**MEMO# 22732**

July 24, 2008

# ICI Submission On Money Market Funds And SIV Restructurings

[22732]

July 24, 2008

TO: TAX MEMBERS No. 28-08
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 19-08
INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 14-08 RE: ICI SUBMISSION ON MONEY MARKET FUNDS AND SIV RESTRUCTURINGS

ICI today submitted to the Treasury Department and the Internal Revenue Service the attached letter requesting clarification of the tax treatment of a money market fund that participates in the restructuring of a structured investment vehicle ("SIV") or a non-SIV special purpose vehicle. The specific tax issue is whether any portion of the post-restructuring appreciation in the value of the SIV collateral should be treated as ordinary income under the market discount rules. The letter requests clarification that all of the appreciation will be treated as capital gain (which can be offset by the capital loss recognized during the restructuring of the SIV notes for the SIV collateral).

**Factual Discussion**

The SIV notes at issue have gone into technical default because of the credit market liquidity crisis. Most of these SIV assets continue to make their scheduled payments. In general, the SIV noteholders and the market expect that: (1) SIV asset market values will increase as market liquidity is restored; and (2) income and principal payments on the SIV assets will be sufficient to allow senior noteholders to recover a substantial portion, if not all, of their investment. Hence, many money market funds prefer to maintain their economic exposure by working with the receiver to acquire the SIV's collateral and hold the collateral until adequate liquidity returns to the marketplace or the underlying collateral matures. A forced sale of the collateral in this market, in contrast, would lock in a loss and might not be in the best interest of the money market fund's shareholders.

The process by which SIVs are being restructured varies. In general, the restructuring involves the creation of a new entity ("NewCo"). The SIV's senior noteholders, seeking to maintain their economic exposure to the SIV's collateral, will exchange their SIV notes for NewCo notes (with a par value equal to the par value plus accrued interest of the exchanged SIV notes); the NewCo notes will be treated for tax purposes as equity interests in a partnership. NewCo then acquires the SIV's collateral. Under one common mechanism, NewCo will provide the receiver with a "credit bid" (that is equal to the SIV notes' par value) for the SIV's collateral; NewCo fully expects that the credit bid will be accepted because the bid will exceed, often by a substantial amount, the current market value of the SIV collateral. The money market funds holding NewCo notes will maintain their economic exposure to the SIV's collateral after the credit bid is accepted and NewCo's SIV notes are exchanged for the SIV's collateral. [1]

The restructurings are designed to ensure that the senior creditors ultimately hold NewCo notes with an interest in the underlying SIV collateral equal to the full par value of their SIV notes, plus any accrued and unpaid interest, and that such interest is free and clear of any claims by the capital noteholders of the SIV. The NewCo notes provide for "pass through" payments to be made to holders as the underlying collateral makes coupon payments, matures, or is sold.

**Legal Discussion**

The letter's legal discussion first describes the Arrowsmith doctrine, which derives from a 1952 U.S. Supreme Court opinion. Under this doctrine, income received in a later period that is related closely enough to a transaction occurring in an earlier period should have the same tax character. Because no bright line rule exists for determining when Arrowsmith applies, industry guidance is needed.

The letter then explains why the Arrowsmith doctrine should apply to money market funds participating in SIV restructurings. First, the investment in the assets is merely a continuation of the initial investment in a different form. Second, any gain on the assets will represent a recoupment and reversal of the loss incurred by the fund when it exchanged the SIV notes for the assets. Third, and perhaps most important, it was solely the decline in value of the SIV assets that created the fund's economic loss and triggered the SIV's liquidation. The letter also states that providing guidance on this issue would be consistent with the Treasury's announced openness and desire to address tax uncertainties created by the current economic environment.

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Senior Counsel - Tax Law

Attachment

**endnotes**

[1] In another arrangement, pursuant to a pre-arranged plan: (1) a third party (usually an investment bank) will purchase the SIV collateral from the SIV's receiver; (2) the receiver will distribute the sales proceeds to the SIV senior noteholders (i.e., NewCo) for the SIV notes; and (3) NewCo will purchase the SIV collateral from the third party.  Under one variation of this approach, NewCo then distributes the SIV notes back out to the senior noteholders, who continue to have a claim against the SIV that is supported by a small amount of  collateral remaining in the SIV for winding-up purposes.

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