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TAXQUARTERLY

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Editor's Note

We promised last issue that CMTQ would devote a significant part of this edition to LIBOR replacement. What we didn't know then, however, is that fast moving developments would substantially change our focus. In particular, the Internal Revenue Service (the "IRS") in October issued proposed regulations that are designed to make the transition from LIBOR easier tax-wise. In fact, they go out of their way to ensure that a switch to LIBOR is not an exchange for federal income tax purposes. However, as we describe below, the government still couldn't quite let go and the proposed regulations adopt an equivalent fair market value "governor" that is sure to receive a lot of comments from practitioners. Of course, on Wall Street the market doesn't always cooperate with the government and so just before the IRS issued the proposed regulations the Alternative Reference Rates Committee's (the "ARRC") preferred LIBOR-replacement rate, the secured overnight funding rate ("SOFR"), started exhibiting unwanted quirks. Particularly on September 17, 2019, SOFR more than doubled.

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* As described in the Editor's Note (CMTQ 01/01), this quote is attributed to, among others, Sen. Russell Long (D., LA).

Editor's Note (cont.)

LIBOR during the same period, however, remained basically constant. Of course, this is the difference between a rate like LIBOR that is set through a panel of banks based on predictions about the future and a rate like SOFR based on actual market events. Nevertheless, ARRC's faith in SOFR has apparently not been shaken (at least so far) and so it is on track to become the new replacement for LIBOR in dollar-dominated instruments. Meanwhile, Intercontinental Exchange is still pushing alternative approaches sometimes not so subtly. For example, ICE's Benchmark Administration Limited ("IBA") has let it be known that, while it supports a transition from LIBOR, it expects certain LIBOR quotes to be continued after the putative end date for LIBOR of December 31, 2021. Meanwhile, IBA has been touting its own index, the U.S. Dollar ICE Bank Yield Index, as an alternative to the government-sponsored indices. So LIBOR replacement will continue to be an ongoing story as we approach LIBOR's uncertain demise.

This issue of CMTQ also covers recently proposed regulations addressing a question long asked with respect to asset testing under the passive foreign investment company rules, Senator Wyden's latest mark-to-market proposal, and more.

Guidance for Replacing LIBOR

On October 8, 2019, the IRS released proposed regulations (the "Proposed Regulations") addressing certain US federal tax consequences of replacing an interbank offered rate with a successor rate.[1] As discussed in more detail below, the Proposed Regulations generally provide (a) circumstances in which the replacement of an IBOR, such as LIBOR, with a fallback rate, or an addition of a fallback mechanic to an existing instrument, will not result in a deemed exchange of the instrument under section 1001 of Code,[2] (b) the source and character of any one-time payment associated with a replacement of an IBOR rate, (c) relief under the rules for real estate mortgage investment conduits ("REMICs"), and (d) some relief pursuant to specific tests under existing regulations governing variable rate debt instruments ("VRDIs").

A detailed discussion of the regulations is available in our Legal Update from earlier this month.[3] In this article, CMTQ focuses on the key guidance in the Proposed Regulations, namely, the circumstances in which the replacement of LIBOR with a fallback rate, or an addition of a fallback

1 The Proposed Regulations are available at https://www.govinfo.gov/content/pkg/FR-2019-10-09/pdf/2019-22042.pdf.

2 Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations thereunder.

3 Our Legal Update, entitled The World's Most Important Number: The IRS Addresses the Replacement of LIBOR, available at https://www.mayerbrown.com/en/perspectives-events/publications/2019/10/the-worlds-most-important-number-the-irs-addresses-the-replacement-of-libor.

mechanic to an existing instrument, will not result in a deemed exchange. As discussed in more detail below, the key takeaway is that under the Proposed Regulations, replacement of an IBOR (or the addition to an instrument of a fallback mechanic to replace an IBOR) will generally not result in a deemed exchange for US federal income tax purposes if: (1) the fallback rate is a qualifying rate (which is broadly defined), and (2) the fair market value of the instrument after the replacement or addition is substantially equivalent to the fair market value of the instrument before the replacement or addition.

The Concern

For debt instruments and other financial instruments, a main US federal income tax concern surrounding the replacement of an IBOR rate on an outstanding financial instrument is whether the replacement (or addition to include a fallback mechanic) results in a "significant modification." If the replacement or addition is a significant modification, holders of the debt instrument would have a deemed (potentially taxable) exchange of their "old" note for a "new" note. This deemed exchange could result in current gain recognition to a holder or counterparty.

An alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument is not a "modification." In addition, issuer and holder options that can be unilaterally exercised are generally not modifications (provided, in the case of a holder option, that the exercise does not result in a deferral of, or reduction in, any scheduled payment of principal or interest). An option is unilateral only if, under the debt's terms or applicable law (i) there does not exist, at the time of exercise or as a result of exercise, a right in the other party to alter or terminate the debt instrument or to put the instrument to a person related (using a more than 50 percent standard) to the issuer, (ii) the exercise of the option does not require the consent of the other party, a related party or a court, and (iii) the exercise of the option does not require consideration unless on the debt instrument's issue date the consideration is a *de minimis* amount, a specified amount or based on a formula that uses objective financial information.

There are multiple tests for determining whether a modification is "significant," including a test measuring whether there has been a change in yield, which generally asks whether the annual yield on the "new" instrument differs from the annual yield of the "old" instrument by no more than the greater of 0.25 percent or 5 percent of the annual yield of the old instrument.

There is a similar concern for non-debt instruments, but there are no clearly defined tax rules for when a deemed exchange occurs for such instruments.

Without specific guidance on the replacement of an IBOR rate, in order to avoid a deemed exchange, parties were left with these imperfect exceptions which invariably create uncertainty in many circumstances.[4]

The Approach of the Proposed Regulations

The Proposed Regulations provide for the circumstances in which the replacement of an IBOR rate by a "qualified rate," the alteration of terms of an instrument to add a fallback "qualified rate" for an IBOR rate, or the replacement of an IBOR rate that is itself a fallback, will not constitute a modification, and therefore will not result in a deemed exchange.

For debt instruments, the Proposed Regulations provide that if the terms of a debt instrument are modified (1) to replace an IBOR rate with a "qualified rate," (2) to provide for a fallback for an IBOR rate with a "qualified rate," or (3) to substitute a "qualified rate" in place of a rate referencing an IBOR rate as a fallback to another rate, those modifications (and certain associated alterations and modifications with respect to those modifications) are not treated as modifications and, therefore, do not result in a significant modification. The Proposed Regulations contain a similar rule for non-debt contracts, including swaps and forwards.

The Proposed Regulations define "associated alteration or modification" as any alteration of an instrument that is associated with the alteration or modification by which a qualified rate replaces, or is included as a fallback to, the IBOR rate that is reasonably necessary to adopt or implement that replacement or inclusion. For example, technical, administrative, or operational alterations or modifications, such as a change to the definition of an interest period or a change to the timing and frequency of determining rates or making payments of interest, are intended to be covered by this definition.

The associated alteration or modification rule allows the parties to account for any anticipated difference between the expected yield of the IBOR rate and the expected yield of the replacement rate with a one-time payment without triggering a modification. The Preamble to the Proposed Regulations noted that industry groups, in particular the ARRC, had requested guidance on the source, timing of recognition of income, and withholding tax consequences of a one-time compensating payment. The Proposed Regulations treat compensating payments in the same manner as other payments under the instrument.[5] Thus, with respect to debt instruments, this treatment would mean that a compensating yield payment would be treated as interest if made by

4 For a detailed discussion of the Alternative Reference Rates Committee (the "ARRC") recommended waterfalls, some of the federal tax considerations of concern before the Proposed Regulations were issued, and industry group letters to the IRS, see Brennan W. Young and Thomas A Humphreys, "Breaking Up With LIBOR," Tax Notes Federal (September 9, 2019), available at https://s3.amazonaws.com/pdfs.taxnotes.com/2019/2019tnf36-7.pdf.

5 *See* Prop. Treas. Reg. section 1.1001-6(d).

the issuer and an offset to interest if made by the holder of the debt instrument. We explore these issues in detail below.

For a replacement or fallback rate to be a "qualified rate," (1) the rate must fall within one of the enumerated categories of rates that can be qualified rates (a "Qualifying Rate"), and (2) the fair market value of the instrument after the modification or alteration must be substantially equivalent to the fair market value of the instrument before the modification or alteration (the "Substantial Equivalence Requirement").

In implementing the requirement that a replacement or fallback rate constitutes a Qualifying Rate, the Proposed Regulations were as broad as could have been reasonably hoped. The Proposed Regulations list the following rates as Qualifying Rates:[6]

1) SOFR, which is published by the Federal Reserve and is the base component of the fallback options championed by the ARRC, the Sterling Overnight Index Average, the Tokyo Overnight Average Rate, the Swiss Average Rate Overnight, the Canadian Overnight Repo Rate Average, the Hong Kong Dollar Overnight Index, the interbank overnight cash rate administered by the Reserve Bank of Australia, and the euro short-term rate administered by the European Central Bank;
2) Any alternative, substitute or successor rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof) as a replacement for an IBOR or its local currency equivalent in that jurisdiction;
3) Any qualified floating rate (a "QFR"), as defined in Treas. Reg. § 1.1275-5(b) (without regard to the limitations on multiples contained in that regulation) that is not described in (1) or (2) above;
4) Any rate that is determined by reference to a rate described in (1)-(3) above, including rates determined by adding or subtracting a specified number of basis points to or from the rate or by multiplying the rate by a specified number; and
5) Any rate identified as a Qualifying Rate in subsequent IRS guidance.

There are two points worth emphasizing about this list of Qualifying Rates. First, the inclusion of any QFR as a Qualifying Rate demonstrates the IRS's intent to define "qualified rate" broadly. Under the current regulations, a rate is a QFR if variations in the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which a debt instrument is denominated.[7] Thus, while at first glance one might not see their preferred replacement

6 *See* Prop. Treas. Reg. section 1.1001-6(b)(1).

7 Treas. Reg. section 1.1275-5(b)(1).

rate on the list, as long as the rate meets this definition, that rate is a Qualifying Rate within the meaning of the Proposed Regulations. Second, by including (4) above, the Proposed Regulations bless the SOFR-based rates backed by the ARRC, term SOFR and compounded SOFR.

The Substantial Equivalence Requirement is where the Proposed Regulations may present challenges in practice. As noted, under this requirement, the fair market value of the instrument after the modification or alteration must be substantially equivalent to the fair market value of the instrument before the modification or alteration.[8] In determining fair market value for this purpose, the parties to an instrument can use any reasonable, consistently applied valuation method and must take into account the value of any one-time payment that is made in connection with the alteration or modification. A reasonable valuation method may, but does not have to, be based in whole or in part on past or projected values of the relevant rate. The Proposed Regulations provide two safe harbors for the Substantial Equivalence Requirement.

First, a modification or alteration satisfies the Substantial Equivalence Requirement if the historic average of the relevant IBOR rate does not differ by more than 25 basis points from the historic average of the replacement rate, taking into account any spread or other adjustment to the rate, and adjusted to take into account any one-time payment that is made in connection with the alteration or modification.[9] The concern with this safe harbor stems from a situation in which an instrument includes a fallback waterfall for its IBOR rate. One cannot be sure today whether, when LIBOR is no longer available, a replacement rate will satisfy this historical averaging test. For example, while SOFR (which looks at a single overnight rate) has historically been relatively close to overnight LIBOR, the rate exploded to be more than two times higher than overnight LIBOR for a day in September.[10] Thus, there is a risk that market participants may not have absolute certainty that they will be able to rely on this safe harbor in structuring their IBOR rate fallback mechanics today.[11]

8 *See* Prop. Treas. Reg. section 1.1001-6(b)(2).

9 The historic average can be determined by (a) using any industry-wide standard, such as a method of determining a historic average recommended by the International Swaps and Derivatives Association or the ARRC for the purpose of computing the spread adjustment for a rate that replaces an IBOR rate or (b) any reasonable method that takes into account every instance of the relevant rate published during a continuous period beginning no earlier than 10 years before the modification or alteration and ending no earlier than three months before the modification or alteration. This 10-year period is somewhat peculiar, since SOFR, for example, was first published only a year and a half ago in April 2018.The Proposed Regulations provide that the historic average must be determined for both rates using the same method and historical data from the same timeframes and must be determined in good faith by the parties with the goal of making the fair market value of the instrument with the new rate substantially equivalent to the fair market value of the instrument before the alteration or modification.

10 *See* https://apps.newyorkfed.org/markets/autorates/SOFR/ for SOFR, compared with https://www.global-rates.com/interest-rates/libor/american-dollar/usd-libor-interest-rate-overnight.aspx for overnight LIBOR. *See* Daniel Kruger and Vipal Monga, "Repo-Market Tumult Raises Concerns About New Benchmark Rate," the *Wall Street Journal* (September 23, 2019), available at https://www.wsj.com/articles/repo-market-tumult-raises-concerns-about-new-benchmark-rate-11569247352/.

11 In the case of a replacement of a LIBOR rate, for instance, measurement of this test would occur on the date of the LIBOR rate replacement.

Second, a modification or alteration satisfies the Substantial Equivalence Requirement if the parties to the instrument are not related[12] and the parties determine, based on *bona fide* arm's length negotiations between them, that the fair market value of the instrument after the modification or alteration is substantially equivalent to the fair market value of the instrument before the change (again, taking into account any one-time payment that is made in connection with the change) (the "Arm's Length Safe Harbor").

The Arm's Length Safe Harbor should work reasonably well in many OTC agreement situations. However, it implicates some practical complexities in many other circumstances. Many financial transactions using IBOR rates are widely syndicated and often have an arranger or indenture trustee that interacts with the debtor. As drafted, it is unclear if the participation and agreement of a syndicator or indenture trustee, for example, constitutes a determination by a party "to the debt instrument." In addition, in the case of an indenture trustee, the trustee may be reluctant to take any action that it deems to constitute the exercise of discretion. Given the general difficulty of accessing the noteholders in many transactions, market participants may prefer or require that the replacement generally rely on the judgment of borrower-side parties in one form or another. In that case, the Arm's Length Safe Harbor would be unavailable. While the unilateral option alteration exception under existing Treasury Regulation § 1.1001-3 (described earlier) could still be available, given the various possible commercial considerations that might influence the borrower-side replacement mechanics, the certainty of its application may not always be apparent. As such, more comprehensive relief from the Treasury could have provided a compliance-friendly safe harbor that did not sacrifice the argument that the replacement of an IBOR rate is pursuant to a unilateral option.

The preamble provides that the Substantial Equivalence Requirement is intended to "broadly facilitate the transaction away from IBORs." Thus, it does not appear the requirement is intended to be onerous for taxpayers and necessarily require the use of the safe harbors. However, many deals include an opinion requirement at a high degree of comfort that there is no deemed reissuance. It could be reasonably expected in such cases for taxpayers and their advisors to require reliance on the two safe harbors.

In addition to the requirements discussed above, a rate is only a qualified rate if the interest rate benchmark to which the rate refers after the modification or alteration and the IBOR rate to which the instrument referred before the modification or alteration are based on transactions conducted in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency.

12 The Proposed Regulations cross reference sections 267(b) and 707(b)(1) in defining relatedness, which generally define the term to mean parties related by more than 50 percent ownership, directly or indirectly.

In general, the Proposed Regulations will become effective when final regulations are published in the Federal Register, but taxpayers can rely on them before that date (provided, in some cases, that the regulations are applied consistently before final regulations are published).

Congressional Relief for Tax on Mortgage Cancellation?

On June 18, House Ways and Means Subcommittee on Select Revenue Measures Chairman Mike Thompson (D-CA) introduced the Taxpayer Certainty and Disaster Tax Relief Act of 2019.[13] Besides proposing to extend numerous expiring tax credits and providing tax relief for certain areas affected by natural disasters, the bill would notably exclude from gross income the discharge of qualified principal residence indebtedness.[14] This would be an extension of a provision under section 108(a)(1)(E) of the Code that expired on December 21, 2017.

For background, the Code defines "qualified principal residence indebtedness" as including any debt incurred in acquiring, constructing, or substantially improving a principal residence that is secured by the principal residence.[15] The bill, as proposed, would exclude discharge of such indebtedness from gross income after December 31, 2017 and prior to January 1, 2021. At this point, the bill has only been introduced.

Proposed PFIC Regulations Answer Long Asked Question

The passive foreign investment company, or "PFIC", rules were enacted in 1986 as a counterpart to the Subpart F regime and aim to curtail deferral of foreign earnings by requiring US persons owning stock in a PFIC to account for their pro rata share of foreign income under either the "qualifying electing fund" rules, the "deferred interest charge" method, or the "mark-to-market" rules.

For many years, taxpayers have relied on Notice 88-22[16] for guidance in respect of resolving the complexities surrounding the application of the PFIC rules; however, there are many items that have remained unresolved resulting in ambiguous application of the Code and regulations. On July 11, 2019, the U.S. Treasury and the IRS issued proposed PFIC regulations (the "Proposed Regulations")[17] that include much anticipated guidance on a number of long-standing issues and that intend to clarify many of these complex rules.

13 H.R. 3301.

14 For full text of the bill, please see https://www.congress.gov/bill/116th-congress/house-bill/3301/text.

15 See Code sections 108(h) and 163(h).

16 Notice 88-22, 1988-1 CB 489.

17 The Proposed Regulations are available at https://www.govinfo.gov/content/pkg/FR-2019-07-11/pdf/2019-12030.pdf.

Although analyzing the full breadth of the Proposed Regulations is beyond the scope of this analysis, the following items are particularly significant for capital markets transactions.

General Background

In general, a PFIC is defined as any foreign corporation ("Tested Corporation") which meets either an income or asset test. Under the "Income Test," a Tested Corporation is a PFIC if at least 75% of the corporation's income is "passive income".[18] Under the "Asset Test," a Tested Corporation is a PFIC if the average percentage of the assets held by the Tested Corporation during the taxable year which produce passive income or that are held for the production of passive income represent 50% or more of the value of all assets held by the Tested Corporation during the taxable year.[19]

The Proposed Regulations clarify and expand many of the rules relating to the application of the income and asset tests.

Income test:

The term passive income is generally defined as any income of a kind that would constitute foreign personal holding company income ("FPHCI") as defined under the Subpart F rules.[20]

Exceptions to Passive Income: There are a number of exceptions to the definition of FPHCI that apply for purposes of Subpart F; however, questions have been raised regarding the scope of the cross-reference of these exceptions to the PFIC regime. The Proposed Regulations clarify that the FPHCI "same country" exception,[21] "look-through" rules[22] and the insurance exception[23] do not apply for purposes of excluding items of FPHCI under the PFIC Income Test.[24] Notwithstanding, the Proposed Regulations confirm that other exceptions, such as the active banking and financing exception, do apply for purposes of determining PFIC status.[25]

Partnership Income: A Tested Corporation that receives FPHCI from a corporation in which it owns 25% or more of the value of the stock ("Look-Through Subsidiary") is generally treated as directly receiving its proportionate share of income of the Look-Through Subsidiary.[26] Under the prior rules, it was unclear whether the "Look-Through Subsidiary" rules applied to an interest in a partnership. The Proposed Regulations clarify that the distributive share of partnership income attributed to a Tested Corporation will be treated as *per se* passive income unless the Tested Corporation owns 25% of the value of the partnership (a "Look-Through Partnership"). If the ownership threshold is met, elimination rules similar to those for Look-Through Subsidiaries apply and the underlying income

18 See section 1297(a)(1).

19 See section 1297(a)(2).

20 See section 1297(b)(1).

21 See section 954(c)(3).

22 Id.

23 See section 954(i).

24 See Prop. Reg. section 1.1297–1(c)(1)(i)(B).

25 See Prop. Reg. section 1.1297–1(c)(1)(i)(A).

26 See section 1297(c).

may be treated as non-passive if the Look-Through Partnership engages in relevant business activities.[27]

Net Gains and Losses: The Income Test is generally computed based on a Tested Corporation's gross income; however, the Proposed Regulations provide that items of FPHCI that are determined by netting gains against losses are taken into account by a Tested Corporation on that net basis, so that only net gains in a particular category of FPHCI are taken into account.[28] In situations where a Tested Corporation is treated as earning its pro-rata share of income from a "Look-Through Subsidiary", the net amount of income in each category of FPHCI is determined separately for each separate entity, such that net gains or losses of a corporation of any Look-Through Subsidiary may not be netted against net losses or gains of another Look-Through Subsidiary or the tested entity.[29]

PFIC Insurance Exception. The Proposed Regulations provide specific guidance regarding whether the income of a foreign corporation is excluded from passive income when the income is derived in the active conduct of an insurance business. Prior Proposed Regulations issued in 2015 in respect of the PFIC insurance exception are withdrawn in connection with the Proposed Regulations.[30]

<u>Asset test:</u>

For purposes of the Asset Test, a Tested Corporation is a PFIC if the average percentage of the passive assets of a Tested Corporation represent 50% or more of the value of its total assets.

Publicly Traded Corporations: Under the Code, the value of the assets of a Tested Corporation are required to be measured based on their FMV if the Tested Corporation is publicly traded.[31] On the other hand, the assets of a Tested Corporation are measured based on their adjusted basis if the Tested Corporation is a controlled foreign corporation ("CFC") with respect to other shareholders or so elects.[32] For purposes of this test, the Proposed Regulations clarify that a publicly traded Tested Corporation is required to use FMV for the entire year if it was publicly traded on the majority of days during the year.[33]

Weighted Average: Notice 88–22 provides that the average percentage of assets of a foreign corporation is calculated by averaging the value of the assets of the corporation, determined as of the end of each quarterly period of the corporation's taxable year. The Proposed Regulations clarify that the average percentage of a foreign corporation's assets is determined using a "weighted average" approach at the end of each quarter of the Tested Corporation's taxable year.[34] Assuming a quarterly measuring period where the FMV (or adjusted bases) of a corporation's passive assets for a

27 See Prop. Reg. section 1.1297–1(c)(2)(i).

28 See Prop. Reg. section 1.1297–1(c)(1)(ii).

29 See Id.

30 See Prop. Reg. section 1.1297–5(c).

31 See section 1297(e)(1)(A).

32 See section 1297(e)(1)(B).

33 See Prop. Reg. section 1.1297– 1(d)(1)(v)(A).

34 See Prop. Reg. section 1.1297– 1(d)(1).

quarter is represented as "PA Qx", and the FMV (or adjusted bases) of a corporation's total assets for a quarter is represented as "TA Qx", this determination can be made as follows:

- (PA Q1 + PA Q2 + PA Q3 + PA Q4) / 4, divided by (TA Q1 + TA Q2 + TA Q3 + TA Q4) /4

Dual-Character Assets: Notice 88–22 states that an asset that produces both passive income and non-passive income during a foreign corporation's taxable year is treated partly as a passive asset and partly as a non-passive asset in proportion to the relative amounts of income generated by the asset during the year. The Proposed Regulations provide that an asset that produces both passive income and non-passive income during a taxable year is treated as two assets, one of which is passive and one of which is non-passive.[35] Consistent with the rule in Notice 88–22, the FMV (or adjusted basis as applicable) of the asset is allocated between the passive assets and non-passive assets based on the ratio of passive income produced by the asset during the taxable year to non-passive income.[36]

Characterization of Dealer Property: Under the PFIC dealer exception,[37] gain from the disposition of certain dealer property is treated as non- passive income for purposes of the Income Test. The Proposed Regulations provide that property that is subject to the dealer exception is characterized as a non-passive asset for purposes of the Asset Test, notwithstanding the dual-character asset rules described above.[38]

Stapled Stock: Under the Proposed Regulations, for purposes of determining whether two or more Tested Corporations that are stapled entities are PFICs, all entities that are stapled entities with respect to each other are treated as a single entity that holds all of the assets of the stapled entities, conducts all of the activities of the stapled entities, and derives all of the income of the stapled entities.[39]

Applicability

The Proposed Regulations will apply to tax years that begin on or after the regulations are finalized; however, taxpayers can rely on the proposed regulations provided they apply them consistently. Taxpayers can also continue to rely on Notice 88-22.[40]

35 See Prop. Reg. section 1.1297– 1(d)(2)(i).

36 See Prop. Reg. section 1.1297– 1(d)(2)(ii).

37 See section 954(c)(2)(C).

38 See Prop. Reg. section 1.1297– 1(d)(4)

39 See Prop. Reg. section 1.1297– 1(e).

40 See Prop. Reg. section 1.1297– 1(g).

CCA 201933010: Clarification on Lien Priority for Purchase Money Mortgages

The IRS has long held that a purchase money security interest or mortgage valid under local law is protected even if it arises after a notice of federal tax lien is filed.[41] See Rev. Rul. 68-57, 1968-1 CB 553. This is often referred to as the "super-priority" of purchase money mortgages and security interests.

On occasion, a deed of trust or mortgage will include a provision wherein the deed secures not only a specifically described obligation, but also all other obligations between the debtor and the deed's holder, whether then existing or later contracted (a "cross-collateralization" or "dragnet" clause). On August 16, 2019, the IRS released Chief Counsel Advice 201933010 (Mar. 25, 2019) addressing whether a cross-collateralization clause in a deed of trust would prevent a security interest from being classified as a "purchase money mortgage" and, thus, afforded super-priority over federal tax liens.

In the Service's view, the inclusion of the cross-collateralization clause does not "poison" an otherwise valid purchase money mortgage. However, the extent of the protection afforded to the holder of the purchase money mortgage would be limited to the amount of the purchase money and would not extend to any antecedent debt, after-acquired property or future advances.

Tax Court Memo 2019-100: A Cautionary Tale for Debt Treatment

A taxpayer could not show that payments he made represented interest on loans and, although he was able to deduct some commission expenses, the amount was limited due to issues with his records in *Moore v. Commissioner*.[42]

In that case, the taxpayer formed a single-member limited liability company to conduct a tax return preparation business. Seeking to expand that business, he approached individuals to raise additional capital, and prepared promissory notes, which listed a "loan period" and also a "return on investment" percentage. Each promissory note specified a return of investment of 100% or more, which the taxpayer indicated was an interest rate. The taxpayer claimed a deduction of $161,750 in "investment expenses" related to payments under these notes. At trial he conceded his claimed deduction was $39,500. The IRS argued that the taxpayer had not shown these advances were bona fide loans.

41 Although not explicit in the law, the IRS based this conclusion on the legislative history of the Federal Tax Lien Act of 1966.

42 *Moore v. Comm'r*, T.C. Memo 2019-100.

The Tax Court agreed that the taxpayer had failed to show he was entitled to a deduction under Code Section 163(a). The Court held that the taxpayer failed to prove that the aforementioned transactions represented bona fide loans for the following reasons: (i) the notes, with the exception of one, were not signed and bore no indication of a good faith agreement between the parties; (ii) there was no evidence to prove any intention on the part of the lenders to act as creditors and to enforce repayment; (iii) there was no evidence to show how the creditors characterized the transactions; (iv) the notes did not state interest rates or provide for any type of security interests; and (v) the notes did not have execution dates.

The case serves as yet another reminder that including at least the minimum features of debt in an instrument intended to be treated as debt for federal tax purposes is highly recommended to support that treatment.

Proposed Regulations Under Section 451(b)

On September 5, 2019, the IRS and the Treasury Department released (i) proposed regulations implementing section 451(b) of the Code, which was added to the Code by the 2017 Tax Cuts and Jobs Act, and (ii) Revenue Procedure 2019-37, which provides procedures for a taxpayer to change its method of accounting to comply with the amendments to section 451 of the Code, including the proposed regulations. The proposed regulations provide rules for accrual-method taxpayers on the timing of recognizing income under the "all-events test." A more detailed discussion of the proposed regulations is available in our Legal Update.[43] A key takeaway for capital markets transactions is that section 451(b) of the Code does not generally apply to original issue discount or market discount.

Another Mark-to-Market Proposal

On September 12, 2019, Senator Ron Wyden (D-Ore.), the ranking Democratic member on the Senate Finance Committee, released a tax plan[44] that would establish a broad mark-to-market tax regime intended to raise money for the Social Security system. This plan, which would only apply to high-income or high-net worth taxpayers, would impose annual "mark-to-market" accounting and taxation for tradable assets such as publicly traded stock and lookback taxation upon sale for assets that are less easily valued, such as real estate, closely held businesses and valuable collectibles.

This plan is not the first mark-to-market proposal floated in the past few years. In 2014, then-Chairman of the House Ways and Means Committee Dave Camp proposed a mark-to-market regime

43 Our Legal Update, entitled Creative Accounting: The IRS Proposes Regulations Addressing Advance Payments and Book-Tax Conformity, is available at https://www.mayerbrown.com/en/perspectives-events/publications/2019/09/analysis-of-new-irs-tax-accounting-rules.

44 The plan is available at https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.

for derivatives, under which a variety of derivatives would be treated as sold at fair market value as of the end of each year, with the resulting gains and losses treated as ordinary. This plan would have applied to both publicly traded and non-publicly traded derivatives, and would have even applied to non-traded derivatives that referenced a non-publicly traded asset. A particularly contentious aspect of this proposal was the very broad definition of "derivative," which would have potentially encompassed a broad range of contracts. Practitioners raised concerns about the difficulty of valuing non-traded derivatives with non-traded reference assets and the potential for taxpayers to game the new system by generating their own losses with hard-to-value derivatives. However, some practitioners saw Camp's proposal as feasible because taxpayers using derivatives generally needed to value them for financial accounting purposes.

In 2016 and 2017, Senator Wyden introduced the Modernization of Derivatives Tax Acts of 2016 and 2017, which would have enacted a similar derivative mark-to-market regime, with taxpayers being permitted to rely on valuations made for financial statement purposes and on valuations from brokers in computing their annual gains and losses.[45] These proposals would also have enacted mark-to-market and ordinary tax treatment in the case of "Investment Hedging Units," or "IHUs," which were defined in the proposals as an underlying investment combined with a derivative if the derivative had a delta of between negative 0.7 and negative 1.0 – that is, if the ratio of an expected change in the fair market value of the derivative to the expected change in fair market value of the underlying investment were between negative 0.7 and negative 1.0. IHUs would be exempt from the straddle rules and the constructive sale rules of Section 1259. Both the derivative and underlying investment in an IHU would be marked to market annually, with gains in both being treated as ordinary income. A taxpayer would be able to elect not to compute the delta and treat all derivatives with respect to an underlying investment and all of the underlying investment as part of the IHU.

Senator Wyden's new proposal would apply separate anti-deferral accounting rules to "tradable property" and "non-tradable property." Tradable property would include assets for which there is a readily ascertainable value, including actively traded property. Generally, all other capital property would be non-tradable property under this proposal. Any applicable taxpayer would need to mark all tradable assets to market as of the end of each tax year. Non-tradable property would be subject to tax on gain upon realization using a lookback rule and imposing a charge to reduce the benefit of deferral. The proposal discusses different options for such a charge, including an interest charge (similar to rules for distributions from a passive foreign investment company), a yield-based tax and a surtax based on the holding period.

This proposal would only apply to taxpayers who meet an income threshold of $1 million or an asset threshold of $10 million of applicable assets for three years in a row. "Applicable assets" for this

45 The 2016 version is available at https://www.finance.senate.gov/imo/media/doc/MODA%20Leg%20Text%20(FRA16044).pdf, and the 2017 version is available at https://www.finance.senate.gov/imo/media/doc/S.%201005_Modernization%20of%20Derivatives%20Tax%20Act%20TEXT%20(FRA17032).pdf.

purpose would include all capital property, including stocks, partnership interests, bonds, futures, options, other derivatives, intangibles, real property, acquired patents and copyrights, collectibles, some personal property and cash. The first $2 million of combined value of a taxpayer's primary and secondary personal residences would be excluded, as would the first $5 million of value of a taxpayer's operating family farms and the first $3 million of tax-preferred savings accounts. Once taxpayers meet one of those thresholds for three years in a row, that taxpayer would remain subject to the new rules until the taxpayer failed to meet either test for three years in a row, at which point the taxpayer would have the option to elect out.

This system would apply to individuals, estates and trusts, and the proposal asked for public comments on whether the rule should be applied to C corporations. In the case of a partnership, with respect to tradable assets, the partnership would calculate and report to each partner that partner's share of any realized gain or loss and each partner's share of annual mark-to-market gain or loss. In the case of a partnership with non-tradable assets, upon disposition of such assets, the partnership would be required to calculate each partner's share of realized gain or loss and each partner's share of the lookback charge. Each partner that was an "applicable taxpayer" would be required to include in income mark-to-market gain or loss from the partnership's tradable assets and realized gain or loss and lookback charge from the partnership's non-tradable assets.

This proposal would aim to raise money to extend the solvency of the Social Security system, which is currently estimated by the Social Security Board of Trustees to only be able to pay 80 percent of benefits by 2035. Based on estimates of similar proposals, the Senate Finance Committee estimated that Senator Wyden's proposal would raise between $1.5 trillion and $2 trillion within the 10-year budget window. According to the Social Security Administration Actuary, an additional $1.85 trillion each decade beginning in 2020 would allow the payment of full benefits until 2095.

Taxpayer Taking the "Basket Option" Transaction to Court

In *GWA, LLC v. Comm'r*,[46] a partnership (the "Partnership") filed a petition challenging the IRS's position that the Partnership, by entering into certain basket option contracts, owned the reference stocks included in the basket option contract (rather than a derivative). The petition may be of particular interest in the structured products area, because basket option contracts were the target of two IRS notices in 2015. Notice 2015-73 targeted transactions like the one in the petition specifically, treating such a transaction as a listed transaction. Notice 2015-74 labeled as transactions of interest other transactions where a taxpayer or its designee has discretion to change the reference assets in the basket. The latter notice was drafted broadly enough that it could arguably be read to pick up a

46 *GWA, LLC v. Commissioner*, U.S.T.C Docket No. 6981-19 (Filed May 1, 2019).

note linked to the performance of an index if the index sponsor had discretion (and an exception in the notice did not apply).[47]

In the transaction at issue, the Partnership entered into contracts with a bank between 2003 and 2006, in which the Partnership made single lump sum payments to the bank entitling the Partnership to the cumulative changes in the value of notional portfolios of reference securities (the "Reference Portfolios"). The contracts subject to dispute in the petition were entered into in April 2003 and December 2006 and were terminated in April 2009 and May 2010, respectively.

In each contract, the Partnership's initial lump sum payment was equivalent to ten percent of the initial value of the underlying Reference Portfolio. Also, each initial payment was nonrecourse. So, the Partnership was able to achieve its desired level of leverage and limit its downside risk in the contracts to the initial payments. Under the contracts, the bank retained an investment adviser (the "Adviser") to manage the composition of the Reference Portfolios. At all relevant times, the Partnership owned a majority interest in the Adviser. At no time was the bank required to hold corresponding physical positions in the Reference Portfolios. If the bank did own any of the Reference Portfolio securities, it retained complete control over the securities and could sell them at any time.

When settling the contracts with the bank in 2009 and 2010 at a gain, the Partnership took the position that it held an ownership interest in the contracts for federal tax purposes. As such, the Partnership treated the cash settlement received by the bank as long-term capital gain under section 1001. The IRS's adjustment for the Partnership's 2009 and 2010 taxable year determined the contracts were not options for federal tax purposes and imputed direct ownership of the underlying securities in the Reference Portfolios to the Partnership. Accordingly, the IRS sought a large deficiency arguing each disposition was subject to short-term capital gain and ordinary income tax rates.

In its Tax Court petition, the Partnership sets forth two main arguments supporting its position that the ownership interest was in the contracts held with the bank. First, the Partnership emphasizes it could not be attributed direct ownership in the securities because it could not have legally held the securities due to regulations imposing margin limitations on financial institutions when extending credit, which did not apply to the option contracts. In other words, the Partnership could not have achieved the same degree of leverage without the option contracts since the bank would not have been able to provide a comparable amount of leverage had the Partnership directly invested in the underlying securities.

Next, the Partnership argues the regulations prohibiting financial institutions from extending credit for the acquisition of securities with nonrecourse loans did not apply to these contracts. So, through

47 For a more detailed discussion of Notice 2015-73 and Notice 2015-74, see Thomas. A. Humphreys, Remmelt A Reigersman, and Brennan W. Young, New Notices for "Basket Contracts" Revoke and Replace July Notices, Journal of Taxation of Financial Products (January 26, 2016). If you have trouble locating the article, a pdf is available upon request.

these contracts, the Partnership was able to limit its downside risk to the initial lump sum payment. Again, the Partnership states this would not be possible through direct investment in the underlying securities.

Another argument eluded to in the petition confirms that the contracts could only be cash settled and if the bank failed to make any payments, the Partnership's recourse was to sue the bank as a general unsecured creditor, not the issuers of the underlying securities.

Assuming the case goes to trial (scheduled for January 2020), the Tax Court will have to parse through these arguments and determine whether these option contracts have sufficient economic significance to be respected for federal tax purposes or whether they should be disregarded as abusive transactions which defer income recognition and convert ordinary income or short-term capital gain into long-term capital gain.

FATCA FAQs: Some Extended Relief for Model 1 FFIs Unable to Provide TINs for Account Holders with US Indicia

In 2017, IRS Notice 2017-46 provided transitional relief for the requirement that a Model 1 foreign financial institution ("FFI") report US tax identification numbers ("TINs") to local tax authorities for specified account holders if the FFI complied with certain requirements described therein. As this temporary relief is set to expire at the end of 2019, the IRS recently posted an FAQ on its FATCA FAQ general webpage[48] answering whether a Model 1 FFI is required to report all required TINs starting in 2020. *See* FAQ3 under "Reporting."

The FAQ provides that Model 1 FFIs are "not required to immediately close or withhold on accounts that do not contain a TIN beginning January 1, 2020." If there are missing or invalid TINs, the FFI may receive an error notice, which the FFI would have to correct within 120 days. However, if the FFI is unable to provide correct TINs in that time, the FAQ suggests the IRS will not automatically determine the FFI is in significant non-compliance. Rather, the IRS will assess the facts and circumstances of the missing TINs and consider, for example, why the TINs were not obtained and the procedures the FFI has in place to obtain TINs.

If the United States ultimately determines that an FFI is in significant non-compliance, the United States would notify the partner jurisdiction and work with such jurisdiction to address the non-compliance. The FAQ provides that an FFI would have at least 18 months from the date of notification of noncompliance to correct the TIN error before the IRS took any other further action, such as removing the FFI's Global Intermediary Identification Number from the IRS FFI List.

48 The FATCA FAQ webpage is available at https://www.irs.gov/businesses/corporations/frequently-asked-questions-faqs-fatca-compliance-legal.

In the News

RECENT RECOGNITION

GlobalCapital has named Mayer Brown "Global Law Firm of the Year – Overall" at *GlobalCapital's* 2019 Global Derivatives Awards. In addition, we were shortlisted in the European Law Firm of the Year (Transactions) and the European Law Firm of the Year (Regulatory) categories.

Earlier this year, we were also named the "Americas Law Firm of the Year – Overall" for 2019 at *GlobalCapital*'s Americas Derivatives Awards. In addition, we were shortlisted in the America's Law Firm of the Year (Transactions) and the America's Law Firm of the Year (Regulatory) categories.

International Tax Review named Mayer Brown "North America Tax Disputes Firm of the Year," "US Tax Court Firm of the Year" and "US Transfer Pricing Firm of the Year," at *International Tax Review*'s 14th annual Americas Tax Awards. This marks the second consecutive year that the firm has won the "North America Tax Disputes Firm of the Year" award.

RECENT SPEAKING ENGAGEMENTS

PLI's Swap Dealer Conduct Risk – On July 17, Matt Kluchenek and Curtis Doty led a PLI webinar covering the principal external and internal business conduct obligations imposed on swap dealers. They focused on best practices for compliance with these obligations and provided ways to mitigate risk. In addition, they reviewed relevant enforcement actions related to areas such as: obligations to furnish risk disclosure, identifying and disclosing material conflicts and incentives, pre-hedging practices and other uses of confidential information, new product approvals process, documentation and legal risks, and prime brokerage and multi-participant transaction structures.

Alternative Finance Summit 2019: Marketplace Lending, Cryptocurrency and Crowdfunding – On August 5, Jerry Marlatt spoke on Securitization and Secondary Markets for Marketplace Lending. Jerry's talk included a discussion of topics such as securitization issues after Madden, asset model and loan-level disclosure, "skin in the game" and impact on risk retention requirements, role of rating agencies, loan trading process, custody and clearing issues, true lender doctrine, and the OCC fintech initiative. The program's purpose was to hear from the leading lawyers, dealmakers, and federal and state regulators on the state of marketplace lending.

Liability Management Transactions: Debt Repurchases & Exchanges – On August 21, Anna Pinedo and John Berkery hosted a webinar on liability management in which they covered topics such as disclosure issues and handling material non-public information, structuring repurchases to avoid the application of the tender offer rules, the tender offer rules, no-action letter relief for non-convertible debt securities, consent solicitations, court decisions relating to the trust indenture act, and accounting and tax considerations.

NIBA Chicago Conference 2019: Real Time Compliance – On September 12, 2019 Matthew Kluchenek presented at the NIBA Chicago Conference on "Real Time Compliance" in which audience members had the opportunity to vote in real time on which compliance/regulatory topics to discuss. NIBA is a non-profit association that helps its members find greater success in the derivatives industry through education and networking while providing members with a voice in regulatory and industry matters.

Euromoney/ECBC Covered Bond Congress 2019 – On September 12, Anna Pinedo and Jerry Marlatt participated in the Euromoney/ECBC Covered Bond Congress in Munich. The event brought together issuers, investors, intermediaries and policymakers from over 35 different countries. The conference explored key trends in the global covered bond market, including preparing participants for the imminent implementation of the covered bond directive, confronting the end of the ECB purchase program and navigating the increasing political uncertainty in Europe. Jerry's panel was entitled "Panel VI: 2020 vision: the covered bond market in the next twelve months."

Effective Hedge Fund Tax Planning – On September 17, Mark Leeds participated in the "Qualified Opportunity Zones: New Tax Benefit for Investors and Managers?" panel at the Effective Hedge Fund Tax Planning Conference.

Pocket MBA 2019: Finance for Lawyers and Other Professionals – On September 24, Anna Pinedo attended a PLI conference in San Francisco and participated in a panel discussion entitled, "Investment Banking Basics: Fundamentals of Capital Structures." Topics included common financing alternatives (debt, equity, and hybrids), sources of funding (public and private markets), liquidity (raising and deploying capital), finding the optimal capital structure, and current marketplace developments. The conference was specifically designed for in-house and law firm attorneys as well as other professionals who work with financial information. Its goal was to enhance understanding of business strategies, accounting fundamentals and vocabulary used by management, investors, auditors, and bankers.

The SEC's Concept Release on Exempt Offerings: Will it Create Harmony? – On October 2, Michael Hermsen and Anna Pinedo led a PLI webinar on issues pertaining to the SEC's recent Concept Release on Harmonization of Securities Offering Exemptions. Topics included traditional private placements conducted under Section 4(a)(2) and Rule 506(b); the evolution of general solicitation and Rule 506(c), the motivations for using one of these approaches over another; integration of offerings in close proximity to one another and the changes in integration analyses over the years; choosing among a Regulation A, a crowdfunded, and a Rule 506(c) offering; investor qualifications, sophistication and disclosure, and resale exemptions.

Executive Compensation University – On October 3, Anna Pinedo, Jen Carlson, and Laura Richman presented on "Executive Compensation Related Disclosure Matters for the Upcoming Proxy Season" at Mayer Brown's 2nd Annual Executive Compensation University. The half-day program explored tax, employment and securities issues impacting executive compensation, as well as how those issues should be approached given the changing regulatory landscape. Some topics included: common executive compensation mistakes to avoid, disclosure issues, hot topics and current trends in executive compensation and employment disputes related to executive compensation.

15th Annual Summit of the Structured Investment Industry – On October 8, Brad Berman, Tom Humphreys, Marlon Paz, Anna Pinedo and Brennan Young participated in the annual structured products summit held by Mayer Brown in conjunction with Bloomberg and the Structured Products Association. The summit featured industry leaders who presented their thoughts on the latest developments in the structured products market and provided their predictions for 2020 and beyond. Panel presentations included, "Tax Developments" (Thomas Humphreys and Brennan Young), "Index Creation & Index Governance" (Brad Berman), "Licensing Indices to Annuity Providers" (Anna Pinedo) and "Update on Regulation Best Interest, State Fiduciary Laws, and the DOL's Fiduciary Rule" (Marlon Paz). The keynote event featured Anna Pinedo interviewing Congressman Jim Himes, who provided an insider's perspective on today's political climate and its implications for financial services regulation. The keynote address was titled "Financial Services Regulation, The Pendulum Swings Back."

Opportunity Zone Expo - Houston – On October 10, Mark Leeds presented on "OZ Investing 101: What are Opportunity Zones and How to Take Advantage of Them" at the Opportunity Zone Expo in Houston.

11th Annual Conference on Futures and Derivatives – On October 17, Matthew Kluchenek presented the Enforcement Panel, where he and Steven Schweitzer, Senior Director and Regional Head of Enforcement at CME Group, discussed, in a point/counterpoint fashion, various CME Group disciplinary and investigatory considerations, including the following topics: advantages/disadvantages of global settlements, role and impact of cooperation, including self-reports, parallel investigations involving CME group and the CFTC, use of prior cases in negotiating sanction determinations, pros and cons of taking cases to hearings, and negotiating notices of disciplinary action.

REVERSEInquiries Workshop Series: ETNs and Daily Redeemable Notes – On October 16, Brad Berman and Brennan Young led a webinar discussing the securities law and exchange requirements related to issuing ETNs and daily redeemable notes. Among other things, they discussed securities law-elated issues including Regulation M considerations, exchange listing processes, disclosure related considerations and regulatory concerns.

Israel's Expanding International Presence and its Opportunities – On October 23, Phyllis Korff and Anna Pinedo hosted an event along with the Israeli Business Forum of New York. The event featured a discussion of Israel's expanding international presence and its opportunities, led by Major Gen. (Ret) Matan Vilnai, former Ambassador to China, Former Israeli Government Minister and Member of Knesset.

Advanced Swaps & Other Derivatives 2019 Seminar – On October 23-24, Mark Leeds participated in "Tax Developments in the Derivatives Area" at PLI's Advanced Swaps & Other Derivatives Seminar. The program covered documentation issues, and recent developments in tax, accounting and litigation related to OTC derivatives, as well as professional responsibility issues associated with derivatives.

US ECM Roundtable – On October 24, Anna Pinedo attended the 8th annual International Financing Review (IFR) event, which brought together a panel of the most senior ECM practitioners to assess the current state of the market, discuss the latest trends and developments and provide an outlook for the remainder of the year and beyond.

Authors

Steven Garden
Chicago
T: +1 312 701 7830
E: sgarden@mayerbrown.com

Russell Nance
New York
T: +1 212 506 2534
E: rnance@mayerbrown.com

George Haines
Chicago
T: +1 312 701 8775
E: ghaines@mayerbrown.com

Andre Smith II
Chicago
T: +1 312 701 8890
E: andresmith@mayerbrown.com

Brennan Young
New York
T: +1 212 506 2691
E: byoung@mayerbrown.com

Jared Goldberger
New York
T: +1 212 506 2421
E: jgoldberger@mayerbrown.com

Remmelt Reigersman
Palo Alto
T: +1 650 331 2059
E: rreigersman@mayerbrown.com

Juan Lopez Valdek
New York
T: +1 212 506 2471
E: jlopezvalek@mayerbrown.com

Grace Sur
New York
T: +1 212 506 2311
E: gsur@mayerbrown.com

Thomas Humphreys
New York
T. +1 212 506 2450
E: thumphreys@mayerbrown.com

Lucas Giardelli
New York
T: +1 212 506 2238
E: lgiardelli@mayerbrown.com

Amit Neuman
New York
T: +1 212 506 2263
E: aneuman@mayerbrown.com

Stephanie Wood
New York
T: +1 212 506 2504
E: swood@mayerbrown.com

Additional Contacts

James Barry
Chicago
T: +1 312 701 7169
E: jbarry@mayerbrown.com

Mark Leeds
New York
T: +1 212 506 2499
E: mleeds@mayerbrown.com

David Goett
New York
T: +1 212 506 2683
E: dgoett@mayerbrown.com

Jason Bazar
New York
T: +1 212 506 2323
E: jbazar@mayerbrown.com

Michael Marion
New York
T: +1 212 506 2651
E: mmarion@mayerbrown.com

Minju Kim
New York
T: +1 212 506 2169
E: mikim@mayerbrown.com

Jeffrey Bruns
Chicago
T: +1 312 701 8793
E: jbruns@mayerbrown.com

Jonathan Sambur
Washington DC
T: +1 202 263 3256
E: jsambur@mayerbrown.com

Michael Loquercio
Chicago
T: +1 312 701 8904
E: mloquercio@mayerbrown.com