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TaxTalk

Editor's Note

As we were waiting for the Treasury Department's ("Treasury") Foreign Account Tax Compliance Act ("FATCA") regulations to spoil our holidays, Treasury officials gave us a gift of sorts and said the regulations would be out sometime "early" this year. Hopefully, they will be published prior to FATCA's next effective date of March 18. Even without the FATCA regulations, Q4 2011 had a number of important tax developments affecting the capital markets. Treasury released the final version of the specified foreign financial asset reporting form, along with temporary and proposed regulations. The Tenth Circuit affirmed the Tax Court's ruling in *Anschutz Co. v. Commissioner* on whether a prepaid variable forward plus a stock loan is a sale for federal income tax purposes. The Internal Revenue Service (the "IRS") issued various pieces of private guidance addressing the tax consequences of a number of transactions including modifications of debt instruments, worthless stock deductions for affiliated corporations and accreting dividends on preferred stock. These are discussed below. In addition, to kick-off Q1 2012, Treasury released temporary and proposed regulations addressing dividend equivalents. To conclude this edition, we have our regular features, *The Classroom* and *MoFo in the News*.

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Treasury Releases Temporary and Proposed Regulations on Withholding under Equity Swaps

On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (the "Hire Act").[1] The Hire Act, by enacting Section 871(m),[2] imposes a withholding tax on "dividend equivalents" paid under equity swaps by treating such amounts as U.S. source dividends.[3] On January 19, 2012, Treasury released temporary and proposed regulations addressing dividend equivalents.

Background

Pursuant to Section 871(m), a dividend equivalent is (i) any substitute dividend (made pursuant to a securities-lending or "repo" transaction), (ii) any amount paid pursuant to a "specified notional principal contract," and that is contingent on, or determined by reference to, the payment of a U.S.-source dividend, and (iii) any amount that the Treasury determines is substantially similar to a payment described in (i) and (ii) (i.e., substantially similar to dividend equivalents).

A specified notional principal contract is any notional principal contract if (i) in connection with entering into the contract, any long party (i.e., the party entitled to receive the dividend related payment) transfers the underlying security, (ii) in connection with the termination of the contract, any short party (i.e., any party that is not a long party) transfers the underlying securities to any long party, (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral, or (v) the Treasury identifies the contract as a specified notional principal contact. In addition, unless the Treasury determines that a notional principal contract is of a type that does not have the potential for tax avoidance, any notional principal contract pursuant to which payments are made after March 18, 2012, will be a specified notional principal contract.

Temporary Regulations

The temporary regulations apply to payments made after March 18, 2012 and before December 31, 2012. Under the temporary regulations, the current definition of "specified notional principal contracts" is extended through December 31, 2012.

As indicated in the preamble to the regulations, Treasury and the IRS believe that an extension of this definition is necessary to allow taxpayers and withholding agents to modify their systems and other operating procedures to comply with these rules.

Proposed Regulations

The proposed regulations broaden and expand the circumstances under which a notional contract would be considered a "specified notional principal contract" and will be effective for payments as of January 1, 2013, once finalized.

Specifically, a notional principal contract is a specified notional principal contract if (i) the long party is in the market on the same day that the notional principal contract is priced or terminates;[4] (ii) the underlying security is not regularly traded on a qualified exchange; (iii) the short party posts the underlying security as collateral and the underlying security represents more than 10% of the total fair market value of all collateral; (iv) its actual term is less than 90 days (regardless of its contractual term); (v) the long party controls the short party's hedge;[5] (vi) the notional principal amount is greater than either 5% of the total public float of the underlying security or 20% of the 30-day daily average trading volume; or (vii) the notional principal contract is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.[6]

The proposed regulations also expand the definition of dividend equivalents ot include the following: (i) any payment of a beneficial owner's tax liability with respect to a dividend equivalent (e.g., a tax gross-up) and (ii) any payment (including the payment of the purchase price or an adjustment thereto) with respect to an equity-linked instrument[7] that is determined by reference to a U.S. source dividend.

The proposed regulations state that payments determined by reference to an estimate of an expected dividend, without reference to or adjustment for the amount of any actual dividend, are not treated as dividend equivalents.

If a notional principal contract is linked to more than one underlying security or to a "customized index,"[8] each security or component of such index is treated s an

1 See our prior client alert addressing the Act at http://www.mofo.com//files//Uploads/Images/100322FATCA.pdf.

2 All Section references are to the Internal Revenue Code of 1986, as amended, (the "Code").

3 This withholding provision is located in section 871(m) of the Internal Revenue Code of 1986, as amended (the "Code").

4 A long party is generally "in the market" if, subject to a 10% de minimis exception, the long party (i) disposes of the underlying security on the same day or days that the parties price the contract, (ii) acquires the underlying security on the same day or days that the contract terminates, or (iii) disposes or acquires the underlying security at a price determined by reference to an amount used to price or terminate the contract.

5 The term "control" in this regards includes control contractually, by conduct or an underlying equity control program which means a system that permits the long party to direct how a short party hedges its risk or permits a long party to acquire an underlying security in a transaction with a short party and to instruct the short party to execute such transaction in the form of an notional principal contract after acquiring such underlying security.

6 For purposes of applying the foregoing seven tests, a related person is treated as a party to a notional principal contract. However, a notional principal contract entered into between related persons is not treated as a specified contract if such contract hedges another notional principal contract entered into with an unrelated party and both contracts were entered into in the ordinary course of their business as a dealer.

7 An equity-linked instrument for these purposes is a (or a combination of) financial instrument(s) that reference one or more underlying securities to determine its value, including a future contract, forward contract, option or other contractual arrangement.

8 A customized index means any index that is (i) narrow based (as defined in the proposed regulations), or (ii) any index if no futures contracts or option contracts trade on such index.

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Regulations on Withholding under Equity Swaps

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underlying security in a separate notional principal contract for purposes of applying the dividend equivalent provisions.

Further, a dividend equivalent is treated as a dividend for treaty purposes and for purposes of the special Code provision exemption foreign governments and international organizations from U.S. federal income tax.

This issuance of these regulations is likely to be followed by additional FATCA-related regulations. For all FATCA updates, including drafts of these temporary and proposed regulations, see our FATCA website at KNOWFatca.com.

IRS Releases Temporary and Proposed Regulations on Reporting of Specified Foreign Financial Assets

In addition to the enactment of a new U.S. withholding regime, FATCA also included a new set of reporting requirements for specified foreign financial assets, currently residing in Section 6038D. These reporting requirements were enacted, along with the withholding regime, as part of the Treasury's attempt to improve tax compliance by U.S. taxpayers with offshore accounts. Pursuant to the reporting requirements, an individual generally must file a statement with his or her income tax return to report interests in specified foreign financial assets if the aggregate value of such assets exceeds certain thresholds. In the summer of 2011, the IRS issued guidance[9] suspending the reporting requirements under Section 6038D for tax years beginning after March 17, 2010, until the IRS released the final version of Form 8938, "Statement of Foreign Financial Assets."[10] In December 2011, Treasury and the IRS released temporary and proposed regulations, addressing the specified foreign financial asset reporting requirements, along with Form 8938 in its final form.[11] These reporting requirements are effective for tax years beginning after March 18, 2010, which for most people will be their 2011 tax returns filed during the 2012 calendar year. The filing of Form 8938 is not a substitute for a "Report of Foreign Bank and Financial Accounts" ("FBAR") filing requirements; both forms must be filed, if required.

Subject to certain exceptions, an individual is generally required to complete and attach Form 8938 to his or her income tax return if (i) he or she is a specified individual who has an interest in specified foreign financial assets and (ii) the value of those assets is more than the applicable reporting threshold. Under the temporary regulations,[12] a "specified individual" includes a U.S. citizen, a resident alien and certain non-resident aliens. A specified individual is not required to file Form 8938 for any tax year for which he or she is not required to file an annual income tax return, regardless of the value of his or her specified foreign financial assets. For purposes of the reporting requirements, a specified individual is generally considered to have an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds or distributions attributable to the holding or disposition of such asset are or would be required to be reported on such individual's annual income tax return.

[9] See Notice 2011-55 and MoFo Tax Talk Volume 4, No. 2.

[10] To review Form 8939 along with the related instructions, see our website: KNOWFatca.com.

[11] A draft Form 8939 was released in October 2011.

[12] T.D. 9567.

Under Section 6038D and the temporary regulations, there are two main categories of specified foreign financial assets: (i) financial accounts maintained by foreign financial institutions and (ii) certain other foreign financial assets or instruments. The preamble to the temporary regulations clarifies what constitutes a "foreign financial institution" for these purposes, which includes a financial institution which is a foreign entity that accepts deposits in the ordinary course of a banking or similar business, holds financial assets for the account of others as a substantial portion of its business, or is engaged, or holds itself out as being engaged, primarily in the business of investing, reinvesting, or trading in certain interests. While a financial institution organized under the laws of a U.S. territory is generally not a foreign financial institution for other purposes under the Code, a specified foreign financial asset includes a financial account maintained by a financial institution organized under the laws of a U.S. territory. As previously mentioned, a specified foreign financial asset includes certain other foreign financial assets or instruments that are held outside of a financial account maintained by a financial institution, including certain assets held for investment.[13] The temporary regulations provide a carve-out for certain assets not subject to the reporting requirements, including assets for which a specified individual uses the mark-to-market method of accounting and a financial account maintained by a foreign financial institution for which the specified individual uses the mark-to-market method of accounting for all holdings in such account.

A specified individual is only required to file Form 8939 when such interest in one or more specified foreign financial assets has an aggregate fair market value exceeding either $50,000 on the last day of the taxable year or $75,000 at any time during the taxable year. To balance the reporting burden on taxpayers with the IRS's desire for compliance improvement, there are

[13] Such assets include stock or securities issued by a non-U.S. person, a financial instrument or contract issued by a non-U.S. person that has a non-U.S. counterparty, and any interest in a foreign entity.

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Regulations on Reporting of Specified Foreign Financial Assets

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higher asset thresholds for married couples and those living abroad. Taxpayers who fail to file Form 8938 are subject to penalties, including a $10,000 failure to file penalty, an additional penalty of up to $50,000 for continued failure to file after IRS notification, and a 40 percent penalty on an understatement of tax attributable to non-disclosed assets.

Along with the release of the temporary regulations, Treasury and the IRS also released proposed regulations which apply Section 6038D to certain domestic entities that are formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets.[14] Until Treasury and the IRS issue such proposed regulations in final form, which is anticipated to occur during the 2012 calendar year and will apply to taxable years beginning after December 31, 2011, no domestic entity is required to file Form 8938 to report specified foreign financial assets with its annual income tax return. Under the proposed regulations, domestic entities that are subject to the reporting requirements of Section 6038D include certain domestic corporations, domestic partnerships, and trusts. For a domestic corporation or partnership to be subject to the reporting requirements, the corporation/partnership must have an interest in specified foreign financial assets with an aggregate value exceeding the reporting threshold for specified individuals (as stated above), it must be closely held (80 percent by vote or value at the end of its taxable year) by a specified individual, and it must either meet an "at least" 50 percent passive income/assets test or meet an "at least" 10 percent passive income/assets test and the corporation/partnership is formed or availed of with a principal purpose of avoiding reporting under Section 6038D. The proposed regulations include a set of attribution rules. For the reporting thresholds, multiple domestic corporations and partnerships that are closely held by the same specified individuals are treated as a single entity. In addition, for the passive income/assets test, domestic corporations and partnerships that are closely held by the same individual and that are a brother-sister entity, are treated as a single entity.

[14] REG-130302-10 and Prop. Reg. Section 1.6038D-6.

IRS Issuers Private Letter Ruling on Look-Through Approach for Purposes of Worthless Stock Deduction

With respect to a "security" that is a capital asset, a taxpayer is permitted to take a worthless security deduction if the security becomes worthless during the taxable year.[15] This deduction is a capital loss. Where the taxpayer, however, is a domestic corporation and the security is issued by a corporation which is "affiliated" with the taxpayer, such loss may be treated as an ordinary loss.[16] For this exception to apply, the issuing affiliated corporation must satisfy a "gross receipts" test, which essentially requires that more than 90 percent of the corporation's aggregate gross receipts for all taxable years to be "active income" (i.e., cannot be passive receipts). In a private letter ruling[17] released in early December 2011, the IRS issued guidance on a look-through approach for purposes of applying the gross receipts test for a parent corporation seeking an ordinary loss deduction for the worthless stock of an affiliated corporation.

The facts in the private letter ruling were as follows: the taxpayer, the common parent of an affiliated group of corporations ("Taxpayer"), owned 100 percent of HoldCo1, which owned 100 percent of HoldCo2, which owned 100 percent of Subsidiary. HoldCo2 previously entered into intercompany transactions with other members of consolidated groups to which it was a member, including the receipt of cash dividends, providing management services in exchange for a management fee, and the purchase of furniture and fixtures. After Subsidiary's last significant asset was rendered worthless, both HoldCo2 and Subsidiary were legally dissolved, at which point the stock of HoldCo2 and Subsidiary was rendered worthless for purposes of Section 165(g)(1).[18] Taxpayer wanted to claim a worthless stock deduction with respect to the stock of HoldCo2.

The IRS ruled that HoldCo1 could claim a worthless stock deduction under Section 165(g)(3) upon the dissolution of HoldCo2. Taxpayer represented that the stock of HoldCo2 and Subsidiary was worthless within the meaning of Section 165(g)(1) as of the date of dissolution. For purposes of the gross receipts test, the IRS ruled that HoldCo2 must include in its aggregate gross receipts all amounts of gross receipts received in intercompany transactions and must employ a "look-through approach" in determining the portion of the gross receipts that were from passive sources. The gross receipts from intercompany transactions were treated as gross receipts from passive sources to the extent they were attributable to the intercompany transactions' counterparty's gross receipts from passive sources.[19] In addition, in determining its gross receipts, HoldCo2 must take into account the historic gross receipts of any corporation if HoldCo2 succeeded to such corporation's tax attributes. In applying the look-through approach to gross receipts from

[15] Section 165(g)(1).
[16] Section 165(g)(3).
[17] PLR 201149015.

[18] HoldCo2 shares were cancelled and HoldCo1 did not receive any consideration.
[19] And the intercompany transaction counterparty is required to apply a similar look-through approach with respect to any additional intercompany transactions.

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Look-Through Approach for Worthless Stock Deduction

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intercompany dividends, the amounts were attributed pro rata to the gross receipts that gave rise to the earnings and profits from which the dividend was distributed. Finally, in applying the look-through approach with respect to gross receipts from intercompany transactions other than intercompany dividends, provided the intercompany transaction's counterparty's gross receipts are greater than its own intercompany transaction payments, the IRS noted that the amounts will be attributed pro rata to the gross receipts of the counterparty for the taxable year during which the intercompany transaction occurred.

IRS Private Letter Ruling: Conversion of Bonds to a New Interest Rate Period is Not a Significant Modification

In a recent private letter ruling,[20] the IRS addressed the debt modification regulations.[21] The facts of the ruling were as follows: A taxpayer issued bonds with an initial term rate period. The taxpayer had the option to terminate the initial rate period prior to the end of its term. At the end of each interest rate period, including the initial rate period, the taxpayer had the option to continue the same rate period, change to a new rate period as specified in the terms of the bonds, or redeem the bonds. At the beginning of each interest rate period after the initial rate period, the interest rate is set by the remarketing agent as the lowest rate which would enable the remarketing agent to sell the bonds at a price equal to 100% of the principal amount thereof, but in no event higher than a maximum rate. The bonds were subject to mandatory tender by the holders on any date when the option to change interest rate periods was exercised, at the end of any term rate period, and on certain other dates. Bonds tendered and not redeemed were remarketed by the remarketing agent.

Treasury regulations provide that gain or loss should be recognized upon the exchange of property for other property differing materially either in kind or in extent.[22] In this context, a debt instrument differs materially in kind or in extent if it has undergone a "significant modification." A "modification" means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. An alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument, however, is not a modification. An alteration that results from the exercise of an option provided to an issuer to change a term of a debt instrument is a modification, even if the alteration occurs by operation of the terms of a debt instrument, unless the option is unilateral.

Generally, an option is unilateral only if, under the terms of an instrument or under applicable law, (i) there does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related to the issuer, (ii) the exercise of the option does not require the consent or the approval of the other party, a related party, or a court or arbitrator, and (iii) the exercise of the option does not require consideration, except as further described therein.

The IRS held that the conversion of the bonds to a new term rate period and the setting of a new interest rate upon such conversion did not result in a modification of the bonds because the changes were pursuant to the terms of the bonds and mandatory tender was not a right of the holders to alter or terminate the Bonds. As a result, the Taxpayer's option to change interest rate periods was unilateral and the exercise of that option by Taxpayer was not a modification for federal income tax purposes.

New Proposed Regulations Clarify Scope of Section 892 and Create De Minimis Exception for Inadvertent Commercial Activity

On November 2, 2011, the IRS and Treasury issued proposed Treasury Regulations (the "Proposed Regulations")[23] which modify and clarify the temporary Treasury Regulations promulgated in 1988 (the "Temporary Regulations") under Section 892.[24] In general, Section 892 exempts from U.S. federal income taxation qualified investment income received by foreign governments as long as the foreign government or an entity controlled by the foreign government does not engage in commercial activity. While clarifying that all revenue from an entity controlled by a foreign government will

[20] PLR 201149017.
[21] Reg. Section 1.1001-3.
[22] Reg. Section 1.1001-1(a).
[23] REG-146537-06.
[24] T.D. 8211.

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Section 892 Proposed Regulations

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not qualify for Section 892's exemption if the entity is engaged in commercial activity, the Proposed Regulations create a safe harbor for entities controlled by foreign governments that "inadvertently" engage in commercial activities. This is a welcome development, particularly for sovereign wealth funds, which may be considered separate, controlled entities under Section 892.

Background

Income received by a foreign government generally will be exempt from U.S. federal income taxation under Section 892 unless the income is derived from a commercial activity, a controlled commercial entity, or the sale of an interest in a controlled commercial entity.[25]

Under the Temporary Regulations, a foreign government is limited to its integral parts and its controlled entities.[26] If an integral part of a foreign government receives income from both qualified investments and commercial activities, the qualified investments will be eligible for the Section 892 exemption, but the income from commercial activities will be subject to U.S. federal income taxation. However, if a controlled entity engages in any commercial activity anywhere in the world, none of the U.S. income of the controlled entity will be eligible for the Section 892 exemption, even if some of the income would otherwise qualify as noncommercial income. For purposes of these rules, a corporation is deemed to be engaged in commercial activities if it is a U.S. real property holding corporation ("USRPHC") or would be but for the fact that it is a foreign corporation.

The definition of commercial activity in the Temporary Regulations is extremely broad. The Temporary Regulations first define commercial activity inclusively, as all activity ordinarily conducted for the current or future production of income or gain, but then enumerate a list of exceptions, including investments, cultural events, nonprofit activities, and governmental functions.[27]

The rules in the Temporary Regulations with respect to attribution of the commercial activities of a partnership to its partners are also extremely far-reaching. Both general and limited partners are treated as engaging in any commercial activities which are undertaken by their partnerships.[28] The only relief from this attribution regime is a limited exception for publicly traded partnerships.

Proposed Treasury Regulations

In response to comments that the Temporary Regulations offered too narrow an exemption under Section 892 and posed administrative and operational burdens on foreign governments, the Proposed Regulations generally expand the availability of the exemption under Section 892. First, the Proposed Regulations restrict the definition of controlled commercial entity by adding a *de minimis* exception for inadvertent commercial activity and by delineating the testing period for determining whether a controlled entity is commercial. Second, the Proposed Regulations confine the definition of commercial activities by modifying and clarifying the definition in the Temporary Regulations. Finally, the Proposed Regulations limit the attribution of the commercial activities from partnerships to partners by creating a new exception for limited partners.

Restricting the Definition of Controlled Commercial Entity

The Proposed Regulations contain a new *de minimis* exception for inadvertent commercial activity by controlled entities of foreign governments which should provide a reasonable safe harbor for controlled entities to make investments. A controlled entity can avoid being classified as a controlled commercial entity if it engages in only inadvertent commercial activity. A controlled entity will qualify for the exception if three requirements are met: (i) the failure to avoid commercial activity is reasonable; (ii) the controlled entity promptly stops engaging in the commercial activity after becoming aware of the activity; and (iii) the controlled entity maintains records according to certain standards. In order to meet the first requirement (that the failure to avoid commercial activity was reasonable) the foreign government must implement written policies and operational procedures to monitor the controlled entity's worldwide activities. The reasonableness requirement also contains a safe harbor. The failure to avoid commercial activity will be considered reasonable if the value of the assets held for use in the commercial activity is no more than 5 percent of the total value of all of the controlled entity's assets, and the income earned from the commercial activity is no more than 5 percent of the entity's gross income. Even if the controlled entity meets all of the requirements of the *de minimis* exception, however, all income derived from the inadvertent commercial activity will be subject to U.S. federal income taxation but will not taint income from noncommercial activity.

The Proposed Regulations also specify that the determination of whether a controlled entity is a controlled commercial entity is made on an annual basis. A determination in one year that an entity is a controlled commercial entity will not cause the entity to be a controlled commercial entity in another year.

Confining the Definition of Commercial Activity

Although the Proposed Regulations maintain that an activity may be commercial even if it would not constitute a business activity for other purposes of the Code, the Proposed Regulations limit the definition of commercial activity in several ways. They provide that the

[25] Sections 892(a)(1) and (2).
[26] Reg. Section 1.892-2T(a).
[27] Reg. Section 1.892-4T(b).
[28] Reg. Section 1.892-5T(d)(3).

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Section 892 Proposed Regulations

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determination of whether an activity is commercial hinges on the nature of the activity, rather than the purpose for conducting the activity.[29] The Proposed Regulations further provide that investments in financial instruments will not be treated as commercial activities, even if they are not held in connection with the execution of governmental monetary or financial policy, as required by Section 892(a)(1)(A)(ii) and the Temporary Regulations.

The Proposed Regulations also provide that the mere disposition, or deemed disposition, of a U.S. real property interest will not rise to the level of a commercial activity, absent other commercial activities. This clarification should prevent foreign governments investing in U.S. real estate through a blocker corporation that is not a USRPHC from being subject to tax on distributions made by the blocker. In addition, controlled entities investing in real estate that are not USRPHCs should not be subject to tax on income from other investments even though any income from the disposition of the U.S. real property interest will not be exempt from U.S. tax under Section 892.

Limiting the Attribution of Commercial Activities to Limited Partners

Under the Proposed Regulations, an entity which is not otherwise engaged in commercial activity will not be treated as engaged in commercial activity merely because it holds a limited partner interest in a limited partnership. This new exception applies only if the limited partner has no rights to participate in the management and conduct of the partnership's business at all times during the partnership's taxable year. However, any income received by a limited partner attributable to commercial activity of the partnership will not qualify for the Section 892 exemption. In addition, if an integral part of a foreign government receives income from a partnership that is a controlled commercial entity, none of the income will qualify for the Section 892 exemption, but the income will not taint the limited partner's other income. This clarification should allow controlled entities such as sovereign wealth funds to invest as limited partners in U.S. or non-U.S investment partnerships without the risk of becoming controlled commercial entities.

The Proposed Regulations also provide that an entity which is not otherwise engaged in commercial activities will not be deemed to be engaged in commercial activities solely because it is a partner in a partnership that transacts in securities, commodities, or financial instruments for its own account. This exception does not apply if the partnership is a dealer in securities, commodities, or financial instruments.

[29] Proposed Section 1.892-4(d).

IRS Guidance on REMICs and REITs with Respect to the Home Affordable Refinance Program

In late December, the IRS issued guidance (Notice 2012-5 and Rev. Proc. 2012-14) that relaxed the real estate mortgage investment conduit ("REMIC") and real estate investment trust ("REIT") rules to accommodate refinanced "underwater" loans in Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac") sponsored single family mortgage-backed securities.

The government recently expanded (on October 24, 2011; details announced on November 15, 2011) its Home Affordable Refinance Program ("HARP"). The government expects a wave of mortgage refinancings under the new program. The problem is that a lot of the new loans will be held by REMICs. The further problem is that REITs are expected to hold a lot of the residual and regular interests in those REMICs.

The new guidance applies to REMICs that are created after November 30, 2011 and is therefore designed to allow the new loans created in a HARP refinance to continue to be securitized in REMICs.

The issue under HARP is that a new loan may be "underwater" upon origination. Normally, mortgage loans that go into REMICs are secured by a house with a value equal to or greater than the loan amount (the test is only done once--when the loan is contributed to the REMIC). When a REMIC holds only these loans, a REIT that holds that REMIC's regular or residual interests can treat the entire regular or residual interest as a "good" real estate asset that produces "good" real estate income (REITs have to have at least 75% good assets and 75% good income).

The problem with HARP loans is that the underlying real estate's value may be less than the loan's face amount. As long as the real estate is worth more than 80% of the loan amount, the loan can still go into a REMIC. However, absent the recent IRS pronouncement, the REMIC would have to report on a "look through" basis to its regular and residual interest holders, i.e., reporting precise percentages of "good" assets and "bad" assets. This, in turn, would require the REMIC to figure out, on a loan by loan basis, if the loan was underwater and by how much. Moreover, the REMIC would have to separately report income, if any, from the underlying real estate if the loan was foreclosed on and the REMIC acquired the property. All of this would obviously be a large headache.

What the new guidance does, in a nutshell, is allow a REIT that holds REMIC interests in a Fannie Mae or Freddie Mac guaranteed

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single family pool to automatically treat the interest as an 80% "good" asset and 20% "bad" asset that produces 80% "good" income and 20% "bad" income. This relieves the REMIC from cumbersome "look through" reporting. The guidance does not apply to "private label" REMICs.

Tenth Circuit Affirms Tax Court's Holding in Anschutz Co. v. Commissioner

In 2010, the Tax Court ruled against the taxpayer in *Anschutz Company v. Commissioner*,[30] and held that a prepaid variable forward plus a stock loan is a sale for federal income tax purposes.[31] On December 27, 2011, the United States Court of Appeals for the Tenth Circuit affirmed the Tax Court's ruling.[32]

In determining whether the Tax Court was correct in treating the transactions at issue as sales of the pledged stock, the Tenth Circuit conducted a 10-part analysis involving the following factors: (1) legal title to the pledged shares; (2) how the parties treated the transactions; (3) whether DLJ (Anschutz's counterparty) acquired an equity interest in the pledged shares; (4) present obligations of the parties; (5) right of possession of pledged shares; (6) risk of loss; (7) opportunity for gain; (8) voting rights; (9) dividend rights; and (10) right to sell or rehypothecate the pledged shares. When the Tenth Circuit considered all of the factors together, it agreed with the Tax Court that the transactions should be treated as current sales of the pledged shares to DLJ. The Tenth Circuit explained that not only did DLJ effectively obtain and dispose of the actual shares pledged by Anschutz, but Anschutz received significant value for those shares and simultaneously lost nearly all of the incidents of ownership of the shares.

Similar to the Tax Court, the Tenth Circuit held that Anschutz's reliance on Rev. Rul. 2003-7 was misplaced due to the nature of the transaction at issue. Whereas the circumstances in Rev. Rul. 2003-7 involved only a prepaid variable forward contract, these facts involve a prepaid variable forward contract, a master stock purchase agreement and a stock lending agreement.

Finally, the Tenth Circuit also held that the transactions were not protected from recognition under Section 1058, providing an analysis similar to the one provided by the Tax Court.

IRS Technical Advice: Cumulative Preferred Stock that Pays Accumulated Dividends at Redemption is Section 1504(a)(4) Preferred Stock

A corporate taxpayer is generally entitled to a 70 percent dividends-received deduction with respect to dividends received from a domestic corporation. This deduction percentage is increased to 80 percent if the taxpayer owns 20 percent or more (by vote and value) of the stock of the dividend paying corporation. In applying the 20 percent test, plain vanilla preferred stock (i.e., Section 1504(a)(4) stock) is ignored. Preferred stock meets the requirements of Section 1504(a)(4) if (i) it is not entitled to vote, (ii) it is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) it has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (iv) it is not convertible into another class of stock.

In a recent Chief Counsel Advice Memorandum[33] ("CCA"), released December 30, 2011, the IRS argued that cumulative preferred stock was Section 1504(a)(4) preferred stock because a payment of unpaid accumulated dividends upon redemption at maturity was not an "unreasonable redemption premium."

The corporate taxpayer at issue held two classes of preferred stock (voting and non-voting) in a corporation. The non-voting preferred stock had a fixed dividend rate which compounded daily, and the accumulated dividends were only paid on redemption of the stock. Presumably, the voting stock accounted for at least 20 percent of the voting rights but less than 20 percent of the value and the taxpayer needed the non-voting stock to not be treated as plain vanilla preferred stock in order to qualify for the 80 percent dividends-received deduction. The taxpayer took the position that such stock was not Section 1504(a)(4) stock because the redemption premium consisting of the unpaid accumulated dividends constituted an "unreasonable redemption premium." The taxpayer included the accruing dividends in income on a current basis.

In the CCA the IRS argued that the accruing dividends on the preferred stock were properly included in income on a current basis and therefore were not part of the redemption premium for purposes of Section 1504(a)(4). The IRS argued that after subtracting the previously included dividends, the preferred stock was redeemed at its issue price, and satisfied Section 1504(a)(4). As a result, the taxpayer was not entitled to the 80 percent dividends-received deduction. Although the IRS ruling cannot be relied on by other taxpayers, taxpayers will, of course, begin to wonder whether they can now use such stock to raise efficient funding without affecting tax consolidation.

[30] 135 T.C. No. 5 (July 22, 2010).
[31] See our prior client alert at http://www.mofo.com/files/Uploads/Images/100723TaxCourt.pdf.
[32] *Anschutz Co. v. Commissioner*, 10th Cir., No. 11-9001 (December 27, 2011).
[33] CCA 201152016 (September 1, 2011).

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IRS Provides Transitional Relief from Reporting Obligations of Corporate Actions

Enacted as part of the Energy Improvement and Extension Act of 2008, Section 6045B provides 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."[34] With respect to organization actions occurring prior to 2012, a specified security was limited to stock in a corporation.[35] The issuer generally must file the return within 45 days after the organizational action and must furnish a corresponding statement to each nominee of the stockholder by January 15th of the year following the calendar year of the organizational action. An issuer of stock is generally subject to a penalty under Section 6721 that does not timely file a correct issuer return with the IRS as required by Section 6045B(a). In addition, Section 6722 imposes a penalty on any issuer of stock that does not timely furnish correct issuer statements to stockholders as required by Section 6045B(c).

The IRS previously released Notice 2011-18 which provided transitional relief from the information reporting requirements in 2011. Under Notice 2011-18 no penalties were imposed for failure to file an issuer return with the IRS within 45 days of an organizational action taken in 2011, provided that the issuer files the issuer return with the IRS (or posts the return to its website) by January 17, 2012.[36]

Based on the limited timeframe provided to taxpayers between guidance released by the IRS and the reporting requirements effective dates, the IRS issued Notice 2012-11, where, in lieu of filing the required form with the IRS, the IRS will permit an issuer to publicly report an organizational action by posting either the required form or the required information to its website. The issuer will be treated as filing the required information on the date of posting.[37] Penalties under Section 6721 and 6722 will not be imposed on issuers that report incorrect information while employing good-faith efforts to timely post the required form/information on its website or to file the required form with the IRS. This transitional relief is limited to reporting organizational actions occurring in 2011.

The Classroom – Legging-In and Legging-Out of an Integrated Transaction

In the last edition of Tax Talk, our Classroom addressed integrating a debt instrument with a hedge into a synthetic debt instrument, where we reviewed the requirements in order to create a synthetic debt instrument under Section 1.1275-6.[38] This time, we want to talk about "legging in" and "legging-out" transactions.

A legging-in transaction is one in which a Section 1.1275-6 hedge is entered into after the date when the qualifying debt instrument is issued (or acquired). If a taxpayer legs into an integrated transaction, the taxpayer treats the qualifying debt instrument under the applicable rules for taking interest and OID into account up to the leg-in date. The day before the leg-in date is the end of an accrual period. As of the leg-in date, the instruments are integrated under Section 1.1275-6.

A legging-out transaction involves an integrated transaction where, prior to maturity of the synthetic debt instrument, the Section 1.1275-6 hedge fails to meet the requirements to constitute a "Section 1.1275-6 hedge," the taxpayer fails to meet one of the integration requirements, or the taxpayer disposes of or terminates the qualifying debt instrument or Section 1.1275-6 hedge. The consequences of a legging-out transaction are as follows: (i) the transaction is treated as an integrated transaction during the time it qualified as an integrated transaction; (ii) immediately before the taxpayer legs out, the synthetic debt instrument is treated as being sold for its fair market value and any income, deduction, gain or loss is realized at that time; (iii) if the taxpayer keeps the qualifying debt instrument outstanding, adjustments are made to reflect any difference between the fair market value and the adjusted issue price of the instrument; (iv) if the taxpayer remains a party to the Section 1.1275-6 hedge, such hedge is treated as entered into at its fair market value; and (v) if a taxpayer legs out of an integrated transaction by disposing of or terminating the Section 1.1275-6 hedge within 30 days of legging into such transaction, any loss or deduction with respect to selling the synthetic debt instrument is disallowed.

An example with respect to the legging-out rules may be useful: suppose Issuer issues a 5-year principal protected note (the "Note") with an issue price of $100. In order to hedge its risk, Issuer enters into a swap with a counterparty ("CP"). Issuer has the right to call the Note on certain specified dates and CP has the right to call the swap on the same dates. Issuer integrates the Note and hedge under Section 1.1275-6. During year 2, CP calls the swap when it is in the money and Issuer leaves the Note outstanding (at which time the fair market value of the Note is $80).

Because the Section 1.1275-6 hedge was terminated while the Note remained outstanding, the Issuer is treated as legging-out of the integrated transaction. Immediately prior to termination of the swap, Issuer is treated as selling (i.e.,

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[34] See MoFo Tax Talk Volume 3, No 4 and our prior Client Alert here: http://www.mofo.com/files/Uploads/Images/110105-IRS-Reporting-Obligations.pdf.

[35] Sections 6045B(d), 6045(g)(3)(B) and 6045(g)(3)(C).

[36] See Notice 2011-18 (March 14, 2011) and MoFo Tax Talk Volume 4, No 1.

[37] See Notice 2012-11 (January 13, 2012).

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

The Classroom

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assigning its obligations under) the synthetic debt instrument for its fair market value or $80, resulting in Issuer realizing $20 of COD income (i.e., the difference between the fair market value of $80 and the Note's adjusted issue price of $100). Because the Note remains outstanding, the issuer makes an adjustment to reflect the difference between the Note's fair market value and adjusted issue price. Therefore, the Issuer should reduce the adjusted issue price of the Note to $80. As the Note has the same $100 principal amount, Issuer will accrue the $20 difference as a deduction over the remaining term of the Note. This additional deduction offsets the $20 of COD income, resulting in only a timing difference (which nevertheless may be significant).

MoFo in the News

On December 1, 2011, MoFo partners Charles Horn and Jeremy Jennings-Mares spoke at the BBA's Prudential Regulatory Review. This session provided a comprehensive overview of the key challenges affecting those involved in prudential regulation and risk management. CRD4, Basel 3, Dodd Frank, and more, were covered. The review had a dual emphasis – how these new regulations interact on a national and global scale, and how the changes will impact the day-to-day operations of those involved in risk management, stress testing, liquidity risk management, and more.

Thomas A. Humphreys and Remmelt A. Reigersman led the West Legalworks Webinar titled "The Foreign Account Tax Compliance Act Examined" on December 6, 2011. The panel discussed the new FATCA 30% tax on "withholdable payments" such as interest, dividends, and securities sales proceeds made to non-U.S. banks and brokers unless they agree to information report on their U.S. account holders beginning January 1, 2014; the repeal of the U.S. "bearer bond" exception for obligations targeted to non-U.S. persons, effective for obligations issued after March 18, 2012; and the new U.S. withholding tax on "dividend equivalent" payments made on certain cross border swaps and other payments which took effect on September 14, 2010.

IFLR sponsored a webinar titled "The ICB Report and the Impact on UK Banking" on December 12, 2011, led by Peter Green and Jeremy Jennings-Mares. The Final Report of the UK's Independent Commission on Banking has recommended very significant changes to the UK banking industry including a structural ring-fence of retail banking activities and additional requirements on the issuance of equity and debt with loss-absorbing features, in particular requiring banks to issue a minimum amount of "bail-in" debt. Initial indications are that the UK government is likely to implement all or most of the recommendations. Speakers discussed the likely impact of such changes including the likely restructuring that will be required of UK banks, the impact on the way banks fund themselves including in the wholesale markets, the effect on the competitive position of UK banks against other international banks and the interaction of the proposals with other European and global initiatives including the Volcker Rule in the U.S.

Andrew Smith participated in the December 13, 2011 GARP Webinar titled "The Ramifications of Dodd-Frank: Consumer Protection." The Dodd-Frank Act created a new independent oversight agency, housed at the Federal Reserve, to assist U.S. consumers in getting clear, accurate information on mortgages, credit cards, and other financial products. The act also seeks to protect consumers from hidden fees, abusive terms, and deceptive practices. The panel of experts discussed the impact of the act on consumer lending practices and intended benefits to consumers. Significant changes to the institutional operations of savings and loans and thrifts are critical issues that were covered.

PLI's seminar on Understanding the Securities Laws 2011, was held on December 14, 2011. MoFo partner Anna Pinedo participated in the seminar. This program included an overview and discussion of the basic aspects of the U.S. federal securities laws provided by leading in-house and law firm practitioners and key SEC representatives. Emphasis was placed on the interplay among the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act, the Dodd-Frank Act, and related SEC regulations, and on how a securities lawyer can solve practical problems that arise under them in the context of public and private offerings, SEC reporting, mergers and acquisitions, and other common corporate transactions.

On December 14, 2011, Charles Horn and Dwight Smith led A Protiviti and Morrison & Foerster Webinar on the Volcker Rule. The federal financial regulatory agencies agreed to publish proposed rules that implement the proprietary trading and private fund sponsorship and investment prohibitions of the Dodd-Frank Act's Volcker Rule. Several of the participating agencies have already published the proposed rules for public comment. In addition to applying the basic restrictions of the Volcker Rule to covered banking entities, the proposed rules create a number of significant regulatory compliance, corporate governance and reporting obligations for affected financial institutions.

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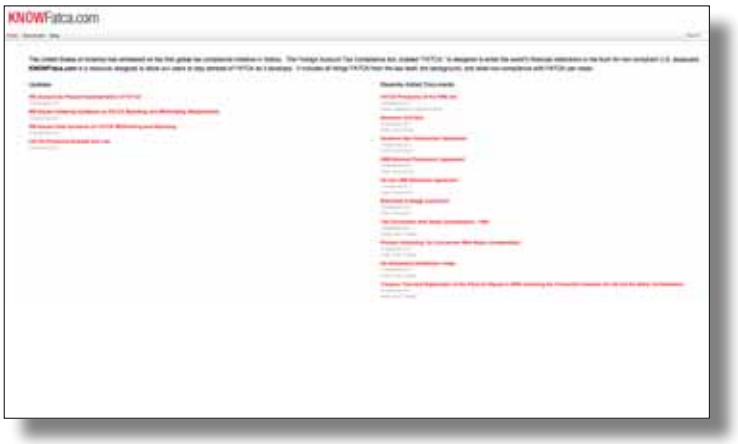

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