MORRISON | FOERSTER

News Bulletin March 7, 2008 Volume 1, Issue 1

MoFo Tax Talk

Exchange Traded Notes—A Tax-Favored Investment Vehicle?

Exchange traded funds ("ETFs") are investment funds whose shares trade on a stock exchange. From a U.S. federal income tax standpoint, ETFs are flow-through vehicles that generally must distribute their income currently. Taxable U.S. investors include these amounts in their income annually. Viewed as economic cousins of ETFs, exchange traded notes ("ETNs") are structured notes representing securities issued by corporations, typically financial institutions. ETNs generally do not distribute income currently. Contrary to the current inclusion and ordinary income regime applicable to ETFs, ETNs are treated as prepaid forward contracts for U.S. federal income tax purposes. As such, under current law, investors in ETNs generally do not report current accruals of income and gain or loss is determined only upon a sale of the note. The following chart summarizes the treatment of ETFs and ETNs under current law.

	Tax Structure	Tax Treatment to Holders
ETFs	Pass-Thrus	Current Ordinary Income Treatment on Distributions
ETNs	Structured Notes	Income Deferral and Capital Gain

On December 7, 2007 the Internal Revenue Service ("IRS") and the Treasury Department ("Treasury") published Revenue Ruling 2008-1 ("Ruling") and Notice 2008-2 ("Notice") addressing the U.S. federal income tax treatment of prepaid forward contracts, which include certain ETNs. Viewed together, the Ruling and the Notice serve as a warning that the IRS is inclined to require current accrual of income on instruments, such as ETNs, that the market has previously treated under a "wait and see" accounting system.

The Ruling is expected to have an immediate impact only on a narrow class of single currency-linked ETNs. In the Notice, the IRS and Treasury have asked for public comments on a comprehensive list of tax issues regarding the U.S. federal income tax treatment of prepaid forward contracts including ETNs. This request for public comments comes as the tax treatment of ETNs has come under close scrutiny on Capitol Hill in recent weeks.

Legislation was introduced in the United States Congress by Representative Richard E. Neal (D - MA) in December 2007 which, if enacted, would impact the taxation of notes such as ETNs. Under the proposed legislation, a holder that acquires such a note after legislative enactment would be required to include income in respect of the note on a current basis. As of this writing, it is not possible to predict whether the legislation will be enacted in its proposed form, whether any other legislative action may be taken in the future, or whether any such legislation may apply on a retroactive basis.

That said, Treasury official David Shapiro is reported as having announced at a January 18, 2008 session of the American Bar Association Section of Taxation midyear meeting that any IRS guidance affecting the treatment of prepaid forward contracts is not expected to be retroactive.

MoFo "Developments in Hybrid Capital and Current Issues"

On January 30, 2008, Morrison & Foerster hosted an event entitled "Developments in Hybrid Capital and Current Issues." The event featured panelists Barbara Havlicek and Anna Krayn from Moody's Investors Service, David Kaplan and Scott Sprinzen from Standard & Poor's, and Thomas Humphreys from Morrison & Foerster. Given the increasing importance of addressing current capital needs in the market, the panelists discussed the significance of hybrid issuances as a financing strategy and evaluated the types of hybrid instruments recently issued by major financial institutions and Wall Street firms. The panel highlighted, from each rating agency's perspective, the equity/debt treatment of notable hybrid security issuances, taking into account factors such as maturity date, call options, mandatory deferral provisions, alternative payment mechanisms, and replacement capital covenants. Of particular note was the difference in rating agency treatment regarding State Street's recent Capital Trust III Normal Apex issuance. Moody's viewed the mandatory convertible into preferred stock feature combined with a 3 year call option as triggering Basket A (100% debt) treatment, while panelists from Standard & Poor's viewed this instrument as providing intermediate to high equity treatment. From a tax perspective, Thomas Humphreys addressed the current allowance of interest deductions for purchase-contract/note units and the treatment of long dated securities as debt or equity for tax purposes. Another issue raised on the tax front was the status of "sovereign wealth funds" as governmental entities that may be exempt from U.S. federal income tax on their U.S. investment earnings.

Hybrids—A U.S. Federal Income Tax Review

	Preferred Stock/ Depositary Shares	Convertible Preferred Stock	Mandatory Convertible Unit	Convertible Subordinated Debt	Trust Preferred Securities	Enhanced Trust Preferred Securities	WITS/HITS
Securities Offered	Preferred stock or depositary shares representing an interest in preferred stock	Preferred stock convertible into common stock	Remarketable trust preferred security and a forward purchase contract on issuer common stock	Subordinated debt convertible into issuer common stock	Trust preferred security representing an interest in junior subordinated debt	Trust preferred security representing an interest in junior subordinated debt with enhanced equity features	Remarketable trust preferred security and forward purchase contract on issuer perpetual preferred stock
Tax Treatment (Issuer)	Dividends on preferred stock or depositary shares not deductible	Dividends on preferred stock and common stock not deductible No effect upon conversion	Interest on trust preferred securities tax-deductible Contract adjustment fees on forward purchase contract not deductible Dividends on common stock not deductible No gain or loss upon settlement of forward purchase contract	Interest on debt tax-deductible Dividends on common stock not deductible	Interest on trust preferred securities tax deductible	Interest on trust preferred securities tax deductible	Interest on trust preferred securities tax deductible Contract adjustment fees not deductible No gain or loss upon settlement of forward contract Dividends on preferred stock not deductible
Tax Treatment (Holders)	30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption; holders may be able to fully credit withholding tax Dividends to US corporations generally eligible for the DRD Dividends to US individuals generally eligible as QDI	30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption; holders may be able to fully credit withholding tax No gain or loss upon conversion Dividends to US corporations generally eligible for the DRD Dividends to US individuals generally eligible as QDI	Generally no withholding tax on interest paid on trust preferred securities Contract adjustment fees may be subject to 30% withholding tax No gain or loss to holder upon settlement of forward contract 30% withholding tax on dividends on common stock; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption; holders may be able to fully credit withholding tax	Generally no withholding tax on interest paid No gain or loss on conversion 30% withholding tax on dividends on common stock; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption; holders may be able to fully credit withholding tax	Generally no withholding tax on interest	Generally no withholding tax on interest	Trust preferred securities may be subject to contingent payment debt instrument rules Generally no withholding tax on interest on trust preferred securities Contract adjustment fees may be subject to 30% withholding tax No gain or loss upon settlement of forward contract 30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption; holders may be able to fully credit withholding tax

Hybrids— A Survey of Recent Mega Deals

	Citigroup (A)	UBS	Morgan Stanley	Citigroup (B)	Merrill Lynch	Bank of America (A)	Bank of America (B)
Announce Date	11/26/2007	12/10/2007	12/19/2007	1/24/2008	1/15/2008	1/24/2008	1/24/2008
Issuance Size	$7.5 billion	$13 billion	$5.6 billion	$12.5 billion	$6.6 billion	$6 billion	$6 billion
Investor	Private Placement (Abu Dhabi Investment Authority)	Private Placement (Gov't of Singapore and undisclosed Middle East investor)	Private Placement (China Investment Corporation)	Private Placement (Gov't of Singapore, Prince Alwaleed, Kuwait Investment Authority and others)	Private Placement (Korea Investment Corporation, Kuwait Investment Authority and Mizuho Corporate Bank)	Public Offering	Public Offering
Security	Mandatory Unit DECS (Debt Exchangeable into Common Stock)	Mandatory Convertible Note (MCN)	Mandatory Unit PEPS (Premium Equity Participating Unit)	Optional Convertible Preferred Stock	Mandatory Convertible Preferred	Optional Convertible Preferred	Depository Shares
Terms	11% coupon $31.83 Conversion Price 0% Conversion Premium	9% coupon $46.81 to $66.95 Conversion Price 0% to 17% Conversion Premium	9% coupon $48.07 to $57.684 Conversion Price 20% Conversion Premium	7% coupon $31.62 Conversion Price 20% Conversion Premium	9% dividend $61.31 Conversion Price 17% Conversion Premium	7.25% dividend $50 Conversion Price 25% Conversion Premium	8% dividend until 2018; 3 month LIBOR plus 3.63% thereafter

Investing in the United States—A Sovereign Exemption

Internal Revenue Code Section 892 provides that a foreign government's income received from certain U.S. investments will be exempt from U.S. federal income taxation. These investments include stocks, bonds, or other domestic U.S. securities owned by a foreign government, financial instruments held in the execution of government financial policy and interest on deposit in banks in the United States. In general, since the enactment of the federal income tax laws, the United States has exempted income derived by foreign governments based on grounds of sovereign immunity. With the recent influx of foreign investment in U.S. investment firms, a question arises as to whether the income of a "sovereign wealth fund" may be exempt as income of a foreign government. Under temporary regulations, a foreign government includes the "integral parts" or "controlled entities" of a foreign sovereign. An "integral part" of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body that constitutes a governing authority of a foreign country. A "controlled entity" is an entity that is wholly owned and controlled (directly or indirectly) by a foreign sovereign, is organized under the laws of the foreign sovereign, has its net earnings credited to its own account or to other accounts of the foreign sovereign, and has its assets vest in the foreign sovereign upon dissolution. To claim benefits under Section 892 a qualifying sovereign fund uses IRS Form W-8 EXP.

The Learning Annex: A Taxonomy for Structured Notes—Type 1, Type 2 and Type 3 Notes

Analyzing the U.S. federal income tax treatment of any structured note requires an initial two-step analysis. First, the note must be characterized for tax purposes. There are four fundamental tax characterizations for any financial instrument, including structured notes. It may be a debt instrument, a forward contract, an option, or a notional principal contract. Also, there are any number of additional characterizations that are comprised of various permutations and combinations of the four fundamental characterizations. Second, once an instrument has been characterized, the technical rules that apply to the instrument must be identified.

There are two factual questions to ask in determining the proper tax characterization of a structured note: (i) is the note principal protected? and (ii) does the note bear a current periodic coupon?

If the answer to the first question is "yes," then the characterization of the note is fairly simple regardless of the answer to the second question. These notes typically are treated as debt instruments for tax purposes (e.g., an optionally exchangeable). We refer to such notes as "Type 1" notes.

Alternatively, if the answer to the first question is "no" and the answer to the second question is also "no," then the characterization of the note is also fairly simple. It is treated as akin to a forward contract (e.g., a zero-coupon mandatory exchangeable). The tax rules that apply to forward contracts are fairly simple and well-established. Forward contracts are subject to the so-called "open transaction" doctrine. Essentially, under this doctrine an investor adopts a "wait and see" approach, i.e., no current accrual of income is required and gain or loss is determined only upon sale, exchange or retirement of the note. Further, any such gain or loss is treated as capital gain or loss. These notes are referred to as "Type 2" notes.

Finally, if the answer to the first question is "no" but the answer to the second question is "yes"—a "Type 3" note—then categorizing the instrument with any level of certainty under current law is next to impossible, which makes figuring out what rules to apply very difficult indeed. Despite the legal uncertainty, however, Type 3 notes are issued all the time and the market has adopted consistent characterizations for these types of notes. In effect, the market has adopted a de facto rule that most issuers and investors agree to apply in the face of uncertainty. For example, a structured note may properly be treated as a unit consisting of a debt component and a derivative that is a forward contract (e.g., a mandatory exchangeable) or an option (e.g., a reverse mandatory exchangeable).

Structured Foreign Tax Credit TAM

On February 15, 2008, the IRS issued a technical advice memorandum (TAM 200807015) disallowing foreign tax credits ("FTCs") claimed by a U.S. bank in a structured tax credit transaction. This marks the first concrete evidence that the IRS is making good on its promise that it will attack these transactions.

In the TAM, a U.S. corporation invested in a hybrid instrument issued by a UK entity ("Issuer") that was designed to be treated as debt for UK purposes and a partnership interest for U.S. tax purposes. Issuer purchased a perpetual note issued by its ultimate parent, a UK bank, and paid UK tax on income from the perpetual note. The U.S. corporation asserted it was a partner in Issuer for U.S. tax purposes and claimed FTCs for the UK tax paid.

The TAM sets out four alternative reasons the FTCs should be disallowed:

1. The payment of the UK tax was a "noncompulsory payment" under existing Reg. Section 1.901-2(e)(5) in that the UK group failed to elect "group relief" under UK law in a manner that would have eliminated the UK tax;
2. The hybrid instrument was debt rather than equity for U.S. tax purposes. The IRS argued that, through an auction process, the holder was entitled to seek redemption of its security after one year and this made the hybrid security debt, or debt-like, for U.S. tax purposes;
3. The partnership anti-abuse rule (Reg. Section 1.701-2) applied to the transaction because the partners' tax liability was less than if the partners had directly invested in the perpetual note; and
4. The transaction lacked economic substance.

The TAM asserts that the U.S. corporation must include the net income from the investment, but should not be allowed a credit for the UK tax paid. Accordingly, under the TAM the U.S. corporation would be subject to both UK and US tax on income from the perpetual note.

Coordinated Issue Paper on Variable Prepaid Forward Contracts Plus Share Loans

The IRS has been attacking variable prepaid forward contracts ("VPFCs") coupled with stock loans for the last two years. Wall Street became aware of this when the IRS issued a technical advice memorandum (TAM 200604033) treating such transactions as sales for federal income tax purposes. On February 6, 2008 the IRS issued a "coordinated issue paper" that takes the same position as TAM 200604033, asserting that VPFCs coupled with stock loans result in a sale of the underlying shares for U.S. federal income tax purposes. A "coordinated issue paper" is guidance for IRS field agents that represents the position of the IRS.

Notable points in the coordinated issue paper include: (i) an assertion that it applies to a broad group of transactions (e.g., where taxpayer enters into the share lending agreement within 90 days or possibly longer); (ii) effective invitation for IRS field agents to assert penalties (including negligence and substantial understatement penalties) in appropriate cases; (iii) an assertion that Revenue Ruling 2003-7 (concluding that a VPFC does not result in a current common law or constructive sale) does not provide "substantial authority" for a taxpayer because the ruling did not involve a share loan; and, (iv) instruction to the field to focus on whether the VPFC coupled with a stock loan is a "reportable transaction", whether "material advisors" involved in the transaction are subject to a penalty for failure to report, and whether a taxpayer has a reportable transaction understatement. Overall, the new coordinated issue paper is added evidence of an aggressive IRS posture on transactions involving VPFCs.

Press Corner

An article in the January 24, 2008 edition of the Wall Street Journal "Citigroup and Morgan Stanley Embrace Taxman's Loophole" focused on the recent large hybrid financings by Citigroup and Morgan Stanley and commented that although the issuer and the investors in the transactions came out ahead, the IRS and the existing stockholders came out losers. The article notes that the issuers involved in these transactions "aren't doing anything improper" in that the tax treatment of the transactions is generally supported by Revenue Ruling 2003-97 and the IRS itself defends its position with respect to the ruling. However, the article highlights the tax deduction afforded by the structures and the adverse effect on the value of shares of the existing shareholders, noting a decline in quarterly dividend rates in some instances.

A second article published in Fortune Magazine ("Buy High, Sell Low-How Wall Street Banks Frittered Away Billions") ignores the tax aspects of the transactions altogether and instead focuses on the use of stock acquired through buy back programs in recent convertible issuances by Citigroup, Merrill Lynch, Morgan Stanley and UBS. The article concludes that these firms "have frittered away billions of dollars by selling their stock for much less than they paid for it," resulting in an erosion of shareholder value as opposed to the enhancement generally anticipated in a buyback program.

Contacts

United States Federal Income Tax Law

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

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

Corporate and Securities Law

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

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

About Morrison & Foerster

With more than 1000 lawyers in 18 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.