MORRISON & FOERSTER QUARTERLY NEWS

Volume 6, No. 4 January 2014

# TAXTALK

Authored and Edited By
Thomas A. Humphreys
Anna T. Pinedo
Stephen L. Feldman
Remmelt A. Reigersman
Shiukay Hung
David J. Goett
David N. de Ruig

## IN THIS ISSUE

FATCA Developments: Treasury Signs IGAs; IRS Finalizes FFI Agreement
Page 2

IRS Releases Final and New Proposed "Dividend Equivalent" Regs
Page 3

IRS Issues Final Swap Assignment Regs
Page 4

IRS Issues Final "Net Investment Income" Regs
Page 4

CCA 201343019: Dividends From Cypriot Holding Company Entitled to Preferential Rates
Page 4

CCA 201343020: Payments Made to Foreign Distributors Treated as Compensation; Potentially Subject to U.S. Withholding Tax
Page 5

International Tax Reform
Page 6

Court Dismisses Challenge to Interest-Reporting Regulations
Page 7

IRS Resumes REIT Conversion Rulings
Page 7

*Pilgrim's Pride v. Commissioner*, 141 T.C. 17 (2013): Tax Court Holds Abandoned Stock Generates Capital Loss
Page 7

Discharge of Acquisition Indebtedness Exclusion Ended December 31, 2013
Page 8

Events and Awards
Page 8

## EDITOR'S NOTE

Before we completely close the door on 2013 and ring in 2014, this issue of Tax Talk brings you some of last quarter's more noteworthy tax highlights and developments.

As always, it brings us great joy to share the latest Foreign Account Tax Compliance Act ("FATCA") developments, and this issue of Tax Talk is no exception. With foreign financial institutions expected to finalize their online registration with the IRS this year and withholding slated to begin July 1, 2014 – to name just a few of the looming FATCA deadlines – 2014 is crunch time for FATCA. Even as 2013 drew to a close, the Treasury concluded a plethora of Intergovernmental Agreements ("IGAs"). Not to be outdone, the Internal Revenue Service ("IRS") released a final version of the draft agreement that a foreign financial institution seeking to comply with FATCA must sign.[1] The IRS has also been busy working out some of the kinks in its FATCA registration website, which is used by foreign financial institutions to register with the IRS.[2] For more information on FATCA, please be sure to visit our website at www.KNOWFatca.com.

In the waning days of 2013, the IRS also issued three sets of important regulations addressing the treatment of "dividend equivalent" payments, the assignment of swaps and the 3.8% "Net Investment Income" Medicare tax.[3] Of these three, the new proposed regulations governing dividend equivalent payments were without a doubt among the most eagerly-anticipated in our neck of the woods. After vociferous criticism from the financial industry, the

continued on page 2

IRS scrapped the seven-factor test for determining whether a payment made pursuant to a swap or equity-linked instrument gives rise to a dividend equivalent payment subject to withholding. In its place, the IRS has proposed a "simplified" single-factor test based on the "delta" of the swap or equity-linked instrument. Although the single-factor delta test has superficial appeal, it also represents a significant expansion of the scope of financial arrangements potentially subject to withholding. It is also far from clear whether the proposal will be any more administrable (or "fair").

On the international tax front, Tax Talk brings you a pair of articles discussing two pieces of private IRS guidance. The first discusses whether dividends from a foreign holding company are eligible for reduced rates. The second analyzes the source, character and withholding implications of payments made to a foreign distributor in connection with a U.S. taxpayer's multi-level marketing scheme. Finally, we summarize the high points of yet another proposal to dramatically overhaul the international tax laws, as well as a recent case dismissing a challenge to interest reporting requirements for deposit interest paid to foreign persons.

To round out this issue of Tax Talk, we bring you an update on the IRS's intention to resume work on certain REIT conversions (a topic we previously brought to light in Tax Talk 6.2),[4] as well as a recent Tax Court case holding that abandoned shares of stock resulted in a capital loss even though there was no sale or exchange. We also take the opportunity in this issue of Tax Talk to remind you about the relief for home mortgage debt forgiveness, which, unless retroactively reinstated by Congress, expired at the end of 2013.

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

## FATCA DEVELOPMENTS: TREASURY CONCLUDES IGAS; IRS FINALIZES FFI AGREEMENT

With 2013 rapidly coming to a close, the Government worked feverishly to conclude IGAs with a host of new countries, release a final version of the FFI Agreement and work out the kinks in its FATCA registration website.

In Q4, the United States signed so-called "Model 1" IGAs with France, Costa Rica, the Cayman Islands, Guernsey, Isle of Man, Jersey, Malta, the Netherlands and, as we go to print, Italy and Mauritius. The United States also signed a "Model 2" IGA with Bermuda.

By way of background, under a Model 1 IGA, foreign financial institutions ("FFIs") report to the local tax authorities and the partner jurisdiction agrees to report to the IRS certain information about the U.S. accounts maintained by foreign financial institutions located within its borders. This exchange of information may be reciprocal (meaning that the United States must also provide information to the partner jurisdiction about accounts belonging to residents of that jurisdiction maintained by U.S. financial institutions) or nonreciprocal (meaning that only the partner jurisdiction is obligated to provide information regarding U.S. accounts maintained by financial institutions in that jurisdiction). The IGA between the United States and the Cayman Islands is nonreciprocal, while the IGAs with France, Costa Rica, Guernsey, Isle of Man, Jersey, Malta, the Netherlands and Italy are reciprocal.[5]

Conversely, under a Model 2 IGA, such as the IGA between the United States and Bermuda, the partner jurisdiction agrees to direct and enable financial institutions within its jurisdiction to report specified information about their U.S. accounts directly to the IRS.

For FFIs not located in a jurisdiction that has signed a Model 1 IGA or that are not otherwise exempt from FATCA, the IRS released a final version of the FFI Agreement on December 26, 2013 as Revenue Procedure 2014-10. Aside from correcting various technical errors, the final version of the FFI Agreement contains only a handful of updates from the draft released in October 2013. For example, several of the cross-references in the definitions section of the FFI Agreement were modified in anticipation of two sets of temporary regulations expected to be published early this year. The first set of temporary regulations will apparently provide clarification and modifications to the final FATCA regulations, while the second set will provide rules for coordinating FATCA with the existing withholding and reporting regimes. As soon as these temporary regulations are released, we'll be sure to let you know.

Finally, the IRS provided updated guidance, including a set of FAQs, designed to assist foreign financial institutions as they finalize the FATCA registration process.[6]

For copies of the IGAs and the final version of the FFI Agreement, see our FATCA website, KNOWFatca.com (www.KNOWFatca.com).



continued on page 3

# IRS RELEASES FINAL AND NEW PROPOSED "DIVIDEND EQUIVALENT" REGS

On December 5, 2013, the Internal Revenue Service ("IRS") finalized temporary regulations and issued new proposed regulations under Section 871(m),[7] the Internal Revenue Code provision that treats "dividend equivalents" paid under securities lending transactions, sale-repurchase transactions and certain notional principal contracts ("NPCs") as dividends from sources within the United States and therefore subject to U.S. withholding tax.

The final regulations under Section 871(m) adopt the prior temporary regulations with minimal changes. These regulations conform to the rules applicable to NPCs found in the Code and will continue to apply to payments under such NPCs until January 1, 2016.

More significant, however, are the new proposed regulations under Section 871(m), designed to broaden Section 871(m)'s scope beyond transactions specifically described in the statute. These new proposed regulations replace the seven factor test of the prior proposed regulations with a single factor test for determining when an instrument has the potential for tax avoidance through payment of dividend equivalent amounts.

The single factor test asks whether an NPC or equity-linked instrument ("ELI") has a "delta" of .70 or greater. If so, the proposed regulations treat payments on the instrument that reference dividends paid on a U.S. corporation's stock as "dividend equivalents" that are subject to U.S. withholding tax. An NPC's or ELI's delta is the ratio of the change in the fair market value of the instrument to the change in the fair market value of the underlying property referenced by the instrument. If adopted as final regulations, the proposed regulations would apply to payments on or after January 1, 2016 with respect to NPCs and ELIs that meet the new single factor test.

Further highlights of the proposed regulations include:

- ELIs include futures, forwards, options, debt instruments and other contractual arrangements (such as structured notes) that reference the value of underlying securities.
- The regulations will apply to payments made on or after January 1, 2016 on ELIs acquired by a long party on or after March 5, 2014. Accordingly, an ELI already outstanding or issued today will be subject to the new rules if it is acquired by a secondary market purchaser on or after March 5, 2014. This limited grandfather for instruments acquired before March 5, 2014, however, does not apply to NPCs.
- NPCs and ELIs with a delta that is "not reasonably expected to vary" during the term of the transaction are treated as having a delta of 1.0.
- For purposes of determining whether an NPC is subject to Section 871(m), the delta of an NPC or ELI is determined as of the date it is acquired and is not retested in the hands of the same holder.
- Secondary market purchasers test an NPC's or ELI's delta when the instrument is acquired. Accordingly, a single issue of instruments may include some instruments that carry dividend equivalents subject to U.S. withholding tax and others that are not.
- If an ELI references more than one underlying security, then it is subject to the new rules with respect to any underlying security for which it has a delta of .70 or greater. Thus, an ELI with multiple underlying securities will be "tainted" if any one of them has a delta of greater than .70 when it is acquired.
- The payment of a dividend equivalent includes any amount that references an actual or estimated payment of dividends, whether the reference is explicit or implicit, including actual or estimated dividend payments that are implicitly taken into account in computing one or more of the terms of the transaction (i.e., "price return" only instruments may be covered).[8] The prior regulations had carved out estimated dividends from "dividend equivalent" treatment.
- NPCs and ELIs that reference "qualified indices" are carved out from the dividend equivalent rules and should not give rise to dividend equivalent amounts.[9]
- Broker-dealers who are a party to a potential 871(m) transaction are required to determine whether the transaction is an 871(m) transaction and report the timing and amount of any dividend equivalent. If both parties to a potential 871(m) transaction are broker-dealers, or neither party is a broker-dealer, the short party is responsible for making these determinations.


continued on page 4

- The proposed regulations mark the first time the government has used the objective "delta" standard to distinguish a financial derivative from an underlying. While this concept could be useful under other Code sections, the preamble to the proposed regulations provides that they should not be used as a basis for applying the delta standard elsewhere in the Code.

- Taxpayers that acquire a transaction with a principal purpose of avoiding the application of the proposed regulations would be subject to a general anti-abuse rule that allows the IRS to treat payments as dividend equivalents to the extent necessary to prevent the avoidance of the dividend equivalent rules.

## IRS ISSUES FINAL SWAP ASSIGNMENT REGS

On November 5, 2013, the IRS issued final regulations relating to the transfer and assignment of derivative contracts. The final regulations provide that a taxpayer that enters into a derivative with a dealer or clearinghouse does not have to recognize gain or loss when the dealer or clearinghouse counterparty transfers or assigns the contract to another dealer or clearinghouse, as long as the terms of the derivative permit the transfer or assignment of the contract and the terms of the derivative are not otherwise significantly modified. This rule applies even where consideration is paid between the transferor and the transferee.

Furthermore, consideration paid between the transferor and the transferee when the derivative contract is a notional principal contract ("NPC") is not subject to the "embedded loan rules" of Treas. Reg. 1.446-3(g)(4). The preamble to the final regulations states that the Treasury Department and the IRS "believe that it would be inconsistent for an embedded loan to result from such a payment in circumstances in which the general rule in [the final regulations] treats the transfer or assignment of an NPC as not creating a taxable event for the nonassigning counterparty."

## IRS ISSUES FINAL "NET INVESTMENT INCOME" REGS

On November 26, 2013, the IRS issued final regulations under Section 1411, which imposes a 3.8% tax on the "net investment income" of individuals, trusts and estates. These regulations finalize proposed regulations that were issued on December 5, 2012.[10]

Passed as part of the 2010 healthcare reform package, the 3.8% tax imposed by Section 1411 generally became effective on January 1, 2013 and is sometimes known as the "Medicare surtax." The final regulations generally retain the same structure as the statute and the proposed regulations. As applied to individuals, the tax is imposed on the lesser of (a) the individual's "net investment income" and (b) the excess of the individual's modified adjusted gross income above a certain threshold. Modified adjusted gross income is simply adjusted gross income as defined in Section 62, with certain amounts added back that were excluded by Section 911, pertaining to U.S. taxpayers living abroad. The threshold amount varies depending on the status of the taxpayer. Married taxpayers filing jointly, and surviving spouses, have a threshold amount of $250,000. The threshold amount for married taxpayers filing separately is $125,000. The threshold for all other individuals is $200,000.

The final regulations clarify the treatment of foreign trusts and foreign estates. While Section 1411 by its terms does not apply to nonresident aliens, there is not a similar exception for foreign trusts or estates. The proposed regulations sought comments on whether foreign trusts or estates with U.S. beneficiaries should be subject to the tax, or whether the tax should only apply to distributions from such trusts to the U.S. beneficiaries. The final regulations clarify that foreign trusts and estates are not covered by the 3.8 percent tax, but U.S. beneficiaries of foreign trusts and estates must pay the tax on income that is distributed to such beneficiary.

Although the final regulations take effect January 1, 2014, taxpayers may rely on provisions in the final regulations in order to compute tax under Section 1411 for taxable years beginning in 2013. Furthermore, the IRS will not challenge computations of tax under Section 1411 for taxable years beginning in 2013 if the taxpayer has made a reasonable, good faith effort to comply, including through reliance on the proposed regulations.

## CCA 201343019: DIVIDENDS FROM CYPRIOT HOLDING COMPANY ENTITLED TO PREFERENTIAL RATES

In CCA 201343019, the IRS addressed whether dividends from a Cypriot holding company qualified for preferential income tax rates,[11] even though the corporation had no shareholders who were residents of Cyprus and, as a result, would not have met the "Limitations on Benefits" provision of the U.S.-Cyprus income tax treaty ("Treaty").

The facts are straightforward. A U.S. resident received



continued on page 5

dividends from a Cypriot holding company. The holding company had no other U.S. shareholders, nor did it have any shareholders who were residents of Cyprus. The Cypriot holding company conducted an operating business in a third country (i.e., not the U.S. or Cyprus), but was apparently established in Cyprus for reasons unrelated to obtaining any benefits under the Treaty. In any event, the holding company did not have any U.S. source income, and it had not sought to obtain any benefits under the Treaty.

To obtain these reduced rates for dividends, which, at the highest brackets, are currently subject to a tax at 20%, the dividend must have been received from either a domestic corporation or a "qualified foreign corporation." For these purposes, a qualified foreign corporation is any foreign corporation eligible for benefits of a comprehensive income tax treaty with the United States, which the Secretary of the Treasury "determines is satisfactory" and includes an exchange of information program.[12]

In order to benefit from the Treaty and, therefore, to qualify for the preferential tax rates afforded dividends from qualified foreign corporations, the Cypriot holding company either had to meet the applicable Limitations on Benefits provision, or demonstrate that it was not organized in Cyprus simply to take advantage of Treaty benefits. Because the holding company had no Cypriot shareholders (which is a requirement to meet the "Limitations on Benefits" provision), its only hope was to demonstrate that it was not established principally to take advantage of the Treaty.

As clarified in the Technical Explanation accompanying the Treaty, the holding corporation could demonstrate that it was not operated principally to obtain Treaty benefits by showing some bona fide business purpose for not being owned by residents of Cyprus. For example, if the holding company lent money to a supplier in the U.S. in order to ensure a source of supply, the interest earned could be considered as incidental to its business activities.

Without specifically identifying any non-Treaty related reasons, the CCA concluded that the holding company was established for reasons unrelated to the Treaty and, consequently, met the definition of a "qualified foreign corporation" resulting in dividends qualifying for preferential rates.

Although the scope of the CCA is admittedly limited and, of course, carries no precedential value, U.S. shareholders of foreign corporations that don't meet the applicable "Limitations on Benefits" provisions should take heart (and carefully read the applicable treaty). Where operations of the foreign corporation have been established for bona fide business reasons unrelated to treaty benefits, it may be possible for dividends from those foreign corporations to still qualify for preferential rates.

## CCA 201343020: PAYMENTS MADE TO FOREIGN DISTRIBUTORS TREATED AS COMPENSATION; POTENTIALLY SUBJECT TO WITHHOLDING

In CCA 201343020, the IRS provided private advice regarding the tax implications of payments made by a domestic corporation (the "Taxpayer") to foreign distributors in connection with Taxpayer's multi-level marketing business.

Although the facts are fairly involved, at its core, the CCA is simply about the character and source and withholding implications of payments made to reward foreign distributors for cultivating a multi-level chain of distributors that result in sales of Taxpayer's products.

To promote the sale of its products abroad, Taxpayer established a multi-level marketing structure, in which foreign distributors earn income by "sponsoring" other distributors, which, in turn, may further enroll additional lower-tier distributors, effectively creating a distribution sponsorship chain.

While there is no limit to the number of distributors in a chain, each sponsor in the chain is responsible for training the lower-tier distributor on Taxpayer's products, sales and marketing plans, recruitment guidelines, and generally bringing the lower-tier distributor up to speed on the ins-and-outs of Taxpayer's business.

The IRS analyzed the nature of Taxpayer's payments to its foreign distributors and concluded that the payments functioned as compensation for services, akin to a finder's fee. In substance, the "services" provided by each sponsor amounted to compensation for recruiting, training and supporting lower-tier distributors in the sponsor's chain – not income from sales of products. Indeed, each distributor purchased the products directly from Taxpayer, and the sponsor never took title to the products purchased by the lower-tier distributor.

According to the CCA, in order to determine whether the income earned by the sponsor was sourced to the United States and, as a result, subject to tax in the United States (either as FDAP or ECI), the location of the services provided by the sponsor in recruiting,


continued on page 6

training and supporting its lower-tier distributor is determinative, not the location of the activity of the lower-tier distributor.

The payments, when made by Taxpayer, raise complicated withholding questions. For example, to determine the amount of withholding, Taxpayer would have to determine the portion of the payment constituting income from sources within the United States. Because it is possible that less than 100% of the sponsor's relevant income-generating activities would have occurred in the United States, the CCA admonishes Taxpayer to assess, prior to the time of the payment, the source of the income based on the facts relevant to the place where the sponsor performed the recruiting, training and supporting activities, in order to avoid over-withholding. Furthermore, if the sponsor is engaged in a trade or business within the United States and the payments are earned in connection with that trade or business, it will need to provide Taxpayer with Form W-8ECI, or else risk withholding of 30% on a gross basis. The treatment of the payments may also be modified by an income treaty if the foreign sponsor is a resident of a country with which the United States has an income tax treaty in force.

# BAUCUS DISCUSSION DRAFT FOR INTERNATIONAL TAX REFORM

## Introduction

On November 19, 2013, outgoing Senate Finance Committee Chairman Max Baucus unveiled a discussion draft for an international tax reform proposal. The proposal is intended to overhaul the U.S. international tax system in order to spark economic growth, create jobs and make U.S. businesses more competitive, all while maintaining revenue neutrality over the long term.

Specifically, the discussion draft proposes to tax all offshore income of U.S. companies either immediately or not at all, as well as to eliminate certain existing opportunities to avoid U.S. tax on U.S. income (while modernizing and simplifying other internal tax rules).

This discussion draft is not a final plan but rather is intended to spur a conversation between the parties. The public was urged to submit comments on the proposal prior to January 17, 2014.

*Tax all foreign income of U.S. companies either immediately or not at all*

The discussion draft seeks to end the "lock-out" effect that results because U.S. multinational corporations are encouraged to keep untaxed foreign profits offshore under the current Subpart F income deferral regime. Under the discussion draft, passive income and other highly-mobile income of foreign subsidiaries (both of which are categories of Subpart F income under current law) and income from selling products and providing services to U.S. customers would be taxed currently at full U.S. rates (with only certain limited exceptions).

Income from operations overseas of these companies (such as income from products and services sold into foreign markets) would be taxed either under Option Y or Option Z, to be determined as tax reform is finalized. Under Option Y, a minimum tax of, for example, 80% of the U.S. corporate tax rate (with full foreign tax credits) would apply to all products and services sold into foreign markets. Under Option Z, a minimum tax of, for example, 60% of the U.S. corporate tax rate would apply to all products and services sold into foreign markets if derived from active business operations, but tax at the full U.S. rate would apply if not. Both options would provide a full exemption for foreign earnings repatriated to the United States.

Perhaps of most immediate interest, earnings of foreign subsidiaries that have not yet been subject to U.S. tax would be subject to current tax under a one-time tax charge of 20% (estimated rate), with offset allowed for applicable foreign tax credits. Tax due could be paid in installments over eight years.

## Other proposals

Other proposals in the discussion draft include the following:

1. Limit interest deduction for domestic companies to the extent that the earnings of their foreign subsidiaries are exempt from U.S. tax and to the extent that the domestic companies are over-leveraged when compared to their foreign subsidiaries.

2. Limit income shifting through intangible property transfers.

3. Deny deductions for related party payments arising in a base erosion arrangement.

4. Repeal the domestic international sales corporation rules.

5. Simplify the rules relating to passive foreign investment companies.

6. Modernize the rules relating to foreign investment in real property.

7. Eliminate the "check-the-box" rules for certain foreign subsidiaries. Domestic application of the "check-the-box" rules remains unchanged.



continued on page 7

### Public comment

The discussion draft seeks public comments on a variety of topics including the following:

1. Pros and cons of Option Y and Option Z.
2. Merits of the House Ways and Means Chairman Camp's 2011 international tax reform discussion draft as compared to this proposal.
3. Additional ways to address U.S. base erosion by foreign multinational corporations.
4. Appropriate transition rules.
5. Tightening of thin capitalization rules.
6. Taxation of foreign subsidiaries doing business in the U.S. territories.
7. Taxation of U.S. citizens living overseas or foreign nationals living in the United States.
8. Other opportunities to simplify the international tax system.

## COURT DISMISSES CHALLENGE TO INTEREST-REPORTING REGULATIONS

On January 13, 2014, a federal district court dismissed challenges by the Florida Bankers Association and Texas Bankers Association (collectively, the "bankers' associations") to interest-reporting regulations that require U.S. banks to report to the IRS information about accounts earning more than $10 of interest on deposits that are held by foreign individuals who are residents of countries with which the United States has a tax treaty or other information exchange agreement.

The regulations, which impact interest paid beginning in 2013, generally affect commercial banks, savings institutions, credit unions, securities brokerages and insurance companies that pay interest on deposits to foreign individuals. According to the Treasury Department, the reporting required by the regulations will assist the U.S. government's efforts to combat offshore tax evasion by requiring a payor of interest of $10 or more to a nonresident alien individual to file IRS Form 1042-S ("Foreign Person's U.S. Source Income Subject to Withholding"), even though that interest is generally not subject to U.S. tax under Section 871(i)(2). The reporting requirement is limited to interest on deposits paid to a foreign person who is a resident of a country with an income tax or other convention or bilateral agreement relating to an agreement to exchange tax information with the United States.

The bankers' associations leveled a host of procedural and policy arguments in an effort to bolster their challenge to the regulations. Their chief complaint, however, was that regulations would negatively impact the banking business and could even result in capital flight.

The court quickly swept these arguments aside, finding that the IRS "reasonably concluded that the regulations will improve U.S. tax compliance, deter foreign and domestic tax evasion, impose a minimal reporting burden on banks, and not cause any rational actor – other than a tax evader – to withdraw his funds from U.S. accounts."

## IRS RESUMES REIT CONVERSION RULINGS

On November 15, the IRS issued a statement to Tax Analysts that it is ready to resume REIT Conversion ruling requests relating to the definition of "real estate." Earlier in the year, the IRS had temporarily placed pending ruling requests on hold in order to conduct internal review to ensure a uniform and consistent approach to addressing the definition of REIT real estate. The IRS has completed its review and will resume ruling on such requests in a manner consistent with existing law (Section 856, underlying regulations and previously published guidance).

Recently, a number of non-traditional real estate companies have submitted ruling requests to the IRS to convert into REITs. These include boat slips, data centers, billboards,[13] and wireless communication systems. Some critics have argued (albeit, perhaps unfairly) that the IRS has expanded the definition of REIT real estate. On the contrary, the IRS has remained consistent in its application and interpretation of the law in this area.

## TAX COURT HOLDS ABANDONED STOCK GENERATES CAPITAL LOSS

In *Pilgrim's Pride v. Commissioner*, the Tax Court held that the abandonment of stock that is a capital asset gives rise to a capital loss and not an ordinary abandonment loss.

The Treasury regulations under Section 165 generally allow a deduction for losses sustained in the taxable year, including losses from the abandonment of



continued on page 8

property.[14] However, an abandonment loss is not allowed with respect to losses sustained upon the sale or exchange of property. Section 1234A provides that "gain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." At issue in *Pilgrim's Pride* was whether Section 1234A applied to the abandonment of stock that is held as a capital asset.

According to the facts of the case, the taxpayer purchased preferred stock from two corporations (the "Issuers") for a total of $98.6 million in 1999. By 2004, the stock had declined significantly in value and the Issuers offered to buy back the stock for $20 million. The taxpayer determined that the best course of action was to abandon the stock for no consideration because a $98.6 million abandonment loss would generate tax savings more valuable than the $20 million offered by the Issuers. Accordingly, the taxpayer surrendered the stock to the Issuers, terminating its ownership rights with respect to the Issuers. The taxpayer then claimed an ordinary loss of $98.6 million. The IRS disagreed with the character of the loss, arguing that Section 1234A applied to treat the abandonment as a "sale or exchange," resulting in a capital loss subject to limitation.[15]

The court rejected the taxpayer's argument that Section 1234A applied only to derivative or contractual rights and did not apply to property rights inherent in ownership. Analyzing the statutory text, the Tax Court found that the surrender of the preferred stock terminated all of the taxpayer's rights with respect to the stock, which was a capital asset. Therefore, Section 1234A treated the abandonment of the stock as a loss from the sale of a capital asset, resulting in a capital loss.

# EXCLUSION FOR DEBT DISCHARGE INCOME FROM QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS IS NOT EXTENDED

The 2012 Taxpayer Relief Act previously provided a one-year exclusion for certain debt discharge income from qualified principal residence indebtedness from the general rule that a discharge of indebtedness gives rise to income includible in gross income. This provision expired on January 1, 2014 and has not been extended.

# EVENTS AND AWARDS

## Events

On October 3, 2013, MoFo partner Anna Pinedo spoke on a panel at a New York City Bar event titled "Private Equity Structuring: The Basics." The panel focused on ethical considerations that may arise in connection with offerings or M&A for private equity fund portfolio companies in light of new regulations.

Also on October 3, 2013, MoFo partner Anna Pinedo participated in a Bloomberg Law Event titled "Outlook on Securities – The JOBS Act." The seminar dealt with the latest developments in JOBS Act rulemaking by the SEC.

MoFo sponsored IMN's 5th Annual Covered Bonds – The Americas conference, which took place on October 17, 2013. MoFo senior of counsel Jerry Marlatt participated in the conference, where he moderated a panel titled "USD Funding as part of the Global Funding Strategy: Non-U.S. Issuer Roundtable."

On October 17, 2013, MoFo partners Anna Pinedo, Jeremy Jennings-Mares, Peter Green and of counsel James Schwartz hosted a teleconference titled "Dodd-Frank Title VII vs. EMIR." The briefing covered the similarities and differences between the U.S. and European approaches to derivatives regulation. The participants also focused on the extraterritorial application of each regulatory regime, and aspects of substituted compliance.

MoFo partner David Lynn participated in an ALI CLE webcast on October 22, 2013, titled "Crowdfunding: Will it expand your Clients' Capital Raising Options?" The webcast speakers discussed how existing and proposed options for crowdfunding could change issuers' capital raising options.

On October 23, 2013, MoFo partner David Lynn participated in a West LegalEdcenter webcast called "SEC Proposes Pay Ratio Disclosure Rules." The webcast focused on the new pay ratio disclosure requirements; methodology for identifying the median employee compensation; filings requiring new pay ratio disclosure; and implementation of pay ratio disclosure.

MoFo partners Daniel Nathan and Ze'-ev Eiger spoke on another West LegalEdcenter webcast called "FINRA Actions and the Due Diligence Obligations of Broker-Dealers in Private Placements." The webcast explored the trend of increased scrutiny of private placements by FINRA.

On November 11, 2013, in London, MoFo partners Peter Green and Jeremy Jennings-Mares spoke on a



continued on page 9

variety of panels at *Structured Products* magazine's 9th Annual Structured Products Europe conference, where MoFo was a sponsor. The panels included A European Education: Are Structured Products too Complex for Investors?; Globalisation or Balkanisation? Global Regulatory Update; and Mitigating Counterparty Risk for Investors in the Future.

MoFo partners James Tanenbaum and Anna Pinedo presented on November 14, 2013 in-house seminar titled "Bought Deals, Block Trades and Confidentially Marketed Public Offerings." The session reviewed issues to consider in connection with bought deals and block trades, including variable re-offer and other pricing matters, timing of required disclosures and documentation issues. Best practices related to confidentially marketed public offerings were also reviewed.

MoFo partners Anna Pinedo and David Lynn participated in a PLI webcast on November 15, 2013, titled "Wisdom of Crowds: A Review of the Proposed Crowdfunding Regulatory Framework." The webcast focused on the SEC's approved proposed rules implementing the JOBS Act mandate to create an exemption from registration for certain crowdfunded offerings. Speakers also discussed FINRA's proposed regulations for funding portals.

On November 19, 2013, MoFo partners Anna Pinedo and Oliver Ireland joined a Global Association of Risk Professionals (GARP) webcast that dealt with Basel III Implementation in 2014. The speakers reviewed the phase-in dates for the capital rules; discussed the proposed liquidity coverage ratio rules; and identified areas that will be a focus of additional rulemaking, including the net stable funding ratio, margin requirements for non-cleared swaps and securitization exposures.

MoFo hosted a teleconference on November 21, 2013 that considered European Developments Affecting Structured Notes & Retail Investment Products. The speakers were MoFo partners Peter Green and Jeremy Jennings-Mares, and they focused on the progress of the proposed PRIPS regulation in the EU and related regulatory developments, including MiFID II, and the ongoing debates about suitability of complex products for retail investors.

MoFo sponsored The Clearing House Annual Conference, which took place on November 21-22, 2013. The conference provided a forum to examine the bank regulatory and payments landscape in the post Dodd-Frank era. MoFo partner Oliver Ireland moderated the panel titled "Shaping the Bank Balance Sheet in the Age of Basel III Capital & Liquidity Regulation."

On December 3, 2013, MoFo of counsel Bradley Berman delivered an in-house seminar titled "Bank Note Programs." The session provided an overview of the Section 3(a)(2) exemption for issuances of bank securities, and also discussed the advantages associated with issuances at the bank level.

On December 4-6 2013, MoFo partner Tom Humphreys participated in PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings in California that focused on all the tax issues presented by the entire spectrum of major corporate transactions, including acquisitions, disposition, spin-offs, joint ventures, financings, reorganizations and restructurings. Mr. Humphreys spoke on the panel titled "Interesting Transactions of the Past Year."

MoFo sponsored another *Structured Products* conference on December 10, 2013, in Washington, D.C. The conference provided a strong focus on the most recent developments in the U.S. regulatory landscape for structured products, with speakers from a variety of regulatory agencies. MoFo lawyers Lloyd Harmetz, Anna Pinedo, Bradley Berman, Daniel Nathan and Remmelt Reigersman each led a boot camp class. The classes included "New Product Approval"; "Dealing with Distributors"; "Disclosure Issues;" "Other Compliance Concerns"; and "Taxation of Financial Products."

MoFo partners Lloyd Harmetz and Daniel Nathan held an in-house seminar on December 11, 2013, titled "FINRA's Enhanced Focus on Suitability." The session focused on FINRA's current regulations relating to suitability, and offered practical guidance for broker-dealer policies, product approvals, as well as product reviews.

On December 12, 2013, MoFo partner Anna Pinedo participated in the PLI conference "Understanding the Securities Laws 2013." Ms. Pinedo gave a presentation titled "Securities Act Exemptions/Private Placements," which discussed exempt securities versus exempt transactions; Regulation D offerings and recent changes to them; the new crowdfunding exemption; and the new Regulation "A+" exemption.

MoFo partner Anna Pinedo and of counsel James Schwartz hosted on December 17, 2013 a teleconference called "Title VII Update." The briefing reviewed the current status of the regulatory framework for OTC derivatives in the United States. Topics included both elements of the CFTC's framework for swaps that have not yet been implemented, along with elements that have largely been implemented. The speakers also reviewed the current status of the SEC's security-based swap regulations.



continued on page 10

## Awards

MoFo's Tax Department was recently named "2013 Tax Practice Group of the Year" by *Law360*. *Law360* acknowledged MoFo's work on the ResCap bankruptcy, as well as our work in connection with acquisitions involving Sprint Corp., Toshiba TEC and Pinnacle Entertainment. *Law360* noted that "In the tax world, some firms are experts at tax planning, while others are hard-charging litigators with feared tax controversy practices. Other firms are highly adept at handling federal tax issues, while others excel in the state and local tax realm. But Morrison & Foerster is special among law firms because it excels in all of those areas."

MoFo recently received the 2013 *M&A Advisor* Award in the category "Deal of the Year (Over $1 Billion)" for the section 363 bankruptcy sale of Residential Capital, LLC. The transaction was notable as the first sale of an operating mortgage origination and servicing company out of bankruptcy. The asset sales required extensive planning, including securing debtor-in-possession financing.

---

1 For additional background on the draft FFI Agreement, please see our October 29, 2013 client alert, at http://www.mofo.com/files/Uploads/Images/131029-Draft-FFI.pdf.

2 For further information on the FATCA registration portal, please see our August 21, 2013 client alert, at http://www.mofo.com/files/Uploads/Images/130821-FATCA-Registration-Begins.pdf.

3 For our previous discussion of the proposed 3.8% "Net Investment Income" regulations, see Tax Talk 5.4, at http://www.mofo.com/files/Uploads/Images/130125-MoFo-Tax-Talk.pdf.

4 http://www.mofo.com/files/Uploads/Images/130722-MoFo-Tax-Talk.pdf.

5 As a copy of the IGA with Mauritius has not yet been released, it is unclear whether it is reciprocal.

6 http://www.irs.gov/Businesses/Corporations/FAQsFATCARegistrationSystem.

7 All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

8 For example, suppose a price-return swap contract entitles the long party to receive appreciation in an underlying security (but does not entitle the long party to any dividends) and obligates the long party to pay a fixed rate of LIBOR to the short party. Also suppose that, had the long party entered into a total-return swap, the long party would be obligated to pay the short party LIBOR plus 100 basis points. Because the dividends are taken into account in determining the terms of the NPC (i.e., resulting in a reduced funding payment), the long party is treated as receiving a dividend equivalent on the price-return only swap despite the fact that the swap contract does not contain any reference to an estimated dividend amount. See Prop. Reg. Section 1.871-15(h)(4) Example 2.

9 For these purposes, a qualified index is an index that (1) references 25 or more component underlying securities, (2) references only long positions in component underlying securities, (3) contains no components that represent more than 10% of the weighting of the index, (4) modifies or rebalances only according to predefined objective rules at set dates or intervals, (5) does not provide a dividend yield from component underlying securities that is greater than 1.5 times the current dividend yield of the S&P 500 Index as reported for the month immediately preceding the date the long party acquires the potential 871(m) transaction, and (6) futures contracts or option contracts on the index trade on a national securities exchange that is registered with the SEC or a domestic board of trade designated as a contract market by the CFTC.

10 For a discussion of the proposed regulations, see Tax Talk Vol. 5, No. 4, available at http://www.mofo.com/files/Uploads/Images/130125-MoFo-Tax-Talk.pdf.

11 At issue in the CCA was the preferential rate for qualified dividends under Section 1(h)(11).

12 Notice 2011-64 identifies Cyprus as a country that meets the applicable requirements.

13 Although there is already positive precedent relating to billboards, the IRS recently announced in Revenue Procedure 2014-3 that it will not issue further private letter rulings or determination letters relating to billboards.

14 Treas. Reg. 1.165-2(a).

15 Section 165(g)(3), which allows an ordinary loss with respect to worthless securities of affiliated corporations, did not apply because the taxpayer did not meet the 80% vote and value affiliation test of Section 1504.

---

## About Morrison & Foerster

We are Morrison & Foerster — a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for 10 consecutive years. *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.

## Contacts


### United States Federal Income Tax Law

**Thomas A. Humphreys**
(212) 468-8006
thumphreys@mofo.com

**Stephen L. Feldman**
(212) 336-8470
sfeldman@mofo.com

**Shiukay Hung**
(212) 336-4331
shung@mofo.com

**David J. Goett**
(212) 336-4337
dgoett@mofo.com

**Remmelt A. Reigersman**
(212) 336-4259
rreigersman@mofo.com

**David N. de Ruig**
(212) 336-4059
dderuig@mofo.com

### Corporate + Securities Law

**Anna T. Pinedo**
(212) 468-8179
apinedo@mofo.com

**Lloyd S. Harmetz**
(212) 468-8061
lharmetz@mofo.com


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.