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# TAX LAWMANATT

NEWSLETTER OF THE TAX LAW PRACTICE OF MANATT, PHELPS & PHILLIPS, LLP

Treasury and IRS Issue New Guidance Regarding the Tax Treatment of Transactions Involving Certain Preferred Stock Holdings in Fannie Mae and Freddie Mac

#### Eric S. Jones

In the midst of the Wall Street meltdown an important tax break has been given to our struggling financial institutions and others. As part of the Emergency Economic Stability Act of 2008 ("EESA"), Congress has authorized the treatment of losses and gains by an "applicable financial institution" that relate to "applicable preferred stock" as ordinary losses and income. This is significant because prior law dictated that losses and gains tied to the sale or exchange of "applicable preferred stock" be treated as capital losses and gains. C corporations are not able to utilize their capital losses to offset any of their ordinary income. Although C corporations generally can carry these capital losses back up to three years and forward up to five years they still need to generate capital gains to be able to utilize these capital losses.

The EESA defines "applicable financial institution" as any of the following (with some caveats): banks, financial institutions, small business investment companies, business development corporations, and depository institution holding companies. The phrase "applicable preferred stock" is defined as: (1) preferred stock in Fannie Mae or Freddie Mac and (2) was held by the "applicable financial institution" on September 6, 2008 or was sold or exchanged by the applicable financial institution on or after January 1, 2008 and before September 7, 2008.

This law allows "applicable financial institutions" to convert capital losses they sustained from their ownership of Fannie Mae and Freddie Mac preferred stock to ordinary losses. As a

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result "applicable financial institutions" can use those ordinary losses to reduce their taxable income. For example, if a bank sustains a \$100 million loss on its investment in Fannie Mae preferred stock and it meets the above requirements, it can reduce its taxable income by \$100 million even if it has no capital gains. Assuming a 35% marginal federal tax rate, this will save the bank \$35 million in federal taxes. Without this new law, if the company did not have any capital gains, or an insufficient amount, it would have to attempt to utilize the loss through carrybacks or carryforwards. Capital gains can be very tough to come by in this difficult investment environment so the unused capital loss might have to sit on the company's books for a long time. This new law takes away that problem and converts the capital loss to an ordinary loss allowing the company to reduce the amount of ordinary income that is taxable.

What was unclear about this law was whether an "applicable financial institution" could take advantage of it if the institution did not own the "applicable preferred stock" directly or owned it directly but acquired it in a transferred basis situation. Congress left it up to the Treasury to decide whether or not the law should be extended. The Treasury has decided to extend the law and has done so in its newly issued guidance, Revenue Procedure 2008-64, which can be found <a href="https://example.com/here/beauty-state-stat

Revenue Procedure 2008-64 allows "applicable financial institutions" to recognize an ordinary loss related to their ownership of Fannie Mae and Freddie Mac preferred stock in the following situations:

- Sale or exchange of Freddie Mac or Fannie Mae preferred stock by a partnership in which an "applicable financial institution" is a partner;
- Sale or exchange by an "applicable financial institution" of an interest in a partnership (at least 95% of the value of the partnership's assets must consist of cash/cash equivalents and Freddie Mac or Fannie Mae preferred stock);
- Distribution of Fannie Mae or Freddie Mac preferred stock by a partnership (at least 95% of the value of the partnership's assets must consist of cash/cash equivalents and Freddie Mac or Fannie Mae preferred stock) to a partner that is an "applicable financial institution";
- Sale or exchange of Fannie Mae or Freddie Mac preferred stock by certain subsidiaries of "applicable

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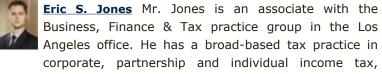
#### financial institutions"; and

■ Sale or exchange by a taxpayer of Fannie Mae or Freddie Mac preferred stock, the basis of which is determined by reference to the transferor.

The new revenue procedure lays down additional requirements that are beyond the scope of this newsletter. Manatt, Phelps & Phillips, LLP's tax attorneys stand ready to assist you in taking advantage of this new revenue procedure and any other tax issues that might arise.

#### back to top

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