A Compendium of Financial Crisis Tax Guidance

By E. Ray Beeman

The IRS and the Treasury respond to tax issues raised by the financial crisis.

Since serious and systemic problems in the credit markets first began to unfold during the summer of 2007, the Treasury and the IRS have published more than 20 items of guidance that deal with potentially severe applications of specific tax rules to the abnormal conditions caused by these problems, which have reached historic proportions and have spread beyond the credit markets into the broader financial markets and the economy as a whole. In many cases, guidance has been provided to remove tax impediments to participation in the various government programs that have been hastily put into place to confront the prevailing market environment.

Due perhaps in part to the transition from the Bush administration to the Obama administration and in part to the possibility that much of the "low-hanging fruit" has now been addressed, the pace of guidance has slowed somewhat, which provides an opportunity to take a look back at the guidance that has been issued to this point. Without question, more guidance can be expected, as the problems with the malfunctioning financial markets manifest themselves in different ways and the resulting tax implications are brought to the attention of the Treasury and the IRS.

Financial Crisis Tax Guidance

The tax guidance that the Treasury and the IRS have issued as of the time of this writing (December 2008) in connection with the financial crisis is presented below in chronological order (by release date), except for related items of guidance or items of guidance involving closely related issues (which are presented together). As a compendium, this list is not intended to provide detailed analysis of any of the items but, rather, to familiarize readers with the specific areas in which the Treasury and the IRS have decided so far that relief or clarification is necessary with regard to the application of various tax rules within the context of the current market and economic conditions.

Rev. Proc. 2007-72, Rev. Proc. 2008-28 and Rev. Proc. 2008-47

The first signs that the credit markets were in for trouble arrived with the initial waves of scheduled interest rate resets on subprime residential adjustable-rate mortgage (ARM) loans that became popular during the height of the housing market. As housing prices peaked and began to decline, it became clear that a substantial portion of these mortgages would not survive the interest rate resets, so efforts were begun to renegotiate the terms of these loans in order to avoid a surge of defaults and, ultimately, home foreclosures.

These efforts were hampered by the fact that the mortgages had been packaged into real estate mortgage investment conduit (REMIC) vehicles or other investment trusts, where the ability to modify mortgages is severely limited by tax rules that are designed to ensure that the REMIC or investment trust maintains a substantially fixed pool of mort-

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gages. Modifications of mortgages held by a REMIC or investment trust may subject the REMIC or investment trust to severe penalties, including a 100 percent–prohibited transactions tax (in the case of REMICs)[1] or even possible loss of REMIC or investment trust status altogether.[2]

To facilitate workouts of residential ARM loans that are at risk of default, Rev. Proc. 2007-72[3] provides that the IRS will not penalize REMICs or investment trusts holding first-lien subprime residential ARM loans that are renegotiated on or before July 31, 2010, if the loans (1) have an initial fixed-rate period of 36 months or less;[4] (2) were originated between January 1, 2005, and July 31, 2007; (3) have an initial interest rate reset between January 1, 2008, and July 31, 2010; and (4) are renegotiated pursuant to fast-track loan modification procedures and criteria established by the American Securitization Forum (ASF), which were released simultaneously with Rev. Proc. 2007-72.

Rev. Proc. 2007-72 also provides that penalties will not apply to a REMIC or investment trust if a second-lien holder subordinates its lien to any new lien that arises from a mortgage loan that is modified pursuant to the conditions outlined above.

Rev. Proc. 2008-47[5] provides substantially the same guidance as Rev. Proc. 2007-72 but reflects revisions to the ASF fast-track loan-modification procedures and criteria to cover an expanded range of loan modifications such as modifications in advance of an interest rate reset subsequent to an initial interest rate reset.

Servicers of other types of residential mortgage loans held by REMICs and investment trusts who implement a foreclosure program will receive similar relief under Rev. Proc. 2008-28,[6] which provides that REMICs or investment trusts will not be penalized if the servicer renegotiates the terms of loans that are at significant risk of default pursuant to a foreclosure prevention program that satisfies certain criteria.

Modifications of mortgages held by a REMIC or investment trust may subject the REMIC or investment trust to severe penalties.

REMICs normally are permitted to change the terms of mortgage loans only if the change is "occasioned by default or a reasonably foreseeable default" (along with a handful of other exceptions),[7] while investment trusts are not afforded even this level of flexibility. Rev. Proc. 2007-72, Rev. Proc. 2008-28 and Rev. Proc. 2008-47 recognize that there probably are entire product lines of outstanding residential mortgages that realistically will require renegotiation under current market conditions. Only time will tell whether concerted efforts will succeed at turning back the predicted wave of foreclosures on residences financed by dubious mortgage products, but this series of guidance should ensure that the tax rules associated with investments in pools of these mortgages will not impede these efforts.

Notice 2008-27, Notice 2008-41 and Notice 2008-88

Early in 2008, the disruptions in the credit markets began to spread into the normally staid municipal bond market. Specifically, rating agency downgrades of major municipal bond insurers were causing a surge in tenders of variable-rate demand bonds (VRDBs, often referred to as "tender option bonds") by money market funds for technical reasons unrelated to the underlying credit quality of the VRDBs. In addition, auctions involving auction-rate bonds (ARBs) were beginning to fail because of declines in indices that establish by formula the maximum interest rates on ARBs.

Certain modifications of the terms of debt instruments can cause a modified debt instrument to be treated as having been retired and reissued for tax purposes, which generally produces the same tax consequences as an actual retirement and reissuance of a debt instrument.[8] For tax-exempt municipal bonds, such a result generally requires a reapplication of all the various program requirements for newly issued tax-exempt bonds. For example, a modified tax-exempt bond that is treated as having been retired and reissued may become exposed to (1) severely negative tax consequences under the various arbitrage rules that apply to tax-exempt bonds, (2) new public approval requirements for qualified private activity bonds and (3) the possibility that the law has changed since the original bonds were issued.

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In response to concerns that modifications of tax-exempt bonds resulting from rating agency downgrades of VRDB insurers and ARB auction failures would cause the bonds to be treated as having been retired and reissued, Notice 2008-27[9] provides that certain modifications will not cause a deemed retirement and reissuance of a tax-exempt bond. The modifications to which Notice 2008-27 apply include certain interest rate–mode changes and the existence or exercise of certain tenders in the case of VRDBs; temporary interest rate–cap waivers between November 1, 2007, and July 1, 2008, in the case of ARBs; and (for purposes of the arbitrage investment restrictions applicable to newly issued tax-exempt bonds) certain modifications of hedging transactions that are integrated with the hedged bond.

As a further measure to facilitate liquidity and stability in the short-term sector of the tax-exempt bond market, Notice 2008-41[10] supplements Notice 2008-27 by expanding the scope of the modifications covered by Notice 2008-27 and adding new modifications that will not cause a deemed retirement and reissuance of a tax-exempt bond. Among other things, Notice 2008-41 extends the period during which interest rate caps on ARBs can be waived to October 1, 2008 (from July 1, 2008), and extends the relief provided for modifications of integrated hedges to hedges of bonds that are temporarily held by the government issuer of the bond. In addition, Notice 2008-41 permits government issuers of certain ARBs to repurchase their bonds if the purchase was made before October 1, 2008, and the issuer does not hold the bond for more than 180 days. Notice 2008-41 also provides similar rules for conduit borrowers who purchase the ARBs that financed their loans in order to facilitate liquidity under adverse market conditions, and for premiums received by an issuer pursuant to the conversion of an interest rate on a VRDB to a fixed interest rate.

In response to the growing illiquidity and instability in the credit markets beyond the ARB sector and into other short-term tax-exempt bond market sectors, Notice 2008-41 itself was supplemented by Notice 2008-88,[11] which permits government issuers of all ARBs and tax-exempt commercial paper to repurchase and hold their bonds and paper at any time (that is, both before and after October 1, 2008) until December 31, 2009, without the bond or paper being treated as having been retired and reissued. Notice 2008-88 also provides more flexibility with respect to repurchases of tendered ARBs by government issuers and again extends the period during which interest rate caps on ARBs can be waived to December 31, 2008 (from October 1, 2008), without the ARBs being treated as having been retired and reissued.

Rev. Proc. 2008-26 and Notice 2008-91

U.S. federal income tax generally is imposed upon the repatriation of foreign earnings that have not been previously subject to U.S. tax (that is, foreign earnings of U.S.-owned foreign subsidiaries that have not already been taxed under an antideferral regime such as the Subpart F rules). In addition to direct dividends from foreign subsidiaries to their U.S. parents, repatriations that are subject to tax may also take the form of various types of investments in U.S. securities and other U.S. property, such as stock in U.S. corporations and debt instruments issued by a U.S. individual or company.[12]

A repurchase agreement would be treated under the general rule as an investment in U.S. property by the foreign subsidiary that is subject to tax because of the obligation incurred by the U.S. person as part of the transaction. However, there are several exceptions to the general taxation of investments of foreign earnings in U.S. property,[13] including an exception for cross-border repurchase agreements involving "readily marketable" securities that are sold or purchased pursuant to the agreement, as well as "readily marketable" securities that are posted as collateral in connection with reverse repurchase agreements.[14]

As liquidity evaporated in the markets for mortgage-backed securities and other over-the-counter debt securities, concerns arose regarding whether these securities ceased to be "readily marketable" for purposes of this exception. In response to these concerns, Rev. Proc. 2008-26[15] provides that the IRS will not challenge whether a security is readily marketable for purposes of the exception if the security is of a type that was readily marketable at any time within three years prior to May 12, 2008 (the effective date of Rev. Proc. 2008-26). Rev. Proc. 2008-26 will apply for calendar years 2007 and 2008.

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Another exception to the general taxation of investments of foreign earnings in U.S. property involves short-term obligations of U.S. persons to U.S.-owned foreign subsidiaries. This exception provides that obligations extinguished within 30 days of being incurred are not subject to taxation as repatriated earnings, provided the subsidiary has not held for 60 or more days during the tax year obligations that would be subject to taxation (without regard to the exception) if held at the end of the tax year of the subsidiary.[16]

In an effort to alleviate short-term liquidity concerns surrounding the funding of U.S. operations of companies with foreign earnings, Notice 2008-91[17] relaxes the constraints on the exception for short-term obligations by doubling the amount of time an obligation can remain outstanding (from 30 days to 60 days) and tripling the 60-day annual limitation on lending to U.S. persons (from 60 days to 180 days). Notice 2008-91 applies for the first two tax years of a foreign corporation ending after October 3, 2008, but not to tax years beginning after December 31, 2009, which means that foreign corporations will receive relief under the notice for only one tax year unless they operate on a calendar year, in which case they will benefit from the notice for two tax years.

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Notice 2008-55

Similar to the circumstances that led to the issuance of Notices 2008-27, 2008-41 and 2008-88 in connection with auction-rate tax-exempt bonds, one of the many consequences of the collapse in the credit markets has been the failures that have occurred since February 2008 in the auctioning or remarketing of auction-rate preferred stock and other securities, usually because the payment rate required by the markets on these securities has exceeded the maximum rate permitted to be paid on the securities.

Money market funds normally are not permitted to hold auction-rate preferred stock because the stock lacks the necessary liquidity features required for the stock to qualify as a security that can be purchased by such funds. In an effort to facilitate successful auctions by broadening the investor base for auction-rate preferred stock, issuers of the stock and others have considered adding liquidity facilities to the stock so that money market funds would be permitted to purchase the stock. In general, the liquidity feature would provide holders of the stock with an option to tender (or sell) the stock to a third-party liquidity provider in the event of a failed auction or remarketing and, in some cases, would provide liquidity providers the right to tender the stock back to the issuer after a period of time during which the liquidity provider has unsuccessfully attempted to resell the stock at auction.

Because preferred stock in general already exhibits debtlike characteristics not found in common stock (for example, fixed dividend rates, dividend and liquidation preferences, *etc.*), concerns were expressed that attaching a liquidity facility of this nature to auction-rate preferred stock could cause the stock to be recharacterized as debt (rather than equity) for tax purposes. In particular, such a recharacterization would prevent municipal bond mutual funds that issue auction-rate preferred stock from paying tax-exempt dividends on the stock.

To respond to these concerns, Notice 2008-55[18] provides that the addition of a liquidity facility of the type described above to auction-rate preferred stock will not result in a recharacterization of the stock as debt, provided the stock was outstanding on February 12, 2008; the liquidity facility is entered into after February 12, 2008, and before January 1, 2010; and several other conditions are met involving the details of the liquidity facility.

Rev. Proc. 2008-51

The deteriorating conditions in the credit markets also have had a significant impact on project finance loans and other loans that have been originated pursuant to financing commitments that were secured when the markets were functioning more smoothly. In the case of project finance, many borrowers that have issued short-term bridge loans pursuant to financing commitments have been unable to refinance the debt into longer-term loans with terms that are at least as favorable as the bridge loans. In other situations, lenders that have originated debt pursuant to financing commitments have sold the loans to third parties at substantial discounts from the amount loaned to the borrower.

In both cases, corporate borrowers have encountered a peculiar interaction between the highly technical original issue discount (OID) tax rules and an equally technical set of tax rules that was enacted in response

to the wave of leverage buyout transactions that took place in the late 1980s. The latter set of tax rules are known as the applicable high-yield debt obligation (AHYDO) rules and generally defer or even disallow interest deductions on debt instruments that have high yields and do not require interest to be paid currently in cash, making them more akin to equity investments than lending transactions (and their yield payments more like nondeductible dividends than deductible interest).[19] The amount of OID on a debt instrument is taken into account for purposes of determining whether the debt is an AHYDO by virtue of having a high yield, and the amount of OID on a debt instrument includes the amount of any discount at which the debt instrument is issued.

When permanent financing is originated pursuant to a financing commitment and the lender sells the debt in the capital markets to third parties at a significant discount in its capacity as an underwriter, the discount could constitute OID and result in interest expense deferral or disallowance to the borrower under the AHYDO rules.

Similarly, bridge financing that was originated pursuant to a financing commitment may be replaced by permanent financing with terms that result in OID because of prevailing credit market conditions that did not exist when the financing commitment was secured. Depending upon the amount of the OID, the AHYDO rules could defer or deny interest deductions to the borrower.

To the extent that a loan originated pursuant to a financing commitment would not be AHYDO if the loan were treated as having been issued for an amount equal to the cash proceeds actually received by the borrower, Rev. Proc. 2008-51[20] provides that the AHYDO rules will not apply to defer or deny interest deductions associated with the loan.

Notably, Rev. Proc. 2008-51 does not address what perhaps may be a more significant issue than the application of the AHYDO rules to these types of lending transactions. The same technical operation of the rules that would produce AHYDO (in the absence of Rev. Proc. 2008-51) in connection with these transactions also likely would result in a significant amount of cancellation of indebtedness income (CODI) to the borrower. However, Rev. Proc. 2008-51 does not address the CODI consequences of these transactions, probably because the Treasury and the IRS do not believe that they have the administrative authority to do so.

Notice 2008-81

One of the more startling events of the credit crisis occurred in September 2008 when the collapse of Lehman Brothers, Inc. triggered widespread concern about the ability of money market funds to maintain their one-dollar-per-share net asset values after two money market funds "broke the buck" as a result of their holdings of debt issued by Lehman Brothers.

On September 19, 2008, the Treasury announced that it would use the agency's existing Exchange Stabilization Fund to insure the holdings of money market funds in order to stabilize the situation and prevent a wave of money market fund redemptions. For funds that hold tax-exempt municipal bonds and pay tax-exempt dividends, questions were raised about whether participation in this program would violate the general prohibitions against federal government guarantees of tax-exempt municipal bonds, which would cause the interest paid on the bonds to become taxable and, in turn, cause dividends paid by money market funds holding the bonds to become taxable.

Notice 2008-81[21] provides that participation in the Treasury program by money market funds holding tax-exempt municipal bonds and paying tax-exempt dividends will not violate the prohibitions against federal government guarantees of tax-exempt municipal bonds. Like the Treasury program itself, the notice is limited to municipal bonds in participating money market funds as of the close of business on September 19, 2008, and to fund investors of record as of that date.[22]

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Rev. Proc. 2008-58

In the aftermath of auction failures involving auction-rate securities, which began in February 2008, many investors in these securities have asserted legal claims that the financial institutions that marketed these securities improperly failed to disclose to investors the potential that the securities could become illiquid (that is, the auctions that periodically reset the payment rate on the securities could fail).

Several financial institutions against which these claims have been asserted have offered to repurchase these securities from their customers, either unconditionally or in the event that the financial institution identifies a purchaser of the securities (in which case the customer tenders the security to the

financial institution at par even if the subsequent sale to the purchaser identified by the financial institution is made at a discount to par, with the financial institution bearing the resulting loss). In some cases, the settlement offers permit customers to borrow against the securities (rather than selling the securities to the financial institution). The settlement offers generally are available for a specified period of time.

These settlement offers effectively insure that the customers holding auction-rate securities can receive par upon disposition of the securities as intended and, in fact, in some instances allow the securities to be monetized prior to disposition of the securities. The availability of these settlement offers, in conjunction with the continuing auction failures involving auction-rate securities, could raise various questions involving tax ownership of the securities, as well as issues involving income realization and the amount of proceeds realized upon tendering the securities pursuant to a settlement offer.

Rev. Proc. 2008-58[23] provides that holders of auction-rate securities who receive a settlement offer will continue to be treated as owners of the securities for tax purposes until they tender their securities upon accepting the settlement offer. In addition, Rev. Proc. 2008-58 provides that holders of these securities will not be treated as receiving any income by virtue of receiving or accepting a settlement offer and that the amount received from tendering the securities to the financial institution making the settlement offer will be the full amount of the cash proceeds received from the institution.

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Rev. Proc. 2008-58 is effective for settlement offers received before June 30, 2009, with respect to auction-rate securities purchased on or before February 13, 2008, provided the settlement offers are available for a period of time that does not extend beyond December 31, 2012.

Rev. Proc. 2008-63

By statute, certain securities lending arrangements are respected as securities loans for tax purposes, rather than being treated as taxable transfers of the securities, provided the transaction meets several conditions.[24] One such condition requires the transaction to "provide for the return to the transferor of securities identical to the securities transferred."[25]

When it filed for bankruptcy, Lehman Brothers, Inc. defaulted on many of its securities lending transactions that had been structured to comply with the statutory requirements for securities loan tax treatment. Consequently, lenders of securities to Lehman Brothers pursuant to these agreements have used the collateral provided to them by Lehman Brothers under these agreements to purchase identical securities. However, it was unclear whether this use of collateral to acquire replacement securities occasioned by the default of the securities borrower satisfied the requirements for statutory securities loan tax treatment—that is, whether the replacement securities constituted "identical securities."

Rev. Proc. 2008-63[26] provides that the use of collateral to purchase replacement securities upon the default of a securities borrower will be treated as satisfying the requirements for statutory securities loan tax treatment, provided (1) the securities lending agreement otherwise satisfies these requirements; (2) the securities borrower defaults on the agreement as a result of filing bankruptcy; and (3) the purchase of replacement securities occurs as soon as is commercially practicable after the default (but in no event more than 30 days following the default).

Rev. Proc. 2008-63 is effective for tax years ending on or after January 1, 2008. Interestingly, this guidance does not have a termination date, unlike most of the other financial crisis tax guidance. This suggests that the guidance may actually reflect the view of the Treasury and the IRS as to the generally correct interpretation of the statutory securities lending requirements, rather than merely providing time-limited relief within the context of the financial crisis.

Notice 2008-76, Notice 2008-78, Notice 2008-83, Notice 2008-84 and Notice 2008-100

Originally enacted to prevent corporate acquisitions for the purpose of acquiring net operating losses, certain tax rules broadly restrict the utilization of net operating loss carryovers and other built-in losses of a corporation when control of the corporation is transferred (the antiloss trafficking rules).[27] In general, the antiloss trafficking rules are triggered when more

than 50 percentage points of the equity ownership of a corporation have changed hands among significant shareholders (that is, those owning five percent or more of the stock of the corporation) over a three-year period.[28] Once these rules are triggered, utilization of the corporation's net operating losses or built-in losses is subject to a restriction that limits the annual utilization of these losses to an amount that equals the preacquisition value of the acquired corporation, multiplied by an applicable long-term tax-exempt interest rate.[29] Over the years, some have criticized the broad scope and complicated contours of these tax rules, but the Treasury and IRS frequently have taken an expansive view of the interpretation and application of the rules.

The antiloss trafficking rules—particularly as interpreted and implemented by the Treasury and the IRS—became problematic when economic conditions in the financial services sector began to deteriorate to the point where it became necessary for the federal government to start injecting capital into a growing number of large financial institutions.

Enacted on July 30, 2008, the Housing and Economic Recovery Act of 2008[30] authorized the Treasury to purchase any obligations or other securities issued by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac), the solvency of which were being threatened by dramatic declines in the value of their mortgage-backed securities portfolios as a result of the housing market collapse and frozen credit markets. Following enactment of the legislation, the Treasury entered into commitments with Fannie Mae and Freddie Mac to purchase up to $100 billion in preferred stock of each entity in exchange for receiving $1 billion of preferred stock and warrants on common stock. Under the antiloss trafficking rules, the acquisition of stock and warrants on stock in Fannie Mae and Freddie Mac would be taken into account in determining whether a 50-percentage-point ownership change had occurred in either entity, thus triggering the limitation on the utilization of losses. However, Notice 2008-76[31] provides that any acquisition of Fannie Mae or Freddie Mac stock or warrants pursuant to the legislation is not to be taken into account in determining whether a 50-percentage-point ownership change has occurred. In addition, Notice 2008-76 seems to indicate that any eventual acquisitions of Fannie Mae or Freddie Mac stock from the federal government also will not be taken into account in determining whether a 50-percentage-point ownership change occurs in either entity.

After the federal government rescued AIG International Group, Inc. on September 22, 2008, Notice 2008-84[32] broadened the scope of Notice 2008-76 by disregarding the acquisition by the federal government of stock or warrants in any corporation for purposes of determining whether a 50-percentage-point change in ownership has occurred for purposes of the antiloss trafficking rules. Notice 2008-84 is not limited to AIG or to financial institutions in general—which means it could apply to assistance provided by the federal government in other economic sectors such as the automobile industry—but it is limited to situations in which the government acquires a controlling interest (including options to acquire a controlling interest) in the corporation (as was the case with AIG).

In order to prevent the preacquisition value of corporations with losses from being artificially increased with capital contributions (for example, by a prospective acquirer) so as to increase the limitation on the utilization of the corporation's losses, the antiloss trafficking rules provide that any capital contribution received by a corporation that has a principal purpose of avoiding the application of the antiloss trafficking rules or increasing the limitation on the utilization of the corporation's losses is disregarded in determining the preacquisition value of the corporation.[33] Except as provided in Treasury regulations, the antiloss trafficking rules further provide that any capital contribution made during a two-year period preceding a date on which more than 50 percentage points of the ownership of a corporation with losses has changed hands is regarded as having such a purpose.[34] Regulations have never been issued to limit the application of this rule. However, Notice 2008-78[35] provides that (1) a capital contribution made within two years of a 50-percentage-point change in ownership will not be presumed to have such a purpose, and (2) a capital contribution in general will not be treated as having such a purpose if one of several conditions is satisfied. While Notice 2008-78 is generally applicable and is not limited to capital injections by the federal government into struggling financial institutions such as Fannie Mae and Freddie Mac, the timing of the guidance makes apparent that its issuance was inspired by the growing expectation that the government would be called upon to provide capital to a wide swath of the financial services industry and the need to eliminate

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the impact of the antiloss trafficking rules on capital contributions that clearly are not motivated by a purpose to circumvent these rules.

Even though Notice 2008-78 is generally applicable beyond capital contributions by the federal government, most of the financial crisis guidance issued by the Treasury and the IRS concerning the application of the antiloss trafficking rules was brought about by circumstances in which the federal government itself is acquiring equity ownership (or options to acquire equity ownership). The one exception is Notice 2008-83,[36] which provides that the antiloss trafficking rules do not apply to limit deductions for losses on loans or bad debts of a bank that undergoes a change of ownership of more than 50 percent of the bank's stock that normally would trigger the application of the antiloss trafficking rules to such losses and bad debts. Like the treatment of capital contributions under Notice 2008-78, Notice 2008-83 is not limited to ownership changes involving the acquisitions of stock or warrants by the federal government and applies to ownership changes brought about by stock or warrant acquisitions by a private acquirer. Unlike Notice 2008-78, however, Notice 2008-83 is widely believed to have facilitated two major private acquisitions of troubled financial institutions—the acquisition of Wachovia Corp. by Wells Fargo & Co. and the acquisition of National City Corp. by PNC Financial Services Group, Inc. As a result, Notice 2008-83 has attracted loud criticism of the Treasury over its motives for issuing the guidance and its authority to preclude the application of statutory rules in this particular instance. In fact, two bills have been introduced in Congress to overturn Notice 2008-83.[37]

As it became increasingly clear that the federal government rescues of Fannie Mae, Freddie Mac and AIG would not be isolated incidents and that a more formal program of recapitalizing the financial services industry would be needed in response to the persistent credit crisis and emerging problems in the broader economy, Congress, on October 3, 2008, enacted the Emergency Economic Stabilization Act of 2008 (EESA).[38] Under the authority of this legislation, the Treasury unveiled the Capital Purchase Program (CPP) pursuant to which the federal government would recapitalize troubled financial institutions in exchange for preferred stock and warrants issued by the institutions receiving capital infusions.

Released in conjunction with the CPP and building on the more narrow guidance previously issued specifically to address the impact of the antiloss trafficking rules on the federal government rescues of Fannie Mae, Freddie Mac and AIG, Notice 2008-100[39] provides more comprehensive guidance concerning the application of these rules to federal government capital infusions in exchange for equity interests in the capitalized firms. Notice 2008-100 sets forth a series of provisions pertaining to the application of the antiloss trafficking rules to CPP transactions, all of which are designed to prevent government capital infusions, acquisitions and dispositions of stock and acquisitions and the exercise of warrants from triggering the application of the antiloss trafficking rules to the losses of the capitalized companies.

For the most part, this series of guidance appropriately limits the effects of the antiloss trafficking rules on transactions that clearly are not intended to transfer the tax benefits of net operating losses or other tax losses. It remains to be seen whether this guidance will precipitate a rethinking by the Treasury and the IRS of its customarily sweeping interpretations of the antiloss trafficking rules and, more important, whether Congress will reconsider whether sound tax policy should, in fact, oppose the practice of acquiring control of firms for the purpose of acquiring their tax benefits associated with recognizable losses.

Notice 2008-92

Segregated asset accounts maintained by insurance companies that support variable life insurance or annuity contracts are required to be adequately diversified.[40] For purposes of determining whether a segregated asset account is adequately diversified, each agency or instrumentality of the U.S. government that issues securities held by the account is treated as a different issuer.[41] In addition, investments in U.S. Treasury securities held by a segregated asset account that supports a variable life insurance contract (but not a variable annuity contract) are automatically treated as adequately diversified.[42] These rules are intended to facilitate investment in securities issued by the federal government without violating the adequate diversification requirement.

IRS administrative policy also limits investments by segregated asset accounts to investments in assets that are available only through the purchase of a life

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insurance contract or annuity contract.[43] Otherwise, the holder of the variable contract (rather than the segregated asset account supporting the contract) may be treated as the owner of the assets held by the account, resulting in the loss of tax-deferral benefits associated with investing in a contract offered by a life insurance company.

For money market funds participating in the Treasury program to insure the ability of money market funds to maintain their one-dollar-per-share net asset values, concerns arose about whether participation in the program by funds whose beneficial interests are held exclusively by segregated asset accounts would violate the adequate diversification requirement or the requirement that the account hold assets that are available exclusively through a variable contract.

Notice 2008-92[44] provides that participation in the program will not result in a violation of the adequate diversification requirement and will not cause the holder of an account investing in a participating fund to be treated as the owner of the account's investment in the fund.

Notice 2008-94

As part of the creation of the Troubled Assets Relief Program (TARP) enacted in EESA, Congress tightened existing rules concerning the tax treatment of executive compensation and golden parachute payments made by financial institutions that sell troubled assets to the Treasury as part of the TARP. For institutions that sell more than $300 million in troubled assets to the Treasury, the existing $1 million limit on the deductibility of non–performance-based compensation paid to the five most highly compensated employees (including the chief executive officer)[45] is, among other things, (1) reduced to $500,000, (2) not limited to non–performance-based compensation and (3) applied to both publicly traded and non–publicly traded companies (the limitation normally is applied only to publicly traded companies). Once a financial institution has sold more than $300 million in assets to the Treasury, the reduced limitation on the deductibility of executive compensation applies to the institution for the remainder of the period during which the TARP program is in place (that is, through October 3, 2010).

Existing tax rules generally disallow a deduction for golden parachute payments if the payment exceeds three times the recipient's average annual compensation over the preceding five years.[46] In addition, an excise tax in the amount of 20 percent of the payment is imposed upon the recipient.[47] A golden parachute payment to which these rules apply includes any payment made on account of a change in the ownership or control of a company or a substantial portion of its assets. For institutions that sell more than $300 million in troubled assets to the Treasury as part of the TARP, the existing rules are extended to payments made by reason of an involuntary termination of the recipient by the institution or in connection with a bankruptcy, liquidation or receivership of the institution.

Notice 2008-94[48] provides guidance implementing the executive compensation and golden parachute provisions of EESA, including a series of questions and answers explaining particular features of these provisions.

As executive compensation practices come under even more scrutiny than they already have been in recent years, it is expected that the restrictions imposed by EESA on firms participating in the TARP could serve as a template for broader—and more permanent—restrictions on executive compensation. If so, Notice 2008-94 likely would serve as a starting point for interpreting and implementing such restrictions.

Notice 2008-101

During the savings and loan crisis of the 1980s, financial assistance provided by the Federal Deposit Insurance Corporation (FDIC) or Resolution Trust Corporation (RTC) in connection with the acquisition of failed institutions generally was excluded from tax liability. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)[49] repealed this exclusion for assistance received pursuant to any acquisition that occurred after May 10, 1989, regardless of whether the acquiring institution gave stock, warrants, notes or other consideration in exchange for the assistance.[50]

Notice 2008-101[51] provides that assistance extended by the Treasury to a financial institution pursuant to the TARP will not constitute financial assistance subject to tax under the FIRREA provision. Presumably, this guidance was necessary because the regulations issued under the FIRREA provision apply the provision to assistance provided by the FDIC, RTC or "any similar instrumentality of the United States government." Notice 2008-101 clarifies that the Treasury does not constitute an instrumentality similar to either the FDIC or RTC.

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Rev. Proc. 2008-64

The problems at Fannie Mae and Freddie Mac that ultimately led them to be placed into conservatorship by the Treasury pursuant to the authority granted by Congress in the Housing and Economic Recovery Act of 2008 triggered steep declines in the value of Fannie Mae and Freddie Mac preferred stock, which was widely held by banks. As with most other taxpayers, losses incurred by banks from the sale or exchange of stock generally constitute capital (rather than ordinary) losses, but these losses are particularly difficult for banks to offset with capital gains because—unlike most other taxpayers—gains from the sale or exchange of debt instruments by banks generally are treated as ordinary income,[52] which cannot be used to offset capital losses.

In EESA, Congress permitted banks and bank holding companies to treat losses from the sale or exchange of Fannie Mae or Freddie Mac preferred stock as ordinary (rather than capital), provided the stock was either (1) sold or exchanged between January 1, 2008, and September 6, 2008, or (2) held by the bank or bank holding company on September 7, 2008. By its terms, EESA only applies to sales of actual preferred stock directly by a bank or bank holding company. However, many banks have held Fannie Mae or Freddie Mac preferred stock through nonbank subsidiaries or adjustable-rate preferred interests in pass-through trusts that are treated as partnerships for tax purposes. In the legislative history of EESA, Congress encouraged the Treasury and the IRS to provide guidance applying the provision to, among other things, sales or exchanges of Fannie Mae or Freddie Mac preferred stock held by banks through nonbank subsidiaries or pass-through interests.

Rev. Proc. 2008-64[53] implements this directive by applying EESA to sales or exchanges of Fannie Mae or Freddie Mac preferred stock in the following circumstances: by a partnership in which a bank is a partner; by a bank of an interest in a partnership at least 95 percent of the assets of which consist of such preferred stock; by a bank after having received the stock after September 6, 2008, in a distribution by a partnership at least 95 percent of the assets of which consist of such stock; by a nonbank subsidiary of a bank; or by a bank after having received the stock after September 6, 2008, in a nontaxable transaction (such as a corporate reorganization involving the bank).

Notice 2009-1

Unlike qualified retirement plans such as individual retirement accounts (IRAs) and 401(k) plans, qualified tuition programs established under Code section 529 ("529 plans") are limited in their ability to permit changes to investment strategies within a 529 plan account after the initial contribution establishing the account.[54] IRS administrative policy generally permits contributors and designated beneficiaries to change their investment strategy for a 529 plan account once per calendar year and upon a change in the designated beneficiary of the account (provided the terms of the 529 plan itself permit these changes).[55]

In response to the rapid and widespread deterioration of the financial markets, Notice 2009-1[56] provides that 529 plan contributors and designated beneficiaries may change their investment strategy twice (rather than once) during calendar year 2009, as well as upon a change in the designated beneficiary of the account (again, provided the terms of the 529 plan itself permit these changes).

Tax Guidance Covers a Wide Range of Issues

Perhaps what is most striking about this digest of financial crisis tax guidance issued by the Treasury and IRS over the past year is the sheer breadth of issues that the guidance has addressed—everything ranging from the tax-exempt bond rules to the anti-loss-trafficking rules to the international tax rules. With the help of practitioners and others who have identified these issues, the Treasury and the IRS are to be commended for the attention that they have given these often obscure problems and the speed with which they have responded to them. Also remarkable is how frequently the financial crisis has produced tax consequences that seem almost comically irrational, which just shows how—as with almost everything else in the financial system today—we are now living in times that are far from normal.

Endnotes

1 Section 860F(a)(1) and (2) of the Internal Revenue Code of 1986, as amended (hereinafter, "the Code" and "Code Sec.").

2 Code Sec. 860G(a)(1) and (3)(A)(i) and (ii); Reg.

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§301.7701-4(c).

[3] Rev. Proc. 2007-72, IRB 2007-52, 1257.

[4] For example, so-called 2/28 and 3/27 ARM loans would satisfy this requirement because they provide for a fixed interest rate during the first two years (in the case of 2/28 loans) or three years (in the case of 3/27 loans), after which the interest rate converts to an adjustable rate for the remaining 28 years (in the case of 2/28 loans) or 27 years (in the case of 3/27 loans).

[5] Rev.Proc. 2008-47, IRB 2008-31, 272.

[6] Rev.Proc. 2008-28, IRB 2008-23, 1.

[7] Reg. §1.860G-2(b)(3)(i).

[8] Reg. §1.1001-3.

[9] Notice 2008-27, IRB 2008-10, 543.

[10] Notice 2008-41, IRB 2008-15, 742.

[11] Notice 2008-88, IRB 2008-42, 933.

[12] Code Sec. 956(a).

[13] Code Sec. 956(c)(2).

[14] Code Sec. 956(c)(2)(K).

[15] Rev. Proc. 2008-26, IRB 2008-21, 1014.

[16] Notice 2008-108, 1988-2 CB 445.

[17] Notice 2008-91, IRB 2008-43, 1001.

[18] Notice 2008-55, IRB 2008-27, 1.

[19] Code Sec. 163(i).

[20] Rev. Proc. 2008-51, IRB 2008-35, 562.

[21] Notice 2008-81, IRB 2008-41, 1.

[22] Although not directly related to the Treasury program or the demise of Lehman Brothers, the IRS later in the year issued Rev. Proc. 2009-10, IRB 2009-2, 1 (Dec. 24, 2008), which provides guidance on the tax consequences when investment advisors or managers make payments to a money market fund, or purchase assets from a money market fund for an amount that exceeds the asset's fair market value, in order to maintain a one-dollar-per-share net asset value of the fund and prevent the fund from breaking the buck.

[23] *Id*.

[24] Code Sec. 1058(a).

[25] Code Sec. 1058(b)(1).

[26] Rev. Proc. 2008-63, IRB 2008-42, 946.

[27] Code Sec. 382(a).

[28] Code Sec. 382(g).

[29] Code Sec. 382(b)(1).

[30] Housing and Economic Recovery Act of 2008 (P.L. 110-289).

[31] Notice 2998-76, IRB 2008-39, 768.

[32] Notice 2008-84, IRB 2008-41, 1.

[33] Code Sec. 382(l)(1)(A).

[34] Code Sec. 382(l)(1)(B).

[35] Notice 2008-78, IRB 2008-41, 1.

[36] Notice 2008-83, IRB 2008-42, 905.

[37] H.R. 7300 (introduced on November 20, 2008, by Representative Lloyd Doggett); S. 3692 (introduced on November 19, 2008, by Senator Bernard Sanders).

[38] Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

[39] Notice 2008-100, IRB 2008-44, 1.

[40] Code Sec. 817(h).

[41] Code Sec. 817(h)(6).

[42] Code Sec. 817(h)(3).

[43] Rev. Rul. 2003-92, 2003-2 CB 350.

[44] Notice 2008-92, IRB 2008-43, 1001.

[45] Code Sec. 162(m).

[46] Code Sec. 280G.

[47] Code Sec. 4999.

[48] Notice 2008-94, IRB 2008-44, 1.

[49] Financial Institutions Reform, Recovery and Enforcement Act of 1989 (P.L. 101-73).

[50] Code Sec. 597.

[51] Notice 2008-101, IRB 2008-44, 1.

[52] Code Sec. 582(c)(1).

[53] Rev. Proc. 2008-64, IRB 2008-47, 1195.

[54] Code Sec. 529(b)(4).

[55] Notice 2001-55, 2001-2 CB 299.

[56] Notice 2009-1, IRB 2009-2, 1.

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