBC News (http://news.bbc.co.uk); The New York Times (www.nytimes.com); the Financial Times (www.ft.com); Reuters (www.reuters.com); and CNBC (www.cnbc.com).


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