

Certain Tax Provisions of the Emergency Economic Stabilization Act of 2008 and IRS Guidance Relating to the Economic Crisis

October 8, 2008

H.R. 1424 (the Act), which was signed into law by President Bush on October 3, 2008, contains tax-related provisions that can have significant implications for financial institutions, certain hedge funds, and investment companies, in addition to a variety of other taxpayers. Specifically, the Act contains provisions that:

- (i) provide special rules with respect to executive compensation paid by employers participating in the Troubled Assets Relief Program (TARP);
- (ii) treat certain sales of Fannie Mae or Freddie Mac preferred stock by financial institutions as giving rise to ordinary income or loss;
- (iii) prevent the deferral of certain compensation from “tax indifferent” parties;
- (iv) require broker reporting of basis information with respect to securities transactions;
- (v) retroactively extend through 2009 certain rules relating to regulated investment companies; and
- (vi) extend the period during which there is an exclusion from income for certain discharge of indebtedness income arising from discharges of indebtedness secured by the taxpayer’s principal residence.¹

In addition to the changes set forth in the Act, the Internal Revenue Service (IRS) has recently issued a number of pronouncements to address tax issues arising from current economic conditions. The most significant of these are the following:

- (i) Notice 2008-83, which provides that, pending further guidance, deductions for losses on loans, or bad debts following an ownership change of a bank will not be treated, for purposes of Section 382(h) of the Code,² as a built-in loss or deduction attributable to a period prior to the ownership change.

1. This LawFlash primarily addresses tax-related provisions of the Act relating to financial institutions, hedge funds, and investment companies and does not address all tax-related provisions of the Act.

2. References herein to the “Code” are references to the Internal Revenue Code of 1986, as amended.

- (ii) Revenue Procedure 2008-63, which provides that a lender in a qualified securities lending transaction that applies collateral to purchase identical securities following a bankruptcy-related borrower default receives the same treatment the lender would have received if the borrower had returned identical securities upon termination of the loan.
- (iii) Revenue Procedure 2008-58, which addresses the treatment of certain taxpayers that participate in settlement offers following failed auctions of auction rate securities.
- (iv) Notice 2008-78, which provides that certain capital contributions to loss corporations will be taken into account (and therefore will not reduce the value of the loss corporation) for purposes of determining limitations under Section 382 of the Code on the use of net operating loss carryforwards and built-in losses.
- (v) Notice 2008-84, which provides that if the United States acquires a greater than 50 percent interest in a loss corporation the rules under Section 382 of the Code that ordinarily would trigger an ownership change are turned off.

Financial institutions, hedge funds, investment companies, and a variety of other taxpayers should consider how the Act and the recent IRS guidance may affect their business activities and tax planning.

I. Key Tax-Related Provisions of the Act

A. Special Rules Relating to Executive Compensation of Employers Participating in the Troubled Assets Relief Program (TARP)

The Act contains a number of tax and nontax provisions relating to executive compensation by employers participating in the TARP.

Where auction purchases of troubled assets from a financial institution under the TARP in the aggregate exceed \$300 million, the Treasury Department (the Treasury) is to prohibit such financial institution from entering into any new employment contract with a senior executive officer that provides for a golden parachute in the event of involuntary termination, a bankruptcy filing, insolvency, or receivership.

In addition, where direct purchases of troubled assets are made from a financial institution under the TARP and in connection with such purchases the Treasury receives a “meaningful” equity or debt position in the financial institution, the Treasury is to require that the financial institution meet appropriate standards for executive compensation and corporate governance. One such standard is that the financial institution may not make a golden parachute payment to a senior executive officer during the period that the Treasury holds an equity or debt position in the financial institution. The Act does not describe what constitutes a “meaningful” position for these purposes. For purposes of the foregoing rules, a “senior executive officer” means an individual who is one of the top five highest paid executives of a public company, whose compensation is required to be disclosed under the Securities Exchange Act of 1934 and the regulations thereunder, and nonpublic company counterparts.

In addition, where an employer has had in the aggregate more than \$300 million of assets acquired under the TARP, the employer is not permitted a deduction for any applicable taxable year for executive remuneration attributable to services by a “covered executive” for such year to the extent that such remuneration exceeds \$500,000. For purposes of these rules, (i) certain related entities are treated as a

single employer; (ii) an employer will not be subject to these limitations if its only sales of assets under the TARP have been “direct purchases” under a specified provision of the Act; (iii) a covered executive with respect to an applicable taxable year is an employee who is the CEO, the CFO, an individual acting in either such capacity, or generally, one of the three other highest compensated officers of the employer for the taxable year; and (iv) an applicable taxable year shall generally be any year during the TARP when the amount of troubled assets acquired from the employer under the TARP exceeds \$300 million. A series of related rules prevent the use of deferred compensation arrangements to avoid this limitation on the deductibility of executive compensation.

The Act would also extend the “golden parachute” rules of Section 280G of the Code to payments to a covered executive of an applicable employer upon severance of employment while the TARP is in effect by reason of the executive’s involuntary termination, or the bankruptcy, insolvency, or receivership of the employer. Employers subject to the limitation on deductibility of executive compensation described in the preceding paragraph are treated as applicable employers for these purposes and “covered executive” has the same meaning as described in the preceding paragraph.

B. Character of Income from Certain Sales of Fannie Mae or Freddie Mac Preferred Stock

Generally, gain or loss from the sale of stock is treated as capital gain or loss unless the stock is held as inventory. The Act carves out an exception to this rule. The exception provides that a sale or exchange by a financial institution of Fannie Mae or Freddie Mac preferred stock that either was owned on September 6, 2008 or was sold or exchanged on or after January 1, 2008 and before September 7, 2008 will be treated as giving rise to ordinary income or loss. For these purposes a financial institution is generally defined to include a financial institution described in Section 582(c)(2) of the Code or a depository institution holding company described in Section 3(w)(1) of the Federal Deposit Insurance Act. A special rule is provided with respect to sales occurring after September 6, 2008 that denies financial institution treatment to an entity that did not qualify as a financial institution at all times during the period beginning September 6, 2008 and ending on the date of the sale or exchange of the preferred stock.

Treatment of dispositions of Fannie Mae or Freddie Mac preferred stock as giving rise to ordinary loss can be advantageous to financial institutions disposing of such stock as ordinary losses, unlike capital losses, can be applied against ordinary income and can give rise to net operating losses that can generally be carried back to the two preceding taxable years.

C. Certain Deferred Compensation Benefits Curtailed

The Act requires the inclusion in gross income of amounts received from a “nonqualified entity” pursuant to a nonqualified deferred compensation plan when there is no substantial risk of forfeiture of the rights to such compensation. For these purposes, a “nonqualified entity” means (i) a foreign corporation unless substantially all of its income is effectively connected with the conduct of a U.S. trade or business or subject to a comprehensive foreign income tax and (ii) any partnership unless substantially all of its income is allocated to persons other than tax-exempt organizations or foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax.

Generally, the income tax of a foreign country is treated as a comprehensive income tax with respect to a foreign person if such person is eligible for the benefits of a comprehensive income tax treaty between the United States and such foreign country, or such person otherwise establishes to the satisfaction of the Treasury that such foreign country has a comprehensive income tax. A “nonqualified deferred compensation plan” generally has the meaning given such term for purposes of Section 409A of the Code,

except that it also includes a plan that provides a right to compensation based on appreciation in value of equity units of the service recipient. These rules generally do not apply where the compensation is associated with income that is effectively connected with the conduct of a trade or business in the United States (as determined for federal income tax purposes).

Rights to compensation are treated as subject to a substantial risk of forfeiture only if the rights are conditioned upon the future performance of substantial services by any individual. The Treasury is authorized to issue regulations providing that compensation is subject to a substantial risk of forfeiture if the compensation is determined solely by reference to gain recognized on the disposition of an investment asset.

Where the amount of compensation is not determinable at the time that it otherwise becomes includible in income, then it is to be includible in income when determinable, with the applicable tax increased by an amount equal to 20% of the amount of such compensation, plus an interest charge.

While these provisions are generally effective for deferred amounts attributable to services performed after December 31, 2008, a special rule provides that, with respect to deferred amounts attributable to services performed on or before December 31, 2008, if such amounts are not otherwise includible in gross income in a taxable year beginning before 2018, then such amounts shall be includable in gross income in the later of (i) the last taxable year beginning before 2018 or (ii) the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation (as described above). The Act requires that the Treasury issue guidance providing a period during which a nonqualified deferred compensation arrangement attributable to services performed on or before December 31, 2008 may, without violating Section 409A of the Code, be amended to conform the distribution date under such arrangement to the date on which amounts are required to be included in income.

These provisions are expected to impact hedge fund managers who are entitled to receive compensation from nonqualified entities under an arrangement that would be treated as a nonqualified deferred compensation plan.

D. Reporting Requirements for Securities Brokers

The Act provides, generally effective on a phased-in basis beginning with securities acquired on or after January 1, 2011, that where a broker is otherwise required to report gross proceeds from the sale of a “covered security,” it shall also be required to report information about the customer’s adjusted tax basis in the security and whether any gain or loss with respect to such security is long-term or short-term. For these purposes, a “covered security” is any specified security that is acquired on or after the “applicable date,” if such security either was acquired through a transaction in the account in which such security was held or was transferred to the account from an account in which the security was a covered security and, in connection with the transfer, the broker received a specified information statement. Specified securities for these purposes include shares of stock and debt instruments, as well as, to the extent specified by Treasury, commodities, commodities contracts, commodities derivatives, and other financial instruments. The “applicable date” means January 1, 2011 with respect to stock other than stock eligible for the average basis method under Section 1012 of the Code, January 1, 2012 with respect to stock eligible for the average basis method under Section 1012 of the Code, and January 1, 2013 with respect to other securities. The Act includes provisions, which are to be effective only with respect to options granted or acquired on or after January 1, 2013, requiring reporting with respect to options on covered securities.

In determining a customer’s adjusted tax basis in securities held in an account, a broker is, in the case of

securities other than stock eligible for the average basis method, to use a first-in, first-out method unless the customer otherwise notifies the broker by making an identification of the stock sold, and, in the case of stock eligible for the average basis method, to use the broker's default method unless the customer notifies the broker that the customer is using another permissible method with respect to the account.

The Act provides that, in the case of a sale, exchange, or other disposition of a specified security on or after the applicable date, the basis determination methods specified in the Treasury regulations under Section 1012 of the Code will be applied on an account-by-account basis. For these purposes, any stock for which the average basis method is permissible under Section 1012 of the Code (generally, shares in regulated investment companies) that is acquired before January 1, 2012 will be treated as a separate account from any such stock acquired after such date, unless the related fund elects, with respect to one or more stockholders, to treat all stock in such fund held by such stockholder(s) as covered securities without regard to the date of acquisition of such stock.

The Act generally extends, effective for returns required to be furnished after December 31, 2008, the date by which gross proceeds or substitute payment information returns must be provided to customers from January 31 to February 15.

Where a broker or such other person as may be specified by the Treasury transfers to a broker a security which is a "covered security" in the hands of the transferor, the transferor is required to provide, within 15 days of the transfer, the transferee broker with such information as the Treasury may specify to facilitate the transferee broker's compliance with the new reporting requirements.

The Act also contains provisions requiring reporting by issuers of specified securities with respect to certain transactions. Generally, such issuers are required to file returns describing organizational actions that may affect the basis of a specified security and the quantitative effects of such actions. Such returns are required to be filed not later than the earlier of 45 days after the date of such organizational action or January 15 of the following calendar year. Related information statements must be provided by the issuer to the nominee (or to the holder, if there is no nominee) of the specified security by January 15 of the calendar year after the year in which the organizational action occurred. No returns or statements are required from issuers with respect to actions occurring prior to the applicable date (as described above) for the relevant security.

E. Retroactive Extensions of Certain Tax Provisions Relating to Regulated Investment Companies

The Act extends, retroactive to January 1, 2008, certain provisions of the Code relating to regulated investment companies.

First, the Act extends through 2009 the eligibility of distributions by a regulated investment company to qualify as "interest-related dividends" or "short-term capital gain dividends" for purposes of Section 871(k) of the Code. Very generally, Section 871(k) of the Code provides that non-U.S. shareholders of a regulated investment company can, subject to certain exceptions, qualify for an exemption from U.S. federal income tax with respect to interest-related dividends and short-term capital gain dividends. Second, the Act extends through 2009 the look-through rules for determining the extent to which stock of a regulated investment company is to be included for U.S. federal estate tax purposes in the estate of a decedent who is neither a resident nor a citizen of the United States.

Finally, the Act extends the rules that treat regulated investment companies as “qualified investment entities” under Section 897(h)(4) of the Code. Under Section 897(h) of the Code, a distribution by a qualified investment entity to a non-U.S. person will, to the extent attributable to gain from sales or exchanges of U.S. real property interests, be treated as gain recognized by such non-U.S. person from the sale or exchange of a U.S. real property interest, except that distributions with respect to a class of stock that regularly traded on a U.S. securities market will not be treated as gain from the sale of a U.S. real property interest where the non-U.S. recipient of the distribution did not own more than five percent of such class of stock at any time during the one-year period ending on the date of the distribution. No interest in a “domestically controlled” qualified investment entity is treated as a U.S. real property interest. Where a qualified investment entity is domestically controlled, it is required to recognize the portion of its gain corresponding to its foreign ownership percentage on any distribution of a U.S. real property interest.

F. Extension of the Income Exclusion for Discharges of Indebtedness Secured by Principal Residence

The Act extends the exclusion from income of cancellation of indebtedness income arising from discharges of certain indebtedness secured by the taxpayer’s principal residence to discharges occurring prior to January 1, 2013. This exclusion, which was originally added to the Code in December 2007 by the Mortgage Forgiveness Debt Relief Act of 2007, had previously applied only to discharges occurring prior to 2010.

II. Recent IRS Guidance

A. Notice 2008-83 – Loan Losses and Bad Debt Deductions for Banks Not Treated as Built-in Losses or Pre-Ownership Change Deductions

Section 382 of the Code limits the extent to which net operating loss carryforwards and certain other tax items, including, under Section 382(h) of the Code, built-in losses and deductions attributable to pre-ownership change periods, may be utilized by a corporation following an ownership change. In Notice 2008-83, the IRS indicated that it was studying the proper treatment for these purposes of losses on loans and bad debt deductions claimed by banks following an ownership change and that, pending further guidance, deductions with respect to losses on loans or bad debts properly claimed by a bank following an ownership change will not be treated for purposes of Section 382(h) of the Code as built-in losses or deductions attributable to a period preceding the ownership change.

B. Revenue Procedure 2008-63 – Terminations of Securities Loans

Recently there have been a significant number of securities loans that have terminated as a result of a default arising from the bankruptcy of the securities borrower or an affiliate thereof. In such circumstances the securities lender has faced the choice of either (i) applying collateral provided under the securities loan to acquire identical replacement securities or (ii) waiting for the securities borrower to provide identical securities to close out the transaction. While the receipt of identical securities from the securities borrower would not, in the case of a securities loan governed by Section 1058 of the Code, result in the recognition of gain or loss by the securities lender, many securities lenders had concluded that application of the collateral by the securities lender to acquire identical securities would be a recognition event. This was a particularly adverse result, since it meant that gains would be recognized but that losses would be disallowed under the wash sale rules.

Revenue Procedure 2008-63 aligns the tax consequences of the two alternatives facing the securities lender by generally providing, for tax years ending on or after January 1, 2008, that the application of collateral to acquire identical securities will be treated as a nonrecognition event for the securities lender under Section 1058 of the Code. The Revenue Procedure applies, however, only where (i) the original securities loan agreement satisfied the requirements of Section 1058(b) of the Code,³ (ii) the securities loan agreement required that the securities borrower provide collateral to secure its obligations, (iii) the borrower defaults under the securities loan agreement as a result of its bankruptcy or the bankruptcy of an affiliate, and (iv) as soon as is commercially practical following the default (but in no event more than 30 days after the default) the securities lender applies the collateral provided (or cash generated by the sale of such collateral) to acquire identical securities.

C. Revenue Procedure 2008-58 – Auction Rate Securities

As a result of failures of auctions of auction rate securities, a number of corporations have made settlement offers to persons (holders) holding auction rate securities that may have claims against such corporations for their conduct relating to such auction rate securities. Revenue Procedure 2008-58 addresses the tax treatment of holders that receive settlement offers with certain terms. Such a settlement offer includes a right for the holder during a specified period (the Window Period) to put the holder's auction rate securities to the corporation at par upon the holder providing the corporation with notice.

If auctions fail during the Window Period (prior to exercise of the put or of any call described below), the holder is entitled to receive the maximum rate specified by the auction rate security. If auctions begin to succeed during the Window Period, then, so long as there has not been an exercise of the put or of the call described below, the holder will receive payments at the reset rate. The auction rate security should not be redeemable upon a fixed date, or, if it is, the fixed date should be at least two years after the close of the Window Period. During the Window Period the holder is entitled to exercise all voting rights associated with the auction rate security and to sell the auction rate security to a third party. The settlement offer may permit the corporation to call the holder's auction rate security during the Window Period at par so that the corporation can sell the auction rate security and mitigate its potential losses. The settlement offer also may permit the holder to borrow the par amount of the security from the corporation during a period before the end of the Window Period, with the obligation to repay being secured by the auction rate security.

Some taxpayers were concerned that the receipt or acceptance of a settlement offer while the taxpayer held a right to put for par was a taxable disposition, especially where the taxpayer borrowed against the security. There was also a concern that a portion of the payments would be treated as ordinary income from a settlement, leaving the remainder of the transaction to generate a capital loss.

In Revenue Procedure 2008-58, the IRS indicated that it will not question the position that a taxpayer continues to own the auction rate security upon receiving or accepting (but before actually tendering the security) a settlement offer of the sort described above if (i) the settlement offer is received before June 30, 2009, (ii) the Window Period does not extend beyond December 31, 2012, and (iii) the settlement offer requires the taxpayer to deliver an auction rate security that the taxpayer purchased on or before February 13, 2008. As a result, the taxpayer will not realize any income upon receiving or accepting the settlement offer. The IRS also indicated that the taxpayer's amount realized from the sale of the auction rate security

3. Generally, Section 1058(b) of the Code requires that the securities lending agreement (i) provide for the return to the lender of securities identical to those loaned; (ii) require that payments be made to the securities lender in amounts equivalent to all interest, dividends, and other distributions that the owner of the securities is entitled to receive during the term of the loan; (iii) not reduce the risk of loss or opportunity for gain for the securities lender with respect to the securities transferred; and (iv) meet such other requirements as may be specified in regulations.

during the Window Period to the corporation offering the settlement is the full amount of the cash proceeds received (and therefore no portion is treated as settlement income).

D. Notice 2008-78 – Capital Contributions and Ownership Changes

Under Section 382(l)(1)(A) of the Code, capital contributions received by a loss corporation prior to an ownership change are not taken into account (that is, the value attributable to such capital contributions is disregarded, with the effect that there is reduced ability to use, following the ownership change, pre-change losses and other attributes) in determining the limitation on post-change use of net operating loss carryforwards and other tax items, if the contribution is part of a plan whose principal purpose is to avoid or increase the Section 382 limitation. Section 382(l)(1)(B) provides that a capital contribution made during the two-year period ending on the date of the ownership change will be presumed to be part of a plan with such principal purpose. Notice 2008-78 relaxes these rules by providing, effective for ownership changes occurring in any taxable year ending on or after September 26, 2008, safe harbors for when capital contributions will not be considered part of such a plan even if they otherwise occur within the two-year period ending on the date of the ownership change. The following safe harbors are identified in the notice:

- (i) The contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party; (ii) no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution; (iii) there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and (iv) the ownership change occurs more than six months after the contribution.
- (i) The contribution is either (x) made by a related party, with no more than 10% of the total value of the loss corporation's stock issued in connection with the contribution or (y) made by an unrelated party; (ii) there is no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and (iii) the ownership change occurs more than one year after the contribution.
- The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of Treasury Regulation Section 1.355-7(d)(8) or (9), respectively.
- The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss), or it is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose).

E. Notice 2008-84 – No Section 382 Ownership Changes While the Government Owns More Than 50% of the Loss Corporation

As noted above, Section 382 of the Code limits the amount of loss carryforwards or certain other tax attributes that may be claimed in a taxable year following an ownership change. The dates on which a loss corporation is required to determine whether an ownership change has occurred are referred to as “testing dates.” Generally, testing dates include all dates on which there is a change in the ownership of the corporation by any 5% or greater shareholder and the dates on which certain “equity structure shifts” occur. Notice 2008-84 changes these rules by providing that, for any taxable year ending on or after

September 23, 2008, no date at the end of which the United States owns, directly or indirectly, a more than 50% interest in a loss corporation will be treated as a testing date. For these purposes a more than 50% interest includes (i) stock representing more than 50% of the voting power or value of the corporation's stock or (ii) an option to acquire such stock.

Taken together, the Act and the recent guidance raise significant issues and compliance requirements for financial institutions, certain hedge funds, and investment companies, among others.

To view other briefings previously released by the Morgan Lewis Financial Crisis Working Group, please visit <http://www.morganlewis.com/financialcrisis>.

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