June 20, 2000

The Honorable Bill Archer
Chair
House Ways & Means Committee
1236 Longworth House Office Building
Washington, D.C. 20515

Re: Proposed Regulations and Legislation To Prevent Evasion of Tax on REMIC Residual Interests

Dear Mr. Chairman:

I am pleased to enclose a report of the New York State Bar Association Tax Section[1] commenting on two recent proposals intended to prevent evasion of tax on residual interests in Real Estate Mortgage Investment Conduits ("REMICs") and ownership interests in Financial Asset Securitization Investment Trusts ("FASITs").

One of the two proposals is legislative. The Administration's Fiscal Year 2001 Budget proposed that REMICs be made secondarily liable for tax owed by holders of their residual interests. Similarly, FASITs would be made secondarily liable for tax owed by holders of their ownership interests.

The other proposal addressed in our report is regulatory. Early this year, regulations were proposed that could effectively impose secondary liability on transferors of REMIC residual interests (and FASIT ownership interests) for tax owed by the transferee unless the amount paid as consideration to the transferee at least equals the present value of the tax, computed using certain assumptions that often are

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[1] The principal drafter of the enclosed report was David S. Miller, co-chair of the Tax Section's Committee on Financial Instruments.

unrealistic. Failure to pay this amount would prevent transferors from relying on a "safe harbor" in current regulations, and thus subject them to the risk that a transfer will be disregarded for tax purposes.

Although we agree with the Treasury Department that changes in current law are needed to reduce opportunities for evasion of tax on income from residual interests, we believe that these proposals could seriously and unnecessarily impede use of REMICs (and FASITs). In our report, we propose other changes in the law that would, we believe, adequately address any opportunities for tax evasion without imposing unnecessary costs on securitization transactions.

Because any tax owed by a REMIC (or FASIT) under the legislative proposal generally would be paid from assets needed to make payments due holders of regular interests, the proposal effectively imposes contingent liability on regular interests for tax owed by residual interest holders. Imposing contingent liability on regular interests could make it difficult (or impossible) for such interests to be rated by rating agencies or traded in the market. Congress enacted the REMIC rules in part to increase the efficiency and liquidity of the mortgage market. By increasing the costs of using REMICs and reducing liquidity in their regular interests, the legislative proposal will undermine that purpose.

Although its consequences may be less serious, the proposed amendment to current regulations would also impede use of REMICs (and FASITs). The proposed amendment would have this effect because it would make transfers of residuals more difficult and expensive. REMIC sponsors often are not the most efficient holders of residuals; in fact, some sponsors may be precluded by law from holding residuals because they are "disqualified organizations".

As alternatives to these two proposals, the enclosed report suggests several changes to current law to minimize opportunities for avoidance of tax on income from REMIC residual interests (and FASIT ownership interests). First, we propose expansion of the list of "disqualified organizations" (which effectively cannot hold residuals) to include Indian tribes and tribal corporations. Second, we propose that issuance or transfer of an interest in a partnership or other pass-through entity holding REMIC residual interests be treated as a transfer of those interests, and thus as subject to the same restrictions that current law imposes on direct transfers. Finally, we propose that the safe harbor in current regulations (which gives transferors certainty that transfers will not be disregarded) be converted into a substantive rule; thus, if its requirements are not met, the transferor would be secondarily liable for tax owed by the transferee. We also describe several other ways that transfers of residuals might be restricted to address concerns about abuse. Some of the changes described in our report would require legislation, while others could be made by regulation.

Please let me know if we can be of further assistance in consideration of the issues addressed in the enclosed report.

Sincerely,

Robert H. Scarborough

cc: The Honorable Charles B. Rangel
Ranking Minority Member
House Ways & Means Committee

Lindy L. Paull, Esq.
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Joint Committee on Taxation

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