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TaxTalk

Editor's Note

In the third quarter 2010, the Tax Court released its opinion in Anschutz Company v. Comm'r, 135 T.C. No. 5 (July 22, 2010), holding that the variable prepaid forward contract plus the stock loan at issue was a sale for U.S. federal income tax purposes. The IRS also issued much anticipated guidance on the new Foreign Account Tax Compliance Act ("FATCA") withholding and reporting rules and guidance (albeit limited) on the codification of the economic substance doctrine. The International Swaps and Derivatives Association also released a protocol on new Section 871(l) (redesignated recently as Section 871(m) by H.R. 1586) addressing withholding tax on certain cross-border equity swaps. FATCA withholding and reporting, economic substance, and Section 871(l) were part of new legislation enacted into law in March 2010.

In other news, we report on the revenue raiser in the Small Business Jobs Act that affects the source rules for guarantee fees. We also clarify how the Medicare tax applies to the sale of a taxpayer's principal residence. And in our regular feature, The Classroom, we discuss the U.S. federal income taxation of fixed-to-floaters, specifically, those instruments that pay interest at a single fixed rate followed by a floating rate.

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Prepaid Forward Plus Stock Loan Equals Sale According to U.S. Tax Court

On July 22, 2010, the U.S. Tax Court ruled against the taxpayer in *Anschutz v. Comm'r*, the widely followed U.S. prepaid forward plus stock loan case.

Background

In 2000 and 2001, Anschutz Company ("Anschutz") entered into a prepaid variable forward contract ("PVFC") plus share loan with Donaldson, Lufkin & Jenrette ("DLJ"). Simplifying the transactions at issue in the case, Anschutz entered into a master stock purchase agreement ("MSPA") with DLJ to sell DLJ a variable number of shares of Union Pacific Resources Group, Inc. and Anadarko Petroleum Corp. common stock in 10 years. In exchange, Anschutz received 75% of the stock's initial fair market value upon executing the transaction. The PVFCs provided for delivery of a variable number of shares or cash depending on the share price at settlement. As such, Anschutz transferred all the downside risk to DLJ, kept the first 50% of the stock's appreciation and any appreciation above that accrued to DLJ. Anschutz was required to pledge the underlying shares as collateral under the MSPA. The shares were pledged pursuant to a "Pledge Agreement" to a collateral agent. The Pledge Agreement also provided that the collateral agent would enter into a stock lending agreement ("SLA") with DLJ. The SLA permitted DLJ to borrow the shares held in the collateral account at any time and to pay a 5% fee to Anschutz if it did so. DLJ, in fact, borrowed the shares immediately when the transactions were entered into. Anschutz argued that the MSPA and the SLA should be considered separate transactions for federal income tax purposes and therefore that the MSPA was not a sale for federal income tax purposes under the authority of an IRS published ruling which holds that a vanilla PVFC does not result in either an actual sale or constructive sale for federal income tax purposes.

Tax Court Decision

Tax Court Judge Joseph R. Goeke held that the transaction resulted in a sale for U.S. federal income tax purposes. Most importantly, without citing a discernible legal standard, the decision held that the MSPA and SLA should be viewed as one integrated transaction for federal income tax purposes. The Court stated that "the two legs were clearly related and interdependent, and both were governed by the MSPA." The Court observed that while Anshutz could recall the shares under the SLAs at any time, DLJ could accelerate the PVFCs if, among other things, it was unable to hedge its position. This was cited as evidence the two agreements should be integrated. The Court also found that lending the shares subject to the PVFCs was a "vital part" of the transaction, and that immediate borrowing of Anschutz's shares by DLJ to cover its market short sales was contemplated during the parties' negotiations. Upon finding that the MSPA and the SLA were one integrated transaction, Judge Goeke then analyzed the overall transaction under a multifactor test. Viewing the SLA and the MSPA together, the Court held that Anschutz had transferred legal title, the entire risk of loss, a major portion of the opportunity for gain, the right to vote the stock and possession of the stock. Accordingly, the Court found Anschutz had sold the stock for federal income tax purposes.

The Tax Court determined Anschutz's amount realized on the transaction equaled the amount of cash received excluding, however, the value of the derivative giving Anschutz the right to future upside in the stock since that derivative might never result in cash received. This was roughly 80% of the value of the share position—the 75% prepayment on the PVFC and the 5% SLA fee.

Importantly, the Court did accept the conclusions of the prior IRS published ruling, which holds that a straight PVFC does not result in a sale or constructive sale for federal income tax purposes if certain requirements are met. That should mean that PVFCs, without share lending agreements, can still be safely executed by U.S. taxpayers.[1] Waiting longer, *e.g.*, 90 days, between the VPFC and the stock lending transaction doesn't help, according to a recent statement by an IRS official.[2]

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1. See our client alert for further observations and a more in-depth discussion of *Anschutz* available at http://www.mofo.com/files/Uploads/Images/100723TaxCourt.pdf

2. See Amy S. Elliot, "Longer Wait Between Hedging Transaction and Stock Pledge Won't Stop Gain Recognition, Official Says," 129 Tax Notes 24 (Oct. 4, 2010).

IRS Issues Initial Guidance on FATCA Withholding and Reporting

On August 27, 2010, the Internal Revenue Service ("IRS") and Treasury Department ("Treasury") issued Notice 2010-60 ("Notice") setting forth initial guidance with respect to the new reporting and withholding obligations enacted into law on March 18, 2010 as part of the Foreign Account Tax Compliance Act.[1] FATCA introduced a new 30% withholding tax on any "withholdable payment" made to either a foreign financial institution ("FFI") or a non-financial foreign entity ("NFFE") unless the FFI meets certain reporting obligations or the NFFE discloses certain information regarding substantial U.S. owners. A "withholdable payment" generally includes any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the U.S. It also includes gross proceeds from the sale of property that is of a type that can produce U.S.-source dividends or interest, such as stock or debt issued by domestic corporations. The new 30% withholding tax on any "withholdable payment" made to an FFI (whether or not beneficially owned by such institution) applies unless the FFI agrees, pursuant to an agreement entered into with Treasury ("FFI Agreement"), to provide information with respect to each "financial account" held by "specified U.S. persons" and "U.S.-owned foreign entities."

The new reporting and withholding provisions apply to payments made after December 31, 2012; "obligations" outstanding on March 18, 2012 are grandfathered.

The Notice includes guidance regarding (1) the grandfather provision, (2) the definition of an FFI, (3) the scope of required information collection and identification of persons by FFIs, and (4) the manner and type of information that FFIs must provide to the IRS with respect to U.S. accounts. The Notice further indicates that the IRS and Treasury intend to issue regulations

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IRS Issues Initial Guidance

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incorporating the guidance provided in the Notice and addressing other relevant matters. In addition, the IRS and Treasury request comments on the issues addressed in the Notice. All comments are due by November 1, 2010. Although the Notice sets forth some of the requirements that participating FFIs will need to comply with pursuant to an FFI Agreement, a draft agreement is not yet available. The Notice does not provide guidance on the obligations imposed on NFFEs by FATCA. Below, we provide a brief overview of some of the guidance included in the Notice.[2]

Grandfather Provision

The Notice provides that the term "obligation" for purposes of the grandfather provision means any legal agreement that produces or could produce withholdable payments. However, an obligation does not include any instrument treated as equity for U.S. tax purposes or any legal agreement that lacks a definitive expiration or term (*e.g.*, savings deposits, demand deposits, or other similar accounts, and brokerage, custodial, and similar agreements to hold financial assets for the account of others and to make and receive payments of income and other amounts with respect to such assets). Thus, these excluded instruments and agreements are not eligible for grandfathering.

For purposes of the grandfather provision, any material modification of an obligation will result in the obligation being treated as newly issued on the date of the material modification. Whether a modification is considered material will be based on all the relevant facts and circumstances. In the case of an obligation that is a debt instrument for U.S. tax purposes, a material modification means a significant modification as defined in Treasury regulations.[3]

Definition of an FFI

Entities Treated as FFIs or Excluded as FFIs

The Notice includes guidance with respect to the three categories of entities that are considered FFIs:

a. Entities that accept deposits in the ordinary course of a banking or similar business, including, but not limited to, entities that would qualify as banks under Section 585(a)(2) (including banks as defined in Section 581 and any corporation to which Section 581 would apply except for the fact that it is a foreign corporation), savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions.

b. Entities that, as a substantial portion of their business, hold financial assets for the account of others (*e.g.*, broker-dealers, clearing organizations, trust companies, custodial banks, and entities acting as custodians with respect to the assets of employee benefit plans).

c. Entities engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities (including through derivatives), such as mutual funds (or their foreign equivalent), funds of funds, exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools, and other investment vehicles.[4]

The Notice further addresses certain entities that are excluded from the definition of an FFI or are otherwise exempt from some or all of the reporting or withholding obligations:

a. Certain holding companies, start-up companies, non-financial entities that are liquidating or emerging from reorganization or bankruptcy, and hedging and financing centers of a non-financial group are excluded from being FFIs, but will be NFFEs. Payments beneficially owned by these entities, however, will be exempt from the NFFE withholding tax.

b. Insurance companies whose business consists solely of issuing insurance contracts without cash value (*e.g.*, property and casualty insurance, reinsurance contracts, or term life insurance contracts) are excluded from the definition of an FFI, but will be NFFEs.

c. Investment funds with a small number of direct or indirect account holders will be treated as deemed-compliant FFIs[5] if certain documentation requirements are met by persons with an interest in such funds.

d. Certain foreign retirement plans are considered to pose a low risk of tax evasion and payments beneficially owned by such retirement plans will be exempt from withholding even though a foreign retirement plan may qualify as an FFI.

Identification and Information Collection

In order to avoid the new withholding tax, an FFI must enter into an FFI Agreement with Treasury (thereby becoming a "participating FFI"). Pursuant to the FFI Agreement, the FFI must agree, among other things, to (i) determine which of its accounts are U.S. accounts, (ii) comply with Treasury due diligence procedures with respect to the identification of U.S. accounts, (iii) report certain information with respect to U.S. accounts, and (iv) withhold tax on certain payments to non-participating FFIs and recalcitrant account holders.[6] Although a draft FFI Agreement is not yet available, the Notice sets forth some of the requirements that participating FFIs will need to comply with pursuant to such an agreement.

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1. FATCA was included in the Hiring Incentives to Restore Employment Act of 2010. See our prior client alert discussing the FATCA provisions at http://www.mofo.com//files//Uploads/Images/100322FATCA.pdf.

2. See our client alert for a more detailed discussion of the Notice available at http://www.mofo.com/files/Uploads/Images/100910FACTA.pdf.

3. Section 1.1001-3. All Section references are to the Internal Revenue Code of 1986, as amended ("Code"), and the Treasury regulations promulgated thereunder.

4. The Notice indicates that the concept of "business" used in Section 1471(d)(5)(C) is different in scope and content from the scope of a "trade or business" used in other sections of the Code and that future regulations will provide guidelines for determining what types of activities constitute a "business" for these purposes.

5. A deemed-compliant FFI is an FFI that: (i) complies with such procedures as the Treasury may prescribe to ensure that the FFI does not maintain U.S. accounts and meets such other requirements as the Treasury may prescribe with respect to accounts of other FFIs maintained by such FFI, or (ii) is a member of a class of institutions with respect to which the Treasury determines that application of the new withholding tax is not necessary to carry out the purposes of the FATCA provisions. Because such a deemed-compliant FFI would remain a "financial institution," it would not be an NFFE, and therefore would not be subject to the withholding tax applicable to NFFEs.

6. Recalcitrant account holders are those account holders who fail to comply with reasonable requests for information by a participating FFI in order for it to meet its obligations under the relevant provisions, or who fail to provide a waiver in any case in which any foreign law would (but for such waiver) prevent the reporting of any information an FFI is required to report.

IRS Issues Economic Substance "Guidance"

As we reported two issues ago in this publication,[1] the "economic substance doctrine" has been codified. New Section 7701(o) provides that any transaction (including a series of transactions) entered into after March 30, 2010 and to which the economic substance doctrine is relevant is treated as having economic substance only if (i) the transaction changes in a meaningful way the taxpayer's economic position (the objective test), and (ii) the taxpayer has a substantial purpose for entering into such transaction (the subjective test). In addition, a new strict liability penalty of 20% has been introduced for an understatement attributable to a disallowance of claimed tax benefits by reason of a transaction entered into after March 30, 2010 lacking economic substance. The penalty is increased to 40% if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment of the transaction on its tax return or in a statement attached to the return. The IRS issued interim guidance in the form of Notice 2010-62 (the "Notice") stating how it will apply the new Code provision. Unfortunately, the "guidance" is short on new information. The IRS has indicated it will not issue substantive guidance on the new provision.[2]

In the Notice, the IRS indicates that it will continue to rely on relevant case law under the common-law economic substance doctrine in applying the above described two-prong test and that it will challenge taxpayers who seek to rely on prior case law holding that a transaction has economic substance if either the objective or the subjective test is met. The IRS states that it does not intend to issue general administrative guidance regarding the type of transactions to which the economic substance doctrine either applies or does not apply (*i.e.*, the IRS does not intend to issue an "angel list").

Further, if the taxpayer is relying on profit motive, in calculating the net present value of the reasonable expected pre-tax profit, the IRS will take into account the taxpayer's profit motive only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected for tax purposes—determined by applying existing relevant case law and other published guidance.[3] In this respect, the Notice, like the legislative history, merely restates the language in the economic substance statute, rather than providing any guidance. As provided for in the new Code provision, the IRS intends to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profits in appropriate cases.

The penalty is increased to 40% if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment of the transaction on its tax return or in a statement attached to the return.

Finally, the IRS indicated that it will not issue private letter rulings regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the new Code provision.

Apart from the Notice, the IRS also issued a Directive for Industry Directors pursuant to which it directs IRS field agents to have any strict liability penalties proposed in connection with the economic substance doctrine reviewed and approved by the appropriate Director of Field Operations.

1. See MoFo Tax Talk Volume 3, No. 1.
2. See Jeremiah Coder and Amy S. Elliott, "IRS Officials Hint at Limited Economic Substance Guidance," 2010 TNT 187-1 (September 28, 2010).
3. This caused us to go back and check the status of Notice 98-5, which has five famous examples comparing tax benefits to economic profit in the international context. Notice 98-5 was ultimately withdrawn by Notice 2004-19, but the IRS continues to use all tools available to combat abusive foreign tax credit transactions.

ISDA 2010 HIRE Act Protocol

As discussed in more detail in a prior issue of MoFo Tax Talk,[1] the HIRE Act treats as a U.S.-source dividend any "dividend equivalent" for purposes of U.S. withholding tax provisions. 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). A specified notional principal contract may include equity swaps and as a result a dividend equivalent may include payments under an equity swap that are determined by reference to a dividend distribution on a U.S. equity security.

To address these HIRE Act consequences, the International Swaps and Derivatives Association ("ISDA") released a protocol (the "Protocol") amending its standard equity swaps documentation. The Protocol includes the following changes: (1) the party to an equity swap that is required to withhold U.S. tax on a dividend equivalent will not be required to pay a gross-up; (2) the addition of representations by the payee under an equity swap (*e.g.*, representations such that the equity swap should not be considered a specified notional contract and representations that the payee will meet the requirements to avoid the new 30% FATCA withholding tax); and (3) the addition of certain termination rights (*e.g.*, in the event there is a substantial likelihood the U.S. payor would otherwise be required to pay a gross-up on the next scheduled payment date, or the IRS provides written notice of an intention to assess tax in connection with an equity swap). Our understanding is that certain foreign counterparties are resisting these provisions and that including or not including them is the subject of case-by-case negotiation. More information on the Protocol including a list of adhering parties can be found at: http://www.isda.org/isda2010hireactprot/hireactprot.html.

1. See MoFo Tax Talk Volume 3, No. 1.

Small Business Jobs Act Affects Source Rules for Guarantee Fees

As discussed in our prior client alert "Small Business Jobs Act of 2010—Key Revenue-Raising Provisions," the Small Business Jobs Act of 2010 (signed into law on September 27, 2010) includes $12 billion in tax cuts aimed at small businesses and several revenue raising provisions. We would like to highlight one particular revenue raiser of the Act—the source rules for income on guarantees, which effectively overrides *Container Corp. v. Commissioner*,[1] discussed in our first quarter 2010 issue.[2]

In *Container Corp.*, a Mexican corporation guaranteed certain of its U.S. subsidiary's notes. In exchange for this guarantee, the U.S. subsidiary paid the Mexican parent corporation a guarantee fee equal to 1.5% of the outstanding principal balance of the notes. The U.S. subsidiary did not withhold any U.S. federal income tax on the guarantee fees. The IRS asserted that the guarantee fees were U.S.-source FDAP because they were analogous to interest paid by the U.S. subsidiary. Interest income is sourced according to the place of residence of the obligor.[3] The U.S. subsidiary argued that the guarantee fees were more analogous to service income and should be treated as non-U.S. source FDAP since the services provided by the Mexican parent were performed in Mexico.[4] In siding with the U.S. subsidiary, the Tax Court found that the Mexican parent's creditworthiness, goodwill and other assets produced the guarantee fees and that such fees were more analogous to payments for the performance of services. The Tax Court then concluded that since the parent was located outside the U.S., and its services were performed outside the U.S., the guarantee fees were not U.S.-source and, therefore, were not subject to U.S. withholding tax.

The Act effectively overrides the Tax Court's holding in *Container Corp.* by amending the source rules to address income from guarantees issued after September 27, 2010. Under new Section 861(a)(9), U.S.-source income includes (i) amounts received (directly or indirectly) from a non-corporate resident or a domestic corporation for the provision of a guarantee of indebtedness of such person and (ii) amounts received from a foreign person (directly or indirectly) for the provision of a guarantee of indebtedness of that foreign person if the payments received are effectively connected with the U.S. trade or business of such foreign person. In addition, the Act provides that this new rule applies to payments that are made indirectly for the provision of a guarantee. The legislative history provides the following example of payments made indirectly for a guarantee: A foreign parent of a U.S. subsidiary guarantees the debt of such U.S. subsidiary owed to a foreign bank. However, instead of receiving a guarantee fee from its U.S. subsidiary, the foreign parent receives a fee from the foreign bank who recoups this cost by charging additional interest to the U.S. subsidiary. In this case, new Section 861(a)(9) would treat the fees received by the foreign parent from the foreign bank as U.S-source guarantee fees.

The U.S. subsidiary argued that the guarantee fees were more analogous to service income and should be treated as non-U.S. source FDAP since the services provided by the Mexican parent were performed in Mexico.

This provision is effective for guarantees issued after September 27, 2010. The Act's legislative history states that no inference is intended regarding the source of income received with respect to guarantees issued before September 27, 2010.

1. 134 T.C. No. 5 (Feb. 17, 2010).

2. See MoFo Tax Talk Volume 3, No. 1 "*Container Corp. v. Commissioner*: No U.S. Withholding Tax on Payment of Guaranty Fees by U.S. Subsidiary to Foreign Parent."

3. Sections 861(a)(1) and 862(a)(1).

4. Payments for the performance of services are generally sourced according to the location where the services were performed. Sections 861(a)(3) and 862(a)(3).

Medicare Tax—On the Sale of a Principal Residence?

As discussed in our prior client alert, "Reconciliation Bill Codifies 'Economic Substance' Doctrine, Expands Medicare Taxes on High Income Earners and Imposes Reporting Requirements on Certain Payments to Corporations," to pay for health care reform, among other revenue raisers, the Health Care Act introduced a 3.8% Medicare contribution tax (the "Medicare tax") on unearned income (*i.e.*, income other than from wages) of certain high income earners. There has been some confusion as to the application of this provision on the sale of a taxpayer's principal residence—specifically, whether the tax is a 3.8% sales tax on a taxpayer's principal residence (*i.e.*, applies on the gross proceeds of the sale of the taxpayer's home). The short answer is that it does not act as a sales tax on a taxpayer's home, but it may apply to net gain on certain sales of a high-income earner's residence, provided that the amount is not otherwise excluded under the Code.

The Medicare tax imposes on individuals a tax at the rate of 3.8% on the lesser of (i) "net investment income," or (ii) the excess of "modified adjusted gross income" over the "threshold amount." The "threshold amount" is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. "Modified adjusted gross income" is adjusted gross income increased by the amount excluded from income as foreign earned income.

"Net investment income" generally equals the taxpayer's gross investment income reduced by the deductions that are allocable to such income. Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (ii) other gross income derived from any business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than

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Medicare Tax

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property held in a trade or business to which the tax does not apply.

Footnote 285 of the accompanying JCT report on the Health Care Act explicitly makes it clear that "[g]ross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax."[1]

In general, Section 121 of the Code provides that "[g]ross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more." The maximum exclusion is $250,000, and, in the case of a husband and wife filing jointly, $500,000.

It thus appears that the Medicare tax may apply to a sale a residence if three requirements are met: (a) the individual selling the real property is a high-income earner; (b) the high-income earner has "net gain" from the disposition of the real property (*i.e.*, it does not operate as a "sales tax" on the gross proceeds from a sale); and (c) the net gain is not otherwise excluded from gross income under the principal residence exclusion. For example, assuming the taxpayer qualifies for the principal residence exclusion, the excess amount over the excludible amount (*i.e.*, $250,000, or $500,000, in the case of joint filers) of the taxpayer's net gain on the sale of the taxpayer's principal residence would get caught by the Medicare tax. If the taxpayer does not qualify for the principal residence exclusion (*e.g.*, if the residence is a second home), the Medicare tax would also apply to the entire net gain. The Medicare tax is effective for taxable years 2013 and thereafter. The tax does not apply to capital gain recognized in 2011 and 2012.

[1] See Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act Of 2010," as amended, in Combination with the "Patient Protection and Affordable Care Act," March 21, 2010, available at http://www.jct.gov

Did You Catch That, Again?

In our first quarter 2010 issue, we included a piece entitled "Did You Catch That?",[1] which addressed select provisions in new legislation that tinkered with (by increasing) the amount of estimated taxes that certain large corporations must pay over the course of a future year, effectively providing the government with a short-term loan. It appears this provision has been amended (at least in some capacity) five more times since, with the latest amendment in the Small Business Jobs Act of 2010. Unfortunately, it is painstakingly difficult to determine what the current law actually is (which may cause some to wonder whether the drafting is purposefully designed to be so), as the amendments are numerous and the drafting is not in plain English. It appears even the latest JCT report accompanying the Small Business Jobs Act, dated September 16, 2010, has difficulty keeping track; the current count according to the accompanying JCT report to the Small Business Jobs Act: (i) payments due in July, August, or September, 2014, are increased to 174.25% of the payment otherwise due; (ii) payments due in July, August or September, 2015, are increased to 158.25% of the payment otherwise due; and (iii) payments due in July, August or September, 2019, are increased to 106.50% of the payment otherwise due. Our count (consistent with RIA checkpoint—see chart below): 174.25% in 2014; 159.25% in 2015; 106.5% in 2019. The discrepancy appears to result from the fact that the report does not take into account recent legislation (which was enacted prior to the date of the report).

So how much revenue do these adjustments actually rake in? Take the Small Business Jobs Act as an example. The Small Business Jobs Act will raise estimated taxes on large corporations by 36% in 2015. The forecasted cost of small business relief for the first five years is approximately $22.3 billion according to the JCT revenue estimates (which can be located at http://www.jct.gov). This revenue raiser will bring in approximately $21.2 billion in 2015. The next year it reverses.

[1] See MoFo Tax Talk Volume 3, No. 1.

	Signed into Law	2014	2015	2019
PL 111-147 § 561 (HIRE ACT)	March 18, 2010	157.75%	121.5%	106.5%
PL 111-152 § 1410 (Health Care Act)	March 30, 2010	+15.75%	N/A	N/A
PL 111-171 § 12 (Haiti Economic Lift Program Act of 2010)	May 24, 2010	+.75%	+.75%	N/A
PL 111-210 § 3 (Joint Resolution: Approving the renewal of import restrictions contained in the Burmese Freedom and Democracy Act of 2003, and for other purposes.)	July 27, 2010	N/A	+.25%	N/A
PL 111-227 § 4002 (United States Manufacturing Enhancement Act of 2010)	August 11, 2010	N/A	+.5%	N/A
PL 111-237 § 4(a) (Firearms Excise Tax Improvement Act of 2010)	August 26, 2010	N/A	+.25%	N/A
PL 111-240 § 2131 (Small Business Jobs Act)	September 27, 2010	N/A	+36%	N/A
Totals		**174.25%**	**159.25%**	**106.5%**

The Classroom — Fixed-to-Floaters

Fixed-to-floating rate notes appear to becoming more popular for fixed-income investors lately. We suspect this is due to a combination of factors, including investors' appetite for higher yielding securities in the current economic environment, where the yield for securities appears to be historically quite low. The current array of fixed-to-floaters provide a relatively high fixed interest during the earlier years, and subsequently a variable rate of interest in later years (potentially subject to a cap or floor), which allows an investor to have a (at least partial) hedge against inflation, should the inflation risk ever rear its head.

So how are these instruments taxed? Fixed-to-floating rate notes are generally treated as either "variable rate debt instruments" ("VRDI") or "contingent payment debt instruments" ("CPDI") for U.S. federal income tax purposes. In a prior issue of MoFo Tax Talk,[1] we explored some of the boundaries of variable rate debt instruments—specifically, the taxation of floating rate notes that provide interest at a floating rate that qualify under applicable Treasury regulations as an "objective rate" (rather than a "qualified floating rate" ("QFR")). QFRs can generally be defined as floating rates that measure the cost of newly borrowed funds under applicable Treasury regulations and can generally be described as "typical" floating rates, such as LIBOR. Objective rates, on the other hand, are more exotic, "atypical" floating rates (such as an inflation rate), which do not necessarily measure the cost of newly borrowed funds, but are nonetheless based on objective financial information.

As discussed in our prior issue of MoFo Tax Talk, in order to qualify for VRDI tax treatment, the tax restrictions imposed on floating rate notes that provide for objective rates are stricter than those restrictions imposed on floating rate notes that provide for QFRs. For example, to qualify for VRDI tax treatment, the note must provide interest at a single objective rate. Accordingly, fixed-to-floating rate notes, for which the floating rate leg of the note provides for interest based on an "objective rate," are generally disqualified from VRDI tax treatment unless a narrow safe harbor (the "Approximation Test") is met, which, in such case, would generally be treated, for purposes of VRDI qualification, as if the note provided interest at a single objective rate.[2]

Example 1. X issues at par a 10-year 100% principal protected note that pays interest annually, equal to, for the first 2 years, fixed interest at 6% and thereafter a variable rate based on the consumer price index. The note would not qualify for VRDI tax treatment, and instead would be classified as a CPDI for U.S. federal income tax purposes. This is because the note does not provide interest at a single objective rate nor can the Approximation Test be satisfied because the fixed interest is not paid for an initial period of one year or less.

A VRDI, may, on the other hand, provide for interest at a single fixed rate followed by one or more QFRs, even if the Approximation Test is not met, if the general requirements of VRDI tax treatment are met (including the requirement that interest is paid or compounded at least annually, the instrument does not, in general, have any contingent principal, and the rate in effect is based on a "current" value, as defined in applicable Treasury regulations).

Example 2. X issues at par a 10-year 100% principal protected note that pays interest annually, equal to, for the first 2 years, fixed interest at 6% and thereafter a variable rate based on 3-month USD LIBOR plus a spread of 2%. The note would generally qualify for VRDI tax treatment because the note provides for fixed interest for an initial period followed by a QFR.

Once the classification of the instrument is determined for U.S. federal income tax purposes, the next question is how that instrument is actually taxed under applicable Treasury regulations. The simplest VRDI is one that provides for a single variable rate. The tax consequences of such an instrument are generally determined by (i) converting the debt instrument into an "equivalent fixed rate debt instrument," (ii) applying the rules applicable to such instruments (*i.e.*, the original issue discount ("OID") rules, which generally assume the taxpayer should accrue interest income under a constant interest basis), and (iii) making appropriate adjustments for actual interest payments on the notes. The debt instrument is converted into an equivalent fixed rate debt instrument by assuming that the QFR is equal to the value, as of the issue date, of the QFR, or in the case of an objective rate, a fixed rate that reflects the yield that is reasonably expected for the debt instrument (the "fixed rate substitute"). If the note that provides interest solely at a single variable rate is issued at par (*i.e.*, not issued at a discount), then the taxpayer generally includes interest income at the time it is received or accrued under the taxpayer's regular method of accounting.

Example 3. X issues at par a 10-year 100% principal protected note that pays interest annually at a variable rate based on the 3-month USD LIBOR plus a spread of 2%. Assume the value of 3-month USD LIBOR on the issue date is .5%. The note would generally qualify for VRDI tax treatment because the note provides interest at least annually at a QFR.

The tax consequences of the note would be determined by converting the floating rate note into an equivalent fixed rate debt instrument. The floating rate note is converted into the equivalent fixed rate debt instrument by assuming the note paid interest at the value of 3-month USD LIBOR on the issue date, or 2.5% per annum. Because the note is issued at par and provides interest at a constant interest rate for each interest period (*i.e.*, 2.5% per annum), the instrument would not have OID.

The taxation of VRDIs that provide for interest at a single fixed rate followed by a QFR is more complex. As described above, the rules require one to convert the debt instrument into an "equivalent fixed rate debt instrument." However, in doing so, applicable Treasury regulations add one additional step in the process. The applicable Treasury regulations first require replacing the initial fixed rate by a QFR that would preserve the fair market value of the notes, assuming the terms of the note otherwise remain identical. Once this initial first step is completed, the rules then require replacing the QFRs with their fixed rate substitutes (*i.e.*, their values as of the issue date), similar to the rules described above. Once the debt instrument is converted into the equivalent fixed rate debt instrument, one applies the tax rules applicable to fixed rate debt instruments, and then makes appropriate adjustments for actual interest payments on the notes. Since the interest rates on the equivalent fixed rate debt instrument are unlikely to be constant throughout, the instrument may have OID (unless the OID is "*de minimis*").[3]

Example 4. X issues at par a 10-year 100% principal protected note that pays interest annually, equal to, for the first 2 years, fixed interest at 6% and thereafter a variable rate based on the

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The Classroom

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3-month USD LIBOR plus a spread of 2%. Assume 3-month USD LIBOR on the issue date equals .5%. Further assume that the note's value would be preserved assuming the note paid interest at 3-month USD LIBOR plus a spread of 5% in lieu of fixed interest for the initial fixed interest rate period. As discussed above, the note would generally qualify for VRDI tax treatment because the note provides for fixed interest for an initial period followed by a QFR.

The taxation of the note would be determined by converting the floating rate note into an equivalent fixed rate debt instrument. The first step would be to substitute for the initial fixed rate 3-month USD LIBOR plus a spread of 5%, which would preserve the fair market value of the notes, assuming all other terms remain identical. The floating rate note would be converted into an equivalent fixed rate debt instrument by assuming the note paid interest at the value of 3-month USD LIBOR on the issue date, or a fixed rate of 5.5% per annum for the first 2 years, and thereafter a fixed rate of 2.5% per annum for the remaining term. Although the note is issued at par, the equivalent fixed rate debt instrument does not provide for interest at a constant rate throughout its term. Accordingly, only 2.5% per annum is considered to be qualified stated interest. The excess of 5.5% over 2.5% for the first two interest rate periods is deemed to be OID, and must be accounted for under a constant-interest basis over the term of the note.

1. See MoFo Tax Talk, Volume 2, No. 4 "The Classroom—Exploring the Boundaries of Variable Rate Debt Instruments."

2. As discussed in our prior issue of Tax Talk, if interest on a debt instrument is stated at a fixed rate for an initial period of one year or less followed by a variable rate, and the value of the variable rate on the issue date is intended to approximate the fixed rate, the fixed rate and the variable rate together constitute a single qualified floating rate or objective rate. A fixed rate and a variable rate are conclusively presumed to meet the requirements of the preceding sentence if the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than .25 percentage points (25 basis points).

3. *De minimis* OID generally equals the product of (i) .25%, (ii) the note's term to maturity, and (iii) the note's "stated redemption price at maturity." A note's stated redemption price at maturity generally equals the sum of all payments other than "qualified stated interest." Qualified stated interest generally is interest that is paid at least annually at a single fixed rate.

Press Corner

Taxes on sliced bagels? In our last issue, we noted that New York State, pressed to raise revenue, increased the sales tax on cigarettes to the dismay of smokers. In this issue, we note that The Wall Street Journal reported that New York State has begun to enforce one of the more obscure state tax laws on bagel franchises to the dismay of bagel aficionados. Apparently, bagels sold and sliced on premises or eaten on premises are subject to New York State sales tax, while whole bagels sold and consumed off premises are not. See Jacob Gershman, "Sliced Bagels, Taxes on Top," WSJ Online, August 24, 2010.

Congress will not vote on tax cuts until after the election. The Bush-era tax cuts expire at the end of the 2011, significantly raising tax rates on wages, capital gains, and dividends to the 2001 levels. (For a FAQ on the expiring Bush-era tax cuts, including a list of what is to expire, see "Frequently Asked Questions on the Expiring Bush-Era Tax Cuts" by the Tax Foundation, available at http://www.taxfoundation.org/publications/show/26135.html). The current administration has stated it intends to keep the Bush tax cuts for the middle class, let the Bush tax cuts expire for high income earners ($200,000 in the case of single filers, and $250,000 in the case of joint filers), and generally tax qualifying dividends and capital gains at a maximum rate of 20%. Opponents seek to keep the Bush tax cuts in place for everyone, including high income earners, arguing that a tax increase in the current economy will stifle economic growth. It will be interesting to see, after the elections, to what extent and in what form the Bush tax cuts remain.

MoFo in the News

On July 1, 2010, Morrison & Foerster LLP presented "The New Regulatory Regime for Derivatives" in the New York office. David Kaufman and David Trapani of Morrison & Foerster LLP discussed the Dodd-Frank Act and its impact on derivative transactions. The Dodd-Frank Act generally imposes comprehensive regulation on over-the-counter derivatives. The regulatory oversight will generally be split between the SEC and the Commodity Futures Trading Commission. For example, the new legislation will generally require many trades to be centrally cleared and/or exchanged traded, impose capital and margin requirements, require data reporting for derivative transactions, and impose new business conduct standards.

On July 6, 2010, Morrison & Foerster LLP presented "The Effect of Regulatory Reform on Tier 1 and Other Hybrid Capital Instruments and on the Financing Environment for Financial Institutions" in the New York office. Thomas A. Humphreys, Oliver Ireland, and Anna Pinedo of Morrison & Foerster LLP discussed recent regulatory reform and its impact on insured depository institutions and bank holding companies. Due to the financial crisis, increased focus is on how to control systemic risk. One consequence is stricter regulatory capital requirements on financial institutions.

On July 13, 2010, Practising Law Institute ("PLI") presented a webcast entitled "Dodd-Frank Act: The Impact on Funds and Private Placements." David Lynn of Morrison & Foerster LLP discussed the Dodd-Frank Act's impact on hedge funds and private funds. During the financial crisis, there was some concern of the ability to assess systemic risk resulting from the activities of hedge funds and private funds. As a result, the Dodd-Frank Act generally requires the managers of funds to register with the SEC, and imposes substantial new record-keeping and reporting requirements.

On July 15, 2010, PLI presented a webcast entitled "Dodd Bill and the New Regulatory Regime for Derivatives." David Kaufman of Morrison & Foerster LLP discussed the Dodd-Frank Act and its effect on derivatives transactions.

On July 19, 2010, PLI presented a webcast entitled "Dodd-Frank Bill and the Volcker Rules and Transactions with Affiliated Entities." Oliver Ireland and Anna Pinedo of Morrison & Foerster LLP discussed the potential impact of the "Volcker Rule" in the Dodd-Frank Act on financial institutions and changes to Section 23A of the Federal Reserve Act affecting transactions between affiliated entities. The "Volcker Rule" generally prohibits banks from engaging in proprietary trading, or sponsoring or investing in hedge funds and private equity funds, the goal of which is to reduce risk of depository institutions.

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MoFo in the News

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On July 22, 2010, ALI-ABA presented a webcast entitled "New Regulation for Derivatives." David Kaufman of Morrison & Foerster LLP discussed the Dodd-Frank Act and its effect on derivatives transactions.

On July 27, 2010, Morrison & Foerster LLP presented "The Effect of Regulatory Reforms on Foreign Banks" in the New York office. Barbara Mendelson and Anna Pinedo of Morrison & Foerster LLP discussed the Dodd-Frank Act and its impact on foreign banks and foreign banks doing business in the U.S.

On July 29, 2010, Morrison & Foerster LLP presented "Game on for Non-Banks: Issues and opportunities for non-bank mortgage, consumer, and commercial finance companies, including mortgage REITs, and private equity investors" in the New York office. The Dodd-Frank Act substantially limits the ability of certain financial institutions to conduct certain business operations in the U.S. as they once did. Kenneth Kohler and James Tanenbaum of Morrison & Foerster LLP discussed the impact of the new Dodd-Frank Act on the U.S. financial system and the potential opportunities that may arise for non-banks as a result of the implementation of the new legislation.

On August 2, 2010, West Legalworks presented a webinar entitled "Hedge Funds and Private Funds after the Dodd-Frank Act." Thomas Devaney, David Lynn, and Kenneth Muller of Morrison & Foerster LLP discussed the Dodd-Frank Act and its impact on hedge funds and private funds.

On August 3, 2010, *International Financial Law Review* presented a web seminar entitled "The Impact of U.S. Regulatory Reforms on Foreign Banks and Issuers." Oliver Ireland and Anna Pinedo of Morrison & Foerster LLP discussed the Dodd-Frank Act and its impact on foreign banks and foreign banks doing business in the U.S.

On August 4, 2010, West Legalworks presented a webinar entitled "Regulatory Reform and Securitization." Kenneth Kohler and Jerry Marlatt discussed the potential impacts of the Dodd-Frank Act, the FDIC's proposal to reform securitization practices as part of its securitization safe harbor rule, the SEC's proposed changes to Regulation AB and new Rule 17g-5 relating to the issuance of ratings on structured finance products, and corresponding international developments, including Basel III.

On August 5, 2010, Morrison & Foerster LLP presented "The Volcker Rules: Transactions with Affiliated Entities." David Kaufman and Anna Pinedo of Morrison & Foerster LLP discussed the Dodd-Frank Act, the "Volcker Rule" and changes to Section 23A of the Federal Reserve Act affecting transactions between affiliated entities.

On September 27, 2010, SIFMA presented a seminar entitled "U.S. Covered Bonds." Jerry Marlatt of Morrison & Foerster LLP discussed recent developments for covered bonds in the United States. Covered bonds are debt instruments of an issuer (*e.g.*, a bank) in which an investor in the bonds has recourse against the issuer and a specified pool of collateral (the "cover pool"), which, in general, consist of high quality assets of the issuer. These instruments are a form of on-balance sheet financing and provide a possible source of alternative financing by banks in lieu of securitization. For a further discussion on covered bonds, *see*, *e.g.*, Anna Pinedo, "Covered Bonds in the U.S.," *Practical Law The Journal*, February 2010.

On September 29, 2010, Morrison & Foerster LLP presented a roundtable luncheon entitled "Systemic Designation." Oliver Ireland of Morrison & Foerster LLP chaired the luncheon, during which a detailed analysis of legal and practical issues arising in connection with the Dodd-Frank Act was discussed. ■

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Because of the generality of this newsletter, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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