REPORT #892

TAX SECTION

New York State Bar Association

REPORT ON SUGGESTED FASIT REGULATIONS

February 7, 1997

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TAX SECTION

New York State Bar Association

February 7, 1997

Hon. Donald C. Lubick
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Report on Proposed Regulations to be Issued Under FASIT Provisions

Dear Secretary Lubick and Commissioner Richardson:

Enclosed is our report setting forth suggestions for regulations to be issued under the FASIT provisions of the Code, Sections 860H through 860L. The report was prepared in response to Announcement 96-121, which solicited suggestions for regulations. The principal drafter of the report was Michael L. Schler.

Our recommendations are summarized in Part II of the report. In addition, Part III of the report lists those regulations as to which we believe it is essential that they be adopted well in advance of the September 1, 1997 effective date of the FASIT provisions.

The FASIT provisions create an entirely new type of pass-through entity designed to facilitate the securitization of receivables and other debt instruments. In making our recommendations, we have attempted to balance the practical needs of taxpayers desiring to make use of FASITs for this purpose against the needs of the government to prevent tax-payers from taking unintended advantage of the provisions.

We would be pleased to assist the Treasury and the Service in the process of adopting FASIT regulations. Please feel free to contact us if we can be of further assistance.

Respectfully submitted,

Richard L. Reinhold

Tax Report #892

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SUGGESTED FASIT REGULATIONS

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REPORT ON SUGGESTED FASIT REGULATIONS

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This Report[1/] provides our recommendations for regulations that should be adopted under Sections 860H through 860L,[2/] relating to Financial Asset Securitization Investment Trusts, or FASITs. We also suggest one technical correction.[3/]

A FASIT is a new type of statutory pass-through entity intended to facilitate the securitization of debt obligations, including credit card receivables, trade receivables, automobile loans, home equity loans, and small business loans. The FASIT provisions, which are effective September 1, 1997, were adopted in Section 1621 of the Small Business Job Protection Act of 1996 (the "Act").[4/]

[1/] The drafting of this Report was coordinated by Michael L. Schler. Significant drafting contributions were made by Charles M. Adelman, Tom Brenner, Mason Crocker, Thomas A. Humphreys, Bruce Kayle, Steven L. Kopp, David S. Miller, David Z. Niremberg, James M. Peaslee, Peter Ritter, Robert H. Scarborough and Michael L. Schler. Helpful comments were received from Dale S. Collinson, Linda L. D'Onofrio, Stephen L. Millman, Richard L. Reinhold and Donald B. Susswein.

[2/] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended, and all references to Treas. Reg. § ____, are to the regulations issued there-under.

[3/] See Par IV.G.

[4/] P.L. 104-188, signed Aug. 20, 1996. The provision was added by Senate amendment and is discussed in S. Rep. No. 104-281, 104th Cong., 2d Sess. at 125-33 (1996) (the "Senate Report"). There was no comparable provision in the House bill, H.R. 3448. A modified version was adopted in Conference, see H. Conf. Rep. No. 104-737, 104th Cong., 2d Sess. at 320-29 (1996) (the "Conference Report"). The provision is also discussed in Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress at 258-67 (1996) (the "Blue Book"). We commented previously on an earlier version of the legislation. NYSBA Tax Section, Report on Proposed "FASIT" Legislation, May 26, 1994, reprinted in Highlights & Documents, June 13, 1994, at 3582.

In Announcement 96-121, 1996-47 I.R.B. 12, the Treasury Department and the Internal Revenue Service solicited comments on issues arising under the FASIT provisions. The Announcement requested that taxpayers give particular attention to rules that would allow multiple members of a consolidated group to own interests in a single FASIT, transitional rules for pre-effective date entities, and any other rules that should be in place before September 1, 1997.

Part I of this Report summarizes the FASIT provisions. Part II summarizes our recommendations. Part III indicates those regulations for which we believe issuance well in advance of September 1, 1997 is essential. Part IV provides our detailed recommendations.

I. Summary of FASIT Provisions

A. Qualification Requirements

To qualify as a FASIT, an entity must elect to be treated as a FASIT, satisfy certain tests concerning the composition of its assets, meet certain requirements relating to its ownership and non-ownership interests, and not qualify as a regulated investment company (a "RIC"). Any entity, including a corporation, partnership, trust, or a segregated pool of assets, may be treated as a FASIT.

An entity need not make the FASIT election in the year of its formation. However, once an election to be a FASIT is made, the election is applied from the date specified in the election (the "startup day") and all subsequent years until the entity ceases to be a FASIT.

Loss of FASIT status is effective on the date an entity ceases to qualify as a FASIT.[5/]

Substantially all of the FASIT's assets must be "permitted assets" at the close of the third month beginning after the date of formation and at all times thereafter. Permitted assets include cash or cash equivalents, and instruments that are indebtedness for federal income tax purposes and that bear interest at either a fixed or qualified variable rate. Obligations issued, directly or indirectly, by the FASIT owner or certain related persons are not permitted assets. Other permitted assets include certain foreclosure property, certain instruments or contracts that hedge or guarantee debt issued by the FASIT, contract rights to acquire debt instruments that are permitted assets or hedges, and regular interests in a real estate mortgage investment conduit (a "REMIC") or another FASIT.[6/]

Unlike a REMIC, a FASIT may acquire permitted assets at any time, including after its formation. In particular, the FASIT provisions are specifically designed to permit the FASIT to reinvest the cash flows on its receivables into new receivables balances.

To qualify for FASIT status, an entity must have only one ownership interest and the interest must be held directly by an eligible corporation (the "Owner"). Generally, an eligible corporation is a domestic C corporation that is not exempt from federal income taxation and does not qualify as a RIC, real

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[5/] Section 860L(a).

[6/] Section 860L(c).

estate investment trust (a "REIT"), REMIC, or cooperative.[7] Congress expects the Treasury to issue guidance, prior to September 1, 1997, on the application of this rule when more than one member of a consolidated group wishes to hold an ownership interest in a single FASIT.[8]

All of the interests in a FASIT other than the ownership interest must be "regular interests." A regular interest must have fixed terms, unconditionally entitle the holder to receive a specified principal amount and, except as permitted by regulations, have a term to maturity of no more than 30 years. Interest thereon must be based on one or more fixed rates or, except as provided by regulations, a variable rate that is permitted with respect to REMIC regular interests (generally, a "qualified floating rate" as defined in Treas. Reg. § 1.1275-5(b)(1), but with a number of liberalizations).[9] Further, the instrument must be issued with a premium of not more than 25 percent of its stated principal amount and, as of its date of issue, have a yield to maturity of no more than five percentage points above the applicable Federal rate under Section 1274(d) ("AFR") for the calendar month in which the instrument is issued.[10]

A FASIT may also issue a special type of regular interest, referred to as a "high yield interest." The only requirements for a high yield interest are that it must have fixed terms, a maturity of not more than 30 years (except as provided by regulations), and an interest rate that either meets the requirements described above or else that consists of a

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[7] Section 860L(a)(1)(C),(2).

[8] Conference Report at 329.

[9] See Treas. Reg. § 1.860G-1(a)(3).

[10] Section 860L(b)(1)(A).

specified, unvarying portion of the interest payments on permitted assets held by the FASIT.[11] A high yield interest may only be held by a domestic C corporation that could qualify as a holder of an ownership interest, another FASIT, or a securities dealer holding the position as inventory.[12]

B. Ongoing Taxation of the FASIT Owner

A FASIT itself generally is not subject to tax and is not treated as a trust, partnership, corporation, or taxable mortgage pool. Rather, in determining the Owner's taxable income, all of the FASIT's assets, liabilities, and items of income, gain, deduction, loss and credit are treated as such items of the Owner. The determination is made using the accrual method of accounting, accruing currently all discount and premium on debt instruments held by the FASIT, treating tax exempt interest as taxable, and disregarding prohibited transactions (discussed below).[13]

The Owner's taxable income derived from the ownership interest (including gains from sales of the interest) can never be less than the taxable income derived solely from the FASIT interest, meaning that non-FASIT losses cannot offset FASIT income. This rule is applied on a consolidated basis.[14]

The Owner is also subject to an excise tax equal to 100 percent of net income derived from any "prohibited transaction" engaged in by the FASIT. Prohibited transactions are the receipt of income from an asset that is not a permitted asset, any

[11] Section 860L(b)(1)(B).

[12] Section 860K.

[13] Section 860H(a),(b).

[14] Section 860J(a),(d).

disposition of an asset other than certain permitted dispositions, the receipt of any income from a loan "originated" by the FASIT, and the receipt of income representing a fee or other compensation for most services. Generally, dispositions are permitted if the purpose is to substitute one permitted debt instrument for another, to completely liquidate a class of regular interests, to reduce over-collateralization, or for the reasons permitted under the REMIC rules.[15/]

C. Transfer of Assets to a FASIT.

If the Owner or a related person transfers assets to a FASIT, gain (but not loss) is recognized immediately and the basis of the assets is increased by the amount of such gain. For this purpose, assets are generally valued at their fair market value, with a very significant exception for debt instruments not traded on an established securities market (i.e., most debt instruments that are typically securitized). Such debt instruments are valued at the sum of the present values of the reasonably expected cash flows from the instruments discounted over the weighted average life of such instruments using a discount rate of 120 percent of the AFR.[16/]

If any non-FASIT assets of the Owner or a related person at any time "support" a FASIT regular interest, those assets are deemed contributed to the FASIT and subject to the above gain recognition rule.[17/] According to the legislative history, assets

[15/] Section 860L(e).

[16/] Section 860I(a)(1),(d).

[17/] Section 860I(b).

support a regular interest if, among other things, they are reasonably expected to pay regular interests, either directly or indirectly, or otherwise to secure or collateralize regular interests.[18/]

Property acquired by a FASIT from someone other than the Owner or a related person is treated as being first acquired by the Owner for an amount equal to the FASIT's cost, and then sold to the FASIT for the amount determined under the above valuation method.[19/] To the extent provided by regulations, gain recognition on contributed (or deemed contributed) assets may be deferred until such assets support regular interests issued by the FASIT or any indebtedness of the Owner or related person.[20/]

D. Holders of Regular Interests

Regular interests (including high yield interests) are treated as debt for Federal income tax purposes regardless of how an instrument with similar terms issued by a non-FASIT would be treated. A holder of a regular interest, including a high yield interest, is taxed in the same manner as a holder of any other debt instrument. However, the regular interest holder is required to account for interest income on the accrual method.[21/] A holder of a high yield interest is not allowed to use NOLs to offset any income derived from the high yield interest.[22/]

[18/] Conference Report at 326 n.67.

[19/] Section 860I(a)(2).

[20/] Section 860I(c).

[21/] Section 860H(c).

[22/] Section 860J(a).

E. Regulatory Authority

The Treasury is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the FASIT provisions, including "regulations to prevent the abuse of the purposes of this part through transactions that are not primarily related to the securitization of debt instruments by a FASIT."[23/]

F. Effective Date

The FASIT provisions generally are effective on September 1, 1997.[24/] Special transition rules are provided for entities (e.g., existing "master trusts") in existence on August 31, 1997 that subsequently elect to be a FASIT (a "pre-effective date FASIT"). In general, under those rules, gain is not recognized on property held by such an entity until the property ceases to be allocable to an interest in the entity issued before the startup day (a "pre-FASIT interest").[25/]

G. Overview of the Statutory Provisions

The foregoing rules are best considered in the context of their purpose, which was an attempt to eliminate the numerous tax uncertainties arising from existing securitization structures. The rules represent a tradeoff for taxpayers. The benefits are that (1) the Owner is entitled to pass-through treatment from the FASIT, i.e., even if the FASIT has publicly traded interests and constantly reinvests in new receivables, there is no risk as under current law that the FASIT will be a

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[23/] Section 860L(h).

[24/] Act Section 1621(d).

[25/] Act Section 1621(e).

publicly traded partnership taxable as a corporation,[26] and (2) regular interests in the FASIT are always treated as debt, i.e., there is no risk as under current law that interests in a securitization vehicle might be re-characterized as equity. On the other hand, the "costs" to the taxpayer are that (1) the Owner has gain recognition on assets transferred to the FASIT, even though such gain would be deferred under many existing securitization structures, (2) the Owner and the holders of high yield interests must be domestic C corporations, in order to prevent equity-like returns from leaving the corporate tax base, and (3) except for the reinvestment of collections, the FASIT must be quite passive, i.e., it cannot receive income for services, it cannot originate loans, and it can only sell assets under limited circumstances.

II. Summary of Recommendations

Our principal recommendations are as follows:

1. Regulations should clarify the extent to which transactions with a FASIT are deemed to be transactions with the Owner, and the extent to which holders of regular interests are deemed to be holding debt of the Owner. (IV.A)

2. Regulations should clarify that, absent application of the "support" rule discussed below, an Owner entering into a contract to contribute assets to a FASIT in the future (or to sell assets to the FASIT for less than fair market value) will not be taxed on a deemed contribution at the time the contract is entered into. The same rule should apply to an Owner guarantee of

[26] Section 7704.

an asset transferred to the FASIT, although the guarantee may increase the value of the asset and thus increase the gain recognized on the transfer of the asset itself. (IV.B.1)

3. Regulations should provide that a taxable debt modification in a workout is not treated as a deemed sale of the new debt by the Owner to the FASIT, and that certain conforming restrictions apply to the recognition of losses by a FASIT in a workout. (IV.B.2(a))

4. Regulations should clarify the tax consequences if a person other than the Owner sells property to a FASIT in exchange for a regular interest. (IV.B.2(b))

5. Regulations should clearly and unambiguously identify the circumstances under which assets held outside a FASIT are deemed to "support" regular interests issued by the FASIT. In our view, support should not generally exist solely because of a retention by the Owner of a non-subordinated interest in debt instruments in which the FASIT has an interest, and should generally exist if the timing and amount of payments on regular interests is determined in large part by the timing or amount of payments on the assets outside the FASIT. In the case of unsecured or secured Owner guarantees of FASIT assets or of regular interests, support should be found to exist if (and only if) the arrangement results in a "change in payment expectations" on the regular interests under the Section 1001 regulations. In the case of an agreement by the Owner to sell debt instruments to the FASIT in the future for less than their fair market value, support should not exist if the instruments are to be sold at their face amount or at a reasonable discount, and in other cases the "change in payment expectations" test should apply. (IV.B.3(a)- (e)).

6. If assets outside a FASIT are considered to support regular interests, the aggregate amount of supporting assets should be limited to the amount necessary to pay the supported regular interests. To the extent support is found to exist, only a one-time gain recognition on such assets (as opposed to mark to market treatment) should apply, and duplication of gain recognition should be avoided. (IV.B.3 (f)-(g))

7. The Treasury and IRS should exercise their regulatory authority to defer gain recognition on a transfer of assets to a FASIT until the assets within the FASIT support regular interests issued by the FASIT. (IV.B.4)

8. Regulations should be adopted to permit gain recognition in certain situations based on the actual fair market values of assets transferred to a FASIT, in lieu of the statutory discount rate for expected cash flows (120% of AFR). The use of actual fair market values should be permitted if there was an arm's length purchase of the assets from a third party or, in the case of assets with an expected weighted average maturity of more than five years, if price quotations from brokers or dealers are readily available. In addition, regulations should modify the statutory discount rate where taxpayers can demonstrate that a higher discount rate is appropriate for specified categories of assets. (IV.B.5)

9. Regulations should clarify that gains recognized by an Owner or holder of a high yield interest on a transfer of assets to a FASIT can be offset by the transferor's net operating losses. (IV.C)

10. Regulations should permit multiple members of a consolidated group to be Owners of a single FASIT. Each member should be required to own a pro rata undivided interest in the FASIT, and should generally be treated as owning undivided interests in each of the underlying assets of the FASIT. Deemed transfers of FASIT assets among consolidated group members should generally not result in gain recognition. (IV.D)

11. In connection with the definition of regular interests in a FASIT, regulations should clarify that such interests can be issued on (not merely after) the startup day, can have a principal amount that increases as the holder makes new investments, and can provide for the pass-through of customary prepayment penalties on the underlying assets. Regulations should clarify the method for determining whether a regular interest meets the yield and issue price requirements for a regular interest. Regulations should clarify whether a high yield interest can have contingent principal. (IV.E)

12. In connection with debt instruments that can be held by a FASIT, regulations should clarify that a FASIT may hold shares in a money market mutual fund, that the debt instruments held by a FASIT may provide for prepayment penalties and withholding tax grossups, and whether a FASIT may hold a participation interest in a pool of revolving loans. (IV.F.1 to .3)

13. Regulations should permit a FASIT to hold a total return swap, and to enter into hedges primarily intended to relate to regular interests even if they incidentally relate to the ownership interest. Regulations should clarify that if a FASIT enters into a notional principal contract that is re-characterized in part as a deemed loan to or by the FASIT, such

re-characterization applies for testing the qualification of the FASIT. (IV.F.4)

14. In connection with the rule that a FASIT may not hold debt (other than cash equivalents) issued by the Owner, regulations should clarify that this rule does not prevent tiered FASITs with a common owner, that a FASIT may make temporary investments in commercial paper of the Owner, that a servicer may retain temporary custody of cash collected on behalf of the FASIT, that the FASIT may hold de minimis amounts of otherwise non-qualifying debt of the Owner, and that a notional principal contract entered into with the Owner may be treated as a deemed loan to the Owner. (IV.F.5)

15. Clarification should be provided for the rule that a FASIT may not "originate" loans. We suggest a safe harbor rule that the prohibited origination will not be deemed to occur if certain conditions are satisfied, which conditions are designed to prevent the FASIT from engaging in an active business. We also suggest examples to illustrate the proposed rule. (IV.H)

16. Regulations should clarify whether a sale of debt instruments by the Owner to a FASIT can be considered a sale to customers by a dealer for purposes of the mark to market rules of Section 475. (IV.I)

17. Any anti-abuse regulations should be limited to transactions that are considered inconsistent with the purposes of the FASIT provisions. They should not attempt to define "securitization" and then broadly provide that a FASIT may only engage in transactions that fit within such definition. Anti-abuse regulations should provide the IRS with the option of imposing sanctions on the Owner or other holder of interests in

the FASIT, rather than necessarily disqualifying the entire FASIT. (IV.J)

18. A pre-effective date FASIT should be treated in part as a FASIT, and in part as a non-FASIT. FASIT and non-FASIT treatment should be pro rata, with the FASIT percentage at any time based on the ratio at that time of outstanding FASIT regular interests to total outstanding FASIT regular interests and pre-FASIT interests. As new regular interests are issued and pre-FASIT interests paid down, the FASIT percentage will gradually increase until it reaches 100%. Regulations should clarify a number of issues that arise from an entity treated only in part as a FASIT. (IV.K)

III. Regulations that are Essential by September 1, 1997

We believe it is essential that regulations on the following matters be issued prior to September 1, 1997. Preferably these regulations should be issued well in advance of that date.

1. Clarification of when assets held outside the FASIT will be deemed to "support" regular interests. (IV.B.3)

2. Exercise of regulatory authority to defer gain recognition on assets held by a FASIT until those assets support regular interests issued by the FASIT. (IV.B.4)

3. Regulations permitting the use of actual fair market values in certain situations in lieu of the 120%-of- AFR discount rate in determining gain on the transfer of assets to a FASIT. (IV.B.5)

4. Regulations permitting multiple members of a consolidated group to be Owners of a single FASIT. (IV.D)

5. Regulations concerning a FASIT's holding of debt of the Owner. (IV.F.5)

6. Clarification of the requirement that a FASIT may not "originate" loans. (IV.H)

7. Regulations concerning the treatment of pre-effective date FASITs. (IV.K)

IV. Recommendations

A. Section 860H: General Rules

Section 860H(a) states that a FASIT is not treated as a trust, partnership or corporation. Section 860H(b)(1) states that in determining the taxable income of the Owner, all assets, liabilities and income and deduction items of the FASIT are treated as such items of the Owner. Finally, Section 860H(c) states that a regular interest shall be treated as debt, but does not say who (the FASIT or the Owner) is the issuer of the debt.

These provisions are not clear concerning the extent to which transactions with a FASIT are to be treated for tax purposes as transactions with the Owner. The implication is that this is not generally the case, since the statute only treats the assets and liabilities of the FASIT as assets and liabilities of the Owner in determining the Owner's own tax consequences.

However, the legislative history indicates[27] that "income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner." This appears to mean, for example, that Section 871(h) would make a 10% shareholder of the Owner (or a controlled foreign corporation with respect to the Owner) ineligible for the portfolio interest exemption from withholding tax on interest paid on a regular interest in the FASIT.

To avoid confusion and inadvertent mistakes by taxpayers, regulations should clarify the extent to which transactions and relationships with a FASIT are deemed transactions and relationships with the Owner. In particular, regulations should clarify the extent to which regular interests issued by a FASIT are treated as debt of the Owner.

Even if regular interests are generally to be treated as debt of the Owner, we suggest a specific rule providing that Section 1001 will not apply to a holder of a regular interest solely because of a change in the Owner of the FASIT (assuming no Owner guarantees are involved). The reason for this rule is that there is no substantive effect on the holder of a regular interest in this situation. Moreover, as a substantive matter the regular interests (if they are viewed as debt of the Owner) should be viewed as nonrecourse debt of the Owner, and Section 1001 does not apply to the substitution of a new obligor on nonrecourse debt.[28]

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[27] Conference Report at 324.

[28] Treas. Reg. § 1.1001-3(e)(4)(ii).

B. Section 860I: Gain Recognition on Transfers to a FASIT

1. Section 860I(a)(1): Property acquired from the Owner

Under Section 860I(a)(1), if "property is sold or contributed" to a FASIT by the Owner, the Owner recognizes gain equal to the excess of the value of the property (determined under the formula discussed below) and the Owner's basis in the property.

(a) Contribution agreements. A typical FASIT can be expected to issue regular interests with a maturity several years in the future, and to use the proceeds to purchase short term revolving assets such as credit card receivables from the Owner. As the revolving assets pay down, the FASIT will use the cash to purchase additional balances from the Owner. This process will continue until the maturity of the regular interests, at which time the payments on the assets will be used to pay off the regular interests (unless new regular interests are issued to refinance the maturing regular interests, in which case the FASIT will continue to reinvest its cash flows in new assets).

The assets sold by the Owner to the FASIT will typically be valued at more than their face amount. Moreover, under Section 860I(a)(1), the Owner will generally expect to have taxable gain as such assets are sold to the FASIT.

It can be expected that in a typical FASIT, the Owner will agree with the FASIT at the time of issuance of the regular interests to sell new assets to the FASIT as the old assets pay down. Such a commitment on the part of the Owner is necessary to provide assurance to the purchasers of regular interests that the FASIT will be able to reinvest its cash in new assets rather than having to prepay the regular interests before their maturity dates. Moreover, assuming the purchase price for the additional assets will be less than their fair market value, such a commitment on the part of the Owner will be a valuable asset to the FASIT. Such a commitment on the part of the Owner to sell assets to the FASIT in the future at a below-market price is clearly permissible, since Section 860L(c)(1)(E) defines "permitted assets" to include contract rights to acquire debt instruments.

However, if the Owner enters into a contract with the FASIT to sell assets in the future to the FASIT for a price less than their fair market value, the question arises as to whether the entering into of such a contractual arrangement is a "contribution" of the contract rights by the Owner to the FASIT at the time the contract is entered into. If so, under Section 860I(a)(1), the Owner would be taxed initially on the entire value of that contract.

We believe the Owner should not be taxed under Section 860I(a)(1) upon entering into a forward sale contract with a FASIT, and that regulations should so provide. The statute and legislative history contemplate that the Owner will be taxed when the underlying debt instruments are transferred to the FASIT, not <u>both</u> when the purchase contract is entered into and <u>again</u> when the instruments are transferred to the FASIT.[29/]

[29/] In fact, the original FASIT bill introduced by Representative Hoagland on May 11, 1993 specifically provided in the predecessor to Section 860I(a) and (d) that "[t]he anticipated cash flows and fair market value of assets transferred to a FASIT shall be determined without regard to any future transfers of assets that the transferor may be obligated or permitted to make. Any such subsequent transfer shall be treated at a separate transfer of assets..." H.R. 2065, 103d Cong., 1st. Sess., § 855B(c)(1)(1993). While this language was omitted from the final version of the legislation, the FASIT provisions that ultimately were adopted vary significantly from the bill and there is no indication that the omission reflects an intentional policy decision.

Moreover, in order to avoid double taxation, taxation of the Owner upon entering into the purchase contract would require complex methods of valuing the contract as well as the Owner's amortization of any resulting gain (and the FASIT's amortization of its basis in the contract) as assets were actually purchased. However, the statute specifically imposes tax on the Owner when the assets are transferred to the FASIT, and does not even hint at any offset for amortization of previously recognized gain. This indicates quite strongly that no taxable gain to the Owner was contemplated prior to the actual transfer of the assets to the FASIT.

Finally, in the context of Section 860I(b) (relating to supporting assets) discussed below, the legislative history clearly states that a commitment to make contributions does not result in tax under that provision until the assets are actually contributed or set aside.[30/] Likewise, Section 860I(d)(2)(A) provides that each extension of credit on a revolving loan account is to be treated as a separate debt instrument; this means that the contribution of the subsequent loan is not deemed to occur until the loan is actually made. The pro-taxpayer statement in the legislative history and the statutory provision would be extraordinarily misleading if a contribution agreement nevertheless resulted in tax under Section 860I(a).

We discuss below the possibility that, notwithstanding this legislative history, in some cases a purchase agreement might cause the assets that the FASIT has the right to purchase to be considered to "support" outstanding regular interests, and thus to be taxed under Section 860I(b). However, we do not believe a purchase contract should ever result in tax under

[30/] Conference Report at 326n.67.

Section 860I(a). Regulations should clarify this point.

(b) Owner guarantees. Similarly, if the Owner guarantees assets held by the FASIT or regular interests issued by the FASIT, the guarantee should not be viewed as property transferred to the FASIT that is subject to gain recognition under Section 860I(a). On the other hand, under Section 860I(d)(1)(A), gain on the underlying property transferred to the FASIT is generally determined on the basis of expected cash flows from the property.[31] We assume that the guarantee (whether of the underlying assets or of the regular interests) is to be taken into account in determining the expected cash flows to the FASIT, with the result that the value of the guarantee is indirectly taxed at the time of the contribution of the underlying assets.

2. Section 860I(a)(2): Property acquired other than from the Owner

Under Section 860I(a)(2), if a FASIT acquires property from a person other than the Owner, the property is treated as having been acquired by the Owner for the FASIT's cost, and as having been sold by the Owner to the FASIT at the formula value determined under Section 860I(d).

(a) Section 1001 modifications. Section 860I(a)(2) could produce unexpected and unfair results if a FASIT held a debt instrument that was modified in a workout if the modification was considered a taxable exchange under Section 1001. Assume the debt is not traded. In a deemed exchange by the FASIT of a loan for a new loan, the Owner would be deemed to buy

[31] See Part IV.B.5.

the new loan for the face amount (or fair market value) of the old loan and sell it to the FASIT for the value of the new loan determined under Section 860I(d).

As a result, depending on the AFR at the time of the exchange, the Owner could recognize significant gain. This would be so even if the old loan had been acquired by the FASIT when its fair market value and Section 860I(d) value were its face amount, and even if the loan had declined in value because of credit problems.

Regulations should address this problem by providing that Section 860I(a)(2) does not apply to a loan modification in a workout that is a Section 1001 exchange. Because of the lack of abuse potential, we suggest a broad definition of "workout". For example, workout might be defined as any modification of a debt instrument reasonably intended to prevent default or foreclosure, as long as the principal amount is not increased.

On the other hand, consider the situation where the Owner recognized $10 of gain under Section 860I(a)(2) on the contribution of the old loan, of which $6 is unamortized. The FASIT thus has a basis of $106 in the loan. A loan workout might result in an amount realized to the FASIT of $100 under general Section 1001 principles. Unless Section 1091 applied, the resulting loss of $6 to the FASIT would generally be allowable because the old loan is sold to a third party (the obligor). If the loss of $6 was allowed, but the Owner was not taxable under Section 860I(a)(2) on the deemed contribution of the new loan, an improper offset of the prior gain recognition would be permitted. We suggest that if Section 860I(a)(2) does not apply to a loan workout that is a Section 1001 event, then a loss not be allowed to the FASIT as a result of the workout to the extent of prior unamortized gain (except to the extent allocable to any reduction in the principal amount or deemed principal amount of the loan).

(b) Sales of property for regular interests.

Section 860I(a)(2) also raises numerous questions as to the results if a person other than the Owner or a person related to the Owner (call the person "X") sells property to a FASIT for a regular interest (which might be a high yield interest). Since the regular interest is a debt instrument for all purposes of the Code,[32/] X should be treated as having sold property for a note.

Presumably X would be viewed either as selling the property to the Owner for a note of the Owner, or as selling the property to the FASIT for a note of the FASIT.[33/] Thus, for example, X should be eligible for installment treatment if the conditions are otherwise satisfied.

However, additional questions arise. If the property is a typical receivable, neither the property nor the note will be publicly traded under Section 1273, and thus Section 1274 will apply to determine the issue price of the debt. Moreover, a high yield interest may have a variety of interest formulae that will cause it not to qualify as a "variable rate debt instrument" under Treas. Reg. § 1.1275-5, and thus the note may be a "contingent payment debt instrument" under Treas. Reg. § 1.1275-4. Under Treas. Reg. § 1.1001-1(g), X's amount realized will equal the issue price of the non-contingent portion of the debt, as determined under Section 1274, increased by the fair market value of contingent payments.

[32/] Section 860H(c)(1).

[33/] See Part IV.A.

If these results are intended for a sale to a FASIT for a regular interest, regulations should so provide. Moreover, consideration should be given to questions such as whether X should be entitled to a loss on the sale, and, if so, whether Section 1091 (wash sale) principles should be the only restrictions on losses.

In that connection, note that an Owner is not entitled to a loss on a transfer to a FASIT, and that X's regular interest may have economic terms very similar both to an ownership interest and to the property sold by X. In an extreme example, X might sell a Treasury security to a FASIT for a regular interest representing all the cash flows, with a nominal ownership interest issued to a third party. If the Treasury has a basis and face amount of $100, a below market interest rate, and a fair market value of $80, the regular interest might even represent the right to receive every dollar of principal and interest payable on the Treasury, yet have a face amount (and issue price) of $80 (with OID of $20 payable at maturity bringing the yield on the regular interest to a market rate). Regulations should obviously disallow a loss in this type of situation.

Finally, assume that regulations permit an Owner to defer recognition of some gain on a transfer of assets to a FASIT in exchange for an ownership interest until the assets support regular interests.[34/] In this case, the issue will arise as to whether X should be permitted to defer recognition of gain on a sale of property to a FASIT for a regular interest if X's position is economically unchanged as a result of the sale as in the above example. We believe gain should generally be

[34/] See Part IV.B.4.

recognized, since X has become a creditor of a different legal entity.[35]

3. Section 860I(b): Gain on non-FASIT property supporting regular interests

Section 860I(b) provides that, if property is held by the Owner (or a related person), and is not sold or contributed to the FASIT, but such property nevertheless "supports" any regular interest, then (i) the Owner generally recognizes gain as if the Owner had sold the property to the FASIT on the first date the property supports the interest, and (ii) the supporting assets are treated as held by the FASIT.

The Conference Report provides that, for purposes of Section 860I(b), "supporting assets" include "any assets that are reasonably expected to directly or indirectly pay regular interests or to otherwise secure or collateralize regular interests."[36] However, the Conference Report also goes on to state that "[i]n a case where there is a commitment to make additional contributions to a FASIT, any such assets will not be treated as supporting the FASIT until they are transferred to the FASIT or set aside for such use."[37]

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[35] We are aware that one comment submitted in response to Announcement 96-121 suggests the possibility that regulations might permit an interest in a FASIT having certain indicia of an ownership interest to be denominated and taxed as a high yield interest. We have not considered this suggestion, but we note that its adoption might change the conclusion in the text (and possibly other conclusions in this Report).

[36] Conference Report at 326 n.67 (emphasis added).

[37] Id.

The "support" concept is one of the most difficult in the FASIT provisions. It exists nowhere else in the Code,[38/] and the meaning is very unclear in numerous common situations.

Moreover, the penalty for failing the support test is draconian. In addition to the Owner's gain recognition on the supporting assets, the FASIT will be disqualified if such assets are not permitted assets that can be held by the FASIT.[39/] The resulting consequences are horrendous.[40/]

We strongly emphasize the need for regulations clearly and unambiguously defining "support". As a practical matter, a FASIT cannot be formed unless tax counsel can give a clean opinion stating that the FASIT will qualify as such. Because improper support can cause the disqualification of the FASIT, tax counsel must be absolutely confident that no disqualifying assets outside the FASIT might be deemed to support regular interests. Thus, a clear definition is essential if taxpayers are to be able to utilize FASITs.

[38/] Treas. Reg. § 301.7701(i)-2(a) states that an asset "supports" a debt obligation for purposes of the taxable mortgage pool rules if the timing and amount of payments on the debt obligation are in large part determined by the timing and amount of payments on the asset. This concept is clearly different than that generally contemplated by Congress for FASITs.

[39/] _See_ Section 860L(a)(1)(D), specifically stating that substantially all the assets of the FASIT, "including assets treated as held by the entity under section 860I(b)(2)", must be permitted assets.

[40/] If substantially all the assets of the FASIT are not permitted assets at the close of the third month beginning after the date of formation, Section 860L(a)(1)(D) is ambiguous as to whether the FASIT is disqualified _ab initio_ or only at that time. If the former, corporate level tax could apply from the date of formation. If the latter, corporate level tax would apply after the initial period, but during the initial period the 100% excise tax would apply to all income from the non-permitted assets (conceivably including all the income of the Owner if the Owner provided a full recourse guarantee), Section 860L(e)(2)(A).

In general, we suggest that the concept be defined in regulations relatively narrowly, to encompass the situation where, under the economic arrangement with the holders of regular interests, the assets would logically have been transferred to a FASIT. In such a situation, the support concept makes sense because the Owner should not be able to avoid gain recognition by formally retaining the assets outside the FASIT while in substance they are part of the FASIT.

We have rejected an approach that would test whether support exists by attempting to determine whether the value of a support agreement exceeded some threshold.[41] Rather, we suggest an approach along the following lines:

(a) Retained interests in debt transferred to a FASIT. The Owner might transfer to a FASIT the right to receive a pro rata portion of the principal or interest paid on specified debt instruments. Alternatively, the Owner might strip coupons from specified debt instruments, and transfer the stripped coupons or stripped principal to the FASIT. In these cases, assuming the Owner's retained interest in the debt is not subordinated to the FASIT's interest, the portion of the debt retained by the Owner should not be treated as supporting the regular interests.

On the other hand, to the extent the Owner's retained interest is subordinated to the interest held by the FASIT, the retained interest should be viewed as supporting the regular interests. In this case, the entire debt instrument would logically be transferred to the FASIT, with the ownership

[41] Under this approach, support would be found to exist if the initial value of the support agreement exceeded some threshold, with the threshold set high enough to permit typical commercial arrangements but low enough to tax an agreement that provided significant credit support. However, valuation of a support agreement would raise considerable difficulty and as a practical matter would require that taxpayers be permitted to rely on any reasonable valuation by an investment banker.

interest in the FASIT representing the retained subordinated interest.

(b) Assets with matching cash flows. Regulations might provide that assets outside a FASIT support regular interests if the timing and amount of payments on regular interests were in large part determined, either directly or indirectly, by the timing and amount of payments on such assets. This test would be violated, for example, if prepayments on the assets would result in acceleration of payments on the regular interests. This test is similar to the standard used in Treas. Reg. § 301.7701(i)-1(f) for purposes of defining a taxable mortgage pool.

If such a correlation in payments existed, the assets would logically be included as part of the FASIT and were probably excluded primarily to avoid gain recognition. As a result, support should be found to exist, whether or not the assets in question secure the regular interests.

(c) Assets of an Owner providing an unsecured guarantee. Under the language of the Conference Report, if an Owner provided an unsecured guarantee of regular interests, assets held by the Owner would be supporting assets if (but only if) the guarantee was reasonably expected to be called upon to pay the regular interests. The same test would apply if the Owner provided an unsecured guarantee of the assets held in the FASIT, since such a guarantee would be an indirect guarantee of the regular interests. We agree that this type of test makes sense.[42]

To further clarify the test, we suggest a rule that a guarantee will only result in support if it results in a "change in payment expectations" on the regular interests within the meaning of Treas. Reg. § 1.1001-3(e)(4)(vi). In this context, such a rule would cause support to exist if the guarantee changed the FASIT's ability to pay the regular interest from being "primarily speculative" to being "adequate".

In order to create an objective test and reduce the possibility of disputes, we urge a safe harbor providing that if the regular interests would be at least "investment grade" without a guarantee (generally, a BBB- rating or the equivalent from a major rating agency), the guarantee will not cause the support test to be violated even if the guarantee causes the regular interests to be rated AAA. We believe this is consistent with the legislative history as well as with the Section 1001 regulations.

We acknowledge that a rule of this type could encourage Owners to transfer to a FASIT the minimum amount of assets necessary to obtain a BBB rating on the regular interests, and to provide a guarantee to the extent necessary to bring the rating to the desired level. However, the Conference Report supports this result, and we do not see any practical alternative.

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[42] Cf. Rev. Rul. 94-42, 1994-2 C.B. 15 (guarantee treated as debt instrument of putative guarantor where at issuance there was a "reasonable expectation" and a "significant risk" of the debtor's default); Treas. Reg. § 1.148-4(f)(3) (a "qualified guarantee" under the arbitrage rules must be a "guarantee in substance" under which "the guarantor must not expect to make any payments" that are not immediately reimbursed).

Moreover, and most importantly, a guarantee of the assets held by a FASIT would increase the expected cash flows to the FASIT. Likewise, a guarantee of the regular interests should be treated as increasing the cash flows available to the FASIT to pay the regular interests. As noted above,[43] this increase in expected cash flows would itself increase the gain recognized to the Owner on the contribution of assets to the FASIT. In fact, the fair market value of a guarantee should not be very different than the increase in value of the expected cash flows from the FASIT assets arising as a result of the guarantee. As a result, an attempt by an Owner to contribute fewer assets to a FASIT, and to offset the lack of additional assets with a guarantee of the contributed assets or of the regular interests, would at best provide limited tax benefits to the Owner.

This conclusion would, of course, justify a rule that a guarantee would never be deemed to create supporting assets outside the FASIT, because the increased gain recognition on the contribution of the assets would itself be sufficient to prevent abuse. We agree that such a rule would make sense, although it would be contrary to the explicit language of the Conference Report.

(d) Assets securing regular interests. Under the language of the Conference Report, all assets of the Owner or a related party securing assets in the FASIT or securing regular interests would be treated as supporting assets. Similarly, if an Owner guaranteed such assets or guaranteed regular interests, any assets of the Owner securing the guarantee (which might be all the assets of the Owner) would be supporting assets.

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[43] Part IV.B.1(b).

Despite the language in the Conference Report, we urge that consideration be given to a rule that assets securing FASIT assets or regular interests be treated as supporting assets under the same standards we suggest (which are based on the Conference Report) for unsecured guarantees. That is, the assets would be considered supporting assets if, and only if, the collateral arrangement changed the "payment expectations" on the regular interests.

We readily acknowledge the per se rule in the Conference Report with respect to assets securing regular interests. On the other hand, we question whether the sole act of securing regular interests with specified assets should cause the support test to be violated if there is no change in payment expectations, if an unsecured guarantee would not cause the test to be violated if there likewise is no change in payment expectations. Moreover, as in the case of the unsecured guarantee, a secured guarantee will increase the expected cash flows on the contributed assets and thereby increase the gain recognized to the Owner. As a result, we believe the rule in the Conference Report should be reconsidered.

In addition, simplification is achieved if the same test is applied to all assets held outside a FASIT. Moreover, if different tests are to be applied to secured and unsecured arrangements, regulations will be required to deal with such situations as unsecured guarantees by special purpose bankruptcy-remote affiliates of the Owner.

(e) Contribution agreements. As noted above,[44] we do not believe that an agreement by the Owner to make future contributions to a FASIT should be viewed as a taxable contribution under Section 860I(a) at the time the agreement is entered into. However, this conclusion raises very difficult issues under the support test of Section 860I(b).

A commitment by the Owner to transfer assets to a FASIT in the future at a price below their fair market value does in a sense provide support for the regular interests in the FASIT. Moreover, while a guarantee of the FASIT assets increases the expected cash flows (and thus gain) on contributed assets, and a guarantee of the regular interests can easily be deemed to do so, a contribution agreement of this type cannot easily be treated as increasing the Owner's gain on assets actually contributed. As a result, an Owner would have an incentive to enter into such a contribution agreement in lieu of guaranteeing existing assets of the FASIT or initially contributing additional assets to the FASIT.

Under the Conference Report language quoted above, the Owner would not recognize gain on assets subject to a contribution agreement "until they are transferred to the FASIT or set aside for such use". In order to reflect this Congressional intent as well as the purposes of the support test, we suggest rules along the following lines. These rules are intended to permit normal commercial transactions and at the same time prevent the use of contribution agreements to allow improper gain avoidance.

[44] Part IV.B.1(a).

(i) An agreement by the Owner to sell debt instruments to the FASIT at their face amount should not be viewed as impermissible support, even if the assets bear an above-market interest rate and have a market value above their face amount. Such a rule is particularly necessary for debt instruments that can be prepaid for their face amount. A sale of such assets to a FASIT at above their face amount would not be practicable because of the risk that the FASIT would incur an economic loss upon a prepayment.

A rule of this type could create an opportunity for abuse, since it would permit an Owner to structure debt instruments with above-market interest rates in order that such instruments could be sold to a FASIT at their face amount. However, given the fact that sales of debt instruments at their face amount are extremely common in securitization transaction, we urge that our general rule be adopted. An anti-abuse rule could also be adopted so as to apply if debt instruments were created with above-market interest rates for the purpose of providing disguised support to FASIT interests. Such an anti-abuse rule should not be difficult to police, given the rarity of debt instruments created for good business purposes with above-market interest rates.

(ii) Our proposal in (i) would not be adequate for many transactions, since many debt instruments that may be held by a FASIT may bear a low interest rate or even no interest (such as in the case of trade receivables). In such case, the FASIT would normally buy the debt at a discount determined so that the "profit" on collection, net of a cushion for losses, would cover the interest owed on the regular interests.

We suggest a rule that impermissible support not be considered to exist if debt is purchased at a discount, so long as the discount is designed to create a yield to maturity to the FASIT at a rate approximating market interest rates (taking into account the riskiness of the assets) with an appropriate "cushion" necessary for the desired rating on the regular interests. This rule might require that the formula for determining discount be set at the time the agreement is entered into.

(iii) It would be possible for an Owner to disguise support for regular interests as an agreement to sell debt to the FASIT. For example, the sale agreement might provide that the FASIT's purchase price for future debt instruments would be as low as necessary to provide the FASIT with the necessary cash to pay the regular interests. Disguised support might also arise if the Owner agreed to contribute debt to the FASIT (for free) to the extent necessary to avoid defaults on regular interests. In these cases, the Conference Report language would literally only tax the Owner when the debt instruments were actually contributed to the FASIT or "set aside for such use".

The Conference Report language is not very helpful in this context. It distinguishes between support agreements and contribution agreements, while the cases in question involve contribution agreements that in substance support regular interests.

To resolve this dilemma, we suggest that agreements to contribute assets to a FASIT generally be eligible for safe harbors of the type described in (i) and (ii) above. However, agreements described in the second preceding paragraph would not be so eligible. If an agreement is not within the safe harbors, it would be governed by the usual rule applicable to unsecured or secured guarantees (depending upon whether the agreement is secured).

This approach avoids the need for still another test applicable to contribution agreements. Moreover, if our suggestion above for a single rule for both unsecured and secured guarantees is adopted, this approach results in a single test applicable to most situations.

(f) Aggregate amount of supporting assets. We believe certain limitations would be appropriate on the amount of assets outside a FASIT deemed to support regular interests. In particular, the value of the supporting assets should never exceed the lesser of (x) the issue price of the supported regular interests and (y) the present value of the maximum dollar amount of the support, determined on the date the agreement is entered into.[45] Moreover, if the support agreement establishes a priority of assets to be sold or contributed to the FASIT, we recommend that gain be recognized in respect of those named assets or classes of assets before other assets.

Limitation (x) is necessary to prevent an Owner that puts up a theoretically large amount of supporting assets from recognizing gain in respect of all such assets where the value of those assets exceeds the total value of the regular interests that are supported. Limitation (y) is necessary to prevent an Owner that issues a guarantee or support agreement subject to a cap from being deemed to sell supporting assets with an aggregate value in excess of the cap.

In determining the amount of assets that can be supporting assets under these limitations, the assets should in principle be valued at their actual fair market values, since such values are actually available to pay the regular interests. However, this approach will necessarily result in some complexity, because the assets will again have to be valued under Section 860I(d) to determine the amount of gain on those assets actually recognized by the Owner.

(g) Consequences of improper support. We assume that, once an asset of the Owner is deemed to support regular interests, there is a one-time gain recognition to the Owner, and the asset is thereafter treated for all purposes as an asset of the FASIT. It follows that a supporting asset is not subject to additional gain recognition as it appreciates in the hands of the Owner, because by that time the entire asset is already deemed owned by the FASIT. Clarification of this point by regulations would be useful.

Moreover, we assume that double counting will be avoided in the calculation of gain arising from support outside the FASIT. For example, if an Owner guarantee of the underlying FASIT assets is considered support, the guarantee will already have increased the value of the assets for purposes of calculating the gain recognized upon the initial contribution of the asset.[46/] If the guarantee is considered support because it is likely to be called upon, gain recognition on the assets supporting the guarantee should be reduced by the additional gain recognized on

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[45/] The discount rate should be a reasonable rate determined by reference to the yield on the supported regular interests.

[46/] See Part IV.B.1(b).

contribution of the underlying assets as a result of the guarantee.[47]

4. Section 860I(c): Deferral of gain

Section 860I(c) provides that the Secretary may prescribe regulations which provide that gain otherwise recognized under Section 860I(a) or (b) shall not be recognized before the earliest date on which such property supports any regular interest in a FASIT (or any indebtedness of the Owner or a related party).

This provision primarily deals with the situation where an Owner transfers debt instruments to a FASIT before the debt will be securitized. In such case, at any given time, there will be more debt instruments in the FASIT than are available under the terms of the outstanding regular interests to support such interests.

The business reason for this approach is the desire of the Owner to treat all its debt instruments (such as credit card receivables) as a single pool. This is critical, both because of the accounting complexities that would arise from multiple pools, and from the significant rating benefits available by treating all the debt held by a single issuer as part of a single pool.

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[47] Similarly, suppose the Owner contributes a senior 50% interest in a $100 debt instrument (worth $100) to a FASIT. The contributed asset, because it is senior, might be worth $55 under whatever valuation method is appropriate, and gain would be recognized to the Owner on that basis. The subordinated 50% interest retained by the Owner would only be worth $45, and thus under the "support" test the Owner would only be considered to have contributed an additional subordinated interest worth $45 to the FASIT.

Thus, it is extremely common, particularly in credit card securitizations, for issuers to create "master trusts" holding all or most of their credit card balances. From time to time, depending on market conditions, the trust will issue debt instruments or (under the FASIT regime) regular interests representing interests in a fraction of the entire pool.

The question is whether the Owner should be required to pay tax under Section 860I(a)(1) on all debt instruments contributed to the pool, or only on the portion of such debt that has been securitized (i.e., the portion from which the cash flow is available to pay outstanding regular interests). In other words, if an Owner contributes a large amount of debt to a FASIT but only issues a small amount of regular interests, and only a fraction of the overall cash flow from the debt is available to pay the regular interests, should there be full gain recognition on all the debt transferred to the FASIT?

It should be noted that this issue could be avoided if a FASIT were permitted to hold a varying participation interest in a pool of revolving debt instruments. In such case, the Owner could make the FASIT election only for a specified principal balance in the revolving pool. However, absent clear authority that such an approach is permitted,[48/] the only method for the Owner to avoid gain on the full amount of debt transferred to the FASIT is if regulatory relief is provided under Section 860I(c).

[48/] See Part IV.F.2.

We recommend that regulations provide this relief. We see no logical reason that a transfer of assets to a FASIT should result in taxable gain to the Owner to the extent that those assets do not support regular interests issued by the FASIT. Moreover, such relief would provide a rule for FASITs similar to the statutory rule for REMICs.[49]

As a result, we recommend a partial gain recognition rule. There are two possible approaches we believe should be considered, a pro rata approach and a dollar limitation approach.

(a) Pro rata approach. Under this approach, gain would be recognized only on a fraction of the gain on the assets transferred to the FASIT. The fraction would be equal to (i) the fair market value of assets of the FASIT that support the outstanding regular interests, over (ii) the fair market value of all the assets of the FASIT. For simplicity, values could be determined under Section 860I(d). This calculation would apply each time additional assets were sold or contributed to the FASIT and each time regular interests were issued or redeemed.

In theory the calculation should also apply, and gain should be recognized, each time the fraction increased as the result of any assets of the FASIT (or collections thereon) being used to reduce the relative size of the ownership interest. In fact, if gain was never recognized in this situation, it would be possible to "stuff" a FASIT with excess receivables in order to reduce the initial fraction, and shortly thereafter to use the excess assets to pay down the ownership interest. While the anti-abuse rule would be available in this case, gain recognition

[49] Section 860F(b).

based on a reapplication of the general fractions rule would be simpler.

However, it would be burdensome for a FASIT to recalculate the relevant fraction each time a distribution was made on an ownership interest. We urge that distributions on an ownership interest require a recalculation of the fraction only in the case of large distributions. Alternatively, a single recalculation could be required on the last day of any taxable year during which any distributions on an ownership interest were made.

(b) Dollar limitation approach. Under this approach, assets in the FASIT would be deemed to support regular interests to the extent such assets had a principal amount (or adjusted issue price) equal to a specified percentage (perhaps 105% or 110%) of the principal amount (or adjusted issue price) of the outstanding regular interests. Gain would thus be recognized on an aggregate amount of assets having such aggregate principal amount, regardless of whether there was a greater or lesser amount of actual supporting assets in the FASIT. The specific assets on which gain would be recognized could be those in the FASIT with the greatest built-in gain.

This approach, while less accurate than the pro rata approach, has the advantage of simplicity. It also could be integrated with the rule of Section 860I(b), relating to assets outside the FASIT that support regular interests.[50] That is, the entire pool of assets in the FASIT, as well as supporting assets outside the FASIT, would be aggregated, the requisite principal

[50] Part IV.B.3.

amount of assets on which gain was to be recognized would be determined, and the assets with such principal amount and having the most built- in gain would be identified. Gain would be recognized on those assets. Presumably gain would not be recognized on assets subsequently contributed to the FASIT unless those assets replaced assets on which gain was previously recognized or until additional regular interests were issued.

5. Section 860I(d): Valuation of contributed assets

(a) Background. Section 860I(a) requires the Owner or any related person to recognize gain upon a transfer of property to a FASIT equal to the excess (if any) of the property’s value as determined under Section 860I(d) (the "subsection (d) value") over the property’s basis. If the FASIT acquires property from an unrelated party, the property is deemed to be purchased by the Owner from the third party at its cost to the FASIT and then sold to the FASIT at the subsection (d) value.

The subsection (d) value is fair market value, if the property is a debt instrument that is traded on an "established securities market" (or is not a debt instrument). The subsection (d) value of a debt instrument that is not traded on an established securities market is determined by discounting the reasonably expected cash flows, taking into account expected losses, prepayments and servicing costs.[51] The discount rate is 120% of the AFR, or such other rate specified in regulations.

[51] Conference Report at 327.

The 120% discount rate can result in the recognition of gain significantly in excess of economic gain in transactions involving medium or long term receivables. For example, we understand that medium-grade commercial mortgages may be priced at 200 to 300 basis points over Treasuries based on credit quality and other factors. Taking a loan with a term of 8 years, and using the December 1996 mid-term AFR (with semi-annual compounding) of 6.21%, the subsection (d) value of the loan would be 104.5% to 110.5% of its face amount.[52/] Thus, if the Owner originated such a mortgage at its face amount and wished to finance it using a FASIT, even though the market had not changed since the origination date, the Owner would potentially recognize gain of 4.5% to 10.5% of the face amount of the loan.

(b) Legislative intent. The legislative intent behind the 120% formula is unclear. On the one hand, there are strong indications that the formula was intended to be simply an arbitrary rate designed for simplicity that by its nature could not produce accurate results in every case. Specifically, the legislative history states that the value determined under the formula is to be used even though the result may be different than the value that would be determined by applying a willing buyer/willing seller standard.[53/] Moreover, even in the clear case of the FASIT's purchase--potentially at arm's length--of an asset from an unrelated third party, Section 860I(a)(2) generally requires that the asset be treated as sold to the Owner for the actual purchase price and resold by the Owner to the FASIT for the formula price. Thus, the fact that fair market value might be determined objectively was not deemed sufficient in all cases to avoid the application of the formula.

[52/] This is the result of applying a discount rate of 120% of 6.21%, or 7.45%, to loans with interest rates of 8.21% and 9.21%.

[53/] Conference Report at 327.

On the other hand, Congress showed a clear preference for the use of the actual fair market value of assets when such value could be determined with sufficient accuracy. This is indicated by the rule requiring the use of fair market value for debt obligations traded on an established securities market. It is also indicated by the regulatory authority given to the Secretary to change the discount rate so as to more clearly reflect a fair market discount rate. Finally, it is supported by the use of fair market value for assets other than debt instruments transferred to a FASIT.[54/]

We think that the most satisfactory synthesis of these disparate rules would require use of the conservative (from the government's point of view) subsection (d) value where good evidence of the value of a debt instrument was not available. If, however, there was an objective indication of market value (e.g., if reliable price quotations for a debt instrument were available from brokers or dealers), that value should be used. Adjustments to the statutory 120%-of-AFR discount rate might then be authorized in cases where a clear indication of value was not available but the prescribed discount rate produced results that were obviously distortive.

(c) The exception for debt traded on an established securities market. Under Section 860I(d), actual fair market value is required to be used for debt traded on an established securities market. While the term "established securities market" is not defined in the FASIT provisions of the Code, the term appears elsewhere in the Code and is defined elsewhere in regulations.

[54/] Section 860I(d)(1)(B).

The definition generally includes a market reflected by the existence of an interdealer quotation system listing price quotations by multiple identified brokers and dealers.[55/] In addition, under Treas. Reg. § 1.1273-2(f)(5), the statutory requirement for an established securities market is satisfied "if price quotations are readily available from dealers, brokers or traders", but only if (among other things) the issue of debt in question has a principal amount of more than $25 million and the issuer has other debt that trades on an actual market and has similar terms.

These definitions will often apply to publicly traded bonds, which of course are eligible for transfer to a FASIT. However, the definitions will rarely apply to pools of receivables (bank loans, mortgages, credit cards, etc.) that are generally securitized. The reason is that most pools of receivables are not fungible in the sense that a buyer is indifferent between one pool and another. Each pool has its own characteristics (geographical and credit mix of obligors, loss history, etc.) that determine its price.

As a result, absent the exercise of regulatory authority by the Secretary, virtually all receivables of the type typically securitized will be subject to the 120% valuation rule.

(d) Suggested relief. We next consider the circumstances under which taxpayers might appropriately be permitted to use the actual fair market value of debt instruments transferred to a FASIT rather than the formula value. As to authority, we think that the Secretary's power to change the discount rate by regulation, coupled with the broad grant of regulatory authority

[55/] See, e.g., Treas. Reg. § 1.897-1(m), interpreting Section 897(c)(3); Treas. Reg. § 1.1273-2 (f)(4), interpreting Sections 1273(b)(3)(A) and (B)(i); Treas. Reg. § 1.7704-1(b)(5), interpreting Section 7704(b)(1).

in Section 860L(h) to prescribe "such regulations as may be necessary or appropriate to carry out the purposes of this part", provide abundant authority to change the method of valuation of assets acquired by a FASIT, so long as the result of the regulations is consistent with the general intent of the statute.

As to policy, we recognize that valuation issues can cause the Service substantial audit difficulties.[56] At the same time, we do not think there is any substantial potential for abuse from the liberalization of the ability of taxpayers to use actual fair market values. The most that a taxpayer might improperly "win" by improperly applying a liberalized fair market value rule is the ability to have gain recognition based on the claimed actual fair market values of the assets transferred to a FASIT, rather than having gain based on a higher formula value with the excess gain being amortizable as a deduction over the life of the assets. Because these timing differences can be significant, however, we think it is important to place some limitations on the ability of a taxpayer to use fair market value in lieu of the subsection (d) value.

In light of the foregoing legislative and policy considerations, we have a number of suggestions for expanding the circumstances under which taxpayers could use the actual fair market value of assets rather than the 120% formula. These are discussed below.

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[56] A recent example is the controversy over the valuation of Treasury obligations, presumably the easiest of all obligations to value, for purposes of the arbitrage restrictions of Section 148. See Rev. Proc. 96-41, 1996-32 I.R.B. 9.

(i) Regulations should allow the use of actual fair market values when a FASIT acquires a debt obligation from an unrelated third party for cash in an arm’s length transaction in which the third party does not retain any remaining direct or indirect interest in the cash flows from the debt obligation. Actual fair market value should also be allowed if the FASIT acquires a debt obligation from the Owner that was recently purchased by the Owner in a similar arm’s length transaction.[57/] Both of these cases are extremely sympathetic situations for the claim that the use of actual fair market value is appropriate.

It could be argued that regulations of this type are contrary to Congressional intent as expressed in Section 860I(a)(2). That provision expressly deals with a FASIT's purchases of assets from third parties and requires that the Owner recognize gain under the 120% formula even in those cases. However, we assume that provision was intended in part as an anti-abuse rule to deal with cases where the third party might be indirectly related to the Owner or else retained some continuing interest in the transaction. In the absence of such special factors, we are reluctant to assume that Congress would have mandated the distortive result that would arise from the use of the mechanical valuation formula where sound and conventional indications of actual value are present. As a result, we believe regulations of this type should be adopted.

We note that in certain situations, the actual fair market value of debt instruments acquired by a FASIT (or by the Owner) from a third party might exceed the amount paid by the FASIT (or by the Owner) to the third party. For example, assume a

[57/] Compare Section 1274(b)(3)(B)(ii), which requires the use of a fair market value (rather than AFR-based) issue price where there are recent sales transactions. This rule is an anti-abuse rule but still supports the general point that fair market value is particularly appropriate where there has been a recent sale.

bank makes loans in the ordinary course of its business. The bank would normally incur advertising, credit checking and other expenses in originating the loans. As a result, the bank could often sell the loans immediately after they were originated for more than their face amount (as demonstrated by the fact that the bank was willing to incur the origination expenses to acquire the loans at face, yet the purchaser would not have to incur those expenses).

If the bank were to sell these loans to the FASIT at their face amount, the FASIT would be acquiring the loans for less than their fair market value. If regulations adopted under this clause (i) were automatically to deem the fair market value of a debt instrument to be the price paid by the Owner to a third party, the regulations would therefore be undervaluing the debt instruments in this situation by not taking into account the origination expenses incurred by the Owner. As a result, regulations adopted under this clause (i) should either be limited to loans acquired by the FASIT or the Owner in market transactions, or should make clear that loans originated by the Owner or by a servicer might be valued for purposes of the regulations at an amount in excess of their face amount. In order to avoid valuation questions, the regulations should probably be limited to loans acquired in market transactions not involving origination by the Owner, any related party, or the servicer.

(ii) In addition to the situations described in (i) above, regulations should also allow the use of actual fair market values for assets transferred to a FASIT if price quotations are readily available from dealers, brokers or traders, within the meaning of Treas. Reg. § 1.1273-2(f)(5), but without the additional conditions imposed by that regulation (and described above) for the existence of an "established market".

While broader than that particular regulation, our suggested regulation can be justified as a liberal interpretation of the requirement in Section 860I(d)(1)(A) of an "established securities market."

Any such regulation should place the burden of proof on the taxpayer to establish the existence of such quotations and the direct applicability of the quotations to the pool of assets in question. Moreover, just as in the case of (i) above, any such regulation should not apply to debt instruments that are generated as part of an ongoing business conducted by the sponsor or its affiliates. Such receivables do not lend themselves to being valued through market quotations.[58] Finally, any such regulations might appropriately be limited to debt instruments with an expected weighted average maturity in excess of, say, five years. Only for longer term debt instruments is there significant distortion from the use of a fixed discount rate.

If regulations along the lines described in (i) and (ii) are adopted, it would be appropriate to make them elective on the part of taxpayers, with each taxpayer subject to a consistency requirement for assets of any specified type. Many taxpayers would prefer the simplicity of the automatic statutory rule, and they should not be forced to determine whether quotations exist for each asset that is transferred to a FASIT.

(iii) Regulations might change the 120% statutory discount rate to a variety of rates that more clearly reflect true market discount rates for different classes of debt instruments. Such regulations could establish various discount rates based on classes of assets. Moreover, while the statutory

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[58] The value of such receivables is based in part on unique servicing arrangements with the sponsor and on the goodwill of the sponsor in the

scheme indicates that Congress wanted simplicity through the use of fixed discount rates, the authority given to the Secretary to change the rates indicates a willingness to have the rates reflect true market conditions.

The use of the fixed 120% discount rate creates the greatest disparity from actual fair market value in the case of debt instruments with a long average life. As a result, we believe it would be fully consistent with Congressional intent, and fair to taxpayers, to change the 120% rate where appropriate.

As a result, whether or not regulations along the lines of (i) and (ii) above are adopted, we recommend that regulations adopt a procedure pursuant to which taxpayers could demonstrate that particular classes of debt instruments are most fairly valued using a discount rate in excess of 120%. Such relief might be made available on an ad hoc, case by case basis, or by publishing discount rates that might be used for classes of assets based on, e.g., ratings provided by major rating services or similar indicia of a proper discount rate or yield.

C. Section 860J: Prohibition on Offset of FASIT Income

Under Section 860J(a), the taxable income of the Owner or of a holder of a high yield interest cannot be less than the holder's "taxable income determined solely with respect to such interests (including gains and losses from sales and exchanges of such interests)". The effect of this provision is to prohibit income from the FASIT to be offset by net operating losses of the Owner (or holder of the high yield interest). The Senate version of the legislation included the quoted language but without the

market. In that setting, the use of an arbitrary discount rate may be the best that can be done.

parenthetical clause, which was added in Conference as a "clarification".[59/]

Regulations should clarify that gains recognized by an Owner under Section 860I on an actual or deemed sale of assets to a FASIT, or on a contribution of assets to a FASIT, can be offset with the Owner's net operating losses. Likewise, the issue should be clarified for gains recognized by a third party on a sale of assets to a FASIT in exchange for a high yield interest.

These gains are recognized on an asset transferred in exchange for the receipt of such interest (or increase in value of an existing ownership interest). Literally, therefore, they are not recognized "with respect to" the ownership or high yield interest, and the loss limitation rule would not apply.

Moreover, the non-applicability of Section 860J in these circumstances is consistent with our understanding of the purpose of Section 860J. We understand that the purpose of Section 860J was to prevent the use of losses to shelter the "phantom income" component of income generated by the FASIT. Phantom income is the taxable income allocable to the Owner in the early years of the receivables in excess of cash distributions payable to the Owner (which income is offset in later years by cash flows in excess of taxable income). Section 860E(a) is a similar rule that limits the use of net operating losses in the case of a REMIC.[60/] Phantom income, of course, has nothing to do with the built-in appreciation in the assets transferred to the FASIT, so under

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[59/] Conference Report at 325, 328.

[60/] That provision prohibits an owner of a residual interest in a REMIC from using net operating losses to offset "excess inclusions" on the residual interest. Excess inclusions are REMIC income inclusions at a rate in excess of 120% of the AFR. It is clear that only income passed through from the REMIC itself is subject to the test. On the other hand, the statutory this rationale losses of the Owner should be usable against such gains.

Moreover, we are not aware of any policy reason why losses of an Owner (or holder of a high yield interest) should not be usable to offset gains on the disposition of an asset held by such person. Since the losses are generally available to offset such gain, it is not clear why the rule should be different solely because the asset is transferred to a FASIT.

On the other hand, we note that the Owner's gain on the assets is determined under the formula in Section 860I(d). If the value of the assets as determined under that formula exceeds the actual fair market value of the assets, allowing the uses of losses against such gains allows losses to be utilized in excess of the amount that would be utilized on an actual sale of the assets to a third party. Moreover, the additional basis to the FASIT resulting from such excess gain reduces future ongoing income to the Owner, which income could not have been offset with losses of the Owner.

We acknowledge that allowing losses to offset gains on contributions to a FASIT might encourage certain tax planning strategies. If the Owner had losses, the Owner would have an incentive to maximize the value of the asset being contributed to the FASIT (e.g., by using a low estimate of expected future losses on the asset). This would maximize the initial income that could be offset with losses, and create a high tax basis in the asset that would reduce the future FASIT income that could not be so offset.

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language of Section 860E(a) is not as broad as that in Section 860J, in that the former does not by its terms cover gains on sales of REMIC interests.

Moreover, a person related to an Owner within the meaning of Section 860L(g) (generally requiring 20% stock ownership) also recognizes gain under the formula rule in Section 860I(d) on a sale to a FASIT. If the related person had net operating losses that were permitted to be used against above-market gain on a transfer to a FASIT, the Owner might be able to transfer assets to the related party and allow that party to offset such gain with its own losses.

On balance, we do not believe the use of losses against gain recognized on a transfer of assets to a FASIT should be restricted. We do not believe such a restriction is contained in the statutory language, and we do not believe the potential for abuse is sufficiently great that regulations should change this result. The more egregious cases of income shifting could be attacked under step transaction principles and Section 482, and any remaining concerns by the government concerning the special valuation rule in Section 860I(d) should be dealt with in anti-abuse regulations.

D. Section 860L(a)(1)(C): Multiple Owners Within a Consolidated Group

Under Section 860L(a)(1)(C), the ownership interest in a FASIT must be held directly by an eligible corporation. As indicated above, the Conference Report indicates that the conferees anticipated that Treasury would "issue guidance on how the ownership rule would apply to cases in which the entity that owns the FASIT joins in the filing of a consolidated return with other members of the group that wish to hold an ownership interest in the FASIT."

Many securitizations involve the transfer to a securitization vehicle of financial assets that were owned or originated by several members of a single consolidated group. For example, a bank may have more than one affiliate that originates credit card loans. The affiliates would then pool their credit card loans in one securitization vehicle. In order to properly compensate each member for its respective contribution of assets, the residual amounts distributed from the securitization vehicle may be allocated among such members in proportion to their contributions.

We strongly urge that regulations allow these business arrangements to qualify as FASITs by allowing multiple members of a consolidated group to be Owners in a single FASIT. We understand that the reason for generally requiring a FASIT to have a single Owner was concern about the shifting of income and deductions among multiple Owners. However, in a consolidated group, this concern is generally not an issue except in the SRLY context.

We further suggest that each member of a consolidated group owning an interest in a FASIT be required to own a pro rata undivided ownership interest in the FASIT. This rule will simplify the tax calculations as much as possible yet to allow a fair allocation of income among group members.

The pro rata percentage of each Owner might change from time to time as that Owner made additional contributions or received distributions, but at any time all interests would be pro rata. Any disparities between net contributions and percentage ownership would be treated as deemed transfers among the Owners.

The use of a pro rata allocation will prevent multiple members from dividing income from an ownership interest in a manner that shifts tax items advantageously among members. Moreover, pro rata allocation ensures that an ownership interest will not be divided in a manner that creates multiple subclasses that differ in substance from the economics of the single undivided ownership interest.

Under Section 860H(b), the holder of an ownership interest is taxed as if it directly owned the FASIT's assets and issued the regular interests. Under our approach, each member would be deemed to own an undivided ownership interest in each of the underlying FASIT assets.

The only complexities raised by this approach of which we are aware are caused by the revolving nature of a FASIT's assets and the fact that contributions and distributions might regularly be made by and to different group members on a non-pro rata basis. The result of treating each member as owning a pro rata share of each asset in the FASIT would literally be continuous deemed sales and purchases of FASIT assets among the members.

We suggest that these complexities by avoided by a rule that taxable gain would not arise because of any deemed transfer of FASIT assets among group members. This would be similar to the result that would arise if the members were partners in a partnership that held the assets of the FASIT.[61/] Such a rule would prevent the enormous complexities that would arise if

[61/] We would not recommend that a partnership among group members actually be deemed to exist. This would raise entity/aggregate issues, other Subchapter K issues such as investment partnership issues under Section 721(b), and state tax issues, as well as cause additional return filing requirements.

deemed transactions among members had to be identified and traced.

To be sure, partners in a partnership would be subject to Section 704(c) principles to prevent the built in gain on assets contributed by one partner from being shifted to another partner through the use of the partnership. Under our proposal, such shifting of gain would in theory be possible.

However, the potential tax avoidance that might result from such shifting appears to be minimal. To the extent that the members of the group recognize gain upon the transfer of assets to the FASIT, there is no built in gain to be shifted. To the extent gain is not recognized on a transfer to a FASIT because of the exercise of regulatory discretion,[62/] any gain that would have subsequently arisen on a deemed transfer of assets between group members would in any event have been intercompany gain not immediately recognized under Treas. Reg. § 1.1502-13. Thus, there is no immediate loss of tax revenue. Moreover, the FASIT will not obtain a stepped up asset basis as a result of any deemed transfer among members not resulting in gain recognition. Thus, the full amount of income on the underlying assets will eventually be recognized by the FASIT and taxed to the members.

The only remaining issue is whether our proposal permits the built in gain on assets transferred to a FASIT to be shifted among members as it is recognized by the FASIT. However, since net operating losses of members (including SRLY losses) cannot offset any income from the FASIT, it should not matter which member reports the eventual income and pays the tax.

[62/] See Part IV.B.4.

Note, however, that the tax basis of the stock of a member is increased by the income of that member.[63] As a result, if a group can shift income from member A to member B, the group can cause an increase in the basis of the stock of B rather than A. Suppose the stock of B was soon to be sold, and A held appreciated debt. In theory A and B could form a FASIT in exchange for ownership interests, A transferring the debt and B transferring an unappreciated Treasury bond. Assuming the exercise of regulatory discretion, A would have no gain on the transfer to the FASIT because no regular interests have yet been issued. On the FASIT's sale of the debt, a portion of the FASIT's taxable gain would be allocated to B. This would increase the basis of the B stock and reduce the gain on the sale of that stock.

An anti-abuse rule would be appropriate (and sufficient) to prevent this type of transaction. At a minimum, such a rule could apply if a principal purpose of a contribution to a multiple-Owner FASIT was to obtain a tax benefit from the shifting of income among group members. Such a rule might even provide that normal intercompany transaction principles would apply to deemed transfers of assets among group members through a FASIT if, regardless of the intent of the parties, the effect of applying our proposed no-recognition rule would result in the saving of a material amount of tax through the shifting of income among group members. Such a rule should permit normal commercial transactions to continue in a relatively simple manner without burdening those transactions with complex rules designed to prevent tax avoidance strategies.

[63] Treas. Reg. § 1.1502-32.

Finally, regulations should clarify the consequences if two members of a consolidated group are Owners of a single FASIT, and one member leaves the group. It would seem that the FASIT would cease to qualify as a FASIT, because it would then have two unrelated owners. Such disqualification could be avoided if the member that was to leave the group sold or transferred its ownership interest to a member that would remain in the group. Such a sale or transfer would result in deferred gain that would be triggered when the selling member left the group. Losses of the selling member would not be usable against such gain by virtue of Section 860J(a)(1).

E. Section 860L(b): Interests in FASIT

1. Issuance on the startup day.

Under Section 860L(b)(1)(A), a regular interest must be issued "after the startup date". Likewise, Section 860L(b)(2) provides that an ownership interest means an interest issued "after the startup day". The startup day is the date the FASIT designates as such when it makes its election, which then becomes the first day of the first taxable year of the FASIT. Section 860L(d)(I).

The regulations should provide that a regular interest and an ownership interest can be issued on or after the startup day. If a FASIT interest cannot be issued on the startup day, then the FASIT election is required to be effective before the entity can have outstanding FASIT debt or equity. Such a rule would make no sense and would be a trap for the unwary. There is no reason the FASIT should have to be in existence and have its first taxable year begin prior to the date it may issue debt or equity.

2. Specified principal amount

Under Section 860L(b)(1)(A)(i), a regular interest must entitle the holder to receive "a specified principal amount (or other similar amount)". Regulations implement similar language in the REMIC context by providing that the principal amount and the latest possible maturity date of a regular interest "must not be contingent."[64]

Since a REMIC is required to be a fixed pool of mortgages and cannot issue additional regular interests after its startup date, the principal amount of a regular interest is necessarily fixed on the startup date. A FASIT, however, can issue new regular interests at any time, and a holder of a regular interest may subsequently purchase an additional regular interest.

Regulations should clarify that the principal balance of a FASIT regular interest is "specified" even if the balance could be increased from time to time to reflect further investment of cash or property in the FASIT by the regular interest holder, provided each increase would be considered a specified amount were it a separate regular interest. This would facilitate the issuance of so-called "variable funding certificates", which are common today. We see no potential for abuse in such an arrangement, which is also common today in bank lines of credit.

[64] Treas. Reg. § 1.860G-1(a)(5).

3. Prepayment penalties

Section 860L(b)(1)(A)(ii) provides that a regular interest must provide for interest based on a fixed rate or, except as provided in regulations, at a qualifying variable rate.

Regulations should provide that customary prepayment penalties received by a FASIT on its assets may be passed through on FASIT regular interests. This would be the same as the REMIC rule in Treas. Reg. § 1.860G-l(b)(2).

We assume that, like the REMIC rule in Treas. Reg. § 1.860G-l(b)(1), other prepayment penalties on a regular interest would not be permitted. We point out, however, that we are aware of no policy reason for this result.

4. Issue price and yield

Under Section 860L(b)(1)(A)(iv), the issue price of a regular interest cannot exceed 125% of its stated principal amount. In addition, under Section 860L(b)(1)(A)(v), a regular interest that is not a high yield interest must have a yield to maturity that is less than the AFR plus 5 percentage points. The calculation of yield to maturity of a debt instrument also depends on the issue price of the instrument. The issue price of the debt in an issue is generally defined as the first price at which a substantial amount of the debt in the issue is sold for money.[65]

[65] Treas. Reg. § 1.1273-2(a)(1).

Regulations should clarify the proper method to calculate the issue price and yield to maturity of an instrument for purposes of determining whether it qualifies as a regular interest that is not a high yield interest. Such method would not necessarily have to apply for other purposes, such as for calculating the actual accrual of OID.

In particular, the regulations should make clear how issue price is determined when a substantial portion of a class of debt is not sold at its original offering price in the initial offering. The regulations might provide that the issue price in such case is the first price at which any material amount of the debt was sold.[66/] To reduce the ability of taxpayers to manipulate the issue price by arranging for initial sales on a non-arm's length basis, a minimum dollar amount of sales at the same initial price could be required in order to determine the issue price. In addition, regulations should provide that the FASIT's good faith determination of whether a regular interest has an issue price less than or equal to 125% of its principal amount or a yield less than the AFR plus 5 percentage points will be respected by the IRS unless unreasonable.[67/]

[66/] See Treas. Reg. § 1.860G-1(d)(1), applying a similar rule to regular interests in a REMIC that are not publicly offered.

[67/] A similar rule applies for determining the prepayment speed for accruing original issue discount on REMIC regular interests. See H. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. at II-238 – II-239 (1986).

5. Definition of high yield interests

Under Section 860L(b)(1)(B)(ii), a high yield interest is any interest that would be a regular interest but for failing to meet (I) one or more of the requirements for a regular interest relating to specified principal amount, issue price not in excess of 125% of principal, and maximum yield, or (II) the requirement that a regular interest have a fixed or qualifying variable interest rate, if the interest payments consist of an unvarying and specified portion of the interest payments on permitted assets.

Because of the "or" between clauses (I) and (II) above, which also appears in the statute, it could be argued that a high yield interest is permitted to fail to meet the requirements described in clause (I), or to fail to meet the requirements described in clause (II), but is not permitted simultaneously to fail to meet the requirements described in both clauses (I) and (II).

Under this interpretation, to qualify under clause (II), a high yield interest would have to meet all of the other tests of being a regular interest. This result is clearly unintended.[68/] Accordingly, the regulations should clarify that a high yield interest is eligible for the relaxation of the requirements of a regular interest described in both clause (I) and clause (II).

[68/] See Conference Report at 174, indicating that the "specified portion" language applies to interest-only regular interests (which generally would not satisfy the other requirements and thus could not be created absent our suggested interpretation).

In addition, because a high yield interest need not have a specified principal amount, literally such an interest could have a contingent principal amount. The contingency could be based on events wholly unrelated to the FASIT, such as the change in price of a stock index. Following the adoption of Treas. Reg. § 1.1275-4, there is no clear policy reason to prohibit such contingent principal. Nevertheless, this result was probably not intended. Regulations should clarify this point.

F. Section 860L(c): Permitted Assets

1. Cash equivalents

Section 860L(c)(1)(A) provides that a permitted asset includes "cash or cash equivalents". It would be helpful if regulations clarified that this included shares in a money market mutual fund. A FASIT will often need to make short term investments pending distribution or reinvestment of its cash flows, and a money market fund may be a simple and convenient investment.

2. Participations

Section 860L(c)(1)(B) provides that a permitted asset includes "any debt instrument" meeting specified conditions. It is not clear whether a FASIT may hold a participation interest in a revolving pool of loans. Moreover, these arrangements may be partnerships for tax purposes, which raises the additional question of whether a FASIT can hold an interest in a partnership that itself holds a revolving pool of qualified assets.

For example, a FASIT may wish to have a 50% interest in a pool of revolving loans. In that case, because the aggregate principal balances of the assets in the pool will increase and decrease over time, the FASIT would be required to put up new money or receive distributions of excess cash flows to maintain its 50% interest.

Alternatively, the FASIT may wish to have a fixed dollar participation in a pool of loans with varying aggregate principal balances. For example, the FASIT may put up $100 to initially receive a 50% interest in a pool of loans with an initial balance of $200. If the balance subsequently increases to $400 (or is reduced to $150), the FASIT's percentage interest would decrease to 25% (or increase to 2/3).

Regulations should clarify whether these structures are permissible for a FASIT.[69/] Note that if the FASIT owns a fixed dollar of participation in a larger pool, each time the pool size increases (or decreases) the FASIT is in effect disposing of a percentage interest in each asset in the former pool in exchange for a lower (or higher) percentage interest in each asset in the larger (or smaller) pool. Such a disposition should not be a prohibited transaction,[70/] although it would result in gain recognition under Section 860I(a)(2).

[69/] Cf. Treas. Reg. § 1.856-3(g), treating a REIT that is a partner in a partnership as owning its share of the underlying partnership assets.

[70/] Section 860L(e)(3)(B) allows a FASIT to substitute one debt instrument for another if a principal purpose of acquiring the former instrument was not to recognize gain on the substitution.

3. Debt instruments providing for noncontingent interest

Section 860L(c)(1)(B) in effect requires that debt instruments owned by a FASIT cannot provide for contingent interest. This is in contrast to the rule for REMICs.[71] The regulations should make clear that prepayment penalties are not considered contingent interest for this purpose. This is consistent with their general treatment for tax purposes.[72]

In addition, a FASIT may acquire a debt instrument issued by a U.S. issuer that provides for a gross-up for U.S. withholding taxes in the hands of a non-U.S. person, or the FASIT may acquire a debt instrument issued by a non-U.S. issuer that provides for a gross-up of foreign withholding taxes in the hands of a holder outside the issuer's jurisdiction. Such withholding tax gross-ups should not be treated as contingent interest for purposes of Section 860L(c)(1)(B).

4. Hedges

Section 860L(c)(1)(D) permits a FASIT to hold certain assets, including an interest rate or foreign currency notional principal contract, insurance or another guarantee against payment defaults, or other similar instruments permitted by the Secretary, if such asset is reasonably required to hedge against the FASIT's risks of being the obligor on interests issued by the FASIT. This provision raises certain issues that should be addressed in regulations.

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[71] See Treas. Reg. § 1.860G-2(a)(7). Contingent interest may not be passed through on regular interests but may be used by a REMIC as additional credit enhancement or to prepay the fixed principal amount of a regular interest.

[72] See Prudential Insurance Co. of America v. Comm'r, 882 F.2d 832 (3rd Cir. 1989).

(a) Total return swaps. The provision does not clearly permit a FASIT to hold a total return swap. A total return swap is in substance an interest rate swap combined with payments between the counterparties based on the value of the underlying assets (the FASIT's debt assets) at specified times. It is similar to an equity swap on stock.

For example, total return swaps are frequently used in securitization transactions to permit the issuance of short term notes when the assets consist of longer term debt instruments.[73/] In such a transaction, a trust might hold a pool of assets (the "assets") consisting of fixed rate debt instruments with a remaining term of more than one year, and issue floating rate notes (the "liabilities") with a term of one year. After one year, the trust sells the assets in order to pay the principal of the liabilities.

However, this transaction standing alone subjects the trust to two risks. First, the floating interest rate on the liabilities may rise above the fixed interest rate on the assets, so that the trust’s interest expense exceeds its interest income. Second, the fair market value of the assets might be lower than their face amount at the maturity date of the liabilities, either because market interest rates have risen or because of a decline in the credit of the issuer of the assets.

The trust can hedge against both of these risks by entering into a total return swap with a one year term providing for payments based on the total return on the assets. Pursuant to the swap, the counterparty would pay to the trust a floating rate of return equal to the interest rate on the liabilities, and

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[73/] Such short-term notes might be sold to money market funds. Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act") generally prevents after one year also would pay an amount equal to the principal amount of the liabilities. In return, the trust would pay to the swap counterparty periodic payments based on the interest rate on the assets, and also would make a payment after one year equal to the fair market value of the assets having a principal amount equal to the principal amount of the liabilities.

We believe total return swaps are similar to the types of hedges expressly permitted by Section 860L(c)(1)(D), and that regulations should expressly authorize total return swaps to be permitted assets. Of course, the requirement would remain that the swap must be reasonably required to hedge the FASIT's risks on its outstanding regular interests.

(b) Hedging the ownership interest. Section 860L(c)(1)(D) literally only permits the FASIT to hedge against risks associated with being the "obligor" on interests issued by the FASIT. The reference to "obligor" appears to indicate that only liabilities represented by regular interests can be hedged.

A FASIT will often issue regular interests representing most of the cash flows from a pool of assets, with the ownership interest representing the remainder of the cash flows. Suppose the assets are fixed rate assets and the regular interests are floating rate. It will often be easier and most convenient for the FASIT to enter into a hedge of all its assets, rather than merely the assets equal to the amount of regular interests that are outstanding.

As a result, we recommend a regulation permitting the incidental hedging of assets allocable to ownership interests. The hedge could be allowed if its principal purpose is described

money market funds from buying instruments with a remaining maturity of in Section 860L(c)(1)(D), or, alternatively, if its size does not exceed 110% of the regular interests being hedged. We see no potential for abuse from this result, because the Owner could have had the FASIT enter into a "smaller" hedge, and the Owner could have directly entered into a hedge of the cash flows on its ownership interest.

(c) Effect of re-characterization as loan. If a notional principal contract has substantial non-periodic payments, it may be re-characterized as in part a debt instrument between the parties.[74/] For example, if a FASIT enters into a swap with a counterparty that involves a significant upfront payment to the FASIT, the swap may be re-characterized as in part a deemed loan from the counterparty to the FASIT. If the swap involves a significant upfront payment from the FASIT to the counterparty, the swap may be re-characterized as a loan by the FASIT to the counterparty.

Regulations should clarify whether such a deemed loan characterization applies for purposes of the FASIT rules. We believe that such a loan characterization should apply. If so, a loan deemed made to the FASIT would have to qualify as a regular interest, and a loan deemed made by the FASIT would have to qualify as a loan permitted to be held by a FASIT.

5. Restrictions on FASIT holding debt issued by Owner

Section 860L(c)(2) provides that a permitted asset does not include a direct or indirect interest in a debt instrument issued by the Owner or a related party, except for cash equivalents and as may otherwise be provided in regulations. This provision raises a number of issues.

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greater than 397 calendar days.

[74/] Treas. Reg. § 1.446-3(g)(4).

(a) Tiered FASITs. Under Section 860L(c)(1)(F), a FASIT may hold a regular interest in another FASIT. Suppose, however, that one FASIT (the "lower tier FASIT") issues ownership interests to an Owner ("X") and all its regular interests to another FASIT (the "upper tier FASIT"). The upper tier FASIT issues regular interests to the public and its ownership interest to X. X is the Owner of both FASITs.

If the regular interests issued by the lower tier FASIT were viewed as debt of its Owner or a related party, namely X, the upper tier FASIT would not be permitted to hold such regular interests. The reason is that the upper tier FASIT would then be viewed as holding the debt of its own owner (also X). As discussed above,[75] the extent to which regular interests issued by a FASIT are to be treated as debt of the Owner is not clear.

We believe that the regulations should clarify that Section 860L(c)(2) does not prohibit a single person from being the Owner of both FASITs in a tiered FASIT structure such as described above. This result could be accomplished with a regulation excluding from that provision all FASIT regular interests.

We have a number of reasons for this conclusion. Most importantly, there is no logical reason to prohibit tiered structures having a common Owner. The purpose of Section 860L(c)(2) was presumably to ensure that a FASIT would be used to finance third party receivables and not debt of the Owner. This goal is fully met if the assets of the lower tier FASIT (which

[75] Part IV.A.

are the assets ultimately financed through the issuance of regular interests by the upper tier FASIT) are third party obligations.

Moreover, tiered REMICs of the above type are extremely common, and are usually designed to allow various types of interest stripping.[76] The Code and regulations acknowledge in a number of places the existence of tiered REMIC structures.[77] We do not believe that Congress intended FASITs to be subject to a prohibition on such a common REMIC transaction, particularly in light of the provision expressly allowing one FASIT to hold a regular interest in another FASIT. While the latter provision could in theory have been designed solely to permit tiered structures with a different Owner at each level, such structures do not generally occur in the REMIC area and it is doubtful that is what Congress had in mind.

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[76] To illustrate, suppose that a trust holds $100 principal amount of 8% mortgages and wishes to create three classes of REMIC regular interests: Class A bears interest at a rate of 7%, has an initial principal amount of $50, and is a "fast-pay" class entitled to the first $50 of principal paid on the mortgages. Class B bears interest at a rate of 8% has an initial principal amount of $50 and receives the mortgage principal not allocated to Class A. Class X receives interest equal to 1% of the outstanding principal balance of Class A. Class X does not qualify as a regular interest. To create the desired classes, a lower tier REMIC would hold the mortgages and issue to an upper tier REMIC two classes of regular interests, Class LA and LB. Each would have an initial principal amount of $50 and an interest rate of 8% and would receive cash corresponding to the combined cash payments on Classes A and X and on Class B respectively. Class X would qualify as a regular interest in the upper tier REMIC because it would be entitled to receive a fixed number of basis points of interest (a specified portion) of the interest paid on Class LA, which is a qualified mortgage held by the upper tier REMIC.

[77] For purposes of applying various asset related tests, REMICs are aggregated if they are part of a tiered structure. See Sections 593(d)(4) (generally effective for taxable years beginning before January 1, 1996, see Section 593(f)), 856(c)(6)(E) and 7701(a)(19)(C) (last sentence). Treas. Reg. § 1.860F-2(a)(2)(i) states that two or more REMICs may be created pursuant to a single set of organizational documents even if, for state law or federal securities law purposes, those documents create only one organization. This rule is relevant principally for tiered REMICs. The regulations governing information reporting by REMICs exempt from certain requirements "a REMIC all of whose regular interests are owned by one other REMIC." Treas. Reg. § 1.6049-7(b)(1)(i). Finally, the OID regulations contain an example involving a two tier REMIC. Treas. Reg. § 1.1275-2(c)(4), Example (2).

(b) Temporary short term investments. A FASIT will often need to make short term investments of its cash flows pending distribution of cash to holders of regular interests. Often a convenient and economical investment will be commercial paper and other short term obligations of the Owner. For example, if the Owner is a bank, commercial paper issued by the bank will pay a higher return than demand deposits of the bank (which are clearly permitted under the statute as cash equivalents).

Therefore, regulations should permit a FASIT to acquire commercial paper and similar investments issued by the Owner, if the principal purpose of the investment is the temporary reinvestment of cash flows of the FASIT pending distribution to holders of interests in the FASIT.

(c) Servicer retention of cash. The servicer of assets held by a FASIT will generally be allowed to retain funds collected on those assets for a temporary period of time. The servicer will generally be permitted to commingle the funds as its own, and simply to pay the required amount to the FASIT on periodic specified dates.

The regulations should clarify that cash equivalents include the right of the FASIT to the return of the proceeds of debt instruments that are permitted to be held by a servicer for temporary periods of time.

(d) De minimis test for debt of owner. A FASIT may unavoidably invest in small amounts of debt of the Owner. For example, if a bank transfers its credit card receivables to a FASIT, a tiny percentage of the receivables might represent balances on corporate credit cards (representing an obligation of the bank) issued to employees of the bank. If such assets were not permitted assets, a 100% excise tax would apply to the income from such assets.

Regulations should provide that permitted assets include a de minimis amount of debt of the Owner (perhaps .2% of the value of all FASIT assets) that is not otherwise treated as a permitted asset.

(e) Re-characterized notional principal contracts. Suppose the Owner enters into a notional principal contract with the FASIT, where the notional principal contract would generally meet the requirements for a permitted asset. As noted above,[78] if the contract has substantial non-periodic payments, it may be re-characterized as in part a debt instrument between the parties. If the FASIT makes a significant upfront payment to the Owner, the result may be a deemed loan from the FASIT to the Owner.

We assume that a notional principal contract between a FASIT and the Owner would be a non-permitted asset to the FASIT to the extent the contract is characterized as a deemed loan from the FASIT to the Owner under the notional principal contract rules. Regulations should clarify this point.

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[78] Part IV.F.4(c).

G. Section 860L(d): Startup day

Section 860L(d)(2) contains a cross reference to Section 860I(c)(2). This is a technical error. The cross reference should be to Section 860I(b)(2). A technical correction is required.

H. Section 860L(e)(2)(C): Excise Tax on Loan "Origination"

Section 860L(e)(2)(C) imposes a 100% tax on net income from "any loan originated by a FASIT." Neither the statute nor the legislative history defines origination, and the concept is not used elsewhere in the Code.[79/] Nevertheless, this term plays a central role in determining the permitted activities of a FASIT.

As a result, it is critical that regulations define the term. At the least, they should address a number of common fact patterns.[80/]

1. Background

One of the key policy issues that was faced in drafting the FASIT legislation was determining the level of activity that a FASIT might carry on. The drafters obviously believed that, because the FASIT can issue regular interests that are automatically treated as debt for tax purposes, a FASIT should be more passive than a bank or other commercial finance business. However, since the statute was intended to allow the financing of

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[79/] It may be that the statute's use of the term "loan" rather than "debt instrument" (the term in the permitted asset definition in Section 860L(c)(1)(B)) was intended to distinguish privately negotiated loan agreements from "bonds," "pass-through certificates" or other "securities." See the Security Bank Minnesota case described below.

[80/] A similar approach was followed in defining the term "dealer" under Section 475. See Treas. Reg. § 1.475(c)-1T, recently finalized as Treas. Reg. § 1.475(c)-1.

short term revolving assets, the grantor trust and REMIC models that prohibit the reinvestment of funds were not available.

The basic package of statutory rules that was adopted to prevent abuse of the debt safe harbor while still allowing revolving accounts is as follows:

(a) A regular interest that can be held by non-corporate investors must resemble conventional debt. The less debt-like high yield interests must be held by taxable corporations so that the corporate tax base is not eroded.

(b) The assets of the FASIT are limited to financial rather than operating assets, and only specified types of liabilities can be incurred. These tests have the practical effect of prohibiting a range of activities that typically are engaged in by banks or other commercial finance companies.[81/] On the other hand, the balance sheet of a traditional bank engaged in core lending activity would reflect mostly loans or other debt instruments and deposits or other borrowings that could qualify as permitted assets and regular interests.

(c) Section 860L(e) imposes a 100% tax on the net income of a FASIT from prohibited transactions. That term includes income from any disposition of a permitted asset with certain exceptions, income from providing services and,

[81/] The asset test prohibits a FASIT from engaging in a range of financial services that are engaged in by banks (e.g., leasing) and prevents it from owning substantial operating assets, such as branch offices, computer systems, or trademarks. The limitation on liabilities would seem to prevent a FASIT from providing letters of credit, endorsing checks or otherwise guaranteeing liabilities.

as indicated above, income from any "loan originated by the FASIT." The restriction on dispositions prevents a FASIT from trading or otherwise selling loans for the purpose of making a profit.

(d) Section 860I requires full gain recognition to the Owner (a taxable domestic corporation) on the transfer or deemed transfer of an asset to the FASIT. This provision would apply even if the FASIT made its own loan.[82] As a result, any profit attributable to the origination of a loan, which would be included in the value of the loan, remains in the corporate tax base.

2. Related authorities.

In a number of settings, a distinction has been made between the business of making loans and investing in debt instruments. For example:

a. A foreign corporation was not engaged in a banking, financing or similar business (and specifically did not make "loans to the public") where a bank originated the loans as "agent" for the foreign corporation under a management agreement and the foreign corporation had no direct presence in the banking community.[83]

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[82] See Part IV.B.5(d), where we discuss the need to preserve this rule even if regulations modify the statutory discount rate in Section 860I(d).

[83] TAM 9611001 (December 5, 1995).

b. While a debt obligation held by a bank is generally a capital asset,[84/] a loan that is originated by a bank is excluded from that definition under Section 1221(4), on the ground that it represents a receivable derived from the service of providing funds to customers.[85/]

c. A bank that makes a loan is not considered to have "acquired an obligation" for purposes of the rules in Section 1281 requiring the accrual of acquisition discount on short-term obligations.[86/]

d. If a non-U.S. bank purchases part of an issue of Eurobonds directly from the issuer, interest on the bonds is not excluded from the portfolio interest exemption on the grounds that the bonds are "an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business."[87/]

[84/] Section 582 (c) provides ordinary treatment of gains or losses from sales or exchanges of debt instruments held by a bank, but does not prevent those instruments from qualifying as capital assets.

[85/] Burbank Liquidating Corp. v. Comm'r, 39 T.C. 999 (1963), modified on other grounds, 335 F.2d 125 (9th Cir. 1964) (described the business of savings and loan institutions as rendering the service of making loans).

[86/] Security Bank Minnesota v. Comm'r, 994 F.2d 432 (8th Cir. 1993) (catalogues cases where Code distinguishes between the making of a loan and the acquisition of a debt instrument).

[87/] See Section 881(c)(3)(A); Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984. 395 (1984).

e. Under Section 7704(d)(2)(A), interest earned in a "financial business" is not considered qualifying income for a publicly traded partnership. While the meaning of this phrase is not clear, it is generally considered that investing in non-revolving loans would result in qualifying income but actively originating loans would not.[88/]

Turning to other types of passive entities, it is clear that a REIT can engage in a loan origination business.[89/] There are no restrictions in the Code on loan origination activity by a RIC, but a RIC must be registered under the 1940 Act, and active finance businesses can generally qualify for an exemption from such registration.[90/] A REMIC can purchase debt directly from the issuer, although the other restrictions on the activities of REMICs would make it impractical for them to engage in a loan origination business.[91/]

[88/] Uncertainty under current law as to the meaning of the term "financial business" in Section 7704(d)(2)(A) is one of the factors that led to the adoption of the FASIT rules.

[89/] See Rev. Rul. 80-57, 1980-1 C.B. 157 (REIT was "engaged primarily in originating, making, and servicing short-term construction and development loans" so loans it made were not capital assets).

[90/] The 1940 Act has exemptions for banks and finance companies and also for entities whose assets consist primarily of consumer finance receivables.

[91/] While a REMIC typically acquires all of its qualified mortgages either on one startup day or in exchange for other qualified mortgages it already holds, the REMIC rules (Section 860G(a)(3)(A)(ii)) do allow a REMIC to acquire loans over an initial 3 month period under a fixed price purchase contract, which would allow a REMIC to acquire loans directly from a borrower.

GCM 38456 (July 25, 1980) discusses at length whether the purchase of second lien mortgage loans by a trust directly from the mortgagors would cause the trust to have a business objective and be classified as a corporation. The trust decided to whom it would make the loan, the terms thereof and the type of security for the loan. The GCM states:

> "If the trustee elects to invest in mortgage loans, it should make no difference whether he buys existing mortgages or makes new loans. Typically the placement of new loans would be done by a mortgage broker who could readily find borrowers and handle the mechanics of making the loans. Even if the broker is considered as acting as an agent of the trustee, the total activity involved in making the one-time loans of the trust corpus would not suggest the conduct of a trade or business."

3. Credit card financings.

The drafters of the statute obviously did not intend that "origination" would extend to the typical credit card receivable financing, which was the reason for the legislation. Thus, to gain some understanding of what the term could mean, it is helpful to describe in brief terms how such a financing works. When a credit card is issued, the card holder establishes an account with the card issuer. Each time the holder uses the card, the holder's obligation to make payments becomes a receivable associated with the account.

In a typical financing arrangement, the card issuer establishes a trust to finance receivables. The trust is subject to the issuer's overall control (for example, in determining when to issue new trust interests and the terms of those interests). The card issuer, or an affiliate thereof, sells to the trust all of the then existing and future receivables relating to specified accounts. Thereafter, accounts may be added or removed in certain circumstances. The accounts themselves (meaning the right to change terms of the card and to deal with the card holder) are retained by the card issuer. The trust does not have its own employees or facilities (e.g., telephones, desks or computer systems), but rather enters into a servicing contract with the card issuer or an affiliate under which the servicer agrees to collect and administer the trust's receivables on behalf of the trust. For that service, the servicer receives a fee which is generally a fixed percentage of the amount of the receivables. In any event, the fee is not designed to allocate to the trust a share of the actual operating costs or profits or losses of the servicer or card issuer.

In general terms, it can be said that the card holder becomes a customer of the card issuer when the card is issued and the account established. The card holder then determines the amount of receivables in the account through his or her use of the card. On the other hand, the card issuer retains the account, and takes steps on an ongoing basis to encourage use of the card and the generation of receivables. Thus, there is some ongoing solicitation of card holder business. The receivables that exist when an account is transferred to a trust are already outstanding debt instruments, but any future receivables generated by the account are owned by the trust from the moment of their creation.

4. Conclusions.

In light of the foregoing, we believe that a number of generalizations can be made regarding the "loan originated by a FASIT" test:

(a) Most obviously, a loan or other debt instrument purchased by a FASIT from a prior holder that was not made in anticipation of a sale to a FASIT should not be considered to be originated by the FASIT. "Origination" requires some involvement in the process of creating a loan.

(b) The fact that a FASIT is the first owner of a loan is not inconsistent with investment activity (and with typical credit card securitizations) and does not make the FASIT the originator of the loan. The term origination would seem to connote some involvement in the solicitation of the customer relationship that gives rise to the loan.

(c) The fact that someone acting as a servicer for or sponsor of a FASIT (including the Owner) was or is responsible for creating and continuing the customer relationships that results in FASIT loans would seem not to be a sufficient basis for treating the FASIT itself as the originator of the loans. This conclusion is supported by the above authorities in which an agent's activities were not attributed to the principal, as well as by the credit card model.

We believe that the key issue in determining whether a FASIT is engaged in loan origination activity is whether the FASIT itself is engaged in the business of soliciting customer relationships and bears the risks and costs, and enjoys the benefits, of that business. Under that view, a FASIT should not be considered to originate a loan if it has no employees or facilities of its own and deals with borrowers through a servicer hired under a servicing contract under which the servicer is paid a conventional servicing fee.[92/] This conclusion should hold true even if the FASIT has some power to approve or disapprove of loans negotiated and solicited by someone else.

However, we are concerned that it may be difficult to devise a sufficiently accurate and administrable definition of the permitted terms of a servicing contract to place full reliance on that concept. Accordingly, we recommend that the regulations also require that a FASIT meet certain objective tests that serve to establish that a party other than the FASIT was responsible for establishing the customer relationship that led to the creation of the loans held by the FASIT. In evaluating our proposal, we think it is important to keep in mind the other safeguards that exist in the FASIT rules to prevent undue erosion of the corporate base. We also believe that any test that is adopted should be as clear and administrable as possible.

[92/] We do not believe that the absolute amount of the fee charged by a servicer (as contrasted with the way it is computed) should be a factor in determining if a FASIT is in an origination business because of the uncertainty that would result in having a 100% tax hinge on whether a fee is arm's length. Section 482 would, of course, apply to control the pricing of transactions between a FASIT and the Owner or its affiliates.

5. Recommendations.

In light of the discussion above, we recommend that the regulations provide a safe harbor rule under which a loan held by a FASIT will not be considered to have been originated by the FASIT if:

(x) it is a "pre-FASIT loan", a "related loan", or "revolving credit account loan" and

(y) the FASIT does not negotiate or solicit the loan using its own employees or facilities.

As to (x), a pre-FASIT loan is a loan that is funded through a source other than FASIT interests before it is acquired by the FASIT (whether or not the FASIT has a right or obligation to buy the loan after it is so funded). A related loan is a loan that (i) is made to the same borrower (or a related party) as a loan held by the FASIT, and (ii) either refunds a loan held by the FASIT, is made for a purpose related to the purpose for a loan held by the FASIT, or is made under an existing arrangement relating to a loan held by the FASIT. A "revolving credit account loan" is a loan made pursuant to a revolving credit account, if the FASIT had previously been assigned (or was contemporaneously assigned) the right to future balances in the account.

As to (y), a FASIT would not be considered to negotiate or solicit a loan using its own employees or facilities if it hires a servicer to perform those activities and pays the servicer a fee that does not result in the FASIT participating in the net profits or losses of the servicer’s business. The servicer could be the Owner or a related party.

Our recommendations may be illustrated by the following examples, which we suggest be included in the regulations:

Example 1. The Owner assigns to a FASIT any existing and all future balances in the credit card accounts of specified persons. All receivables created as the credit card is used would be qualifying loans, whether or not there was a positive balance in the account at the time of the assignment to the FASIT. The same results would arise for revolving home equity loan accounts.

Example 2. A loan held by a FASIT is modified in a transaction that constitutes a taxable exchange under Section 1001. The modified loan is a related loan.

Example 3. A FASIT holds a commercial mortgage loan that is secured by an interest in a real estate project, and the borrower requests from the servicer additional financing to finance an expansion of the project. Alternatively, a FASIT holds a student loan, and the student requests from the servicer an additional loan to finance additional educational costs. In each case, the new loan is a related loan.

Example 4. A FASIT is organized as a trust. The sponsor, X, is the Owner. The tmistee is unrelated and receives a conventional trustee fee. The trust and X enter into a servicing contract under which X agrees to service and manage the trust assets. For some purposes, X may be considered to act as the agent of the trust. The trustee, independent rating agencies rating the FASIT regular interests or certain holders of those interests have the right to approve certain specified actions taken by X. X's fee equals a fixed percentage of the assets, plus any income earned on cash accounts held by X plus a percentage of collections on delinquent receivables. The FASIT would not be considered to negotiate or solicit loans using its own employees or facilities.

Example 5. X, a loan originator, enters into a contract with a FASIT which has an unrelated Owner under which X agrees to originate loans meeting certain underwriting criteria and the FASIT agrees to purchase such loans for a predetermined price. X will make each loan with its own funds and will then sell the loan to the FASIT. The sale to the FASIT may occur immediately following the closing of the loan by X. The loans are pre-FASIT loans.

I. Section 860L(f)(2): Coordination with Section 475.

Under Section 475, a dealer in securities is required to mark to market securities that are considered held for sale to customers in the ordinary course of business. Section 860L(f)(2) provides that except as provided by regulations, if an Owner sells or contributes to a FASIT a security that was subject to mark-to-market under Section 475 in the hands of the Owner, Section 475 continues to apply to the security in the hands of the FASIT. However, the value of the security is never less than its value under Section 860I(d).

It should be noted that:

(1) if a non-financial company (such as an automobile manufacturer) transfers customer receivables to a FASIT (or a non-FASIT) in a transaction that is a sale for tax purposes, the company is not treated as a dealer in the receivables and thus Section 475 does not apply;[93/]

(2) if a financial company originates receivables (such as credit card receivables) and finances them through a sale to a non-FASIT entity in a transaction that is treated as a financing for tax purposes, for tax purposes there is no sale of the receivables to customers and thus Section 475 does not apply;[94/] and

[93/] Treas. Reg. § 1.475(c)-1(b).

[94/] See the preamble to the proposed Section 475 regulations, 1995-1 C.B. at 925-6.

(3) if a financial company regularly transfers receivables to a trust or other entity in transactions that are treated as sales for tax purposes, the company might well be viewed as selling receivables to customers in the ordinary course of business, in which case Section 475 would apply to the receivables.[95]

Section 860L(f)(2) raises the question whether a financial company that regularly sells receivables to a FASIT should properly be treated as selling the receivables to customers, as in (3) above, or should properly be treated as financing the receivables, as in (2) above. If a sale to customers is deemed to occur on the transfer to the FASIT, Section 475 will apply to the receivables prior to their transfer to the FASIT and thus, under Section 860L(f)(2), will continue to apply after their transfer to the FASIT. If a sale to customers is not deemed to occur on the transfer to the FASIT, Section 475 will not apply to the receivables prior to their transfer to the FASIT, and nothing will cause it to apply after the transfer.

The argument for treating a sale to a FASIT as a sale to customers is that (just as on a tax sale to any other securitization entity, which might be a sale to customers) the seller recognizes gain on the sale. Moreover, the FASIT may have equity-like high yield interests, or the retained ownership interest may have nominal value, or both, with the result that a sale to a FASIT may be economically equivalent to a sale to one or more unrelated parties.

[95] Treas. Reg. § 1.475(c)-1.

The argument for not treating a sale to a FASIT as a sale to customers is that under Section 860H(b)(1), the Owner is treated for its own tax purposes as selling the receivables to itself. The Owner can hardly be viewed as a dealer selling receivables to itself as customer. Moreover, mark-to-market under Section 475 is based on the actual fair market value of the debt instrument, and it would be peculiar for that rule to apply until the debt instrument was transferred to a FASIT, at which point the special valuation rules of Section 860I(d) would apply on a one-time basis. This anomaly indicates that gain recognition on the transfer to a FASIT is a legal fiction that should not be viewed as a Congressional judgment that the transfer to a FASIT is analogous to a sale to customers.

Regulations should clarify the result in this situation.

J. Section 860L(h): Anti-Abuse Regulations.

Section 860L(h) provides that the Secretary "shall" issue regulations as may be necessary or appropriate to carry out the purposes of the FASIT provisions, including "regulations to prevent the abuse of the purposes of [the FASIT provisions] through transactions which are not primarily related to securitization of debt instruments by a FASIT." The Conference Report defines securitization as the process of converting one type of asset to another, and states that the instruments created in the securitization of debt instruments typically have different maturities and characteristics than the debt instruments that are securitized.[96/]

[96/] Conference Report at 320. See also Blue Book at 258.

1. Scope of anti-abuse rule

We assume that there are at least two types of transactions that might have been intended to be covered by the anti-abuse rule. One is the use of a FASIT primarily to achieve tax benefits unrelated to the third party financing of debt instruments. An example might be the use of a FASIT to accelerate gain recognition, which could be a concern to the Treasury because of the formula that might create a deemed sale for more than fair market value. A second type of transaction might be the use of a FASIT to create the economic equivalent of a sale of a debt instrument but without full gain recognition on the debt instrument. (We are not aware of any such potential transactions.) If these types of transactions are a concern, anti-abuse regulations directed at them would be appropriate.

However, we are concerned that Section 860L(h) can be read to contemplate that regulations will define "securitization" and then provide that any transaction that is not such a "securitization" is inherently abusive and not permitted for a FASIT. We strongly believe that regulations should not take this approach. We have several reasons for this belief.

First, it would be extremely difficult for regulations to define securitization even as it is commonly practiced today.

Second, the types of transactions that comprise securitization (as used in common parlance) are constantly changing, and any fixed definition is likely to become obsolete fairly quickly. A regulatory definition of securitization that seems adequate today would in effect freeze FASITs into today's securitization formats for many years to come, while non-FASIT structures could continue to evolve and become more efficient.

Third, the FASIT rules work well from the government's perspective. The various rules for high yield and ownership interests insure that gain is recognized on all transfers to a FASIT, and all equity returns on FASIT assets will in fact be subject to a corporate level tax. Thus, the use of FASITs for a wide variety of transactions should be encouraged.

Finally, the Treasury and IRS should not be concerned that abusive FASIT transactions will occur without the knowledge of the government. We assume that FASIT information reporting will be similar to REMIC information reporting on Form 1066, which requires, for a REMIC's first taxable year, a description of the REMIC's interests or a copy of the offering materials related to the offering of the REMIC interests. As to a FASIT, similar information could be required for each subsequent issuance of a regular interest or transfer of the ownership interest. Any additional information considered necessary to prevent abusive transactions could also be required. Thus, the government should promptly become aware of any FASIT transactions that it might consider inconsistent with the purposes of the FASIT provisions, and could promptly issue guidance accordingly.

2. Consequences of violation of anti-abuse rule

We suggest that any anti-abuse regulations provide the IRS with an option to impose an intermediate sanction, and not merely to disqualify the entity as a FASIT. Under this approach, if a transaction violates the anti-abuse rule, the IRS would have the discretion (in lieu of disqualifying the FASIT) to re-characterize or otherwise adjust only the taxation of the Owner (or particular interest holders) to eliminate any inappropriate tax benefit. Any rule that requires the invalidation of the FASIT would force the IRS to choose between the unpalatable choices of doing nothing and allowing the sponsor to achieve an inappropriate tax benefit or invalidating the FASIT and adversely effecting innocent investors.

K. Pre-effective Date FASITs

1. Statutory background

Under Act Section 1621(e), an entity in existence on August 31, 1997 may make a FASIT election (the resulting entity being referred to as a "pre-effective date FASIT"). In such event, the Owner does not recognize gain under Section 860I or Section 860L(d)(2) on the deemed transfer of assets to the entity until the assets cease to be properly allocable to interests in the entity issued before the startup date (a "pre-FASIT interest") and not held by the Owner. In addition, Act Section 1621(e) provides that property shall be allocated to a pre-FASIT interest in such manner as the Secretary may prescribe, except that all property in a FASIT shall be treated as properly allocable to pre-FASIT interests if the fair market value of all such property does not exceed 107 percent of the aggregate principal amount of all outstanding pre-FASIT interests.

None of the Code provisions relating to FASITs refers to pre-effective date FASITs, and the legislative history simply repeats the statute. This rule raises a number of issues.

2. General approach for transition entities

The statute does not indicate whether a pre-effective date FASIT is intended to be treated entirely as a FASIT (except for partial non-recognition of gain), or, alternatively, whether some portion of the entity is intended to be treated as a FASIT and the remainder of the entity is intended to be treated as may be appropriate under prior law.

The former approach would have implications that we doubt could have been intended without further discussion in the statute or legislative history. For example, all the assets of an existing entity (which might be a corporation or partnership) would, upon the making of the FASIT election, be deemed to be owned by the Owner, losses of the Owner could not be used to offset income arising from such assets, and outstanding interests in the entity (which might be stock or partnership interests) would become statutory debt. It is not clear what would happen if outstanding interests would not qualify as regular interests, if outstanding interests that would only qualify as high yield interests were held by individuals, or if an asset of the entity (such as an interest rate swap with the Owner that was treated as involving a deemed loan to the Owner) was not an eligible asset for a FASIT.

As a result, we believe the approach intended by Congress was that a pro rata portion of the entity (based on interests issued after the FASIT election) be treated for all purposes as a FASIT, and a pro rata portion of the entity (based on pre-FASIT interests) be treated in the same manner as under current law (whatever that may be). This approach also makes the most sense. We therefore urge that regulations clarify that this is the proper approach.

Under this approach, at the time the FASIT election is made and the initial FASIT interests are issued, a specified pro rata portion (discussed below) of each asset of the entity would be considered a FASIT, and the remaining portion of each asset would be considered a non-FASIT. Only regular interests in a

FASIT could be issued by the entity thereafter. As such interests were issued, and as the pre- FASIT interests were paid down, the FASIT percentage for the entity would gradually increase and a corresponding amount of gain would be recognized on the underlying assets. When the pre-FASIT interest with the longest remaining maturity on the FASIT election date was paid off, the FASIT percentage would be 100%.

As noted above, it is possible that an existing entity would hold some assets (such as certain interest rate swaps with the Owner) that would not qualify as FASIT assets. Under a "pure" pro rata rule for allocating assets between the FASIT and non-FASIT portions of the entity, a portion of the disqualified asset would be deemed to be an asset of the FASIT, potentially disqualifying the FASIT. We suggest that, as an exception to the pro rata rule, the Owner be permitted to identify non-qualifying assets that support only pre-FASIT interests, and to exclude such assets entirely from the FASIT portion of the entity.

Assuming this approach is adopted, regulations should clarify a number of issues, including: (a) that gain is not recognized under Section 860I(b) (requiring gain recognition on assets outside a FASIT that "support" regular interests) on the assets of the entity allocable to the pre- FASIT interests, as long as the pre-FASIT interests are not subordinated to the FASIT interests, (b) that provisions such as Section 860J (the prohibition on use of the Owner's loss against income from the FASIT) do not apply to the pre- FASIT portion of the entity, (c) that holders of pre-FASIT interests are unaffected by the FASIT election, (d) that the characterization of the entity and the interests therein under current law (e.g., as partnership interests or debt in a partnership) continue as to the pre-FASIT portion of the entity, (e) whether the rule in (d) applies to a pre-FASIT interest that is acquired by the Owner (since such a transaction could be equivalent to a contribution by the Owner to the FASIT for a new FASIT interest followed by the FASIT's redemption of the pre-FASIT interest), (f) that the FASIT portion of the entity is not disqualified by provisions such as Section 860L(a)(1)(B) (requiring all the interests in a FASIT to be regular interests or the ownership interest), and (g) that an entity in existence on August 31, 1997, can continue to issue non-FASIT interests under current law, and at any time thereafter a FASIT election can be made for the entity that will apply the FASIT rules to all future interests issued by the entity under the approach described above.

3. Amount of gain recognition

As noted above, regulations are required to determine the amount of assets of the entity allocable to pre-FASIT interests. A significant issue arises because the total amount of assets in the entity will often exceed the amount needed to make payments on all the currently outstanding interests. The allocation of that surplus between the non-FASIT and the FASIT determines the amount of gain to be recognized by the Owner.

It should be noted that this question is different than the question discussed above[97/] concerning the proper amount of gain recognition when the assets actually held by a FASIT exceed the assets supporting the regular interests. Whatever the result in that situation, the same result should apply to the assets allocable to the FASIT portion of a pre-effective date FASIT. However, the question here arises at an earlier stage in the computation, when it is determined how many assets are to be

[97/] Part IV.B.4.

considered allocable or not allocable to the FASIT in the first instance.

For example, suppose an existing entity has assets of $1000, but only $450 of outstanding debt which requires an additional $50 of subordinated credit support (using up a total of $500 of assets). Thus, the sponsor could at any time issue up to another $450 of additional debt on the same terms. Suppose, however, the sponsor makes a FASIT election and issues only $90 of FASIT regular interests at that time (using up a total of $100 of assets). The question is whether the FASIT percentage should be 50% (i.e., 500/1000, the percentage of all the assets not allocable to the pre- FASIT interest) or 1/6 (i.e., 100/600, the ratio of the assets supporting the FASIT interests over the assets supporting all outstanding interests).

In other words, the question is whether the $400 of "surplus" assets should be allocated entirely to the FASIT portion of the entity, or instead disregarded for purposes of the calculation. Disregarding those assets is the same as allocating them pro rata between the FASIT and non-FASIT portions of the entity.[98/] Whatever the result, the assets allocable to the FASIT portion will be treated as transferred to a FASIT and subject to gain recognition under the usual rules of Section 860I, while the assets allocable to the non-FASIT portion will remain under current law.

[98/] If the $400 of surplus assets is allocated 1/6 to the FASIT and 5/6 to the non-FASIT, total FASIT and non- FASIT assets are $166.67 ($100 plus $66.67) and $833.33 ($500 plus $333.33), respectively, retaining the FASIT ratio of 1/6.

We believe the pro rata rule makes sense and is fairer to taxpayers. In the above example, adoption of the rule allocating all surplus assets to the FASIT would (absent Treasury exercise of regulatory relief under Section 860I(c) deferring gain on a transfer to a FASIT until regular interests are issued) require the Owner to recognize gain on the appreciation in $500 of assets upon the making of the FASIT election, even if only one dollar of regular interests was issued. We see no logic to this approach.

Thus, we recommend that the assets deemed allocated to the FASIT at any time equal a fraction of each asset in the entity (other than the excluded nonqualified assets discussed above). The numerator of the fraction is the aggregate adjusted issue prices of the FASIT regular interests outstanding at such time, and the denominator is the aggregate adjusted issue prices of the FASIT regular interests and pre-FASIT interests outstanding at such time (treating outstanding nondebt pre-FASIT interests as if they were debt).

In accordance with Act Section 1621(e)(2), an exception to this (or any other) gain recognition provision applies to the extent that the fair market value of the permitted assets does not exceed 107 percent of the aggregate principal amount of all outstanding pre-FASIT interests. In determining the fair market value of permitted assets for this purpose, the method specified in Section 860I(d) (namely the method used for determining the Owner's gain on a contribution to a FASIT) should be used. Unnecessary complexity would arise if the method for calculating the fair market value of property is different for the purpose of applying the 107 percent safe harbor than for calculating gain recognition under Section 860I.