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Kudos to the tax writers

The bailout demanded quick answers, and the government responded admirably

By Robert N. Gordon

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The government rescue plan inevitably will produce many villains. But one group that has performed like heroes in this turmoil is the Washington tax writers, who acted quickly to remove possible tax roadblocks to free up seized credit markets. "Sometimes Washington works really well," said Steve Rosenthal, an attorney with Ropes & Gray LLP in Washington.

Attorney Bill Paul of Covington & Burling LLP in Washington summed up the activity: "Treasury and IRS are in high gear in their efforts to address tax uncertainties arising as a result of the crisis in the credit markets ... the pace at which they are able to generate the guidance is remarkable."

First came Notice 2008-27, which was needed because of the mess in auction rate securities. The notice made clear that debt modification isn't a new issuance.

Then came Revenue Procedure 2008-51, which dealt with the interest deductions on debt issued at "exorbitant" interest rates. These anti-high-yield discount-obligation rules deny some interest deductions on debt issued at the applicable federal rate plus 5% or more.

Then the government had to deal with money market fund problems. It did so by stepping in to guarantee the money invested in such funds Sept. 19.

The Department of the Treasury stated that coverage would be available for both taxable and tax-exempt money funds. In addition, the Treasury Department and the Internal Revenue Service will issue guidance confirming that a fund's participation in the program "will not be treated as a federal guaranty that jeopardizes the tax-exempt treatment of payments by tax-exempt money market funds."

Also, Notice 2008-92 was needed to clarify any problems that might arise with insurance-dedicated money market funds, which are those whose beneficial interests are held exclusively by segregated asset accounts of insurance companies.

Notice 2008-91 allows loans to domestic corporations from their controlled foreign corporations without the normal tollgate tax penalties under Section 956 that are levied as money is repatriated. This was done to free the flow of funds in a cash-strapped economy.

Revenue Procedure 2008-63, issued at the behest of Mr. Rosenthal on behalf of mutual fund firms, was designed to provide guidance for the taxpayers who lend shares to short- sellers in the securities lending market. When a securities lender lends a certificate to a short-seller, the securities lender receives cash as collateral.

If the securities lender demands the shares back, the share borrower has three days to return the shares or the share lender can take the cash collateral and buy shares in the market to replace the original shares. Because this was happening on shares lent to Lehman Brothers Holdings Inc. of New York, the pressing question arose as to whether the share lender has realized a gain when the lender grabs the collateral and doesn't get back the original shares.

Fortunately, the government made it clear that this replacement process won't be a taxable event.

You have to hand it to the banks. Amid the turmoil of receiving government help, they had the foresight to ask for some pain-relieving favors. The first came in Section 301 of the rescue bill that stipulates that losses on preferred shares of Fannie Mae of Washington or Freddie Mac of McLean, Va., held by a financial institution are an ordinary loss, not a capital loss. As ordinary losses can offset any type of corporate income while capital losses can be offset only against capital gains, this is a bonanza.

Then came the big one: In Notice 2008-83, the IRS amended IRC Section 382H. The changes allow losses on loans and other bad debts in a failed company to be immediately used by an acquirer.

New York-based tax analyst Robert Willens figures the amendment will allow Wells Fargo & Co. of San Francisco to use about $74 billion in Wachovia Corp. of Charlotte, N.C., losses now, versus $930 million a year over the next 20 years.

The bailout bill was in part financed by killing deferred-compensation arrangements, thereby taxing income now earned offshore by hedge fund and buyout fund managers. This raises a lot of money.

The rescue bill also requires brokers to report the cost basis on securities sold. This starts in 2011 on equities and will eventually encompass bonds and options; this, too, is considered a revenue raiser.

All in all, it has been a busy few months for the already overworked tax writers. Thanks and kudos are in order.

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