Editor’s Note

When U.S. voters go to the polls on November 6, they may not understand much about the respective candidates’ tax policies but that won’t be because Tax Talk didn’t try. In this issue we continue our quadrennial review of the Republican and Democratic presidential candidates’ tax proposals. Unfortunately, as you will observe, details are in short supply. No matter who wins, however, taxpayers face an uncertain tax landscape with 2013 right around the corner. Tax reform is again in the air (or maybe just a six month extension of current law until the next Congress figures out what to do). Anyway, our regular readers will realize we are fixated on FATCA (www.KNOWFatca.com) and Q3 is no different. In this issue, we report on the first “FATCA substitute” intergovernmental agreement announced on September 14th between the United States and the United Kingdom. The agreement provides for information sharing between the two countries and gives a FATCA pass to participating UK financial institutions. In other tax news, the IRS issued a private letter ruling that income from excess mortgage servicing qualifies as a good REIT asset and produces good REIT income. We suspect this ruling will be the foundation on which a new class of REITs will be constructed. Also, after several disappointing taxpayer defeats, the Tax Court finally took the taxpayer’s side on a debt-equity case in Pepsico Puerto Rico, Inc. v. Commissioner. In Dorrance v. United States, a Federal District Court ruled on the tax consequences of demutualizing an insurance company. In CCA 201238025, the IRS addressed whether the taxpayer was a dealer in trust preferred securities and whether a one-year cessation of dealer activities during the height of the illiquid markets during the financial crisis meant the taxpayer was not a dealer in securities under Section 475. In the area of foreign currency transactions, the IRS promulgated proposed and final regulations addressing “legging in” and “legging out” of foreign currency integration elections. Finally, in Bartlett v. Commissioner, the Tax Court rejected a taxpayer’s attempt to blame TurboTax for underreporting income. Nice try. Our regular section, Mofo in the News, is included as well.

IN THIS ISSUE

2 Obama v. Romney Tax Plans
2 IRS Rules That Excess Mortgage Servicing Is “Good” Asset and Produces “Good” Income for REIT purposes
3 Tax Court Finds Arrangement to be Equity for Tax Purposes in Pepsico Puerto Rico, Inc. v. Commissioner
3 Court Addresses Demutualization Tax Treatment in Dorrance v. United States
4 United States and United Kingdom Enter into FATCA Cooperation Agreement
4 IRS Issues Guidance on Dealer Status
5 IRS Releases Regulations on Integrated Hedging Transactions of Qualifying Debt
5 Tax Court: TurboTax Not to Blame for Underreporting of Income
6 More Uncertainty Regarding Medicare Tax
7 MoFo in the News

Authored and Edited By

Thomas A. Humphreys
Anna T. Pinedo
Stephen L. Feldman
Remmelt A. Reigersman
David J. Goett
IRS Rules That Excess Mortgage Servicing Is “Good” Asset and Produces “Good” Income for REIT Purposes

PLR 201234006 (August 24, 2012) answers the long-asked question whether “excess” mortgage servicing can be a good REIT asset and produce good REIT income. The answer is yes, and we expect a number of offerings of REITs formed to hold “excess” mortgage servicing.

In the ruling, a mortgage servicer received mortgage servicing fees on mortgage pools that it serviced. The servicing fee was a fixed percentage of the mortgage principal balance. The mortgage servicing fee consisted of a reasonable fee for services and an “Excess Servicing Spread,” representing the servicing fee in excess of a reasonable servicing fee. The taxpayer proposed to spin off a real estate investment trust ("REIT") that would purchase and hold the Excess Servicing Spread.

The IRS treated the Excess Servicing Spread as a “coupon strip” under Section 1286.1 The ruling also holds that for REIT purposes, the Excess Servicing Spread is an interest in a mortgage on real property and therefore a qualifying “real estate asset” for REIT purposes. Moreover, the ruling holds that the Excess Servicing Spread coupon strip produces qualifying income for REIT purposes.

Historically, practitioners wondered whether a coupon could be a qualified “real estate asset” when the REIT did not actually own an interest in the mortgage loan principal. The ruling answers the question in the affirmative and will pave the way for REITs to be set up to acquire these amounts from banks. In particular, because master servicing rights under Basel III are subject to relatively unfavorable regulatory capital treatment in that they may be subject to at least partial deduction from common equity Tier 1 capital and penalty risk-weightings it may be attractive for a bank to separate its servicing into reasonable servicing fees and excess servicing and sell off the excess portion to reduce the unfavorable regulatory capital charge associated with servicing rights. The private letter ruling, however, is issued to the taxpayer that requested it and cannot be relied upon by other taxpayers.

Obama v. Romney Tax Plans

With the presidential election in the final stretch, Barack Obama and Mitt Romney have laid out tax plans that represent different fundamental beliefs about the tax code. This chart outlines some of the major differences between the plans.

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<th>President Obama</th>
<th>Mitt Romney</th>
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<tr>
<td>Individual Tax Rates</td>
<td>Maintain current rates for taxpayers earning up to $250,000 per year; increase rates for two highest brackets</td>
<td>Reduce all individual rates 20 percent</td>
</tr>
<tr>
<td>Estate Tax</td>
<td>Restore 45 percent estate tax after $3.5 million exemption, instead of current 35 percent estate tax after $5 million exemption</td>
<td>Eliminate the estate tax</td>
</tr>
<tr>
<td>Investment Income</td>
<td>Tax dividends at ordinary rates for two highest brackets</td>
<td>Eliminate 3.8 percent Medicare tax; eliminate tax on dividends for individuals making less than $200,000</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>Increase tax on capital gains from 15 percent to 20 percent for two highest brackets</td>
<td>Eliminate tax on capital gains for individuals making less than $200,000</td>
</tr>
<tr>
<td>Corporate Tax</td>
<td>Lower top rate from 35 percent to 28 percent</td>
<td>Lower top rate from 35 percent to 25 percent; move international taxation of corporations to a territorial system</td>
</tr>
</tbody>
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Source: [www.barackobama.com/taxes](http://www.barackobama.com/taxes) [www.mittromney.com/issues/tax](http://www.mittromney.com/issues/tax)

Spread as a “coupon strip” under Section 1286.1 Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended.

Tax Court Finds Arrangement to Be Equity for Tax Purposes in *Pepsico Puerto Rico, Inc. v. Commissioner*  

In *Pepsico Puerto Rico, Inc. v. Commissioner*, the U.S. Tax Court found that PepsiCo’s “advance agreements” between two Pepsico U.S. subsidiaries and a Netherlands affiliate were equity.

(Continued on Page 3)
Pepsico Puerto Rico, Inc. v. Commissioner

(Continued from Page 2)

rather than debt for federal income tax purposes. This, in turn, permitted the Pepsico U.S. subsidiaries to treat payments on the advance agreements as nontaxable returns of capital rather than interest payments for the taxable years in question.

Pepsico designed the advance agreements to be equity for U.S. tax purposes and debt for Dutch tax purposes. They were used to fund Pepsico’s international expansion during the 1990s. To create the advance agreements, Pepsico contributed notes issued by Frito Lay Inc. to the Netherlands affiliate. Interest on the Frito Lay notes paid to the Netherlands affiliate was deductible by Frito Lay in the U.S. and exempt from U.S. withholding tax under the U.S.-Netherlands tax treaty. The structure was designed, however, so that payments on the advance agreements, which mirrored interest payments on the Frito Lay notes, were distributions on equity and not includable in Pepsico’s taxable income.

The advance agreements provided for 40-year terms plus a potential 10-year extension at the issuer’s option (which could then be followed by another five-year extension). If any affiliate loan receivables held by the issuer (i.e., the Netherlands affiliate) defaulted, the advance agreements became perpetual. The advance agreements accrued a preferred return, but the preferred return was payable by the issuer only under certain circumstances including that the issuer’s net cash flow exceeded its operating expenses and capital expenditures. The advance agreements were subordinate to all of the issuer’s indebtedness.

The IRS had argued that the advance agreements were debt for federal income tax purposes. It pointed to Pepsico’s discussions with Dutch tax authorities that focused on treating the instruments as debt for Dutch tax purposes. It also pointed to the subordination features, the long term, and the fact that the instruments were not equity under local law.

The Tax Court (Judge Goeke), however, found that the advance agreements constituted equity for federal income tax purposes. The Court looked at 14 debt-equity factors found in Fin Hay Realty v. U.S. 3 Although a maturity date is necessary for debt, the Tax Court found that a receivable default that converted the advance agreements to perpetual instruments was possible. It also found that the subordination and the intent of the parties indicated equity.

The case is one of the few instances in the past few years where a taxpayer’s characterization of an instrument as debt or equity has been upheld by the courts. IRS victories in TIFD III, 4 Hewlett-Packard, 5 and Pritired found that purported equity instruments were actually debt for federal income tax purposes. One distinguishing factor is that, at least according to the court, Pepsico entered into the transaction to fund its expanding overseas business rather than creating a transaction to result in U.S. tax benefits, a factor that to a greater or lesser degree was present in each of the other cases.

At issue in Dorrance v. United States 6 was the proper tax treatment of stock received by taxpayers during the process of demutualization of a mutual insurance company.

In 1995, the taxpayers formed a trust that purchased five life insurance policies so that, upon the death of the taxpayers, their heirs would have liquidity to pay estate taxes and would not be forced to liquidate the family stock portfolio. The five life insurance policies were purchased from mutual insurance companies. Policyholders in a mutual insurance company are given certain rights in addition to their life insurance policy; they vote on corporate decisions and are given surplus if the company should liquidate. The court decision refers to these rights as “mutual rights.”

From 1995 until 2001, the five mutual life insurance companies servicing the taxpayers’ policies were all demutualized. In a demutualization, the mutual insurance company becomes a standard stock company under local law and the policyholders (who must approve the demutualization process) are given the option of accepting cash or stock in return for their mutual rights, but their policies remain unchanged and they continue to pay the same premium.

The taxpayers chose to accept stock worth nearly $1.8 million, which they later sold for $2.2 million. The taxpayers paid tax upon sale of the stock following IRS policy that no basis was attributable to the mutual rights. The taxpayers then sued for a refund in the Arizona Federal District Court.

The court in Dorrance was presented with competing motions for summary judgment from the government and from the taxpayers. The government sought summary judgment on the grounds that the entirety of the premiums paid by the taxpayers was paid to purchase the policy and, therefore, no basis should be allocated to the mutual rights.

The taxpayers, on the other hand, argued that the open transaction doctrine should apply. Under this approach, the amount realized on the sale of the stock would

3 398 F.2d 694 (3d Cir. 1968).
6 110 AFTR 2d 2012-5176.
Dorrance v. United States
(Continued from Page 3)

represent a return of capital on the entire amount of premiums paid by the taxpayers, resulting in no tax. The end result would be that the gain would never be taxed, assuming the insured died (in which case the amount of premiums paid would be irrelevant).

The open transaction doctrine allows a taxpayer to offset gain from the sale of a portion of property against the entire basis in the property. The taxpayers cited another demutualization case, Fisher v. United States,7 in which the taxpayer successfully argued that the entire amount of premiums paid during the life of the policy was a capital investment and cash received upon demutualization was a return of capital on the investment.

The Dorrance court struck a middle path by denying both summary judgment motions and finding that the basis should be equitably apportioned among the assets. The government’s argument was rejected because the taxpayer had shown that it had paid something for the mutual rights. The court also found, however, that the open transaction doctrine should apply only in “rare and exceptional” circumstances. The court found that demutualization was not such a rare and exceptional circumstance, and the taxpayer’s basis in the combined policy and mutual rights could be equitably apportioned between the divided assets.

The court did not address which method of apportionment would be most appropriate but noted two approaches that seemed reasonable. First, the basis allocated to the policy could be inferred by comparing the cost of the policy to comparable life insurance policies issued by nonmutual insurance companies. On the other hand, some commentators suggest that it would be more appropriate to apportion basis by comparing the fair market value of the policy and the stock at the time of demutualization.

United States and United Kingdom Enter into FATCA Cooperation Agreement

On September 14, the United States and the United Kingdom announced an intergovernmental agreement “To Improve Internal Tax Compliance and to Implement FATCA.” The agreement is the first of its kind although the U.S. has announced negotiations on similar agreements with several other countries.

The gist of the Cooperation Agreement is that U.S. and UK financial institutions will report information to their respective governments about citizens from the other country that hold accounts at the financial institution. For example, UK financial institutions will report information about U.S. persons that hold accounts with the UK financial institution to the U.K. government. The U.S. and UK tax authorities will then automatically share this information under the information exchange provisions of the U.S.-UK Income Tax Treaty.

The benefit of the Cooperation Agreement is that a “Reporting United Kingdom Financial Institution” gets an exemption from the FATCA Section 1471 withholding tax so long as it supplies the required information to the UK government. It must also (i) for 2015 and 2016, report to the UK tax authorities the name of each Nonparticipating Financial Institution (“NFI”) to which it makes payments (and their amount), (ii) comply with certain registration requirements for financial institutions in partner jurisdictions (i.e., those countries that have also signed cooperation agreements with the U.S.), and (iii) either withhold on payments of U.S. source withholdable payments made to NFIs or provide information to the next person up the chain information with respect to such NFI that would permit that person to withhold.

Another key feature of the Cooperation Agreement is the extensive list of exemptions. These are entities that will be treated as FATCA compliant. They include UK pension schemes, UK nonprofit organizations, and U.K. financial institutions with a local client base including credit unions, industrial and provident societies, and building societies among others.

Automatic information exchange under the Cooperation Agreement must occur before September 30, 2015 for 2013 and by September 30 of the following year for calendar years beginning with 2014.

IRS Issues Guidance on Dealer Status

The IRS issued a Chief Counsel Advice Memorandum on September 21, 2012, addressing whether a taxpayer (a parent company) that regularly bought and sold securities qualified as a dealer, despite one year in which the taxpayer suspended its trading activities due to distressed markets.

In CCA 201238025, the taxpayer regularly bought trust preferred securities (TruPs) from various regional banks, warehousing them in trusts formed by its subsidiary. The TruPs were “repackaged” and combined with other debt sold by insurance companies and REITs, and once enough debt was accumulated, the trust would issue securities to third-party investors.

The taxpayer received a warehousing fee from the issuers of the trust securities. In earlier years, the taxpayer did not report any gain or loss on the TruPs, but as the securitization market began to dry up, the taxpayer was forced to retain the TruPs for longer periods of time. These later years,

7 82 Fed. Cl. 750 (Fed. Cl. 2008).
the taxpayer began to mark to market its losses, claiming that it had always marked to market the TruPs but never had occasion to in prior years.

The IRS first dealt with the preliminary issue of whether the taxpayer qualified as a dealer in securities, and if so, whether it ceased to qualify once the securitization market dried up. The IRS found that the taxpayer was engaged in the buying and selling of securities, as evidenced by the taxpayer’s buying debt from regional banks and selling to the trusts. The IRS then analyzed whether the taxpayer was buying and selling securities to customers and noted that courts had traditionally looked to how the taxpayer was compensated. In concluding that the taxpayer was compensated through its function as a “middleman,” indicative of a dealer, rather than through a rise in value indicating an investment, the IRS looked to the fact that the taxpayer served as a middleman that brought together buyers and sellers. Finally, despite the fact that the taxpayer ceased to sell TruPs in later years, the IRS concluded that “the Service should not take the position that a taxpayer no longer qualified as a dealer because it held securities rather than [sic] sold them at severely distressed market prices during this time.”

The IRS then addressed whether the taxpayer made an unauthorized change in accounting by marking to market its TruPs in later years. Although the taxpayer did not report any mark to market gains or losses in prior years, the IRS noted that there was a possibility that this was due to the fact that there was no gain or loss to report in these years. The taxpayer claimed that it did not have gain or loss in these years because it always bought and sold at par value, which at all times equaled fair market value. The Chief Counsel Advice concluded by advising the Area Counsel to inquire whether there were any gains or losses in earlier years equal to fair market value. The Chief Counsel Advice concluded by advising the Area Counsel to inquire whether there were any gains or losses in earlier years.

On September 6, 2012, the IRS issued final and temporary regulations addressing foreign currency denominated debt that is hedged by a combination of multiple hedging transactions. In general, Treas. Reg. 1.988-5 permits taxpayers to integrate a qualifying debt instrument with a hedge in order to create a synthetic debt instrument that is treated as an integrated economic transaction. If the taxpayer disposes of either the qualifying debt instrument or the hedge but retains the other piece, the taxpayer is said to have “legged out” of the integrated transaction. In addition to recognizing gain or loss on the transaction actually disposed of, the taxpayer is deemed to have disposed of the other piece for its fair market value. The purpose of the deemed disposition is that the gain or loss on the actual disposition will be offset by the gain or loss on the deemed disposition.

When hedging a qualifying debt instrument, taxpayers may enter into multiple transactions whose effect in the aggregate is to hedge a qualifying debt instrument in a particular way. For example, a taxpayer that receives a fixed-rate loan denominated in British pounds may wish to hedge against currency risk by entering into a currency swap that, when integrated with the loan, has the economic effect of creating a synthetic debt instrument that is a fixed-rate loan denominated in U.S. dollars. The taxpayer also wishes to hedge against fluctuations in interest rates, the taxpayer may further enter into an interest rate swap that, when combined with the already-integrated transaction, has the economic effect of creating a new synthetic debt instrument that has a variable rate and is denominated in U.S. dollars. In this case, the qualifying debt instrument is hedged by two financial contracts, a currency swap and an interest rate swap. The integration rules allow the taxpayer to integrate the loan, the currency swap, and the interest rate swap, and treat the three contracts as a single integrated transaction: a variable-rate loan denominated in U.S. dollars.

According to the preamble of the proposed and final regulations, the IRS has recently become aware of taxpayers that take the position that legging out of only one piece of an integrated transaction does not require recognition of gain or loss on every piece of the integrated transaction. In the example above, such a taxpayer would take the position that, under the legging-out rules, the disposition of the interest rate swap requires the taxpayer to recognize gain or loss on a deemed disposition of the loan, but not on the retained portion of the hedge, that is, the currency swap.

The purpose of the proposed and final regulations is to make clear that if any component of an integrated transaction is disposed of, all of the remaining components shall be treated as sold for their fair market value on the legging-out date.

On September 4, 2012, the Tax Court filed a memorandum opinion rejecting a taxpayer’s attempt to blame TurboTax for misreporting the taxpayer’s income. In Bartlett v. Commissioner, the taxpayer argued that she made “honest mistakes” and that the underreporting of over $100,000 of income was due to a lack of familiarity with TurboTax, believing that the audit feature of the software would catch...
MoFo in the News

On July 18, 2012, MoFo, along with Grant Thornton LLP, hosted a seminar titled “JOBS Act, Theory and Practice.” Led by MoFo partners David Lynn and Anna Pinedo, along with David Weild of Grant Thornton, the seminar addressed the many issues raised by the Jumpstart Our Business Startups Act (JOBS Act). The panel also discussed how the JOBS Act is being implemented by the SEC, issuers, investment banks, and practitioners.

MoFo partner David Kaufman spoke on a panel at the Hedge Funds and Alternative Investments Conference on July 19, 2012. The panel focused on regulatory reform updates and discussed the evolving regulatory and registration environment, reporting requirements, and strategies for passing SEC examinations.

On July 24, 2012, MoFo partner Charles Horn spoke on a Protiviti webinar titled “The Terrible Two’s: Dodd-Frank’s Second Anniversary.” The webinar discussed the Dodd-Frank rule-making progress and provided a view into key upcoming decisions that will further impact financial services organizations.

MoFo partner Dwight Smith led a Bloomberg LP seminar on “Managing Risk: Can Dodd-Frank Prudential Regulations Prevent Another Crisis,” on July 26, 2012. This seminar provided an overview of Dodd-Frank’s compliance requirements including capital and liquidity requirements, reporting, and examinations leading to potential operational changes.

On July 31, 2012, MoFo partners Jay Baris, David Kaufman, Kenneth Kohler, Anna Pinedo, and Dwight Smith participated in an IFLR webinar titled “The Dodd-Frank Act’s Second Anniversary.” This seminar provided a status update at the second anniversary milestone on Dodd-Frank rule-making progress. Panelists focused on concerns for foreign banks, funds and advisers and addressed several major areas, including developments affecting funds and their advisers, prudential supervision, SIFI designation, Orderly Liquidation Authority and resolution planning, ratings and securitization, and derivatives.

MoFo partner Dwight Smith also led a Financial Executives Networking Group webinar on August 1, 2012, on “How Much Capital Is ‘Enough’? Understanding the New Regulatory Capital Needs of U.S. Financial Institutions.” This seminar discussed the impact of these proposed regulations on sources and uses of funds on both financial and nonfinancial institutions; overview of new capital requirements: core elements, minimum requirements, and transition periods; components of common equity, additional Tier 1 and Tier 2 Capital; regulatory capital adjustments and deductions; elements and consequences of the standardized approach risk weights; and differences between the proposed rules and Basel III and CRD IV.

MoFo partner Anna Pinedo also participated in the ALI-ABA Webcast/Teleseminar “Swap Definitions, Mixed Swaps, and Books and Records Requirements: New Joint Rules from the CFTC and the SEC” on August 2, 2012. This webinar discussed opportunities for private capital entering the mortgage market, the mortgage REIT market, considerations for structuring certain activities within a mortgage REIT, mortgage servicing assets, nonbank participation in the mortgage market, and the covered bond market.

MoFo partner Anna Pinedo also participated in the American Bar Association’s Mortgage Bankers Association webinar, “How to Evaluate Private Capital—Alternatives to Securitization” on August 2, 2012. This webinar discussed opportunities for private capital entering the mortgage market, the mortgage REIT market, considerations for structuring certain activities within a mortgage REIT, mortgage servicing assets, nonbank participation in the mortgage market, and the covered bond market.

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(Continued on Page 7)
book and records with respect to "security-based swap agreements."

On August 28, 2012, MoFo partners Anna Pinedo and Kenneth Kohler led a MoFo telephone briefing titled "Proposed Bank Capital Rules and the Mortgage Market." This telephone briefing discussed the effects of the proposed bank capital rules on the U.S. mortgage market. Discussion focused on the aspects of the proposals affecting residential mortgages, mortgage servicing rights, and securitization exposures.

The MoFo Tax Department was a sponsor of the Circle of Hope Gala held Wednesday, September 19 at The Beverly Hills Hotel. The Gala supports One Mind for Research (www.1mind4research.org), a charity dedicated to research, funding, marketing, and public awareness of mental illness and brain injury, by bringing together the governmental, corporate, scientific, and philanthropic communities in a concerted effort to drastically reduce the social and economic effects of mental illness and brain injury within ten years.

MoFo tax partners Patrick McCabe and Tom Humphreys attended the event which was MC’d by Tom Hanks.

Upcoming Events

MoFo partner Anna Pinedo will speak at the GARP Master Class program on October 24, 2012. This program will include a comprehensive overview of major regulatory proposals such as Basel II.5, Basel III, the Dodd-Frank Act, CRD IV, EMIR, U.S. implementation of Basel III, derivatives trading, counterparty credit risk, competitive changes in the capital markets and the securitization markets. Anna Pinedo will deliver the session titled "How Has the Dodd-Frank Act Framed the U.S. Response to the Crisis?"

On November 2, 2012, MoFo partner Anna Pinedo will speak at the Cornell Law School Symposium on Law, Innovation and Entrepreneurship. This symposium will focus on federal and state legal and regulatory issues that affect entrepreneurship and new business, including changes in how new businesses are formed and governed, proposed reforms affecting intellectual property rights, and recent (and pending) developments in the federal securities laws. Authors at the symposium will present their papers, and comments from a designated commentator will follow.

MoFo partner David Lynn will moderate a discussion at the PLI 44th Annual Institute on Securities Regulation taking place November 7-9, 2012. The panel, titled "Jumpstarting Capital Formation—The New Legislation and Other Developments," will discuss the practical impacts of the JOBS Act, measures to foster capital formation while maintaining investor protection, changes in the communications environment after the JOBS Act, dealing with nonpublic public companies, increased pressure for resale liquidity, and the impact of market structure changes on capital raising.

MoFo partners Anna Pinedo and Remmelt Reigersman will conduct a seminar titled "MoFo Classics: Debt Repurchases & Exchanges" on November 8, 2012. With many debt securities trading at discounted levels, this session will discuss the structuring, documentation, securities law, and tax consequences associated with debt repurchases, tenders, and exchanges.

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Contacts

**United States Federal Income Tax Law**

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
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</thead>
<tbody>
<tr>
<td>Thomas A. Humphreys</td>
<td>(212) 468-8006</td>
<td><a href="mailto:thumphreys@mofo.com">thumphreys@mofo.com</a></td>
</tr>
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</tr>
<tr>
<td>Stephen L. Feldman</td>
<td>(212) 336-8470</td>
<td><a href="mailto:sfeldman@mofo.com">sfeldman@mofo.com</a></td>
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**Corporate + Securities Law**

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<tr>
<th>Name</th>
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<tbody>
<tr>
<td>Anna Pinedo</td>
<td>(212) 468-8179</td>
<td><a href="mailto:apinedo@mofo.com">apinedo@mofo.com</a></td>
</tr>
<tr>
<td>Lloyd Harmetz</td>
<td>(212) 468-8061</td>
<td><a href="mailto:lharmetz@mofo.com">lharmetz@mofo.com</a></td>
</tr>
<tr>
<td>Remmelt A. Reigersman</td>
<td>(212) 336-4259</td>
<td><a href="mailto:rreigersman@mofo.com">rreigersman@mofo.com</a></td>
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Because of the generality of this newsletter, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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