Editor’s Note

With Q1 already in the books, this issue of Tax Talk brings you the latest tax developments and news from 2013 so far.

The biggest Q1 news in our small corner of the world is possible financial instrument tax reform in the United States. In January, Rep. Dave Camp (R-MI), Chairman of the House Committee on Ways and Means released a proposal to radically change the U.S. system for taxing financial derivatives. This proposal is one of three; the two others cover international tax and pass-through taxation. The proposal for financial instruments, which is styled as a “Discussion Draft,” would adopt a mark-to-market system, in which all derivatives would be treated as sold at the end of the taxable year. The taxpayer would recognize ordinary gain or loss in the deemed sale with a corresponding basis adjustment. This mark-to-market regime would ostensibly bring much-needed uniformity (and simplicity) to the tax law governing financial instruments. However, the proposal is not without controversy, and we outline the key details in this issue of Tax Talk. Those who look for clairvoyance in this piece will be disappointed: Tax Talk will never attempt to predict whether mark-to-market will become law.

On the other side of the aisle, a pair of Democrats has introduced a bill that would impose a pithy — but nettlesome — financial transactions tax of 3 basis points on certain “covered transactions” occurring or cleared on a United States facility. Similar proposals have been introduced in Congress since the financial crisis. This type of “financial transactions tax,” billed as a quick fix to the budget sequestration debacle, has been met with widespread enthusiasm throughout Europe. We have a hunch it won’t be as popular on this side of the pond. Stay tuned!

As we indicated in our previous issue of Tax Talk, the final regulations implementing the Foreign Account Tax Compliance Act (“FATCA”) (www.KNOWFatca.com) were issued in January. We highlight the key provisions of these complicated, and far-reaching, rules. As promised, the Treasury

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Department has been busy this quarter negotiating intergovernmental agreements with a number of countries to facilitate FATCA compliance. For example, on Valentine’s Day, the United States and Switzerland signed a “Model II” intergovernmental agreement — the first and only Model II agreement entered into by the United States to this point. Moreover, as we go to press, the United States has just signed a “Model I” agreement with Norway; Model I agreements have also been initiated with Germany, Italy, and Spain.

Not to be outdone, the IRS has also been busy, recently releasing private letter rulings relating to the consolidated income tax return rules and the so-called bankruptcy exception to the NOL limitation rules. The first private letter ruling addressed whether a wholly-owned subsidiary could be included in its parent’s affiliated group, even though the subsidiary’s shares were subject to a proxy agreement entitling the proxy holders to exercise exclusive control over the subsidiary’s management. The ruling has important implications for subsidiaries indirectly owned by foreign corporations that are seeking to retain valuable government contracts, but which cannot be influenced by their indirect foreign parent for purposes of maintaining security clearances.

The second private letter ruling dealt with an ownership change pursuant to a bankruptcy reorganization plan and, importantly, whether the reorganization plan would result in an ownership change that would limit the debtor corporation’s ability to retain and use NOL carryforwards.

Finally, in CCA 201310027, the IRS addressed the scope of the straddle rules in connection with equity-linked debt. The IRS concluded that the equity-linked debt, which referenced shares held by the issuer, constituted part of a straddle, as defined in Section 1092. As a result, the issuer was required to capitalize the interest expense incurred on the debt under Section 263(g).

As always, our regular section, MoFo in the News, concludes this issue of Tax Talk.

House Ways & Means Committee Proposal Would Require Mark-to-Market for Derivatives and Modify Certain Other Tax Rules

For many years, academics have proposed that the U.S. replace the current hedge-podge U.S. federal income tax rules applicable to financial derivatives with a “mark-to-market” regime. In the first significant legislative initiative ever on this topic, Representative David Camp (R. MI), Chairman of the House Committee on Ways and Means, recently released a discussion draft containing proposed legislation to reform the taxation of financial instruments. If enacted, the legislation would apply to most financial instruments beginning January 1, 2014. Designed to be part of a package of comprehensive tax reform, the proposal, if adopted, would radically alter the current taxation of financial products.

Representative Camp styled the proposal as the antidote to the next financial crisis, “The U.S. is a leader in the financial world, but our broken and antiquated tax code has failed to keep up with the rapid pace of financial innovation on Wall Street. The lack of consistent and comprehensive tax policy has contributed to some corporate scandals and the recent financial crisis that devastated our economy and threatened our standing in the global community. Updating these tax rules to reflect modern developments in financial products will make the code simpler, fairer and more transparent for taxpayers; and it will also help to minimize the potential for abuse that has occurred in the past.”

The most significant aspect of the proposal would require “mark-to-market” tax treatment for derivatives. Under current U.S. federal income tax law, derivatives are taxed under a variety of regimes. Most of these regimes are based on the realization principle for gains and losses, i.e., gains and losses are taxed only when “realized” for tax purposes. Certain instruments and taxpayers (e.g., Section 1256 contracts and dealers) are subject to mark-to-market regimes while other instruments, e.g., notional principal contracts and contingent payment debt instruments, are subject to a combination of current accrual and realization regimes.

The proposal, if adopted, would require most derivatives to be marked to market; any hedging transactions (which, under the proposal and as discussed below, will include any transaction treated as a hedging transaction for financial accounting purposes), however, will be carved out of the proposal and continued to be subject to Section 1221. The provision, if adopted, would be effective for derivatives acquired, and positions established, on or after January 1, 2014. In addition, the proposal will apply to all derivatives held by dealers, who are currently subject to Section 475 with respect to securities they hold as inventory or for sale. Under the proposal, gains and losses from derivatives would be reported on an annual basis under a mark-to-market system. Under the proposed system, all year-end unrealized gains or losses would be recognized, and the resulting gain or loss would be ordinary. The tax basis of any derivative held at the beginning of the following tax year would be adjusted to take into account gain or loss previously recognized. To the extent provided in regulations, if the fair market value of a derivative is not readily determinable, the value is determined by using the method the taxpayer has adopted for reporting purposes, or as used for obtaining credit. In addition, because the proposal would deem all items of income, gain, loss and deduction with respect to a derivative to be attributable to a trade or business for purposes of determining a

1 All Section references are to the Internal Revenue Code of 1986, as amended.

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Finally, the mark-to-market and ordinary treatment rules would apply to all positions in a straddle that includes any derivative to which the provision applies, even if these positions are not otherwise marked to market.

Notably, the discussion draft does not address the treatment of (i) any current income components of a derivative (e.g., distributions made or coupons paid with respect to a derivative prior to its maturity or settlement), or (ii) non-U.S. investors or counterparties.

The proposal also aims to simplify the identification of hedging transactions. The proposed law would treat any transaction that qualifies as a hedge for financial accounting purposes as meeting the identification requirement under Section 1221. A transaction that is treated as a hedge under U.S. GAAP, however, would only be treated as a hedge for tax purposes if it also meets the substantive requirements under current tax law.

Under current law, a borrower may recognize cancellation of indebtedness (“COD”) income when a debt instrument is significantly modified, even though the borrower still owes the same actual principal amount it owed before the modification. This can happen, for example, where the fair market value of a debt instrument has declined and either there is an actual exchange of new debt for old debt or the debt instrument is modified in a way that triggers a deemed exchange under Section 1001.

In the case of certain debt modifications, however, the proposal provides that the issue price of the modified debt instrument will be the lesser of (1) the adjusted issue price of the existing debt instrument, or (2) the issue price of the modified debt instrument determined under Section 1274 if the debt instrument would be otherwise subject to that section. As a result, if the principal amount of the debt does not change, the debt modification would not result in the recognition of COD income to the borrower. In other words, COD income would not be recognized on transactions where the principal amount does not change and the modified debt has adequate stated interest. Any amount of actual principal forgiven would still result in COD income consistent with current law.

This proposal would apply to the following types of debt modifications: (i) an exchange by the issuer of a new debt instrument for an existing debt instrument of the issuer, or (ii) the amendment of an existing debt instrument, including a significant modification of an existing debt instrument which is accomplished by the issuer and the holder indirectly through one or more transactions with unrelated parties. The proposal does not apply to alter the current definition of when a significant modification of a debt instrument qualifies as an exchange under current tax law. It would apply to transactions after December 31, 2013.

In a significant departure from current law, the proposal would require current inclusion in income of market discount for debt instruments purchased at a discount in the secondary market. Under current law, market discount that accrues while the taxpayer holds the debt instrument is treated as ordinary income, rather than capital gain, upon the disposition of the debt instrument, unless a taxpayer elects to include market discount in income as it accrues.

The proposal, however, would require the holder of a market discount debt instrument acquired after December 31, 2013 to currently include in gross income the market discount, amortized over the post-purchase life of the instrument. The proposal would also apply to all short-term nongovernmental bonds. The amount of taxable market discount would be limited to the amount that reflects increases in the interest rates since the debt instrument was originally issued. Specifically, the proposal would limit market discount to the greater of (a) the original yield on the debt instrument at issuance plus 5%, or (b) the applicable federal rate at the time of acquisition plus 10%. As a result, accrual of market discount would effectively be limited to accrual at prevailing market interest rates. In sum, the proposal would effectively impose parity in the tax treatment of discount vis-à-vis debt instruments purchased in a secondary market transaction and those purchased at original issuance.

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House Ways & Means Committee

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The proposal would also authorize the deduction of amortizable bond premium as an “above-the-line” deduction which reduces adjusted gross income.

For sales of certain securities on or after January 1, 2014, the proposal would no longer permit taxpayers to specifically identify which shares have been sold for purposes of determining gain or loss. Instead, taxpayers would be required to use a cost basis averaging rule similar to the method used for redemptions of mutual fund shares and other registered investment companies.

The proposal provides a grandfathering exception for securities acquired before 2014. These grandfathered securities would be treated as if they were acquired in a separate account.

Finally, the proposal would expand the current scope of the wash sale rules to disallow losses on the disposition of stock or securities if substantially identical stock or securities is acquired by a related party. For purposes of this rule, the definition of a related party includes the taxpayer’s spouse, dependents, controlled or controlling entities (e.g., corporations, partnerships, trusts, or estates), and certain qualified compensation, retirement, health and education plans or accounts. The proposal punitively restricts the ability to recognize these disallowed losses by providing that the basis of the substantially identical stock or securities is not adjusted to include the disallowed loss in the case of any acquisition by a related party other than the taxpayer’s spouse.

Legislative prospects for the proposal are uncertain but will likely depend in substantial part on whether and when Congress moves ahead with fundamental tax reform.

After Months of Anticipation, Final FATCA Regulations Released

On January 17, 2013, the U.S. Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) issued final regulations implementing the Foreign Account Tax Compliance Act (“FATCA”).

Congress enacted FATCA in 2010 as part of the Hiring Incentives to Restore Employment Act (the “HIRE Act”), and it is housed in Sections 1471 through 1474 of the Code.

As described in the final regulations, the purpose of FATCA is broadly to buttress the existing U.S. information reporting regime by imposing reporting requirements on certain foreign financial institutions (“FFIs”), as well as other nonfinancial foreign entities (“NFFEs”) with substantial U.S. ownership.

The mechanism laid out in the final FATCA regulations to facilitate the flow of this information is complex, and the failure to comply carries a hefty price. In short, a 30% withholding tax will be levied on any “withholdable payment” to an FFI, or NFFE, that does not agree to report certain information—spelled out in great detail in the final regulations—about their U.S. account holders or substantial U.S. owners to the IRS.

Consuming more than 500 pages, these long-awaited final regulations are comprehensive and lengthy. In fact, they are anything but light reading, and the casual reader should be cautioned about their soporific effects. They do, however, (helpfully) refine and clarify many of the information reporting and withholding tax provisions of the proposed regulations, which were issued in February 2012, and we bring you just a few of the most relevant high points.

Perhaps the best news in the short run is the extension of the grandfathering provisions, which were set to expire under the proposed regulations on January 1, 2013.

By carving out a special exception for certain grandfathered obligations from the definition of a “withholdable payment,” the final FATCA regulations extend grandfathering treatment to certain obligations outstanding as of January 1, 2014. As explained in the final FATCA regulations, the extension of the grandfathering dates was motivated by the government’s altruistic desire to ease potential administrative burdens and facilitate an orderly implementation of FATCA. As a result, FATCA withholding will not be required for any payment under any obligation outstanding on January 1, 2014.

To determine whether the grandfathering provisions apply in the first place, it is important to identify those obligations given special treatment under the final FATCA regulations. As a threshold matter, for purposes of the grandfathering provisions, the final regulations define an obligation to include any legally binding agreement or instrument, illustrated by the following five examples:

1. a debt instrument;
2. an agreement to extend credit for a fixed term (e.g., a line of credit or a revolving credit facility) provided that the agreement fixes the material terms at the issue date;

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Final FATCA Regulations Released

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3. a derivatives transaction between counterparties under an ISDA Master Agreement that is evidenced by a confirmation;

4. a life insurance contract that provides that the entire contract value is payable no later than upon death of the insured; and

5. an immediate annuity contract payable for a period certain or for the life of the annuitant.

With respect to debt obligations, the final regulations determine the date the obligation is outstanding based on the issue date of the debt. Thus, whether debt issued in a qualified reopening will be treated as a grandfathered obligation depends on the original issue date of the reopened issue. The final regulations provide that a withholding agent (other than the issuer or an agent of the issuer) may, absent actual knowledge, rely on a statement by the issuer of an obligation in determining whether such obligation is grandfathered.

Consistent with the proposed regulations, in the case of an obligation treated as debt for U.S. federal income tax purposes, a material modification is any significant modification of the debt instrument. In all other cases, whether a modification of an obligation is material is a fact-specific inquiry. Thus, a grandfathered obligation that is materially modified after the extended grandfathering period expires would be subject to FATCA withholding, unless another, independent exception applies. In addition, the final regulations provide that a withholding agent is required to treat a modification as material only if the withholding agent knows or has reason to know that the modification is material. A withholding agent is treated as having “reason to know” for these purposes if the agent receives a disclosure of the material modification from the issuer of the obligation.

By contrast, an obligation does not include any legal agreement or instrument that is treated as equity for U.S. tax purposes, lacks a stated expiration or term, constitutes a brokerage or custodial agreement.

The final regulations also address obligations that would be subject to FATCA solely because they give rise to U.S. source dividend equivalent payments under Section 871(m). These obligations are grandfathered if they are issued or executed on or before the date that is six months after the date on which obligations of that type become subject to dividend equivalent treatment.

The final regulations similarly exempt from FATCA withholding any agreement requiring a secured party to make a payment with respect to, or to repay, collateral posted to secure a grandfathered obligation.

Finally, the final regulations provide that, for purposes of “foreign passthru payments,” a grandfathered obligation includes an obligation that is executed on or before the date that is six months after the date on which the term “foreign passthru payment” is defined. The final regulations have opted to punt on the definition of a foreign passthru payment for now. Consistent with the proposed regulations, an FFI is not required to withhold on foreign passthru payments until January 1, 2017.

Although the final FATCA regulations did not extend the withholding date for standard FDAP-type payments, such as U.S. source interest and dividends, which begins January 1, 2014, the IRS did modify the rule set forth in the proposed regulations concerning withholding of gross proceeds.

The final regulations now provide that the term “withheldable payment” includes gross proceeds from any sale or other disposition of property that can produce interest or dividends that would be U.S. source FDAP income, but only if those sales and dispositions occur after December 31, 2016. This two-year extension means that gross proceeds from the disposition of property that can produce U.S. source FDAP-type income will be exempt from withholding until 2017.

The statutory definition of a “withholdable payment,” which was maintained in the proposed regulations, has been retained, virtually without change. The final regulations did, however, broaden the scope of a withholdable payment in the context of dispositions to include any contract producing dividend equivalent payments, as defined in Section 871(m) and the regulations thereunder. The final regulations clarify that these contracts will be treated as property that can produce U.S. source FDAP income, when sold or exchanged.

Furthermore, the final regulations also clarified that withholdable payments include payments in connection with a securities lending transaction, as well as a forward, future, option or swap, or any other similar financial instrument.

By contrast, the final regulations confirm that payments of interest or original issue discount on certain short-term obligations will not be treated as a withholdable payment; the same goes for accrued interest on the date of a sale or exchange of an interest-bearing debt obligation if the sale occurs between two interest payment dates. Likewise, any payment that gives rise to effectively connected income will not be treated as a withholdable payment.

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14 The final regulations provide that debt obligations are considered outstanding on a date if it has an issue date before such date. Non-debt obligations are outstanding on a date if a legally binding agreement establishing the obligation was executed between the parties to the agreement before such date. Treas. Reg. 1471-2(b)(2)(iii).

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Final FATCA Regulations Released

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Summary of Relevant Dates—
See chart below

Since the proposed regulations were issued last February, Treasury has been busy trying to make good on its promise to provide an alternative to FATCA compliance for those FFIs residing in countries that have entered into information sharing agreements with the U.S.

As detailed in our previous client alerts and issues of Tax Talk, Treasury has issued two model intergovernmental agreements ("IGAs"). Technically, the IGAs do not offer a FATCA exemption, but merely offer an information sharing framework. For a complete list of FATCA partner countries to date, please see KNOWFatca.com.

The first model IGA ("Model 1 IGA"), released on July 26, 2012, requires a partner FATCA country to collect information from resident FFIs about its U.S. account holders. The required information generally will mirror the information reporting framework laid out in the final FATCA regulations. The FATCA partner country then automatically provides this information to the IRS.

The second model IGA ("Model 2 IGA"), released on November 12, 2012, operates in a similar fashion, but with one significant difference. FFIs residing in a FATCA partner country that is a party to a Model 2 IGA are still required to register with the IRS and report information about their U.S. accounts directly to the IRS.

A major benefit to FFIs covered by a Model 1 IGA—aside from the promised reduction of compliance burdens—is that they will be deemed to have satisfied FATCA's due diligence and reporting requirements. In short, these FFIs will avoid FATCA withholding altogether. FFIs covered by a Model 2 IGA, on the other hand, are still required to comply with FATCA, except as provided in their respective IGA.

Congress Considers Financial Transaction Tax Bill

So far, 2013 is proving to be a busy year for anyone trying to stay up-to-date on proposed changes to the tax code. One such change, the Wall Street Trading and Speculators Act (the "Act") was introduced on February 28, 2013 by Senator Tom Harkin (D-IA) and Congressman Peter DeFazio (D-OR). The Act, which was introduced in the last session of Congress but did not make it out of committee, would impose a new tax of three-hundredths of a percent on certain "covered transactions." This type of financial transaction tax is all the rage in Europe, where earlier this year a group of at least nine EU member states agreed to implement such a tax.14

The proposed tax is .03 percent (three "basis points") of the fair market value of the security being traded and would apply to securities that are purchased or cleared on a United States facility or transactions with respect to derivatives that are traded or cleared on a United States facility or under which a United States person has rights. Although the tax is generally imposed on transactions with respect to stock, partnership interests, indebtedness and derivatives (including options, futures, forwards, or notional principal contracts), the tax would not apply to transactions with respect to the initial issuance of stock, partnership interests, or indebtedness. Additionally, short-term debt instruments (defined, for these purposes, as indebtedness with a fixed maturity of not more than 100 days), would not be taxed. In general, the tax on transactions occurring or cleared on a United States

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FATCA Withholding Dates

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<td>Gross proceeds from the disposition of property producing FDAP-type income</td>
<td>January 1, 2017</td>
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<td>Foreign passthru payments</td>
<td>January 1, 2017</td>
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<tr>
<td>Obligations giving rise to Withholdable Payments solely because they are subject to dividend equivalent treatment</td>
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<td>(i) January 1, 2014 OR</td>
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<td>(ii) 6 months after Section 871(m) dividend equivalent treatment applies to such instrument</td>
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<td>Obligations giving rise to foreign passthru payments</td>
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Financial Transaction Tax Bill

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government. Central to the IRS’s ruling, however, was the fact that the proxy holders held no economic interest in the subsidiary.

As part of the proxy agreement, the proxy holders became directors of the subsidiary. In their capacity as directors, the proxy holders were entitled to act on behalf of the subsidiary. Even so, they could not authorize certain fundamental corporate transactions, such as: 1) the sale or disposal, in any manner, of capital assets or business of the subsidiary; 2) pledging, mortgaging, or encumbering the subsidiary’s assets for purposes other than obtaining working capital or funds for capital improvements; 3) the merger, consolidation, reorganization, or dissolution of the subsidiary; 4) selling, transferring, pledging, or otherwise encumbering the subsidiary’s stock; and, 5) the filing or making any petition under the federal bankruptcy laws or any similar law or statute of any state or foreign country.

Consistent with their role as directors of subsidiary, the proxy holders were required to act in good faith and, because of the nature of the subsidiary’s business, in the national interest. The proxy holders held limited terms, and they could only be removed as specified in the proxy. Finally, the proxy agreement was for a five-year term. The proxy agreement could, however, be terminated before the end of the five-year period, but only by the U.S. government and only under certain circumstances.

In light of these facts, the IRS found that, as long as the proxy agreement (or a successor agreement) was in place, ownership of the subsidiary would constitute beneficial ownership and, as such, direct ownership for purposes of the consolidated return rules and Section 1504(a) of the Code. Accordingly, the subsidiary would be a member of the affiliated group and would be permitted to join in the filing of a consolidated federal income tax return with its parent’s affiliated group. Furthermore, a transfer of the subsidiary’s stock to another member of the parent corporation’s affiliated group would

Proxy Agreement No Barrier to Affiliated Group Membership

In a recent private letter ruling,18 the IRS addressed whether a wholly-owned subsidiary could be included in its parent’s affiliated group, even though the subsidiary’s shares were subject to a proxy agreement entitling the proxy holders to exercise exclusive control over the subsidiary’s management.

The IRS concluded that, although the parent company lacked voting rights, the ownership requirements of Section 1504(a) of the Code were met and the subsidiary could join in the filing of the group’s consolidated return. The IRS also ruled that the parent could even transfer the subsidiary’s stock to another member of the affiliated group, with the same result, so long as the acquiring corporation would also be bound by the proxy agreement.

By way of background, the subsidiary whose shares were subject to the proxy agreement was an indirect subsidiary of a foreign corporation. The subsidiary was engaged in providing services to the U.S. government, requiring it to maintain various security clearances. However, in order to effectively insulate the subsidiary from foreign ownership, control, or influence — a prerequisite to retaining its security clearances — the foreign corporation and subsidiary, as well as each of the interposed domestic corporations, were required to enter into a proxy agreement.

The proxy agreement vested control of the subsidiary’s management in the proxy holders. Under the terms of the proxy agreement, the proxy holders were required to: 1) be resident U.S. citizens; 2) have no prior contractual, financial, or employment relationships with the foreign corporation or entities controlled by the foreign
corporation; 3) certify their willingness to accept various security responsibilities; 4) be eligible for the requisite security clearance; and 5) be approved by the U.S. government. Central to the IRS’s ruling, however, was the fact that the proxy holders held no economic interest in the subsidiary.

As part of the proxy agreement, the proxy holders became directors of the subsidiary. In their capacity as directors, the proxy holders were entitled to act on behalf of the subsidiary. Even so, they could not authorize certain fundamental corporate transactions, such as: 1) the sale or disposal, in any manner, of capital assets or business of the subsidiary; 2) pledging, mortgaging, or encumbering the subsidiary’s assets for purposes other than obtaining working capital or funds for capital improvements; 3) the merger, consolidation, reorganization, or dissolution of the subsidiary; 4) selling, transferring, pledging, or otherwise encumbering the subsidiary’s stock; and, 5) the filing or making any petition under the federal bankruptcy laws or any similar law or statute of any state or foreign country.

Consistent with their role as directors of subsidiary, the proxy holders were required to act in good faith and, because of the nature of the subsidiary’s business, in the national interest. The proxy holders held limited terms, and they could only be removed as specified in the proxy. Finally, the proxy agreement was for a five-year term. The proxy agreement could, however, be terminated before the end of the five-year period, but only by the U.S. government and only under certain circumstances.

In light of these facts, the IRS found that, as long as the proxy agreement (or a successor agreement) was in place, ownership of the subsidiary would constitute beneficial ownership and, as such, direct ownership for purposes of the consolidated return rules and Section 1504(a) of the Code. Accordingly, the subsidiary would be a member of the affiliated group and would be permitted to join in the filing of a consolidated federal income tax return with its parent’s affiliated group. Furthermore, a transfer of the subsidiary’s stock to another member of the parent corporation’s affiliated group would

18 PLR 201306007 (Feb. 8, 2013).
No Barrier to Affiliated Group Membership

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also constitute direct ownership, as long as the acquiring corporation became subject to the proxy agreement.

Reorganization Plan Qualifies for Bankruptcy Exception to NOL Limitation Rules

In another recent private letter ruling, the IRS ruled that an ownership change pursuant to a bankruptcy reorganization plan qualified for an exception to the general rule limiting net operating loss ("NOL") carryforwards under Section 382(a).

The transaction at issue concerned a reorganization of a holding company, the common parent of an affiliated group of corporations that filed a consolidated federal income tax return. As part of the reorganization, the parent holding company’s creditors became equity owners — an ownership change under Section 382 of the Code. The parent’s principal operating subsidiary, which did not declare bankruptcy, carried on a business in a regulated industry.

However, to preserve the parent corporation’s net operating losses, the bankruptcy court approved a stock and claims trading order that provided for various requirements designed to allow the parent corporation’s plan of reorganization to fall within the scope of Section 382(l)(5), the so-called “bankruptcy exception” to the NOL loss limitation rules set forth in Section 382(a).

Typical of reorganizations designed to maintain NOLs, the trading order contained the following provisions: 1) requirement that substantial equity holders provide notice of their ownership percentage to the parent company; 2) requirement that substantial equity holders notify the bankruptcy court of any transaction that would increase or decrease their ownership of the parent; 3) right of the parent company to file a reporting notice with the bankruptcy court, requiring any claimholder to report its holdings; and, 4) option by the parent company to file a request for a “sell-down” order with the bankruptcy court, authorizing the parent company to require claimholders to sell down a certain percentage of their claims (ostensibly to meet the 5% stock ownership cutoff under Section 382).

After reviewing the salient features of the parent company’s trading order and plan of reorganization, the IRS determined that the change in ownership resulting from the bankruptcy reorganization, although an ownership change for purposes of Section 382(a), would nonetheless qualify for the bankruptcy exception under Section 382(l)(5). As a result, the parent company’s NOLs would not be subject to an NOL loss limitation upon exit from bankruptcy.

The IRS also ruled that because the parent’s operating subsidiary maintained its operations throughout the bankruptcy, the subsidiary’s activities qualified as a significant active trade or business of the parent group for purposes of Treasury Regulation Section 1.269-3(d), which provides that in the absence of a significant active trade or business during and subsequent to the bankruptcy, the IRS is authorized to disallow the benefits (i.e., NOL preservation) afforded by Section 382(l)(5).

Holding the PHONE? — Equity Linked Debt Instrument Forms Part of a Straddle

In a recent Chief Counsel Advice memorandum, the IRS concluded that equity-linked debt instruments issued by the Taxpayer, which referenced the value of shares of an underlying company, X, held by the Taxpayer, constituted a “position” under Section 1092(d)(2) and thus, qualified as part of a straddle for federal tax purposes. Accordingly, the IRS held that the Taxpayer must capitalize interest expense related to the debt instrument pursuant to Section 263(g)(1), and the basis of new shares of the underlying company received in a non-taxable exchange must include the related repurchase premium and interest capitalized into the basis of shares so transferred. Although the CCA is redacted, the instrument described in the CCA has many of the same features as a PHONES transaction.

The debt instruments issued were publicly traded and were exchangeable for X stock held by the Taxpayer, which was previously acquired in an unrelated transaction. The debt instruments were publicly traded and were treated as contingent payment debt instruments for federal income tax purposes. The debt instruments issued by the Taxpayer replaced similar debt of the Taxpayer, which were retired with the new debt issuance.

CCA 201310027 (Mar. 8, 2013). In addition, on April 26, 2013, the IRS released CCA 201317009, which further ruled that the debt instruments at issue in CCA 201310027, including the embedded exchange feature, did not constitute a call option for tax purposes or qualified covered call options under Section 1092(c)(4).

For an example of a PHONES transaction see, e.g., Prospectus Supplement filed by Comcast Corporation for the issuance of Exchangeable Extendable Subordinated Debentures Due 2029 (Exchangeable for Cash Based on Value of AT&T Corp. Common Stock, Maturity Subject to Extension to 2059) dated March 9, 1999. The CCA does not name the taxpayer involved in the transaction.

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19 PLR 201306003 (Feb. 8, 2013).
Equity Linked Debt Instrument
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The debt instruments contained a put right by the holder for a fixed number of shares of X stock subject to adjustment for certain events such as a merger or stock split, or at the Taxpayer’s option, the equivalent amount of cash. Pursuant to the terms of the debt instrument, Taxpayer was required to maintain a deposit of shares of X stock with an exchange agent sufficient to meet the exchange obligation. Taxpayer retained the right to dividends and to vote the X stock; however, Taxpayer could not otherwise use the X stock, including pledging it for another debt or hypothecating it.

Before the stated maturity date of the debt instruments, the holders exercised their put right to exchange the debt instruments for shares of X stock. The Taxpayer chose to pay the cash equivalent amount to the holders. At all times during the redemption period, the average stock price exceeded the exercise price of the debt instrument. Taxpayer deducted the repurchase premium as interest. At a later time and in an unrelated transaction, Taxpayer exchanged the X stock for stock of a new corporation spun-off by X in a tax-free reorganization.

A straddle is defined in Section 1092(c)(1) as consisting of “offsetting positions with respect to personal property.” A position is considered to be offsetting if there is substantial diminution of the taxpayer’s risk of loss from holding one position by reason of holding the other position. Personal property is defined in Section 1092(d)(1) as “any personal property of a type which is actively traded,” and a position is defined in Section 1092(d)(2) to include “an interest (including a futures or forward contract or option) in personal property.”

The IRS concluded that the debt instruments and shares of X stock were offsetting positions under Section 1092 because the Taxpayer’s risk of loss from the debt instrument was substantially diminished by its holding of the X stock. Implicit in the IRS’ determination is that in certain instances, a debt instrument can represent a “position” since the debt instrument at issue was exchangeable at the holder’s option for an amount that referenced the value of X stock, and thus economically was equivalent to a short position in the stock. The IRS ignored the fact, however, that the issuer could not force an exchange.

The IRS then determined that the X stock was a position with respect to substantially similar or related property to the debt instruments under Treas. Reg. Sec. 1.246-5(b)(1) since (i) the fair market value of the X stock and the debt instruments taking into account exchange rate on the X stock primarily reflected the performance of X corporation and (ii) changes in the fair market value of the stock are reasonably expected to approximate changes in value of the debt instruments. As a result, the IRS held that the stock was personal property for purposes of the straddle rules and the Taxpayer’s position in the debt instruments coupled with its holdings of X stock constituted a straddle.

The next issue the IRS addressed was whether the Taxpayer’s payment of a repurchase premium and coupon interest with respect to the debt instruments constituted interest or carrying charges “incurred or continued to purchase or carry” the X stock under Section 263(g). The repurchase premium paid by the Taxpayer resulted from the fact that the amount paid to repurchase the debt instruments, which included settlement of the holder’s put right for X stock, was greater than the adjusted issue price of the debt instrument. Treas. Reg. Sec. 1.163-7 provides that where an issuer repurchases its own debt instrument at a price which exceeds the adjusted issue price, such excess amount is deductible as interest in the tax year the repurchase occurs. The IRS, therefore, concluded that the repurchase premium was treated as “interest on indebtedness” for purposes of Section 263(g).

The IRS then considered whether the repurchase premium and interest coupon qualified as interest which was “incurred or continued to purchase or carry personal property that is part of a straddle.” The IRS concluded based on a facts and circumstances determination that a clear, direct relationship existed between the debt instruments and the X stock, specifically that the Taxpayer’s purpose for incurring the debt instrument was to carry the X stock. Specifically, the IRS looked to various agreements the Taxpayer entered into following the issuance of the debt instruments, including Taxpayer’s deposit of the X shares with the exchange agent. The IRS also took into account the fact that holders benefited from the right to share in the appreciation of X stock in exchange for the receipt of interest payments which were below the stated market rate, or the relevant comparable yield which the Taxpayer used to accrue interest income pursuant to the CPDI rules.

Lastly, the IRS held that the Taxpayer’s basis in new shares it received in exchange for its X stock pursuant to a tax-free reorganization would include any repurchase premium and interest coupons previously capitalized into Taxpayer’s holdings of X stock.

Of course, it goes without saying that the CCA is private IRS guidance that cannot be relied on and that does not represent an official position of the IRS. Moreover, a key tax benefit of PHONES was eliminated by the expansion of Section 163(l) in the American Jobs Creation Act of 2004.

IRS Releases New FATCA Form
In the latest demonstration that the IRS is continuing to gear up for the implementation of FATCA, Draft Form 8957 has been released, which enables foreign financial institutions (“FFIs”) to register with the IRS. The draft form gathers basic information about the FFI and asks the FFI to appoint a responsible officer (“RO”) to act as a point of contact for the FFI. The RO can authorize other points of contact to take other FATCA-related actions and obtain access to the FFI’s tax information.

Although only the paper version of the draft form has been released, the IRS strongly encourages FFIs to take advantage of the online registration portal that will be available in July 2013. According to the
IRS Releases New FATCA Form

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IRS website, “paper registration forms will not be processed until October 2013 and financial institutions may experience a delay in receiving notice of registration acceptance and obtaining the GIIN [Global Intermediary Identification Number] needed to demonstrate FATCA compliance.” Those FFIs that are determined to register for FATCA via a paper form must wait until the final draft of the form is released in July 2013.

Ambac Seeks Bankruptcy Court Approval of Settlement with Government Resolving Dispute Arising out of Tax Treatment of Credit Default Swaps

On April 9, 2013, Ambac Financial Group, Inc. (“Ambac”) submitted a proposed settlement with the United States to the U.S. Bankruptcy Court for the Southern District of New York. If approved, the proposed settlement would resolve more than two years of litigation concerning the tax treatment of losses sustained by Ambac in connection with credit default swap contracts entered into during the 2008 financial crisis. The settlement would result in a payment by Ambac to the Government of $101.9 million, as well as possible future additional payments of up to $14.9 million. In connection with the settlement, Ambac would also be required to reduce its net operating loss carryovers attributable to the credit default swap contracts at issue by $1 billion. According to Preet Bharara, the U.S. Attorney for the Southern District of New York, “The proposed settlement reflects an extensive investigation into Ambac’s reported financial losses and accounting methods in the wake of the financial crisis, and, if approved, will result in a significant recovery of Treasury funds. The settlement will also prevent Ambac from taking $1 billion in future offsets against its income and thus potentially reducing its tax burden by several hundred million dollars, a reduction to which it is not entitled.”

MoFo in the News

On January 7, 2013, MoFo Partners Charles Horn, Oliver Ireland and Barbara Mendelson presented a teleseminar entitled “The Federal Reserve’s Proposed Prudential Regulations for Foreign Banks,” which focused on the Federal Reserve’s proposed significant new regulations affecting the operations of foreign banks in the United States. The proposals are designed to implement the enhanced prudential regulation and early remediation requirements of Dodd-Frank Act sections 165 and 166.

MoFo Partners Anna Pinedo and David Kaufman presented a PLI Webcast entitled JOBS Act: Growing Momentum on January 8, 2013, discussing how, since enactment of the JOBS Act in April 2012, the Staff of the Securities & Exchange Commission has published many of the required studies and released significant guidance concerning many of the JOBS Act provisions. Market practice continues to evolve in relation to emerging growth company IPOs.

MoFo Partners Anna Pinedo and Jerry Marlatt and Ze’ev Eiger also presented at the IFLR Webcast, discussing How Foreign Banks Can Finance in the U.S. “The webcast discussed how foreign banks are increasingly seeking to diversify their financing opportunities and how, with careful planning, they can access U.S. investors without subjecting themselves to the securities registration requirements applicable to public offerings, or ongoing disclosure and governance requirements applicable to U.S. reporting companies.

On January 17, 2013, MoFo Partner Anna Pinedo gave a seminar at the 5th Annual SPA & MoFo Structured Products Legal, Regulatory & Compliance Update. This presentation addressed developments in the legal-regulatory-compliance landscape, including FINRA Communications Rules, estimated value disclosures, areas of attention for FINRA and the SEC related to structured products, retail communication on an online, electronic forum and hedging related to structured products post-Dodd-Frank.

MoFo Partners Peter Green and Thomas Humphreys hosted a seminar entitled “A Capital Question: How will banks address more stringent capital requirements?” on January 22, 2013 in London. The seminar addressed how financial institutions in Europe and the United States are considering a range of products to address their funding needs while questions still remain regarding the products that will achieve beneficial regulatory capital treatment.

On January 23, 2013, MoFo Partners Nilene Evans and James Tanenbaum, with Stikeman Elliott Partner Ian Putnam, hosted a seminar entitled “MoFo Classics: All Things Canadian.” The seminar discussed the rules of the road for securities offerings by non-Canadian issuers into Canada and the prospectus regime applicable to Canadian issuers, focusing on the shelf registration process and on dual-listed issuers. Additional time and attention was devoted to certain popular deal formats.

As part of the ALI CLE Webcast series, MoFo Partners David Kaufman and Anna Pinedo gave a talk entitled “New SEC Rules on Clearing Agency Standards for Derivatives and Other Securities Transactions” on January 23, 2013. This webcast provided a review of new SEC rules for registered clearing agencies and their implications for the risk management and
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other policies and procedures of participants.

MoFo Partners Brian Bates and Scott Ashton spoke at the 26th Annual Private Placements Industry Forum on January 23-25, 2013. The 2013 Private Placement Industry Forum covered pressing issues in the industry including: global deal generation, how rating agencies are affecting deal prices and yields, and an in-depth look at the latest changes in deal documents.

On January 29, 2013, Lloyd Harmetz, Marissa Nicole Golden, Charles Horn, Bradley Berman, and Remmelt Reigersman gave a teleseminar entitled “U.S. Structured Product Offering by Non-U.S. Banks.” The teleseminar addressed the opportunities and challenges in the U.S. market for non-U.S. banks that seek to offer their structured products and how these offerings are conducted, including the key securities, banking and tax considerations. The seminar also addressed current U.S. regulatory environment and key areas of focus of the SEC and FINRA.

On January 29, 2013, MoFo Partner Jerry Marlatt spoke on the panel “Origination Hotspots” at the seminar “Pfundbrief & Covered Bonds Outlook 2013.” This seminar discussed the key issues and challenges in the covered bond markets in 2013 and beyond, and surveyed the issuance outlook in covered bond origination hotspots, including new jurisdictions, periphery countries and new global markets including Canada and Australia, emerging markets, their comparative cover pools and asset structures, and where originators should focus in 2013 for market growth.

On February 11, 2013, together with Lisa Chippindale, U.S. tax counsel at Royal Bank of Canada, MoFo Partners Remmelt Reigersman and Tom Humphreys held an ALI CLE Webcast entitled “FATCA: Does Your Client Comply?” This webcast gave an overview of FATCA and its impact on the capital markets. Topics included background of FATCA, the FATCA 30% tax on “withholdable payments” and FATCA’s impact on debt and equity offerings, swap transactions, and other structured products.

MoFo Partners Thomas Humphreys and Remmelt Reigersman hosted a seminar entitled “Tax Update — Tax Treatment of Financial Products” on February 12, 2013 in MoFo’s New York office. The seminar addressed the sweeping regulatory changes on Wall Street and how the U.S. federal income tax rules for financial products are beginning to change as well. The seminar focused on Representative Dave Camp’s (R-MI) proposal for a mark-to-market system for taxing derivatives.

MoFo Partner Anna Pinedo spoke at the Broker-Dealer and Adviser Regulatory Compliance Forum on February 20, 2013. The talk covered topics impacting the relevant regulatory framework, as well as practical considerations regarding the design and implementation of such programs. Anna Pinedo spoke on a forum called “Complex Products” examining what types of products are “complex”, the FINRA regulatory Notice 12-03, and recent enforcement cases.

On March 12, 2013, MoFo Partners Anna Pinedo and David Kaufman gave a seminar entitled “Navigating the Requirements for Derivatives Trading — Title VII of Dodd-Frank.” The seminar discussed how market participants are preparing themselves to function in a very different derivatives market now that the rulemaking relating to Title VII of the Dodd-Frank Act has been nearly finalized. Title VII imposes a comprehensive regulatory framework for derivatives, and requires both end-users and dealers to adopt new compliance and operating procedures.

On March 13, 2013, MoFo Partners Brian Bates and Anna Pinedo and counsel Scott Ashton hosted a seminar entitled “Accessing the U.S. Market to Raise Capital.” The seminar discussed how foreign issuers, including corporates and banks, are increasingly seeking to diversify their financing opportunities and how, with careful planning, they can access U.S. investors without subjecting themselves to the securities registration requirements applicable to public offerings, or the ongoing disclosure and governance requirements applicable to U.S. reporting companies. Foreign issuers also may consider registering with the SEC. This seminar primarily focused on Swedish issuers.

MoFo Partners Charles Horn and James Schwartz hosted a seminar entitled “Basel III and Derivatives Exposures: Understanding the Regulatory Capital Effects” on March 15, 2013. They addressed derivatives under the new regulatory capital rules, including the state of play under last year’s U.S. regulatory capital proposals, key issues presented by these rule proposals, and how the final regulatory requirements may play out in light of industry comments as well as domestic and international regulatory capital developments.

On March 19, 2013, MoFo counsel Nilene Evans and Partner Anna Pinedo reviewed the FINRA rules applicable to offerings, including new Rule 5123 in their MoFo Classics seminar “FINRA—Offerings and Research.” The seminar also covered the rules relating to research on emerging growth companies, and proposed debt research rules.

MoFo Partners Ze’ev Eiger, David Lynn, and Anna Pinedo hosted a PLI webcast entitled “SEC Registration for Foreign Banks” on March 20, 2013. The seminar addressed how foreign banks seeking to diversify their financing opportunities may consider SEC registration and focused on the registration process, disclosure considerations for financial institutions, and compliance, governance and ongoing reporting.

MoFo Partner Anna Pinedo and senior counsel Jerry Marlatt discussed how, despite the sovereign crisis and heightened volatility, the covered bond market remains very attractive in their April 2, 2013, PLI webcast “Foreign Banks Issuing Covered Bonds into the U.S.” The discussion centered on the market environment, the legal and regulatory considerations and the process for an exempt offering by a foreign issuer.

On April 3, 2013, MoFo Partners Anna Pinedo, Lloyd Harmetz and senior counsel Jerry Marlatt hosted a West LegalEd Webcast entitled “Foreign Banks Accessing the U.S. Markets.” The webcast addressed
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how foreign banks are increasingly seeking to diversify their financing opportunities and how, with careful planning, banks can access U.S. investors without subjecting themselves to the securities registration requirements applicable to public offerings and to ongoing disclosure and governance requirements applicable to U.S. reporting companies.

MoFo counsel Melissa Beck, senior counsel Jerry Marlatt and partner Anna Pinedo hosted a West LegalEd Webcast entitled “Foreign Banks Issuing Covered Bonds into the U.S.” on April 10, 2013. The webcast discussed how, despite the sovereign crisis and heightened volatility, the covered bond market remains very attractive and how foreign banks continue to access the U.S. markets with covered bond offerings. Topics included the market environment, the legal and regulatory considerations and the process for an exempt offering by a foreign issuer.

Awards

MoFo senior counsel Jerry Marlatt was named a “Dealmaker of the Year” by the American Lawyer for his work on the first-ever U.S. SEC registered covered bond for Royal Bank of Canada.

MoFo was named Law Firm of the Year 2013 by Operational Risk & Regulation magazine for its leadership and expertise in financial regulatory matters.

About Morrison & Foerster

With more than 1,000 lawyers in key technology and financial centers in the United States, Europe and Asia, our clients include some of the largest financial institutions, investment banks, and Fortune 100, technology and life science companies. We’ve been included on The American Lawyer’s A-List for nine straight years, and Chambers Global named MoFo its 2013 USA Law Firm of the Year. Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. Visit us at mofo.com.

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