Tax Report #973

New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

TAX SECTION

2000-2001 Executive Committee

ROBERT H. SCARBOROUGH
Chair
Freshfields
520 Madison Avenue
34th Floor
New York, NY 10022
212/277-4045
ROBERT A. JACOBS
First Vice-Chair
212/530-5664
SAMUEL J. DIMON
Second Vice-Chair
212/450-4037
ANDREW N. BERG
Secretary
212/909-6288
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Stuart J. Goldring
Dale L. Ponikvar
Capitalization and Cost Recovery
Joel Scharfstein
Alan J. Tarr
Character, Gains & Losses
Michael S. Farber
Erika W. Nijenhuis
CLE and Pro Bono
James A. Locke
Elizabeth A. Smith
Compliance, Practice & Procedure
Robert S. Fink
Arnold Y. Kapiloff
Consolidated Returns
Deborah L. Paul
Lawrence M. Garrett
Corporations
Lewis R. Steinberg
Diana L. Wollman
Employee Benefits
David A. Pratt
Andrew W. Stumpff
Estates and Trusts
Mildred Kalik
Carlyn S. McCaffrey
Financial Instruments
David S. Miller
David M. Schizer
Financial Intermediaries
Yaron Z. Reich
Andrew P. Solomon
Foreign Activities of U.S. Taxpayers
Peter H. Blessing
Emily S. McMahon
Individuals
Kimberly S. Blanchard
Lisa A. Levy
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
New York City Taxes
Robert J. Levinsohn
William B. Randolph
New York State Franchise and Income Taxes
Maria T. Jones
Arthur R. Rosen
New York State Sales and Misc.
John P. Dugan
Hollis L. Hyans
Partnerships
William B. Brannan
Patrick C. Gallagher
Pass-Through Entities
Janet Beth Korins
Paul R. Wysocki
Real Property
Elliot Pisem
Lary S. Wolf
Reorganizations
Kathleen L. Ferrell
Jodi J. Schwartz
Tax Accounting
Marc L. Silberberg
Linda Z. Swartz
Tax Exempt Bonds
Linda L. D'Onofrio
John T. Lutz
Tax Exempt Entities
Dickson G. Brown
Michelle P. Scott
Tax Policy
David P. Hariton
Victor Zonana
U.S. Activities of Foreign Taxpayers
James Ross MacDonald
David R. Sicular

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
Peter v. Z. Cobb, M. Carr Ferguson, Sherwin Kamin, Charles I. Kingson, Glen A. Kohl, Sherry S. Kraus, Stuart E. Leblang, Donald C. Lubick, Charles M. Morgan, III, David M. Rievman, David H. Schnabel, Robert T. Smith, Dana L. Trier, Eugene L. Vogel, David E. Watts

May 5, 2000

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service, Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Jonathan Talisman, Esq.
Acting Assistant Secretary (Tax Policy)
Treasury Department, Room 1330 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Proposed Regulations on FASITs

Dear Commissioner Rossotti and Mr. Talisman:

I am pleased to enclose a report of the New York State Bar Association Tax Section[1] commenting on recent proposed regulations on Financial Asset Securitization Investment Trusts, or FASITs.

The Tax Section commends the Treasury Department and the Internal Revenue Service for attempting to provide clear, bright-line rules for taxpayers engaged in securitization transactions. As explained in detail in the enclosed report, however, we believe that the proposed regulations need to be modified in a number of respects if FASITs are to be of practical use as a vehicle for securitization. We are concerned that some of the rules in the proposed regulations will unnecessarily impede use of FASITs in common commercial transactions.

[1] The enclosed report was prepared by the Section's Committee on Pass-Through Entities. The principal drafter of the report was Paul R. Wysocki.

FORMER CHAIRS OF SECTION:
Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John E. Morrissey, Jr., Charles E. Heming, Ralph O. Winger, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos, Michael L. Schler, Carolyn Joy Lee, Richard L. Reinhold, Richard O. Loengard, Steven C. Todrys, Harold R. Handler

We believe that the proposed regulations would require taxpayers forming FASITs to recognize gain, and in particular gain measured using a noneconomic valuation rule, in situations where that both is not required by statute and produces inappropriate results. Thus, for example, we recommend that taxpayers be permitted to defer gain on contribution of assets that do not yet support securities issued by the FASIT. We also recommend that debt instruments that are readily quotable be valued for purposes of gain recognition at actual fair market value rather than using the special valuation rule.

We believe that several per se rules in the proposed regulations, including a rule for determining whether substantially all the assets of a FASIT are permitted assets, should be modified. These per se rules should be replaced with rules that conform more closely to the statutory provisions and, in several instances, to provisions in the REMIC regulations dealing with similar issues.

The proposed regulations also contain a number of provisions designed to address perceived abuses in the international context, such as a prohibition on foreign FASITs and a new anti-conduit rule to address possible avoidance of the portfolio interest rules. While we recognize the concerns addressed by these provisions and support targeted anti-abuse rules, we believe that a number of these proposed rules can and should be crafted more narrowly. As proposed, these rules will significantly impede nonabusive transactions.

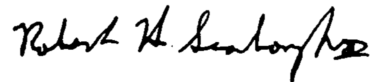
While we support inclusion of a general anti-abuse rule in the final regulations, we believe that proposed rule needs clarification in several respects. Clarification is needed if the certainty that Congress intended to provide for taxpayers using FASITs is not to be undermined by the anti-abuse rule.

Finally, the report supports the proposed effective dates that would apply the proposed regulations to FASITs formed prior to their issuance. Because the proposed regulations set forth various substantive rules that could not have been anticipated by taxpayers, however, we suggest that the final regulations provide liberal transition rules to give existing

FASITs an opportunity to comply with the substantive rules or liquidate within a reasonable period.

Please let me know if we can be of further assistance as the Treasury Department and Internal Revenue Service work to finalize the proposed regulations.

Sincerely,



Robert H. Scarborough

cc: Treasury Department

Eric Solomon
Joseph Mikrut
Philip West
Michael Novey

Internal Revenue Service

Stuart Brown
Lon Smith
Marshall Feiring

CC: DOM:CORP: R (REG 100276-97 and REG 122450-98)

May 5, 2000

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS RELATING TO FINANCIAL ASSET SECURITIZATION INVESTMENT TRUSTS

This report[1] comments on the regulations proposed on February 4, 2000 under Sections 860H through 860L,[2] relating to Financial Asset Securitization Investment Trusts, or FASITs (the "Proposed Regulations"). The FASIT provisions created a new pass-through entity to facilitate the securitization of debt instruments, such as credit card receivables, trade receivables, automobile loans, home equity loans and other consumer and corporate debt, including mortgage loans. The FASIT provisions, which became effective September 1, 1997, were adopted in Section 1621 of the Small Business Job Protection Act of 1996 (the "Act").[3]

In Announcement 96-121, 1996-47 I.R.B. 12, the Treasury Department and the Internal Revenue Service solicited comments on issues to be considered in developing guidance under the FASIT provisions. Comments were specifically requested on (i) rules to permit more than one member of a consolidated group to own ownership interests in a single FASIT, (ii) transitional rules for securitization entities in existence prior to the effective date of the FASIT provisions ("pre-effective date FASITs") and (iii) other rules that should be adopted prior to

[1] This report was prepared by the Committee on Pass-Through Entities of the New York State Bar Association Tax Section. Paul Wysocki was the principal author of the report. Substantial drafting contributions were made by Linda Beale, Janet Korins, David Nirenberg and Michael Schler. Helpful comments were received from Charles Adelman, Steven Kopp, David C. Miller, Robert Scarborough and Andrew Solomon.

[2] All "Section" references are to the Internal Revenue Code of 1986, as amended, all "Treas. Reg. §" references are to the Treasury Regulations promulgated thereunder, and all "Prop. Reg. §" references are to the regulations proposed thereunder.

[3] P.L. 104-188, signed August 20, 1996.

September 1, 1997. In response to Announcement 96-121, we prepared a report dated February 7, 1997 on these and other issues that we thought should be addressed in the proposed FASIT regulations.[4]

This report is divided into four parts. Part one summarizes our principal recommendations. Part two provides an overview of the Proposed Regulations. Part three provides our detailed recommendations. Part four comments on several technical issues.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

A. Issues Presented by the Proposed Regulations.

The FASIT provisions were enacted to facilitate the securitization of debt obligations such as credit card receivables, home equity loans and auto loans. The Proposed Regulations represent a first attempt to provide workable rules for taxpayers engaged in legitimate securitization transactions while attacking potential abuses with a broad anti-abuse rule and a number of per se rules. We acknowledge the Treasury Department's and Internal Revenue Service's objective of preventing potentially abusive FASIT transactions. We believe, however, that some of the provisions in the Proposed Regulations are vague and overbroad, while others impose unduly burdensome requirements that are not supported by the statutory provisions. If the Proposed Regulations were finalized as written, they would likely make it difficult for most potential securitization sponsors to use the FASIT provisions. We believe that the Proposed Regulations should be modified in several material respects in order to facilitate legitimate securitization transactions. We have set forth our principal recommendations below.

[4] "Report on Suggested FASIT Regulations," New York State Bar Association Tax Section, reprinted in Tax Notes Today, February 11, 1997 (hereinafter, the "Prior Report").

B. Principal Recommendations.

1. The final regulations should clarify that contribution agreements are not subject to the gain recognition rule, and should further narrow the application of the special valuation rule to non-publicly traded debt instruments. We believe, for example, that permitted debt instruments that are readily quotable within the meaning of Treas. Reg. § 1.1273-2(f)(5) should be treated as traded on an established securities market and therefore not subject to the special valuation rule for non-publicly traded debt instruments.

2. The exception from the special valuation rule for certain purchases of debt instruments from unrelated parties (the "Spot Purchase Exception") should be extended to permit a period of at least 60 days from the date of purchase to the date of contribution to the FASIT. The exception should also clarify whether a loan origination by an Owner or related party can qualify as a purchase for purposes of the Spot Purchase Exception.

3. Because debt instruments are commonly contributed into a master trust structure prior to the sale of securities to public investors, a gain deferral rule should be adopted. Until a gain deferral rule is adopted, taxpayers should be able to elect to defer gain on assets contributed to a FASIT that do not support regular interests and should be able to compute the deferred gain under any reasonable method that is consistently applied.

4. The substantially all test of Prop. Reg. § 1.860H-2(a) should conform to the substantially all test of Treas. Reg. § 1.860D-1(b)(3), applicable to REMICs.

5. The definition of a permitted debt instrument should be expanded to include additional categories of stripped bonds that otherwise qualify as permitted debt instruments. For example, a permitted debt instrument should include a commercial mortgage

providing for certain contingent payments (i.e., an equity kicker), provided the contingent payments are stripped from the commercial mortgage prior to contribution of the stripped mortgage to the FASIT.

6. The definition of a variable rate debt instrument for purposes of Prop. Reg. § 1.860H-2(b)(1)(ii) should conform to the definition of a fixed or variable rate debt instrument for purposes of Treas. Reg. § 1.860G-1(a)(3) (which permits rates based on one or more fixed or variable rates).

7. The exception from the definition of a permitted asset for a defaulted debt instrument generally should not apply to debt instruments having one or more prior, uncured payment defaults.

8. The definition of a hedge or guarantee contract should be expanded to permit the FASIT to enter into a hedge or guarantee contract that manages risk with respect to all of the assets held by the FASIT, including those assets that are not expected to support the regular interests.

9. The per se rule limiting the value of all guarantee contracts provided by an Owner to a FASIT to less than 3 percent of the value of all the assets of the FASIT should be eliminated or liberalized.

10. Similar to the rule in Treas. Reg. §§ 1.860G-2(a)(3) and 1.860G-2(f)(2), the final regulations should provide a rule under which any instrument that the Owner reasonably believes is a permitted debt instrument will be treated as a permitted asset until 90 days after the discovery that it fails to meet the requirements of being a permitted asset (the "90-day Rule").

11. The final regulations should provide further guidance on the relationship between a FASIT and the Owner for purposes of other Federal income tax provisions.

12. The final regulations should permit ownership of a single FASIT by more than one member of a consolidated group.

13. Gains realized by an Owner on a contribution of assets to a FASIT should not be subject to the loss limitation rule in Section 860J.

14. Consistent with Section 860L(e)(3)(A), the final regulations should permit a qualified liquidation of a FASIT without the prior consent of the Commissioner and without subjecting any gain to the 100 percent tax on prohibited transactions. The rules of Section 860F(a)(2)(A)(iv) and Treas. Reg. § 1.860F-1 should generally apply to a qualified liquidation of a FASIT.

15. The rule which requires gain recognition on certain dispositions of debt instruments that are removed from a FASIT by substitution or upon distribution to reduce over-collateralization (the "180-day Rule") should be replaced by a narrowly drawn rule that addresses the potential character conversion noted in the Preamble.

16. The final regulations should clarify that an Owner (or related party) regularly originates similar loans in the ordinary course of its trade or business if the Owner (or related party) only originates loans to be sold to the FASIT.

17. Because of the greater leeway given to substitution of assets in a FASIT, a FASIT should be permitted to significantly modify a loan (within the meaning of Treas. Reg. § 1.1001-3) without being considered to "originate" the modified loan, as long as the modification

is approved either by the Owner in the ordinary course of its trade or business or by the servicer in the ordinary course of its trade or business.

18. The international provisions should be modified to permit foreign FASITs that do not present any opportunity for abuse. We also urge the Treasury Department to reconsider the need for the special FASIT conduit rule in light of the applicability of the general conduit rule under Section 881, and to refrain from extending such a rule to REMICs or other securitization vehicles.

19. The anti-abuse rule should be modified to reduce the significant uncertainty created by the current language. In particular, the rule should focus on the purpose of the FASIT provisions to facilitate securitizations by providing debt characterization to regular interests and acknowledge that the purposes of legitimate securitizations extend well beyond mere spreading of credit risks. Further, we believe that, if the corollaries are retained in the final regulations, the corollaries relating to asset mix should be modified in certain significant respects. Finally, as in the case of the partnership anti-abuse regulation, any final anti-abuse rule should illustrate the scope of the rule through examples of transactions that are considered consistent and inconsistent with the intent of Congress to facilitate securitizations.

20. The rules governing pre-effective date FASITs should be modified to ensure that a subsequent FASIT election does not trigger gain with respect to assets supporting interests issued before the startup date.

21. Because the Proposed Regulations are intended generally to be effective on the date final regulations are filed with the Federal Register, these Proposed Regulations, if adopted as final regulations, would apply to existing FASITs. We believe that the final regulations should provide a transition rule for FASITs formed before the publication of the final

regulations that would permit existing FASITs a reasonable period of time to conform to the substantive rules governing qualification as a FASIT by amending existing FASIT documents, by disposing of non-permitted assets (without being subject to the 100 percent tax on prohibited transactions) or by taking other corrective actions. In addition, while we agree that the anti-abuse rule should be effective on and after February 4, 2000, it is critical that the scope of the rule be clarified and narrowed because, as drafted, the anti-abuse rule covers legitimate, non-abusive transactions.

II. OVERVIEW OF THE PROPOSED REGULATIONS

A. Definition of a FASIT.

A FASIT is a corporation (other than a regulated investment company), partnership, trust or segregated pool of assets that elects FASIT treatment and otherwise satisfies various requirements.[5] A FASIT can have only one ownership interest and that ownership interest must be directly held by a single eligible domestic corporation (the "Owner").[6] A FASIT may issue multiple classes of regular interests and those interests are treated as debt for all Federal income tax purposes. Substantially all of the assets of a FASIT as of the close of the third month beginning after the date of its formation must consist of permitted assets.

An Owner reports on its Federal income tax return the items of income, gain, deduction, loss and credit of a FASIT, and the FASIT is not subject to tax. A FASIT election is made by the Owner by attaching a statement to its timely filed Federal income tax return for the

[5] Prop. Reg. § 1.860H-1(a)(1).

[6] Prop. Reg. § 1.860H-1(a)(1); Section 860L(a)(2) defines an eligible corporation to mean a domestic C corporation other than a tax-exempt corporation, a REMIC, a regulated investment company, a real estate investment trust or a cooperative.

taxable year that includes the startup day for the FASIT.[7] The Proposed Regulations clarify the information that should be included in the statement and various procedural issues.[8]

The Proposed Regulations generally do not define the relationship between a FASIT and its Owner. A FASIT could be viewed as a branch of the Owner or as an entity separate from the Owner for Federal income tax purposes. Except in limited contexts,[9] the Proposed Regulations do not address the relationship between a FASIT and the Owner. Instead, the Treasury Department and the Internal Revenue Service expect to provide clarification on an issue-by-issue basis. The Treasury Department and Internal Revenue Service request comments on this issue.

B. Permitted Assets.

Section 860L requires, after the initial three month startup period, that substantially all of the assets of the FASIT (including any assets held outside of the FASIT that support the regular interests) consist of permitted assets.[10] The Proposed Regulations provide that substantially all of the assets of a FASIT consist of permitted assets if the total adjusted bases of the permitted assets is more than 99 percent of the total adjusted bases of all assets held (or deemed to be held under the support rule) by the FASIT.[11] Unlike a similar 1 percent rule

[7] Prop. Reg. § 1.860H-1(b)(1) and -1(b)(2).

[8] Prop. Reg. § 1.860H-1(b)(2) (form of election); -1(b)(3) (time for filing election); -1(b)(4) (contents of election); -1(b)(5) (required signatures); and -1(b)(6) (special rule regarding startup day).

[9] See e.g., Prop. Reg. § 1.860H-6(f) (treatment of FASIT as a branch of the Owner for purposes of subtitle F of the Code); Prop. Reg. § 1.860H-5 (certain foreign regular interest holders look through FASIT to certain underlying assets).

[10] Section 860L(a)(1)(D).

[11] Prop. Reg. § 1.860H-2(a).

under the REMIC provisions that creates a safe harbor if at least 99 percent of a REMIC's assets are permitted assets,[12] the Proposed Regulations create a bright line test of whether substantially all of the assets of the FASIT consist of permitted assets.

Permitted assets are defined as cash and cash equivalents, certain debt instruments, foreclosure property, certain hedges or guarantees, certain contract rights and any regular interest in a REMIC or FASIT.[13] Cash and cash equivalents include certain short-term investment grade debt instruments and, in response to comments, shares in U.S.-dollar denominated money market funds.[14] Permitted assets also include debt instruments that are fixed rate debt instruments, certain variable rate debt instruments, REMIC or FASIT regular interests, inflation-indexed debt instruments, receivables under a revolving credit agreement, stripped bonds or coupons of any of the foregoing permitted debt instruments, and trust certificates evidencing an interest in a pool of permitted debt instruments.[15] The term permitted debt instrument specifically excludes equity-linked or contingent payment debt,[16] debt issued by the Owner other than certain short-term investment grade commercial paper issued by the Owner or a FASIT regular interest,[17] debt with an uncured payment default at the time of contribution to the FASIT unless the default is expected to be cured within 90 days of the date of contribution,[18]

---

[12] Treas. Reg. § 1.860D-1(b)(3).

[13] Section 860L(c)(1).

[14] Prop. Reg. § 1.860H-2(c).

[15] Prop. Reg. § 1.860H-2(b)(1).

[16] Prop. Reg. § 1.860H-2(b)(3)(i).

[17] Prop Reg. § 1.860H-2(b)(3)(iii); Prop. Reg. § 1.860H-2(b)(2) and -2(b)(1)(iv).

[18] Prop. Reg. § 1.860H-2(b)(3)(ii).

debt guaranteed by the Owner if the Owner is viewed as the primary obligor,[19] debt linked to the Owner's credit,[20] a stripped bond or coupon of any of the foregoing[21] and debt of a foreign issuer that is traded on an established securities exchange if interest on the debt instrument is subject to tax on a gross basis (such as a withholding tax).[22]

A hedge or a guarantee contract is a permitted asset only if the hedge or guarantee contract is reasonably required to offset one or more of four specified risks that could affect the amount or timing of receipts on the assets held (or to be held) by the FASIT and the amount and timing of payments on the regular interests issued (or to be issued) by the FASIT.[23] The four specified risks are (i) fluctuations in interest rates, (ii) fluctuations in currency rates, (iii) default or credit quality and (iv) timing of payments. In order to prevent a FASIT from receiving the economic return on non-permitted assets, a hedge or guarantee contract is not a permitted asset if it references an asset other than a permitted asset or references an index, economic indicator or financial average other than those that are widely disseminated and designed to correlate closely with one of the specified risks.[24] Because the hedge or guarantee contract must manage risks with respect to regular interests issued or expected to be issued, the Proposed Regulations do not permit the hedge or guarantee contract to protect against risks associated with FASIT assets that

---

[19] Prop. Reg. § 1.860H-2(b)(3)(iv).

[20] Prop. Reg. § 1.860H-2(b)(3)(v).

[21] Prop. Reg. § 1.860H-2(b)(3)(vi).

[22] Prop. Reg. § 1.860H-2(b)(3)(vii).

[23] Prop. Reg. § 1.860H-2(d)(1).

[24] Prop. Reg. § 1.860H-2(d)(2).

support the Owner's interest in the FASIT.[25] A hedge or guarantee contract must not create, at the time it is entered into, an investment in the FASIT.[26]

Several special rules restrict the types of hedge and guarantee contracts that are permitted assets. A hedge contract (other than a credit hedge) may be entered into with the Owner (or related party) only if the Owner (or related party) enters into similar contracts in the ordinary course of its trade or business and the terms of the contract are consistent with the terms of an arm's length transaction.[27] This rule treats a hedge between the FASIT and an Owner not engaged in the business of entering into similar hedges as a non-permitted asset even if the Owner enters into an offsetting, or back-to-back, hedge with a counterparty engaged in the business of entering into similar hedges. A guarantee contract issued by an Owner is a permitted asset only if (i) it is a permitted hedge (i.e., a hedge against any of the enumerated risk factors) with terms consistent with an arm's length transaction, (ii) it is a credit enhancement contract within the meaning of Treas. Reg. § 1.860G-2(c) and (iii) immediately after the guarantee contract is acquired by the FASIT, the value of all of the guarantee contracts issued by the Owner is less than 3 percent of the value of all of the FASIT's assets.[28] The value of the guarantee contracts and the value of the FASIT assets are determined under the special valuation rule for non-publicly traded debt instruments. If the value of all of the guarantee contracts issued by the Owner is 3 percent or more of the value of the FASIT assets, the guarantee contracts are

[25] Prop. Reg. § 1.860H-2(d)(1).

[26] Prop. Reg. § 1.860H-2(d)(4).

[27] Prop. Reg. § 1.860H-2(e)(1). Presumably a credit hedge is viewed as providing credit support in the nature of a guarantee or similar arrangement.

[28] Prop. Reg. § 1.860H-2(e)(2).

not permitted assets. Because substantially all of the assets of the entity or arrangement would not, in that case, be permitted assets, the entity or arrangement would fail to qualify as a FASIT.

Permitted assets also include foreclosure property, which is defined as property acquired by a FASIT in connection with the default or imminent default of a permitted debt instrument.[29] Foreclosure property is generally a permitted asset for a grace period which may extend up to six years after the close of the calendar year in which the foreclosure occurs. Thereafter, unless the foreclosure property otherwise qualifies as a permitted asset, a 100 percent tax is imposed on income or gain derived from the foreclosure property. If foreclosure property is itself a permitted asset, the foreclosure property is treated as contributed by the Owner to the FASIT immediately after the end of the grace period, and gain may be recognized to the Owner on the deemed contribution.[30] A FASIT may also hold a contract or agreement in the nature of a line of credit provided the FASIT does not originate the contract or agreement.[31] Finally, contracts to acquire permitted hedge contracts and permitted debt instruments are permitted assets only if the transfer to the FASIT is for at least (i) fair market value consideration in the case of hedge contracts or debt instruments traded on an established securities market or (ii) 90 percent of value in the case of debt instruments not traded on an established securities market, as determined under the special valuation rule for non-publicly traded debt instruments.[32]

---

[29] Prop. Reg. § 1.860H-2(f).

[30] Id.

[31] Prop. Reg. § 1.860H-2(g); Prop. Reg. § 1.860L-1(b).

[32] Prop. Reg. § 1.860H-2(h).

C. Taxation of Owner.

The Proposed Regulations specify that all assets, liabilities, and items of income, gain, deduction, loss and credit of the FASIT are treated as those of the Owner.[33] The Owner must determine the income from each debt instrument held (or deemed to be held) by the FASIT, including interest, acquisition discount, original issue discount, market discount and premium deductions or adjustments, under the constant yield method (including the rules of Section 1272(a)(6)).[34] The method of accounting for a permitted hedge must clearly reflect income and otherwise comply with the timing principles of Treas. Reg. § 1.446-4.[35] Any gain or loss realized on a permitted hedge is ordinary.[36] Unless otherwise prescribed, the tax information pertaining to the FASIT must be reported annually and set forth on a separate statement that is attached to the Owner's return.[37]

Mark to market accounting does not apply to any asset held by a FASIT.[38] If an Owner transfers an asset that is marked to market under the Owner's method of accounting, then the Owner marks the asset to market immediately before the asset is contributed to the FASIT.[39] If the asset is a non-publicly traded debt instrument, then, immediately after the asset is marked

[33] Prop. Reg. § 1.860H-6(a).

[34] Prop. Reg. § 1.860H-6(b).

[35] Prop. Reg. § 1.860H-6(c).

[36] Id.

[37] Prop. Reg. § 1.860H-6(e).

[38] Prop. Reg. § 1.860H-6(d)(1); Section 860L(f)(2).

[39] Prop. Reg. § 1.860H-6(d)(2).

to market, the asset is valued under the special valuation rule and additional gain may be realized.[40]

The Owner must be a domestic C corporation other than a tax-exempt corporation, REMIC, regulated investment company, real estate investment trust or cooperative and there may be only one Owner of a FASIT.[41] Congress anticipated, however, that the Treasury Department would "issue guidance on how this 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."[42] Notwithstanding the Congressional directive, the Treasury Department and the Internal Revenue Service decided not to permit members of a consolidated group to own jointly an ownership interest because of concerns about potential shifting of stock basis, income or loss among members. They did not believe that shifting of stock basis, income or loss could be prevented through an anti-abuse rule and concluded that preventing such shifting would require rules creating additional administrative complexity. Comments are requested on this issue.

The Owner must recognize gain (but not loss) on assets transferred to the FASIT by the Owner (or a related person), support property and foreclosure property that is held beyond the permitted grace period.[43] Property is support property if the Owner (or a related person) (i) pledges such property to pay a FASIT regular interest or otherwise identifies such property as

---

[40] Id.

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

[42] H. Conf. Rep. No. 104-737, 104th Cong., 2d. Sess. 320-329 (1996). See also Announcement 96-121, 1996-47 I.R.B. 12.

[43] Prop. Reg. § 1.8601-1(a).

providing security for the payment of a FASIT regular interest, (ii) sets aside such property for transfer to the FASIT under any agreement or understanding or (iii) holds an interest in property that is subordinated to the FASIT's interest in the property.[44] Retention by the Owner (or related party) of a subordinated interest in an asset owned by the FASIT is support property under this per se rule even if the retained subordinated interest is held for investment by the Owner (or related party).

Gain is calculated based on the value of the assets at the time of the contribution. Pursuant to the statute, a special valuation rule applies to debt instruments that are not traded on an established securities market.[45] Debt instruments are considered traded on an established securities market (as described in Treas. Reg. § 1.1273-2(f)(2), (3), or (4)) if they (i) are listed on specified securities exchanges, (ii) are traded on a board of trade or interbank market or (iii) appear on a quotation medium that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or sale prices of recent transactions. Debt instruments that are readily quotable within the meaning of Treas. Reg. § 1.1273-2(f)(5) are not considered traded on an established securities market.[46] Comments are requested whether debt instruments that are readily quotable should be considered traded on an established securities market. The Proposed Regulations provide additional rules for the valuation of interests in trusts and stripped investments. A trust certificate is deemed to represent ownership of a debt instrument traded on an established securities market, and thus is not subject to the special valuation rule, if either the certificate is traded on an established securities market or the

[44] Prop. Reg. § 1.8601-1(b).

[45] Section 8601(d)(1)(A); Prop. Reg. § 1.8601-2(a).

[46] Prop. Reg. § 1.8601-2(b).

certificate represents a beneficial interest in a pool of assets composed solely of debt instruments that are traded on an established securities market.[47] A stripped bond or stripped coupon is generally treated as traded on an established securities market if the underlying bond is traded on an established securities market.[48]

Under the special valuation rule, the value of a debt instrument is the sum of the reasonably expected payments on the debt instrument, discounted using semiannual compounding at a rate equal to 120 percent of the applicable Federal rate for instruments having the same term as the weighted average maturity of the reasonably expected repayments on the debt instrument.[49] Reasonably expected payments on a debt instrument must be determined in a commercially reasonable manner, including reasonable assumptions as to early payments, late payments, non-payments and loan servicing costs.[50] These reasonable assumptions must be consistent, in the order listed, with representations (if any) made (i) in connection with the offering of regular interests, (ii) to rating agencies or (iii) in any filings or registration with any governmental agency. If no representations were made to offerees, rating agencies or governmental agencies, then the assumptions must be consistent with industry customs or standards.[51] If an Owner uses an assumption that is not consistent with these rules, the

---

[47] Prop. Reg. § 1.860I-2(d)(1).

[48] Prop. Reg. § 1.860I-2(d)(2).

[49] Prop. Reg. § 1.860I-2(a).

[50] Prop. Reg. § 1.860I-2(c)(1). Factors other than expected payment assumptions are not considered.

[51] Prop. Reg. § 1.860I-2(c)(2).

Commissioner may disregard the assumption in its entirety in determining the reasonably expected payments on the debt instrument.[52]

The special valuation rule does not apply to debt instruments purchased by the Owner (or related party) from an unrelated party for cash, provided the price for the debt instruments is established no more than 15 days prior to the purchase and the debt instruments are transferred to the FASIT within 15 days of the purchase.[53] Because the Spot Purchase Exception requires that the debt instruments must be purchased from an unrelated party, the exception is not available if the Owner purchases the debt instruments from a related party that originated the receivables.

If a person related to the Owner transfers property subject to the special valuation rule to a FASIT, or holds support property subject to the special valuation rule, then the related person is treated as having transferred the property to the Owner for fair market value consideration as determined under general Federal income tax principles.[54] The Owner is then treated as transferring the property to the FASIT for the property's value determined under the special valuation rule and additional gain may be realized. The Proposed Regulations provide that this rule does not apply to transfers of publicly traded property by related persons because the Treasury Department determined that these transfers were unlikely to permit abuse.[55] The

---

[52] Prop. Reg. § 1.8601-2(c)(4).

[53] Prop. Reg. § 1.8601-2(d)(3).

[54] Prop. Reg. § 1.8601-1(g).

[55] Preamble to the Proposed Regulations.

statute applies similar rules to property (whether publicly traded or not) acquired by a FASIT from an unrelated person.[56]

The Proposed Regulations generally reserve on a gain deferral rule that would defer the Owner's recognition of gain on assets transferred to a FASIT until the issuance of regular interests.[57] The Treasury Department and Internal Revenue Service determined that the gain deferral rule must build on rules for accounting for pooled debt instruments, which they continue to anticipate providing in future guidance. The Proposed Regulations do provide a gain deferral rule for pre-effective date FASITs.[58] Comments are requested on how the gain deferral rule for pre-effective date FASITs could be modified for use as a general gain deferral rule.

Section 860J(a) provides that an Owner's annual taxable income may not be less than its FASIT income and REMIC excess inclusion income. The Proposed Regulations take an expansive view of FASIT income to include gains realized by the Owner on the contribution of assets to the FASIT.[59] While the Preamble does not explain the underlying policy why FASIT income should include gains realized on the contribution of assets, it may be intended to prevent a loss corporation from realizing an artificially high value on the contributed assets (which gain is offset by an Owner's net operating losses) and creating corresponding premium or other deductions to reduce future FASIT income. An Owner may aggregate the net income (or loss) from all FASITs that it owns.[60] Presumably this latter rule permits members of a consolidated

---

[56] Section 860I(a)(2).

[57] Prop. Reg. § 1.860I-1(d).

[58] Prop. Reg. § 1.860L-3.

[59] Prop. Reg. § 1.860J-1(a).

[60] Prop. Reg. § 1.860J-1(b).

group to aggregate the net income (or loss) from all FASITs individually owned by members of the group.[61]

The transfer of an ownership interest is disregarded if the Owner knew or should have known that the transferee would be unwilling or unable to pay some or all of the tax attributable to the ownership interest.[62] The Proposed Regulations contain a safe harbor rule for purposes of establishing whether the transfer of an ownership interest in a FASIT will be disregarded.[63] A similar rule is proposed with respect to the transfer of a residual interest in a REMIC. The proposed rules applicable to FASITs and REMICs are generally more stringent than the existing REMIC rules and require a computation showing that the present value of the anticipated tax liabilities associated with the holding of the ownership or residual interest does not exceed the sum of the present value of any consideration given to the transferee to acquire the interest, the present value of the expected future distributions on the interest and the present value of the anticipated tax savings associated with the holding of the interest.[64] Present values are computed using a discount rate equal to the applicable Federal rate under Section 1274(d).[65]

D. Prohibited Transactions.

The FASIT provisions contain rules similar to the REMIC provisions that impose a 100 percent tax on net income from prohibited transactions, including income from a non-

---

[61] See Section 860J(d).

[62] Prop. Reg. § 1.860H-6(g)(1).

[63] Prop. Reg. § 1.860H-6(g)(2).

[64] Prop. Reg. § 1.860E-1(c)(4)(iii).

[65] Prop. Reg. § 1.860E-1(c)(5)(ii).

permitted asset, income representing a fee or other compensation for services (other than consent fees), income from the disposition of certain permitted assets, and income derived from any loan originated by a FASIT.[66] Under the statute, substitutions of one permitted debt instrument for another permitted debt instrument and distributions of permitted debt instruments to reduce over-collaterization are not prohibited transactions if, but only if, no principal purpose of acquiring the asset disposed of was the recognition of gain.[67] A disposition of a hedge contract is not a prohibited transaction.[68]

Under the Proposed Regulations, a FASIT is not considered to have originated a loan if the FASIT acquires the loan (i) on an established securities market, (ii) more than 12 months after the loan was originated or (iii) from a person (including the Owner or a related person) that regularly originates similar loans in the ordinary course of its business.[69] A FASIT is considered to originate a loan if the FASIT (i) solicits the loan, (ii) evaluates the applicant's financial condition, (iii) negotiates or establishes any of the terms of the loan, (iv) prepares or processes any document related to negotiating the loan, or (v) closes the loan transaction.[70] A FASIT is not treated as engaged in loan origination if it receives a new loan from the obligor of the old loan in a workout.[71]

---

[66] Section 860L(e)(1), (2).

[67] Section 860L(e)(3)(B).

[68] Prop. Reg. § 1.860L-1(d).

[69] Prop. Reg. § 1.860L-1(a)(2).

[70] Prop. Reg. § 1.860L-1(a)(3).

[71] Prop. Reg. § 1.860L-1(a)(4).

Notwithstanding clear statutory language to the contrary, the Proposed Regulations impose a 100 percent tax on gain realized by an Owner on any assets sold within 180 days of the date received by the Owner after a substitution of debt instruments or a distribution of debt instruments to reduce over-collateralization.[72] The Proposed Regulations do not provide any exception to the 100 percent tax on gain even if no principal purpose of acquiring the asset disposed of was the recognition of gain.

E. Cessation of a FASIT.

A FASIT may cease to qualify as a FASIT if (i) the arrangement revokes the FASIT election with the consent of the Internal Revenue Service or (ii) the arrangement fails to meet the technical FASIT requirements and the Internal Revenue Services does not determine the failure to be inadvertent.[73] If the FASIT election is revoked with the consent of the Internal Revenue Service, the tax consequences of the revocation will be controlled by the consent document.[74] If an arrangement ceases to qualify as a FASIT and the Internal Revenue Service determines the failure to be inadvertent, then the Internal Revenue Service may either deem the arrangement as continuing to qualify as a FASIT or allow the arrangement to reelect FASIT status notwithstanding the prohibition on reelection in Section 860L(a)(4).[75] The FASIT and each holder of ownership and regular interests in the FASIT during the period of disqualification may be required by the Internal Revenue Service to agree to make adjustments to their respective

---

[72] Prop. Reg. § 1.860L-1(c).

[73] Prop. Reg. § 1.860H-3(a).

[74] Prop. Reg. § 1.860H-3(c).

[75] Prop. Reg. § 1.860H-3(d).

tax returns.[76] In contrast to the statutory language in Section 860L(e)(3)(A)(i), the Proposed Regulations do not provide for a qualified liquidation of a FASIT, which we assume to be an oversight.

If an arrangement fails to qualify as a FASIT and the failure is not determined to be inadvertent, the proposed tax consequences are extremely harsh. An Owner is treated as disposing of the FASIT assets for their value (computed by using the special valuation rule for all assets). Any gain realized on the deemed sale of assets is treated as gain from a prohibited transaction and subject to the 100 percent tax. Any loss realized is disallowed. The determination of gains and losses is made on an asset by asset basis.[77] In addition, the Owner must recognize cancellation of indebtedness income in an amount equal to the difference between the adjusted issue price of the regular interests immediately before the cessation over the fair market value of the regular interests immediately before cessation.[78] No deduction is allowed for acquisition premium.[79]

Immediately after cessation of the FASIT the underlying arrangement reverts to its classification as determined under general Federal tax principles.[80] If the Owner has a continuing economic interest in the assets, the characterization of the interest of the Owner in the assets is also determined under general Federal tax principles.[81] Holders of regular interests are

[76] Prop. Reg. § 1.860H-3(d)(2)(iii).

[77] Prop. Reg. § 1.860H-3(c)(2)(i).

[78] Prop. Reg. § 1.860H-3(c)(2)(ii).

[79] Id.

[80] Prop. Reg. § 1.860H-3(c)(1).

[81] Prop. Reg. § 1.860H-3(c)(2)(iii).

treated as exchanging their regular interests for interests in the underlying arrangement and gain (but not loss) may be recognized on the deemed exchange.[82] Interests of the former regular interest holders in the underlying arrangement are similarly classified under general Federal tax principles.[83]

F. Taxation of Regular Interest Holders.

The Proposed Regulations do not elaborate on the basic definition of a regular interest. The Proposed Regulations do provide, however, that the issue price of a regular interest (i) not issued for property is determined under Section 1273(b) and (ii) issued for property is the fair market value of the regular interest determined as of the issue date.[84] The Proposed Regulations also clarify when the Section 860K(d) and (e) excise tax in respect of high yield regular interests must be paid by a securities dealer that is not an eligible corporation[85] and by pass-through entities.[86]

G. International Provisions.

The Proposed Regulations include a number of international provisions. First, a FASIT election may be made only in respect of a domestic entity or segregated pool of assets of which the income is not (and never has been) subject to foreign net income tax.[87] According to

---

82 Prop. Reg. § 1.860H-3(c)(3).

83 Id.

84 Prop. Reg. § 1.860H-4(a).

85 Prop. Reg. § 1.860H-4(b)(1).

86 Prop. Reg. § 1.860H-4(b)(2).

87 Prop. Reg. § 1.860H-1(a)(3).

the Preamble, this new limitation applies whether or not any actual foreign tax is ever imposed on the entity or arrangement. The Preamble requests comments regarding any circumstances in which legitimate non-tax business reasons justify permitting a FASIT election in respect of a foreign entity or arrangement subject to foreign net basis tax.

Second, a foreign debt instrument that is traded on an established securities market (within the meaning of Prop. Reg. § 1.860I-2(b)) and is subject to withholding tax is not a permitted asset.[88] Again, the Preamble requests comments concerning the scope of this proposed rule.

Third, a special interest expense allocation rule requires that FASIT interest expense be directly allocated solely to income from all of an Owner's FASITs (or, if the Owner is a member of an affiliated group, all FASITs of Owners that are members of the group) and treated as directly related to all activities and assets of such FASITs.[89] Interest expense is apportioned between domestic and foreign source FASIT gross income by applying the asset method to FASIT assets, without regard to other assets of the Owner(s). For these purposes, FASIT liabilities (i.e., regular interests) reduce the value of FASIT assets.[90] The Preamble requests comments on the need for limits to direct allocation (such as by imposing a ceiling on variance between direct allocation and combined asset allocation).

[88] Prop. Reg. § 1.860H-2(b)(3)(vii).

[89] Prop. Reg. § 1.861-10T(f).

[90] Prop. Reg. § 1.861-9T(g)(2)(iii).

Fourth, the Proposed Regulations include a look-through rule that is similar to the anti-conduit rule of Treas. Reg. § 1.881-3.[91] The look-through rule disregards a FASIT by taking into consideration certain relationships between U.S. obligors on FASIT debt instruments (or foreign obligors for which interest expense is treated as paid or accrued by their U.S. trade or business) and foreign investors in FASIT regular interests. The U.S. obligor is a "conduit debtor" if the foreign interest holder is either a 10 percent shareholder of the U.S. obligor or a controlled foreign corporation of which the U.S. obligor is a related person under Section 864(d)(4). If there is a conduit debtor, then the foreign investor is treated as receiving interest directly from the conduit debtor to the extent that the conduit debtor pays interest to the FASIT. This rule applies for all purposes, including the interest deduction deferral provisions of Section 163 and the withholding provisions of Sections 1441 et seq. As a result, interest paid or accrued to the foreign investor is ineligible for the portfolio interest exemption to the extent the FASIT receives an equal or greater amount of interest from the conduit debtor.

The Preamble indicates that the Treasury Department and Internal Revenue Service intend to issue regulations treating FASITs and their Owners as withholding agents in respect of payments made to foreign regular interest holders. It is anticipated that such regulations will provide that the FASIT and Owner do not have a withholding obligation unless they know or have reason to know that the foreign investor would not be eligible for the portfolio interest exemption on interest received in respect of a FASIT regular interest under the look-through rule. The FASIT and its Owner will be presumed to know that the portfolio interest exemption is inapplicable if the foreign investor holds 10 percent or more of the FASIT's regular interests and 10 percent or more of the FASIT's assets are debt of a related U.S. obligor. The

[91] Prop. Reg. § 1.860H-5.

Preamble requests comments regarding (i) the reasonableness of extending this conduit treatment to foreign holders of REMIC regular interests and pass-through certificates and (ii) circumstances where Owners may be unaware of a possible relationship between obligors on FASIT debt and investors in FASIT regular interests.

The first three international provisions are intended to address classes of FASIT transactions that, in the view of the Treasury Department and the Internal Revenue Service, create a potential for abuse of the current foreign tax credit rules similar to the arrangements challenged in Notice 98-5.[92] Foreign entities (or U.S. entities subject to foreign tax) may provide an opportunity for effective duplication of tax benefits by structuring transactions to exploit different characterizations under relevant foreign law and U.S. tax law. Similarly, the Treasury Department and the Internal Revenue Service are concerned that an Owner may cause a FASIT to acquire debt instruments subject to foreign withholding tax so that the Owner can benefit from the related foreign tax credits even though the income stream is essentially passing through to holders of regular interests. Potential foreign tax credit abuses are also the target of the interest expense allocation rule, which is intended to prevent distortions to overall interest expense allocations that affect the ratio of foreign to U.S. source income. The fourth provision addresses conduit financing, whereby foreign investors circumvent U.S. withholding and deduction deferral rules by arranging a financing of their U.S. affiliates through a FASIT.

---

[92] 1998-3 I.R.B. 49.

H. Anti-Abuse Rule.

The Proposed Regulations include an anti-abuse rule, promulgated under the authority of Section 860L(h).[93] The Proposed Regulations state that the FASIT provisions are intended to spread credit risk on debt instruments through securitizations.[94] Implicit in that intent, according to the Proposed Regulations, are the requirements that (i) the assets of a FASIT consist primarily of permitted debt instruments, (ii) the source of principal and interest payments on the regular interests should be the principal and interest payments on the permitted debt instruments and (iii) no FASIT provision may be used to achieve a Federal tax result that cannot be achieved without the provision unless the provision clearly contemplates that result. If a principal purpose of forming or using a FASIT is to achieve a result inconsistent with the intent of the FASIT rules, the Internal Revenue Service has broad authority to disregard the election or to otherwise recharacterize or reallocate tax items or assets.[95]

I. Pre-Effective Date FASITs.

A special transition rule applies if a pre-effective date FASIT has one or more pre-FASIT interests outstanding at the time it elects to be a FASIT.[96] A pre-effective date FASIT is a FASIT whose underlying qualifying arrangement, such as a trust, was in existence on August 31, 1997.[97] A pre-FASIT interest is an interest in a pre-effective date FASIT that (i) was issued prior to February 4, 2000, (ii) was outstanding on the date of the FASIT election and (iii)

---

[93] Prop. Reg. § 1.860L-2.

[94] Prop. Reg. § 1.860L-2(a).

[95] Prop. Reg. § 1.860L-2(b).

[96] Prop. Reg. § 1.860L-3(a).

[97] Prop. Reg. § 1.860L-3(a)(1).

is classified as debt of the Owner under general Federal income tax principles.[98] An Owner of a pre-effective date FASIT may elect to defer the gain attributable to pre-FASIT interests.[99] The Proposed Regulations require that the Owner must establish a method of accounting (which may be the safe harbor method set out in the Proposed Regulations) that computes the aggregate amount of FASIT gain and excludes the portion of the gain attributable to pre-FASIT interests.[100]

J. Effective Date Provisions.

The Proposed Regulations are proposed generally to be effective on the date final regulations are filed with the Federal Register. However, the anti-abuse rule and the regulations allowing the deferral of gain on assets held by a pre-effective date FASIT are proposed to apply on February 4, 2000. The Proposed Regulations state that the amendment to the REMIC safe harbor rule relating to transfers of residual interests is also effective on February 4, 2000, although the Preamble states that those regulations will not be effective until final regulations are published. Presumably the parallel safe harbor rule for transfers of interests in FASITs is not intended to be effective until the date final regulations are published.

III. PRINCIPAL COMMENTS

A. Section 860I Gain Recognition Rule.

Section 860I requires an Owner (or related party) that contributes assets to a FASIT to recognize gain but not loss on the contributed assets.[101] This gain recognition rule

---

[98] Prop. Reg. § 1.860L-3(a)(2).

[99] Prop. Reg. § 1.860L-3(b).

[100] Id.

[101] Section 860I(a).

applies to assets contributed to the FASIT as well as assets retained by the Owner (or related party) that support the regular interests.[102] Debt instruments that are not traded on an established securities market are valued using the special valuation rule.[103] All other assets (other than guarantees of non-publicly traded debt instruments) are valued at fair market value.[104] Section 860I(c) permits the Secretary to prescribe regulations to defer recognition of gain on assets contributed to a FASIT until the contributed assets support the regular interests. The Proposed Regulations reserve on the gain deferral rule.[105]

The gain recognition and special valuation rules of Section 860I greatly impede the use of FASITs in securitization transactions. Traditional non-statutory securitization structures permit assets to be transferred into securitization vehicles without immediate recognition of gain, but the FASIT provisions require current recognition of gain. Equally problematic when compared to traditional, non-statutory securitization structures is the special valuation rule which may overstate (or, in certain cases, understate) the amount of gain recognized at the time the debt instruments are contributed to the FASIT. Within the constraints imposed by Section 860I, we believe that the gain recognition and special valuation rules should be narrowly applied if FASITs are intended to be a viable securitization structure. We have several recommendations to narrow the application of these rules.

1. Scope of Gain Recognition Rule

The Proposed Regulations should expressly exempt contribution agreements and

[102] Section 860I(b).

[103] Section 860I(d)(1)(A).

[104] Section 860I(d)(1)(B); Prop. Reg. § 1.860I-2(d)(4).

[105] Prop. Reg. § 1.860I-1(d).

certain other permitted assets from the gain recognition rule. As discussed in our Prior Report, because contributed assets are subject to the gain recognition rule at the time of contribution, an agreement by the Owner to contribute additional debt instruments to the FASIT over time should not be treated as a taxable contribution.[106] Although not clear, it may be that contracts or options to acquire hedges or debt instruments described under Prop. Reg. § 1.860H-2(h) are intended to be exempt from the gain recognition rule of Prop. Reg. § 1.860I. If that is the intention, the final regulations should clarify this issue. In response to a similar concern about taxing both the value of guarantee contracts and the permitted assets supported by the guarantee, the Proposed Regulations provide that if a guarantee relates solely to non-publicly traded debt instruments, the reasonably expected payments on the guarantee are treated as part of the reasonably expected payments on the guaranteed debt instruments.[107] We assume that this special guarantee rule applies to receivables held (or to be held) by the FASIT. The gain recognition rule should also not apply to (i) taxable debt workouts[108] and (ii) debt instruments contributed to a FASIT in substitution of other debt instruments except to the extent the value (as determined under Prop. Reg. § 1.860I-2) of the debt instrument contributed exceeds the value (as determined under Prop. Reg. § 1.860I-2) of the debt instrument disposed of by the FASIT. In each of these cases, the appropriate amount of gain was taxed when the debt instrument was originally contributed to the FASIT and we see no reason why the FASIT provisions should cause additional gain to be accelerated.

[106] Prior Report at IV.B.1(a) and IV.B.3(e).

[107] Prop. Reg. § 1.860I-2(d)(4).

[108] Prior Report at IV.B.2(a).

2. Readily Quotable and Spot Purchase Exception

We recommend that (i) the definition of debt instruments traded on an established securities market be broadened to include readily quotable debt instruments within the meaning of Treas. Reg. § 1.1273-2(f)(5) and (ii) the Spot Purchase Exception be clarified as to whether the exception applies to debt instruments originated by the Owner (or related party). We note that the Prior Report recommended the adoption of a broad definition of debt instruments traded on an established securities market, which would have the effect of narrowing the scope of the special valuation rule.[109] The Proposed Regulations do not follow our recommended approach and the Preamble states that "[t]he IRS and Treasury do not expect this omission to have a significant impact because, under a special exception (the spot purchase rule. . .) the proposed regulations value non-publicly traded debt instruments at their cost [rather than under the special valuation rule] if a FASIT acquires them in (or soon after) an arm's length cash purchase." However, because the Spot Purchase Exception arguably does not apply to Owner (or related party) originated debt instruments and in certain other cases, the Spot Purchase Exception does not replace the need for a broad definition of debt instruments traded on an established securities market. We continue to believe that the recommendation in our Prior Report to value debt instruments at fair market value if price quotations are readily available should be adopted in the final regulations.

The Spot Purchase Exception requires that the acquired debt instruments must be contributed to the FASIT within 15 days of purchase and that the purchase price must be paid in cash at a price established no more than 15 days prior to purchase.[110] The Spot Purchase

[109] Prior Report at IV.B.5(c).

[110] Prop. Reg. § 1.8601-2(d)(3).

Exception applies only if a "debt instrument is purchased from an unrelated person in an arm's length transaction in which no other property is transferred or services provided . . . ."[111] It is not clear whether this exception applies to Owner (or a related party) originated debt instruments (for example, a loan originated by a bank). The uncertainty arises because a loan origination is treated as a purchase only under certain provisions of the Code.[112] The Preamble, however, states that "the IRS and Treasury believe bank and private placement loans will be securitized in transactions qualifying for the spot purchase exception" and we take this to mean that an "origination" may be a "purchase". If so, the Spot Purchase Exception should be clarified on this point.

If the Spot Purchase Exception is clarified so that the concept of a "purchase" includes "origination", the exception may effectively allow originators, such as credit card banks, to escape recognizing gain on securitization of newly-originated debt instruments. Credit card receivables generally have a fair market value in excess of face which is attributable to the banks' efforts in selling credit cards and in creating customer relationships. The costs of creating these relationships are deducted currently, and the FASIT rules have been interpreted by credit card banks as requiring immediate recognition of the corresponding economic income as the price paid for the certainty of debt treatment for the regular interests. Expansion of the Spot Purchase Exception to cover originations would have the effect of deferring recognition of gain and such deferral may be viewed as inconsistent with the special valuation rule of Section

[111] Prop. Reg. § 1.860I-2(d)(3)(i)(A).

[112] See Section 475(c)(2)(C), (c)(4); Treas. Reg. § 1.475(c)-1(b). See also Rev. Rul. 81-218, 1981-2 C.B. 43, obsoleted by Rev. Rul. 95-71, 1995-2 C.B. 323. But see Security Bank of Minnesota v. Commissioner, 994 F.2d. 432 (8th Cir. 1993).

860I.[113] The Preamble, for example, states that "[b]ecause there is no objective, easily administrable method for allocating the portion of the price allocable to the receivable (as opposed to the portion allocable to the transferor's ongoing business), the special valuation rule seems appropriate in this context."

The final regulations should clarify that the Spot Purchase Exception applies to permitted debt instruments that are treated as acquired by the Owner under Section 860I(a)(2). Section 860I(a)(2) provides that if property is acquired by a FASIT from a person unrelated to the Owner, the property is treated as having been acquired by the Owner for an amount equal to the FASIT's cost of acquiring the property and then having been sold by the Owner to the FASIT. If an unrelated person sells permitted debt instruments to the FASIT for cash, Section 860I(a)(2) characterizes the sale as a purchase by the Owner for cash from an unrelated party and an immediate contribution to the FASIT. The final regulations should clarify that the Spot Purchase Exception applies to transactions subject to Section 860I(a)(2).

Because of the importance of the Spot Purchase Exception as an exception to the special valuation rule, we recommend extending beyond 15 days the time between purchase of the debt instruments and contribution to the FASIT. A period of 60 days between the date of purchase and the date of contribution should permit an Owner (or related party) adequate time to warehouse a pool of debt instruments prior to securitization. While the additional number of days may increase the potential for changes in the market value of the debt instruments prior to their contribution to the FASIT, we believe the benefits from expanding the utility of the Spot

[113] See Prior Report at 10.B.5(d).

Purchase Exception more than outweigh any increased valuation concerns and represent a reasonable balance of competing interests.

3. Gain Deferral Rule

The final regulations should adopt a gain deferral rule, or, in the absence of a specific rule pending the issuance of proposed regulations on the treatment of pooled debt instruments, permit taxpayers to (i) defer gain on assets contributed to a FASIT until the contributed assets support the FASIT regular interests and (ii) report the deferred gain under any reasonable method that is consistently applied. As explained in our Prior Report,[114] it is common, particularly in credit card securitizations, for issuers to contribute receivables to a master trust. Depending on market conditions, the master trust will periodically issue debt instruments backed by the credit card receivables. Unless the final regulations permit taxpayers to defer the recognition of gain on assets contributed to a FASIT that do not support regular interests, FASITs will rarely be used to securitize receivables in a master trust structure. We would welcome the opportunity to work with the Treasury Department and the Internal Revenue Service to design an appropriate gain deferral rule modeled after the approaches suggested in our Prior Report or the deferral regime proposed for pre-effective date FASITs.[115]

B. Section 860L(c) Permitted Assets.

1. Substantially All Test

Section 860L(a)(1)(D) requires, after a three month startup period, that substantially all of the assets of the FASIT, including assets held outside of the FASIT that are

---

[114] Prior Report at IV.B.4.

[115] See Prop. Reg. § 1.860L-3.

treated as supporting regular interests, consist of permitted assets. Permitted assets include cash and cash equivalents, permitted debt instruments (including stripped interests), foreclosure property, certain hedge and guarantee contracts and regular interests in REMICs or FASITs.[116]

The Proposed Regulations provide that substantially all of the assets of a FASIT are permitted assets if the total adjusted bases of the permitted assets is more than 99 percent of the total adjusted bases of all of the assets of the FASIT, including support assets.[117] Unlike this 1 percent ceiling rule, the REMIC provisions provide that substantially all of a REMIC's assets are qualified mortgages and permitted assets if the REMIC owns no more than a de minimis amount of other assets,[118] and the REMIC regulations provide a safe harbor if less then 1 percent of the REMIC's assets are not qualified mortgages and permitted assets.[119] The REMIC regulations specifically state that a REMIC may demonstrate that it owns a de minimis amount of "bad" assets even if it fails to satisfy the 1 percent safe harbor. The Preamble to the Proposed Regulations justifies a more restrictive ceiling on bad assets in a FASIT because a FASIT, unlike a REMIC, can acquire additional assets after the startup period to ensure compliance with the substantially all test. However, a FASIT is likely to fail the substantially all test inadvertently as a result of a change in prepayments on permitted assets or other market circumstances, and the need to contribute additional assets may not be discovered until long after the time when such assets would have to be contributed to cure any incipient violation. Further, in order to cure a $1,000 problem, an Owner would need to contribute more than $99,000 of additional assets,

---

[116] Section 860L(c)(1).

[117] Prop. Reg. § 1.860H-2(a).

[118] Treas. Reg. § 1.860D-1(b)(3)(i).

[119] Treas. Reg. § 1.860D-1(b)(3)(ii).

potentially recognizing significant amounts of gain on the contributed assets. In addition to the issue of gain recognition, the Owner may not have additional permitted assets available for contribution to the FASIT, and even if the Owner has permitted assets available, the Owner may not want to securitize them through a FASIT. Finally, we believe that use of the long-standing REMIC definition will simplify the FASIT regulations.

2. Variable Rate Debt Instrument

The Proposed Regulations define a permitted debt instrument to include a variable rate debt instrument (within the meaning of Treas. Reg. § 1.1275-5) if the debt instrument provides for interest at a qualified floating rate within the meaning of Treas. Reg. § 1.1275-5(b).[120] We believe that the final regulations should conform this definition to the REMIC definition of a variable rate debt instrument.[121] First, the FASIT provisions contemplate that the FASIT definition of a variable rate debt instrument will be the same as the REMIC definition. Section 860L(c)(1)(B) defines a permitted asset to include a debt instrument having interest payments satisfying the requirements under Section 860G(a)(1)(B)(i) or (ii). Section 860G(a)(1)(B)(i) and the regulations promulgated thereunder in turn define a variable rate more broadly than a qualified floating rate (within the meaning of Treas. Reg. § 1.1275-5(b)) that is referenced in the Proposed Regulations. Second, we do not believe there is any compelling policy reason to have two different definitions of a variable rate, and believe that use of the long-standing REMIC definition will simplify the FASIT regulations. It would also recognize that FASITs are a potential vehicle for mortgage securitizations, and that the REMIC rules reflect the range of market expectations for mortgage-backed securities.

[120] Prop. Reg. § 1.860H-2(b)(1)(ii).

3. Stripped Debt Instruments

In order for a FASIT to accommodate various types of debt instruments, the definition of a permitted debt instrument should be expanded to include additional types of stripped bonds and stripped coupons. By way of example, commercial mortgages may provide for one or more payments determined by reference to the future value of real estate securing the commercial mortgage, such as an equity kicker. We see no reason to exclude a commercial mortgage with an equity kicker from the definition of a permitted debt instrument provided the contingent payments are stripped from the commercial mortgage outside of the FASIT prior to contribution to the FASIT. Commercial mortgages with contingent payments qualify as permitted assets under the REMIC rules,[122] and we see no policy reason why a FASIT should not also be permitted to hold such mortgages if the contingent features are stripped prior to inclusion in the FASIT (assuming that such positions will be retained or sold, and will not be used as credit enhancement or support for FASIT regular interests).

More generally, any debt instrument should qualify for inclusion in a FASIT if the non-qualifying payment features (such as equity-linked payments or equity kickers) can be stripped prior to transfer of the debt instrument to the FASIT so that the portion transferred to the FASIT satisfies the requirements for a permitted debt instrument. For example, we believe an Owner should be able to strip off all of the coupons on a debt instrument and contribute only the principal component to the FASIT, provided the principal component otherwise qualifies as a permitted debt instrument. If the stripped debt instrument has terms that would otherwise cause

---

[121] Treas. Reg. § 1.860G-1(a)(3).

[122] Treas. Reg. § 1.860G-2(a)(7).

it to qualify as a permitted debt instrument, we see no reason to exclude the stripped debt instrument merely because it was stripped from a debt instrument that could not qualify as a permitted debt instrument.

4. 90-day Cure Rule

The Proposed Regulations exclude certain debt instruments with uncured payment defaults from the definition of a permitted debt instrument. Proposed Reg. § 1.860H-2(b)(3)(ii) provides that:

> [a] debt instrument is not a permitted asset if, on the date the debt instrument is acquired by the FASIT, the debt instrument is in default due to the debtor's failure to have timely made one or more of the payments owed on the debt instrument and the Owner has no reasonable expectation that all delinquent payments on the debt instrument, including any interest and penalties thereon, will be fully paid on or before the date that is 90 days after the date the instrument is first held by the FASIT.

The Preamble indicates that the Treasury Department was concerned that:

> a distressed debt instrument may take on the characteristics of equity because the FASIT (and in turn the regular interest holders): (1) may have to look to the obligor's general assets for payment of the instrument, (2) may not receive full payment of the instrument, and (3) may not receive any payment until the satisfaction of claims held by the obligor's other creditors.

We believe that these concerns are not a genuine issue for FASIT securitizations, and recommend that this rule should be eliminated. Neither the statute nor the legislative history

indicates that defaulted debt instruments cannot qualify as permitted debt instruments. Rather, Section 860L(c)(3)(A) merely indicates that property will not qualify as foreclosure property if the security interest in such property was created for the principal purpose of permitting the FASIT to invest in such property. This rule, which applies to REMICs as well, is sufficient to preclude FASITs from acquiring property indirectly that they could not acquire directly.[123] Further, because Section 860L(c)(1) (as well as Prop. Reg. §§ 1.860H-2(b)(1) and 1.860H-2(b)(3)(i)) precludes any debt instruments from qualifying as permitted debt instruments if they bear any contingent interest, Prop. Reg. § 1.860H-2(b)(3)(ii) is not necessary to prevent the securitization of instruments that are either equity for tax purposes or have equity-like payment terms.

If the 90-day Cure Rule is not eliminated, the scope of the proposed regulation should be narrowed significantly. First, the proposed regulation applies to all loans, including loans that are obligations of individuals. An individual (or entity) cannot have an equity interest in another individual. Further, each of the three factors listed in the Preamble is as consistent with the characterization of an instrument as indebtedness as it is with the characterization of an instrument as equity. The creditor on *any* unsecured debt instrument has to look to the general assets of the debtor for payment, and if those assets are insufficient, such a creditor ultimately may not receive full payment – that is the very essence of unsecured debt. Further, there is no reason to suspect a defaulted loan will be paid only after other creditors' claims are satisfied. To

[123] For an example of how this regulation is interpreted in practice, see, e.g., P.L.R. 9742022 (July 18, 1997) (applying "improper knowledge" test of Treas. Reg. § 1.856-6(b)(3) to REMICs).

the contrary, a loan that is in default may be accelerated (and then repaid) while other creditors may be required to wait until payments are due under their loans' original terms.[124]

The Preamble suggests indirectly that it is not appropriate for regular interest holders to bear significant credit risk. That approach is inconsistent with using FASITs to spread credit risks among regular interest holders, which was a key purpose behind the enactment of the FASIT provisions. There is nothing in the statute or legislative history that suggests that such credit risk must be limited or ratably distributed over the various classes of regular interest holders. In fact, the provision for high yield regular interests evinces Congress's view that regular interests may have substantial credit exposure -- exposure so great that the expected returns on the regular interests resemble equity-like returns.

Finally, credit card issuers and other lenders that rely on securitization are often, as a practical matter, required to securitize their defaulted receivables along with their performing receivables.[125] (Many in fact securitize charged off receivables as well.) One of the key reasons for raising capital through securitization of assets, rather than, for example, the issuance of straight debt, is to achieve off-balance sheet treatment. That is, after the securitization, neither the securities issued nor the assets supporting them are shown on the

[124] In addition, debt instruments with payment defaults are often treated as performing loans by creditors because a payment default may be minor in amount or minor in effect. For example, consumers who miss a monthly payment on a car loan or mortgage loan often fail to make up the missed payment, but continue to make monthly payments thereafter on schedule. Lenders often assume that it is easier and less expensive just to add a payment to the end of the schedule of payments than attempt to collect the single missed payment. Even where a creditor intends to pursue a late payment, many lenders in many different settings are willing to waive penalties in order to encourage prompt payment on an obligation that is already late. In each of these cases, there is no expectation that all delinquent payments, including interest and penalties, will be fully paid within 90 days. Nevertheless, the proposed regulation would preclude any of the above-described loans from qualifying as a permitted debt instrument.

[125] The prospectus for a typical credit card securitization will disclose that the percentage of cardholders who are delinquent is always well in excess of 1 percent.

balance sheet of the sponsor. Any approach that would require "cherry picking" the highest quality receivables for securitization would lead to adverse accounting and regulatory capital requirement consequences because securitizations would then have the perverse effect of keeping on the Owner's balance sheet only the under-performing and non-performing receivables.

5. Hedges and Guarantees

a. Hedge of Ownership Interest.

The Prior Report recommended that a hedge or guarantee contract should be a permitted asset even if the hedge or guarantee contract managed risks associated with assets that support the ownership interest.[126] For example, an Owner may transfer $1,000,000 of debt instruments to a FASIT and issue $900,000 of regular interests. We believe that the FASIT should be able to enter into hedging contracts to manage risk associated with all of the debt instruments held by the FASIT. The Preamble states that the Proposed Regulations "accommodate this concern by allowing the FASIT to hedge assets held (or to be held) and liabilities issued (or to be issued)." As we interpret the Preamble and the proposed regulation,[127] however, a hedge or guarantee contract is a permitted asset only if it manages risk with respect to assets that support (or will support) payments on the regular interests. We see no policy reason why an Owner should not be permitted to manage risks associated with all of the assets of the FASIT, including those that support the ownership interest. As a practical matter, it will generally be simpler and less costly for an Owner to hedge all of the assets of a FASIT, including those attributable to the ownership interest.

[126] Prior Report at IV.F.4(b).

This requirement that hedges and guarantees only support the regular interests is particularly problematic in the case of guarantees. All guarantees of assets protect the ownership interest first because it is the most subordinated interest. Moreover, in a case where all of the debt instruments to be securitized are guaranteed (e.g., some student loan portfolios and some mortgage pools), it is difficult to see how the requirement could be satisfied. Thus the rule would preclude the securitization of these types of assets through FASITs, which was clearly not intended by the statute.

b. Limitation on Owner Guarantees.

A guarantee issued by the Owner is a permitted asset, if, among other requirements, the value of the guarantee (and all other guarantee contracts provided by the Owner to the FASIT) immediately after it is acquired by the FASIT is less than 3 percent of the value (using the special valuation rule) of all of the FASIT's assets.[128] We recommend that guarantee contracts provided by an Owner should not be subject to this rule limiting their aggregate value to less than 3 percent of the value of all of the FASIT's assets. It is not clear what purpose the guarantee rule is intended to serve. The guarantee rule may be intended to prevent a FASIT from looking principally to the credit of the Owner for repayment. An Owner, for example, could contribute risky debt instruments to a FASIT and then guarantee those risky assets. The economic effect of this arrangement could be similar to the Owner contributing its debt to the FASIT, which is clearly prohibited.[129] This does not, however, appear to be the

[127] Prop. Reg. § 1.860H-2(d)(1).

[128] Prop. Reg. § 1.860H-2(e)(2).

[129] Prop. Reg. § 1.860H-2(b)(3)(iii).

purpose of the guarantee rule because the Proposed Regulations provide that debt instruments guaranteed by the Owner are not permitted assets if the Owner is, in substance, the primary obligor on the debt instruments.[130]

The policy underlying the guarantee rule may be to prevent an Owner's assets from indirectly supporting the regular interests without the associated recognition of gain with respect to those assets. If so, we have several concerns. First, as discussed in our Prior Report, a guarantee contract should increase the value of the contributed assets by increasing the expected cash flow on the permitted debt instruments and thereby increase the amount of gain realized by the Owner on the contribution of assets to the FASIT.[131] In fact, the Proposed Regulations partially adopt our recommended approach by providing that if a guarantee relates solely to non-publicly traded debt instruments and the Owner determines the reasonably expected payments on the debt instruments by including the reasonably expected payments on the guarantee, then the guarantee does not need to be valued separately.[132] This proposed regulation reaches the right economic result and suggests that generally the guarantee rule is not needed to prevent indirect support of the regular interests.

The guarantee rule will require taxpayers and the Internal Revenue Service to value the guarantee contracts, which may result in valuation disputes, with FASIT qualification likely at issue. If the aggregate value of all of the guarantee contracts entered into by the Owner with the FASIT is equal to or greater than 3 percent of the value of all of the assets of the FASIT,

---

[130] Prop. Reg. § 1.860H-2(b)(3)(iv).

[131] Prior Report at IV.B.3(c).

[132] Prop. Reg. § 1.860I-2(d)(4). We understand this rule to mean that the value of the guarantee contract is disregarded for purposes of the 3 percent limitation.

then the guarantee contracts will not be permitted assets and, as a consequence, substantially all of the assets of the FASIT will not be permitted assets under the proposed 1 percent substantially all rule. Given that the guarantee rule is not necessary to prevent indirect support of regular interests, we believe that the 3 percent guarantee rule is not needed and carries unacceptably harsh consequences.

c. Owner Hedges.

A hedging contract between an Owner and the FASIT is a permitted asset only if the Owner regularly provides, offers or sells substantially similar contracts in the ordinary course of its trade or business and the terms of the hedging contract reflect arm's length terms.[133] Presumably the ordinary course requirement imposed on an Owner is to ensure that the hedging contract entered into between the Owner and the FASIT has customary market terms without requiring a FASIT to enter into a hedging contract with a competitor of the Owner. We recommend that an Owner should be treating as satisfying the ordinary course of business requirement if the Owner enters into, contemporaneously with entering into a hedging contract with the FASIT, a substantially similar (i.e., a back-to-back) hedging contract with a person that regularly provides, offers or sells substantially similar contracts in the ordinary course of the person's trade or business. It is common in many securitization transactions for the Owner to enter into back-to-back swaps, one with the securitization vehicle and one with a securities dealer. Therefore, consistent with common commercial practice, we recommend that even if the Owner does not enter into similar hedging contracts in the ordinary course of its trade or business, the Owner should be treated as satisfying this requirement if it enters into a contemporaneous, back-to-back, hedge with a person that enters into hedging contracts in the

[133] Prop. Reg. § 1.860H-2(e)(1).

ordinary course of its business. We believe that a back-to-back hedge would ensure that the Owner's hedging contract entered into with the FASIT has customary market terms.

6. Defective Assets

The final regulations should contain a rule (akin to Treas. Reg. §§ 1.860G-2(a)(3) and 1.860G-2(f)(2)) under which any instrument that the Owner of a FASIT reasonably believes is a permitted asset would be treated as a permitted asset until 90 days after the discovery that it fails to meet the requirements of being a permitted asset. This rule is necessary because a defect in a debt instrument that was unknown when the debt instrument was contributed to the FASIT may be discovered later by the servicer or securitization trustee.[134] The sound policy reasons for the defective asset rule are the same whether assets are securitized through a FASIT or a REMIC and we see no reason why the final regulations should not contain a similar rule.

C. Owner Issues.

The final regulations should address three aspects of the FASIT provisions that affect the Owner. First, the final regulations should provide further guidance on the relationship between the FASIT and the Owner for purposes of other Federal income tax provisions. Second, the final regulations should allow multiple members of the same consolidated group to hold

[134] Such a rule is also necessary because an Owner may not be able to determine with absolute certainty whether an instrument that has been treated as a debt instrument consistently by the obligor and prior holders will be respected as a debt instrument by the Internal Revenue Service. In the absence of such a rule, it may be difficult to use FASITs to securitize any loans other than highly rated loans. With riskier loans there is always some chance the Internal Revenue Service will take the position that the loan represents an equity interest in collateral securing the loan or, other than in the case of a loan to an individual, an equity interest in the borrower. The same issue may arise with a highly rated loan issued by a thinly capitalized special purpose vehicle. A determination that a loan held by a FASIT is not characterized as indebtedness for Federal income tax purposes would either (1) cause the entity to lose its status as a FASIT or (2) if the loan represents a de minimis portion of the FASIT's assets, cause the Owner to be subject to a 100 percent tax, presumably with interest, on the gross amount of income that was recognized on the loan for all periods since its acquisition by the FASIT.

ownership interests in a single FASIT. Third, the final regulations should provide that gain recognized by the Owner on the contribution of assets to the FASIT is not FASIT income and therefore not subject to the limitations of Section 860J.

1. Branch or Separate Legal Entity

We understand that the Treasury Department and Internal Revenue Service were unable to decide whether a FASIT was better viewed as a branch of the Owner or as a separate legal entity and "decided it is better to resolve the nature of the FASIT's relationship with the Owner on an issue-by-issue basis rather than by adopting a single general rule."[135] We agree that a FASIT should, in some instances, be viewed as a branch of the Owner and in other instances as a separate entity. However, we have two recommendations. First, the final regulations should resolve whether a FASIT should be viewed as a branch or a separate entity for common transactions or issues. For example, we believe that a FASIT should be viewed as a branch for purposes of determining whether an Owner that regularly sells receivables to a FASIT is a dealer for purposes of Section 475. On the other hand, under a separate entity approach, regular interests in a FASIT that are retained by the Owner after formation but prior to sale to investors should be viewed as outstanding indebtedness of the FASIT from the date of issuance (otherwise, for example, a regular interest may change its status from or to being a high yield regular interest after issuance as its issue price and yield are recalculated upon its "new" issuance).[136] We note, however, that this separate entity treatment in a rising interest rate environment would cause any discount (other than de minimis discount) on the regular interests

[135] Preamble to the Proposed Regulations.

[136] If regular interests held by an Owner are treated as issued and outstanding, the final regulations should clarify that the interest on the regular interests held by the Owner should be deductible in computing FASIT taxable income for purposes of Section 860J and includible in income by the Owner as holder of the regular interests.

at the time the regular interests are sold to the public to be characterized as market discount rather than original issue discount. To address that issue, the final regulations could provide that the regular interests would be treated as outstanding prior to the sale to the public only if the "issuance" of the regular interests by the Owner would qualify as a qualified reopening under the proposed regulations.[137]

Further, we recommend that the final regulations provide a default rule that applies to issues that are not specifically addressed by regulation. The default rule might provide that a FASIT should be viewed (i) as a branch when considering issues affecting the Owner and (ii) as a separate entity when considering issues affecting the holders of regular interests. Absent a default rule, taxpayers will elect branch or separate entity treatment on an issue-by-issue basis consistent with achieving the most favorable tax result.

2. Consolidated Groups

Our principal concern here is the failure of the Proposed Regulations to permit multiple members of a consolidated group to hold ownership interests in a single FASIT. The legislative history to the FASIT provisions states that "[t]he Finance Committee expected that the Treasury Department will issue guidance on how . . . [the single domestic C corporation 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."[138] According to the Preamble, the Treasury Department and the Internal Revenue Service decided not to permit members of a consolidated group to own ownership interests in a FASIT because of

[137] Prop. Reg. § 1.1275-2(k).

[138] H. Conf. Rep. No. 104-737, 104th Cong., 2d Sess. 320-329 (1996). See also Announcement 96-121, 1996-47 I.R.B.12.

concerns about the possible shifting of stock basis, income or loss among members of the consolidated group. Apparently, none of the approaches considered by the government could, in their view, address these concerns without adding administrative complexity for both taxpayers and the Internal Revenue Service. The Treasury Department and Internal Revenue Service also believed that an anti-abuse rule would not necessarily address potential attribute shifting.

Notwithstanding these concerns, we recommend that the final regulations should adopt the approach discussed in our Prior Report, which treats each member that owns an ownership interest in a single FASIT as owning a pro rata undivided interest in the assets of the FASIT, and ignores deemed transfers of assets among members.[139] While we agree that permitting multiple members to own a single FASIT could permit shifting of stock basis, income or loss, the broad anti-abuse rule of the Proposed Regulations, even if modified as suggested in this report, should provide adequate protection against abusive shifting of stock basis, income or loss, as should other provisions of the Code such as Section 482. Alternatively, a rule might be proposed that would eliminate any positive basis adjustment to the stock of a member if the member leaves the consolidated group within some time period after the basis of its stock has been increased due to FASIT income or gain. For example, positive basis adjustments attributable to FASIT income or gain during the current and 2 fiscal years prior to the fiscal year the member leaves the consolidated group could be reversed and allocated to continuing members of the consolidated group that continue to own an interest in the FASIT.

[139] Prior Report at IV.D.

3. FASIT Income Inclusion

Gains recognized by an Owner on a contribution of assets to a FASIT should not be treated as FASIT income subject to the limitations of Section 860J.[140] Section 860J limits the use of non-FASIT losses against "taxable income determined solely with respect to [an ownership interest] . . . (including gains and losses from sales and exchanges of such [interest] . . . ." The gains recognized by an Owner on a contribution of assets to a FASIT are attributable to the assets contributed and are not attributable to the ownership interest in the FASIT. The Proposed Regulations, however, treat the gains realized by an Owner on contribution of assets to a FASIT as FASIT income. The Preamble does not discuss the rationale for this position which we believe is inconsistent with the statutory language that limits FASIT income to income determined "with respect to" an ownership interest. We acknowledge that our recommendation might permit certain tax planning strategies including refreshening of net operating losses. For example, a taxpayer could contribute appreciated debt instruments to a FASIT, use existing net operating losses to offset the gain realized on the contribution and realize increased future deductions from the premium that would reduce the taxable income of the FASIT. As discussed more fully in our Prior Report,[141] on balance we do not believe the use of losses against gains recognized on transfer of assets to a FASIT should be restricted.

D. Section 860L(e) Prohibited Transactions.

In order to limit the activities of a FASIT to the passive financing of debt instruments and to restrict the business activities of a FASIT, Section 860L(e) imposes a 100 percent tax on the net income derived from a prohibited transaction. A prohibited transaction is

[140] Prior Report at IV.C.

generally defined as (i) the receipt of any income derived from any asset that is not a permitted asset, (ii) the disposition of any permitted asset other than foreclosure property, (iii) the receipt of any income derived from any loan originated by the FASIT, and (iv) the receipt of any income representing a fee or other compensation for services (other than consent fees).[142] The statute excepts certain asset dispositions from the definition of a prohibited transaction. These excepted dispositions generally reflect changes in the structure or operations of the FASIT and do not reflect active trading of assets to realize gains from appreciation. They include (i) dispositions of hedging contracts,[143] (ii) the substitution of one permitted debt instrument for another permitted debt instrument or the distribution of a permitted debt instrument to the Owner to reduce over-collateralization, but only if a principal purpose of reacquiring the permitted debt instrument was not the recognition of gain,[144] (iii) dispositions attributable to (a) the foreclosure, default or imminent default of a permitted asset, (b) the bankruptcy or insolvency of the FASIT or (c) a qualified liquidation,[145] (iv) dispositions to facilitate a clean up call,[146] and (v) dispositions attributable to the complete liquidation of any class of regular interests.[147]

---

[141] Id.

[142] Section 860L(e)(2).

[143] Section 860L(e)(3)(D).

[144] Section 860L(e)(3)(B).

[145] Section 860L(e)(3)(A).

[146] Id.

[147] Section 860L(e)(3)(C).

1. Qualified Liquidation

Section 860L(e)(3)(A), through a cross reference to Section 860F(a)(2)(A)(iv), specifically exempts from the 100 percent tax gain on the disposition of assets in a qualified liquidation. Although the Proposed Regulations do not provide an exception from the definition of a prohibited transaction for a qualified liquidation, we understand that this was an oversight that will be corrected in the final regulations.

2. 180-day Rule

The Proposed Regulations propose a per se rule that imposes the 100 percent prohibited transactions tax on any gain realized on the disposition of a permitted debt instrument by the Owner within 180 days following the substitution of a permitted debt instrument for another permitted debt instrument or the distribution of a permitted debt instrument to reduce over-collateralization. This 180-day Rule replaces the statutory "principal purpose" test which looks to whether a principal purpose of the Owner acquiring the debt instrument through substitution or distribution was other than to recognize gain. The Preamble to the Proposed Regulations states that the 180-day Rule is necessary because "[a]bsent this rule, in times of falling market interest rates, an Owner could inappropriately generate capital gain and economically offsetting ordinary loss by disposing of distributed appreciated debt instruments while having the FASIT dispose of related hedges."

We believe it is unduly harsh to apply a per se prohibited transactions tax to assets sold within 180 days after the exchange or distribution from the FASIT. First, the 100 percent tax is imposed on assets sold within the 180 day period without regard to whether the realized gain was in fact economically offset by ordinary losses or even whether the FASIT had entered into hedging contracts while it held the debt instruments. We also note that if a FASIT has

entered into hedging contracts the hedging contracts are likely to continue to hedge the debt instrument that is substituted for another debt instrument and that substituted debt instrument may have unrealized gain when contributed to the FASIT.[148] Second, the statute presently imposes the 100 percent tax on such gain only if no principal purpose of the transaction was other than to recognize such gain. There is no indication in the legislative history suggesting that Congress intended the "principal purpose" standard to be replaced by a per se rule.

We acknowledge the necessity of a rule to prevent an Owner from generating capital gains outside of the FASIT and ordinary losses within the FASIT, but believe that a regulation targeted to address the perceived problem is more appropriate than the per se rule. To supplement the statutory "principal.purpose" standard, if a FASIT has hedged the debt instruments that are substituted or distributed and realizes a loss on the disposition of the hedge, a rule could be crafted that would characterize as ordinary income any gain realized by the Owner on the disposition of the debt instrument but only to the extent of the built-in appreciation in the debt instrument on the date the debt instrument is exchanged or distributed from the FASIT. Such a rule would address the government's concern without imposing an unduly harsh tax on non-abusive transactions. Because the fair market value of the receivable on the date of exchange or distribution must be determined to compute the 100 percent prohibition transactions tax under the Proposed Regulations, the suggested modification should not create any additional valuation issues.

[148] As discussed above at III.A.1., we believe that an Owner should recognize gain on a debt instrument contributed to a FASIT in substitution of another debt instrument but only on the value of the new debt instrument in excess of the value of the debt instrument formerly held by the FASIT.

We also recommend that the final regulations clarify that a substitution or distribution of a debt instrument should not fail the principal purpose standard if the debt instrument does not have any unrealized gain at the time of the substitution or distribution from the FASIT.

3. Loan Origination

A prohibited transactions tax is imposed on income derived from any loan originated by a FASIT.[149] The Proposed Regulations generally provide bright line rules to distinguish activities presumed not to be loan origination from activities presumed to be loan origination. We request two clarifications to these rules. First, the Proposed Regulations provide that a FASIT is not considered to have originated a loan if the FASIT acquires the loan from a person (including the Owner or related person) that regularly originates similar loans in the ordinary course of its business.[150] The final regulations should clarify that an Owner (or related party) regularly originates similar loans in the ordinary course of its trade or business if the Owner (or related party) only originates loans to be sold to the FASIT. Second, a FASIT should be permitted to significantly modify a loan (within the meaning of Treas. Reg. § 1.1001-3) without being treated as having "originated" the modified loan, as long as the modification is approved either by the Owner in the ordinary course of its trade or business or by the servicer in the ordinary course of its trade or business. Such a result is consistent with the exception from loan origination for loans originated by the Owner or related party in the ordinary course of its trade or business as well as the ability of a FASIT to substitute debt instruments when the realization of gain is not a principal purpose.

---

[149] Prop. Reg. § 1.860L-1(a).

E. International Provisions.

The international provisions of the Proposed Regulations represent a significant departure from the language of the statute and impose material new requirements for FASIT qualification and potential withholding tax obligations under a new conduit regime. The legislative history sheds little light on international issues. There is no Congressional discussion of FASIT-specific concerns regarding inclusion of foreign debt, creation of foreign FASITs, or foreign tax credit arbitrage. To the extent that there is any mention of the area in the statutory text and legislative history, it is positive, in that Congress contemplated that an Owner would be able to take into account credits in respect of the FASIT income in calculating its tax liability.[151]

1. Foreign FASITs

We have already commented on various concerns in respect of the approach outlined in Notice 98-5[152] and need not reiterate those in this context. We note, however, that the Proposed Regulations take an even more restrictive position by eliminating all possibility of foreign FASITs, whether or not an Owner can demonstrate a non-tax business motive for the foreign aspects of the transaction and whether or not the securitization generates a positive pre-tax profit for the Owner without regard to any foreign tax credit benefits. The per se approach taken in the Proposed Regulations in respect of potential foreign aspects of FASIT transactions will prohibit reasonable, non-abusive securitizations that would otherwise have been carried out using the FASIT provisions.

---

[150] Prop. Reg. § 1.860L-1(a)(2)(iii).

[151] Section 860H(b)(1)("all assets, liabilities, and items of income, gain, deduction, loss, and credit of a FASIT shall be treated as assets, liabilities, and such items (as the case may be) of [the Owner]")(emphasis added).

We believe the final regulations should take into account the rapidly increasing interest in non-U.S. securitizations designed for legitimate, non-abusive transactions. For example, special purpose issuers of asset-backed securities are sometimes established offshore so that the offering of the securities complies with the U.S. securities laws. A domestic entity generally may escape classification as an "investment company" under the Investment Company Act of 1940 ("1940 Act") if it either limits the holders of its securities to certain "qualified purchasers" or limits the total number of holders of its securities to 100.[153] While these rules apply to all holders of securities issued by domestic issuers, they apply only to U.S. holders of securities issued by offshore entities.[154] Thus, an offshore entity that issues securities to more than 100 non-qualified foreign purchasers will not be an investment company if it complies with the requisite rules solely with respect to the U.S. holders in the offshore entity. The use of an offshore issuer is important even where all of the expected investors are expected to be qualified purchasers. In determining their status under the 1940 Act, issuers often rely on written representation letters from investors regarding their status as qualified purchasers; often, non-U.S. investors are unwilling or unable as a practical matter to provide such representation. Use of an offshore issuer avoids having to request them. Where the issuer is established in a country that imposes no taxes on the issuer and the debt instruments are not subject to withholding taxes, there is no potential for foreign tax credit abuse.

---

[152] "Report on Notice 98-5," New York State Bar Association Tax Section, reprinted in Tax Notes Today, April 2, 1998.

[153] 1940 Act §§ 3(c)(1), (3)(c)(7).

[154] See, e.g., SEC No Action Letter to Touche, Remnant & Co. (August 27, 1984).

In addition to the use of a foreign FASIT to comply with U.S. securities laws, an Owner may wish to securitize foreign debt instruments in a foreign entity to satisfy foreign regulatory concerns or to minimize foreign transfer taxes that would otherwise apply on transfers of debt instruments (particularly mortgage loans) to other jurisdictions. Another legitimate reason to use a foreign FASIT is to market to U.S. investors FASIT regular interests in a foreign entity that would otherwise be classified as equity interests in a passive foreign investment company ("PFIC"). The complexity of the PFIC tax regime makes it more difficult to market PFIC interests. The debt classification of a FASIT regular interest results in a relatively simple tax regime for U.S. investors. The classification of the regular interests as debt or equity should not materially affect the amount of U.S. income taxes paid by the holders of regular interests who will accrue over time the income on the permitted assets under either approach.

For the foregoing reasons, we believe that the per se prohibition on the use of foreign FASITs should be relaxed to permit legitimate, non-abusive transactions. For example, accepting for these purposes the general view of the Proposed Regulations that accruals of foreign tax credits through a FASIT may be abusive, we do not see any opportunity for abuse in a case where the FASIT is a wholly owned foreign subsidiary of a U.S. corporation in a tax haven jurisdiction and where none of the income on the debt instruments is subject to withholding taxes. In such a case, there is no foreign income or withholding tax to give rise to foreign tax credits, and income from the assets of the FASIT is effectively subject to full U.S. corporate income tax. The final regulations should permit such transactions and targeted rules should address other problems associated with foreign FASITs should they develop. Similarly, FASITs in non-tax haven jurisdictions need not give rise to excessive foreign tax credits, if the

final regulations generally permit foreign FASITs but include a targeted rule to address concerns about foreign tax credits, as discussed below in the section on foreign debt.

2. Foreign Portfolio Debt

A FASIT with foreign portfolio debt subject to withholding permits an Owner to retain a potential foreign tax credit benefit in respect of the withholding taxes paid on the income from the debt instruments while limiting the Owner's U.S. corporate tax liability by passing the income stream through as interest payments on regular interests. In attacking potential foreign tax credit abuses, the Proposed Regulations set forth a per se rule prohibiting a FASIT from holding publicly traded foreign debt instruments subject to withholding. The Proposed Regulations also request comments concerning whether the scope of this rule is adequate to address potentially abusive transactions and whether legitimate non-tax business reasons may justify the use of a FASIT to hold publicly traded foreign debt that is subject to withholding. Although the Preamble does not discuss in detail the rationale for the distinction between publicly traded and non-publicly traded debt in this context, it suggests that publicly traded debt can be easily purchased and securitization of such publicly traded debt is unlikely to result in a legitimate transaction.

We agree that the securitization through a FASIT of publicly traded foreign debt instruments subject to withholding tax would offer little advantage to an Owner other than the potential foreign tax credit benefit. The proposed regulation is overly broad in that it would prohibit the occasional legitimate transaction. However, because of the difficulty in crafting a narrower rule to target the potential abuses more specifically, and because of the small category of cases to which any such rule would apply, we generally support the approach of the Proposed

Regulations to exclude from the definition of permitted assets publicly traded foreign debt instruments subject to withholding.

We do not believe, however, that the restriction on foreign debt subject to withholding should be expanded to include all non-publicly traded debt instruments. It would be reasonable, for example, to use FASITs to carry out securitizations of foreign consumer receivables. Securitization would provide liquidity to such assets and permit U.S. investors to participate in a more diversified market. While Owners are unlikely to be willing to assume a corporate level of tax merely to tranche publicly traded corporate debt, they may well find the marginal spreads sufficient to merit tranching consumer receivables that otherwise would not be offered in the U.S. markets. If the Treasury and Internal Revenue Service are concerned that there will be ancillary foreign tax credit benefits to such transactions that should not be permitted, we recommend that the final regulations permit foreign debt instruments subject to withholding tax to be included in a FASIT provided a targeted rule could be developed to deal with the foreign tax credit issue. We would welcome the opportunity to work with the Treasury Department and Internal Revenue Service to develop a rule targeted to address potential foreign tax credit abuses as well as other problems should they develop. One approach that could be considered is a separate foreign tax credit basket for FASIT income.

3. Conduit Rule

We question whether the proposed conduit rule is necessary. The general anti-conduit rule of Treas. Reg. § 1.881-3 is directly applicable to cases where a foreign investor arranges a FASIT securitization in order to invest in debt instruments of a U.S. affiliate without U.S. withholding tax. For the intermediate entity to be recharacterized as a conduit, the general rule appropriately requires that there be a tax avoidance plan and either (i) a relationship between

the purported conduit entity and the financed or financing entity or (ii) a "but for" causal relationship between the financing entity's participation and the intermediary's participation. A FASIT that holds debt instruments of a U.S. obligor in order to facilitate sales of regular interests to a related foreign investor (or a FASIT whose sponsor approached a particular foreign investor because the FASIT was intended to hold a related U.S. obligor's debt) should fail the tax avoidance plan and "but for" requirements. As in the special FASIT conduit rule, a conduit transaction may be treated as a transaction directly between the financed party and the financing entity for withholding purposes. Therefore, U.S. debtors and foreign investors that arrange a financing transaction through a FASIT to avoid withholding tax that would otherwise apply could be appropriately taxed under the general anti-conduit regulations without further authority.

Moreover, the FASIT conduit rule takes the general anti-conduit approach one step further, by treating a FASIT as a conduit even if there is no intentional arrangement between the foreign investor (financing entity) and U.S. debtor (financed entity) to use a FASIT as a tax avoidance mechanism for a financing arrangement. In the case of a FASIT, we recognize that the existence of a relationship between a foreign investor and a U.S. debtor may increase the risk of an arrangement to avoid tax. Nevertheless, this per se application of the conduit rules is particularly worrisome. At a minimum the conduit rule should be liberalized to permit foreign investors to hold regular interests in a FASIT without penalizing either the holder, the FASIT or the Owner if the FASIT holds the debt instrument of a related obligor without the knowledge of either the Owner or foreign holder.

Consideration should be given, for example, to whether a foreign investor should be able to hold a regular interest in a FASIT that is purchased in the ordinary course of business as a portfolio investment through a capital market transaction, even if by chance an affiliate's

debt is included in the pool of debt instruments. The offering documents may not describe the debtors in such a way that the foreign investor could ascertain its relationship to them, or may offer identifying information regarding the borrowers in the pool only after the investor has committed to purchase an interest in the transaction.[155] If the foreign investor has not undertaken the investment as part of a plan to acquire the related party's debt and was not aware of the inclusion of the debt in the pool at the time of purchase, it may be appropriate not to view the transaction as a financing transaction.

The Preamble states that the Treasury Department and Internal Revenue Service intend to adopt rules designed to reduce the significant administrative burdens of complying with the proposed conduit rule. It is anticipated that such regulations will provide that the FASIT and Owner do not have a withholding obligation unless they know or have reason to know that the foreign investor would not be eligible for the portfolio interest exemption on interest received in respect of a FASIT regular interest under the look-through rule. The FASIT and its Owner will be presumed to know that the portfolio interest exemption is inapplicable if the foreign investor holds 10 percent or more of the FASIT's regular interests and 10 percent or more of the FASIT's assets are debt instruments of a related U.S. obligor.

We appreciate that the Proposed Regulations represent an attempt to balance the need to prevent tax avoidance and the need to minimize administrative burdens on legitimate transactions. However, even with the benefit of these rules, policing investments and investors to avoid tainted relationships and carry out the FASIT withholding responsibility could require

[155] By comparison, in the case of most REMIC transactions carried out by Ginnie Mae, Freddie Mac, and Fannie Mae, mortgage loans are generally packaged in giant pass-through certificates paying at a uniform fixed rate, which are then transferred to a lower-tier REMIC for securitization.

costly administrative measures that may make FASIT securitizations even more difficult to carry out. Because FASITs are not required to hold fixed asset pools or restrict transferability of regular interests, a FASIT and the Owner would need to ascertain its withholding obligations upon every addition of debt, transfer of a regular interest to a new foreign investor or change in ownership or group structure of a current foreign investor. In the ordinary case where the FASIT has not been organized as part of a plan to permit the foreign investor to finance the U.S. debtor without the payment of withholding taxes, the FASIT sponsor will likely not be aware of such changes and may not be able to establish sufficient measures to ensure that it is alerted to such changes.

Owners' inadvertent failures to exclude inappropriate debt or their inability to securitize debt that they have acquired for addition to FASIT pools[156] generally will increase the cost of securitizations.[157] The rule will likely require a sponsor of a FASIT whose interests may be transferred to foreign investors to require a transferee affidavit from every foreign investor attesting to the lack of a tainted relationship with U.S. debtors in the FASIT. The affidavit would have to be updated upon the addition of any new obligor or any change in ownership of the foreign investor. Presumably the FASIT will have to maintain records of the asset mix and

[156] For example, an Owner may acquire a pool of mortgage loans with the intention of adding them to an existing FASIT, only to discover after the fact that a regular interest in the FASIT had been transferred to a foreign party related to the U.S. obligor on the largest loan in the pool.

[157] For example, a FASIT may be structured to pass through essentially all of the interest income on the FASIT assets. If it is discovered that a foreign investor is related to a U.S. obligor on debt included in the FASIT pool, then, to the extent of interest income from the conduit debtor, all of the interest paid to the foreign investor (rather than solely its pro rata share of the FASIT's interest income from the conduit debtor) will be ineligible for the portfolio interest exemption. If the debt constituted 10 percent of the FASIT pool at any time prior to the discovery of the relationship by the FASIT or Owner, the FASIT will be liable for the withholding tax under the proposed rule presuming knowledge for related foreign parties of U.S. debtors comprising 10 percent of the FASIT pool. Payment of that tax may cause shortfalls in interest payments on the FASIT's other regular interests and/or a downgrading of the interests.

investor status throughout its term, in order to establish that it has not violated the special FASIT conduit rule. To ensure that there is no withholding requirement, a FASIT sponsor cannot rely on its ability to monitor the composition of the debt pool at the time that new debt is added to the pool (i.e., to ensure that no single debtor comprises 10 percent of the pool), because the mix of debt in the pool will change over time in ways that are beyond the control of the Owner, as debt pays off at differing speeds. This will be a particular problem for FASITs that securitize a mix of loans, such as mortgage loans and equipment receivables, that are likely to have varying prepayment outcomes. Although in some cases an Owner might be able to arrange a timely substitution for a loan that may cause a conduit problem, the Owner would be subject to the 100 percent tax on gain if the disposition fell within the proposed 180-day Rule. These problems would be exacerbated for multiple-tier FASITs where FASIT interests issued in earlier securitizations may be aggregated with new debt to form the basis for a new FASIT securitization.

Given Congress's goal of facilitating securitizations, it is not clear that such stringent measures should be imposed on FASITs when the general anti-conduit rules are otherwise sufficient to weed out abusive financing arrangements. We recommend that the Treasury Department and Internal Revenue Service reconsider the necessity for this special FASIT conduit rule and reject such a rule for REMICs and other securitization vehicles. If such a FASIT rule is retained, it should include, at a minimum, a "reasonable arrangements" safe harbor whereby foreign investors would be eligible for the portfolio interest exemption, and a FASIT would be exempt from conduit treatment, if (i) investments are sold to foreign investors only through a qualified intermediary (as defined for U.S. withholding tax purposes) or the offering documents and sales materials do not identify the U.S. obligors whose debt will be

included in the FASIT pool, (ii) the Owner and underwriters provide an affidavit to the effect that no U.S. obligor on debt included in the FASIT has referred them to a potential foreign purchaser of FASIT regular interests or otherwise arranged the investment in FASIT regular interests by a foreign party, and (iii) the Owner does not otherwise have actual knowledge or identifying information that links a foreign investor in the FASIT with any U.S. obligor on FASIT debt that constitutes, at the time the debt is added to the FASIT pool, 10 percent or more by value of the debt in the FASIT pool.

F. Anti-Abuse Rule.

The Proposed Regulations include an anti-abuse rule that is promulgated under the authority of Section 860L(h).[158] The rule states that the FASIT provisions are intended to promote the spreading of credit risk on debt instruments by facilitating their securitization.[159] If a principal purpose of forming or using a FASIT is to achieve results inconsistent with the defined intent, the Internal Revenue Service is authorized to make "any appropriate adjustments" in respect of the FASIT and any arrangement of which the FASIT forms a part. A "facts and circumstances" test applies to determine whether such a principal purpose exists. A relevant fact is the comparison of the business purpose for the FASIT transaction and the claimed tax benefits from the transaction. Three corollaries are stated to be implicit in the intent to promote securitizations. These corollaries require a FASIT's primary assets to be debt instruments and

[158] That Section permits the Secretary to prescribe regulations to carry out the purposes of the FASIT provisions, including ones that "prevent the abuse of the purposes of this part through transactions which are not primarily related to securitization of debt instruments by a FASIT."

[159] Prop. Reg. § 1.860L-2(a). We note that the legislative history observes that "[s]ecuritization is the process of converting one type of asset into another and generally involves the use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the debt instruments that are securitized." H. Conf. Rep. No. 104-737, 104th Cong. 2d. Sess. 320-329 (1996).

payments on its regular interests to be made primarily out of payments on debt instruments. They also impose a "clearly contemplated" standard in applying the anti-abuse rule to the "results" of a FASIT securitization. The anti-abuse rule has an effective date of February 4, 2000 (the date of the release of the Proposed Regulations).

We believe that the primary purpose for which Congress enacted the FASIT provisions was to provide certainty to securitization investors and sponsors that regular interests will be treated as debt for tax purposes, even if, in the absence of the statute, analysis of the regular interests applying general tax principles would cast doubt on the appropriate characterization of such interests because of form, thin capitalization or other features. While we support inclusion of an anti-abuse rule in the final regulations, we believe that the rule needs clarification in several respects so that the tax certainty provided by the statute is not unintentionally undone by the anti-abuse rule.

1. Intent of the FASIT Provisions

As noted above, the anti-abuse rule states that the intent of the FASIT provisions is to promote the spreading of credit risk on debt instruments by facilitating their securitization. This language is apparently drawn from a general statement in the legislative history in which Congress expressed its belief that there are substantial benefits to the economy from increased securitization of assets because of the spreading of credit risks. Contrary to the Proposed Regulations, the final regulations should clearly state that the intent of the FASIT provisions extends beyond the spreading of credit risk. For example, the Congressional drafters clearly had in mind that sponsors could use the FASIT provisions to achieve accounting objectives (as is the case for credit card master trust structures) while avoiding any corporate-level tax on the off-balance sheet assets. Other legitimate reasons for undertaking a securitization, such as spreading

prepayment risk, satisfying regulatory requirements, ensuring debt characterization of regular interests when an entity would otherwise be thinly capitalized or the interests would not be considered investment grade, warehousing debt during periods of slowed acquisitions because of market disruption, or creating a form of asset that may primarily be retained for the present but provide liquidity if the need should arise, should also be referenced in the final regulations.[160] At a minimum, the final regulations should recognize the foregoing legitimate purposes for the use of the FASIT provisions.

In addition, we recommend that the anti-abuse rule state that (i) the purpose of the FASIT provisions is to facilitate securitizations of debt instruments and (ii) the FASIT provisions and regulations will be interpreted and applied in accordance with this purpose. Interpretation consistent with this purpose permits the development of innovative securitizations not contemplated at the time the statute was enacted, but also provides grounds for a government challenge of an abusive securitization structure. This approach is similar to the approach taken in the taxable mortgage pool regulations.[161]

---

[160] We believe that Congress clearly intended that each of these purposes could be accomplished within the four corners of the FASIT provisions. For example, the FASIT provisions permit a sponsor to fine-tune the prepayment response of particular classes: interests can be structured to prepay at set speeds (by disposing of assets to pay off particular classes) or to have a single bullet payment at maturity (by reinvesting prepayments in new mortgage loans). Similarly, a sponsor could create a FASIT with the intent of issuing a full range of interests but decide to delay issuance of all but the most senior class of regular interests because of market disruptions. If such a sponsor has an opportunity to purchase suitable loans for the pool during the market disruption, the sponsor should be permitted to add them to the pool (taking advantage of the Spot Purchase Exception to avoid artificial gain recognition) without fear of disqualification of the FASIT because of the failure to issue regular interests corresponding to a significant amount of the collateral. These transactions are not abusive and should not be prohibited by a too narrow definition of the drafters' intent.

[161] See Treas. Reg. § 301.7701(i)-1(a) (stating that the purpose of Section 7701(i) is to prevent income generated by a pool of real estate mortgages from escaping Federal income taxation when the pool is used to issue multiple class mortgage-backed securities, and that the regulations are to be applied in accordance with this purpose); Treas. Reg. § 301.7701(i)-1(g) (anti-avoidance rule providing the Internal Revenue Service the authority to disregard or adjust a

As stated in our Prior Report, we do not believe that the final anti-abuse regulation should attempt to define "securitization."[162] Instead, the final regulations should provide a number of examples of transactions that are either consistent or inconsistent with the intent of the FASIT provisions. As in the case of the partnership anti-abuse rule, such examples will provide illustrative guidance to sponsors developing potential FASIT transactions, and can be easily amended by notice and temporary regulations to address any specific abusive transaction that comes to the government's attention through FASIT information reporting.

2. Corollaries

The anti-abuse rule in the proposed regulations includes a number of corollaries that are stated to be "implicit" in the intent of the FASIT provisions:

(1) Assets securitized through a FASIT must consist primarily of permitted debt instruments (*primary asset test*);

(2) The primary source of principal and interest payments on a FASIT's regular interests must be principal and interest payments on permitted debt instruments rather than other permitted assets held by a FASIT (*primary source test*); and

(3) No FASIT provision may be used to achieve a Federal tax result that cannot be achieved without the provision unless the provision clearly contemplates that result (*clearly contemplated result test*).

---

transaction if it is entered into with a view to achieving the same economic effect as that of an arrangement subject to the taxable mortgage pool rules while avoiding the application of that section).

[162] Prior Report at IV.J.1.

These corollaries to the anti-abuse rule impose additional substantive requirements regarding the mix of permitted assets of a FASIT and the relationship between debt assets and payments on FASIT regular interests. A FASIT could arguably fail the anti-abuse test, even if all of its assets are permitted assets and all payments on the regular interests conform with requirements for regular interests, because of an imbalance in the mix of assets at startup or later. This clearly was not intended by the drafters of the anti-abuse rule.[163] A number of uncertainties in application of the FASIT provisions stem from the inclusion of these corollaries and we believe that at a minimum these uncertainties need to be resolved in the final regulations.

First, it is unclear how payments under a guarantee, income from foreclosure property, proceeds from sales or payments under interest rate and currency swaps should be viewed for purposes of these corollary rules. For example, a FASIT that consists primarily of high-interest mortgage loans could find that an unexpectedly large number of the mortgage loans result in foreclosures at a time when the sponsor is unable to purchase additional loans to add to the FASIT. For some period of time, the primary assets of the FASIT may be foreclosure property, and principal and interest payments on regular interests may be made primarily out of funds derived from such foreclosure properties and/or cash equivalents added to the FASIT to provide short term funding as a bridge to acquisition of new debt instruments. It is not clear whether such payments would be regarded as "principal and interest payments on permitted debt instruments held by a FASIT" for purposes of the anti-abuse rule. The final regulations should

[163] These requirements may pose particular difficulties for FASITs established before the promulgation of the anti-abuse rule, which has an effective date of February 4, 2000. For example, an Owner that had encountered delays in the acquisition of debt instruments could have reasonably interpreted the FASIT provisions to permit establishment of a FASIT with debt instruments, contracts to purchase additional debt, and sufficient cash or cash equivalents to fund the purchases as well as to make initial interest payments on the FASIT's regular interests for several months. If the cash exceeded the funded debt instruments for four or five months or longer, however, such a pre-regulation FASIT would appear to be disqualified by the anti-abuse rule as presently stated, with the attendant discretionary remedies outlined below.

clarify that payments under guarantees or hedges or received in respect of foreclosure properties will be treated as payments in respect of the related debt instruments for purposes of this test.

Second, it would be difficult to assign a percentage requirement to "primary" that would be consistent for both the primary asset test and the primary source test. If a simple majority of the assets are debt instruments (other than cash equivalents), would the primary asset test be satisfied? If 80 percent of the payments of principal and interest on the regular interests are made out of the cash flows on the underlying debt instruments, but 20 percent of the payments are consistently made from cash equivalents of a sponsor affiliate that is added from time to time to the FASIT, would the FASIT fail to satisfy the primary source test? These and other issues illustrate the uncertainty created by the addition of the corollaries to the anti-abuse rule and clear guidance on these issues should be included in the final regulations.

Third, additional uncertainty stems from the lack of a specified testing time and the potential for inadvertent failure to satisfy the requirements at any point because of market events beyond the control of the Owner. Because an Owner can add assets throughout its term and liquidate assets to pay off classes of regular interests, a FASIT would presumably have to satisfy these requirements on each day of the FASIT's existence, and could inadvertently fail the test during transition periods. If the corollaries are retained in the final regulations, they should provide for liberal testing periods to eliminate these concerns about inadvertent failures to comply with the corollaries.

It is arguable that the first two corollary requirements may generally be unnecessary, since an Owner is unlikely to structure a FASIT to rely on income from cash equivalents or significant contributions of cash to make payments on a FASIT's regular interests

throughout its term. Furthermore, by stating the anti-abuse rule in the simpler form of a requirement to interpret the FASIT provisions and regulations consistently with the purpose of facilitating securitizations, as suggested above, the government could, even without relying on the corollary rules, challenge and disregard a FASIT election in respect of a sham securitization that primarily held cash equivalents to make payments of principal and interest on regular interests.

The third corollary cuts across all of the FASIT provisions to prevent use of a FASIT that achieves a "result" (not limited to a tax consequence but arguably including regulatory and other consequences) that could not be achieved without the FASIT provisions, unless the provisions clearly contemplate that result. This language is likely to be inordinately difficult to apply in practice. It is unclear what a taxpayer would rely on to demonstrate that a particular FASIT transaction is "clearly contemplated" by the statute other than the statute itself. The legislative history of the FASIT provisions is relatively slim. It does not provide an in-depth discussion of the securitizations for which the drafters considered the FASIT model to be eminently suited[164] nor of the potential abuses of the legislation that the drafters had in mind in providing authority for promulgation of an anti-abuse regulation.

The weighing of business purpose against tax benefits (as required in testing whether the principal purpose is inconsistent with the intent of the FASIT statute) may be particularly difficult in the context of a securitization. This balancing is further complicated by the imposition of a "tainted result" analysis. In our view, Congress enacted the FASIT provisions specifically to provide certain debt characterization (and the related interest

[164] The only securitization that was clearly discussed in the legislative history is the credit card master trust model.

deduction) for regular interests. A sponsor definitely will use FASITs to achieve such interest deductions, and the magnitude of those interest deductions will almost always outweigh the marginal spreads earned in the securitization. Consistent with Congressional intent, we believe that the anti-abuse rule should clearly state in an example or otherwise that interest deductions on regular interests achieves a result that is clearly contemplated by the statute.

3. Discretionary Remedies

While we believe that the government should have available a range of remedies for abusive transactions, the proposed rule provides sweeping authority to impose punitive tax consequences on Owners, holders of regular interests and other parties. In particular, we are concerned that there is no provision that requires that the remedy selected correspond to the relevant abuse. While many of these problems may be addressed through narrowing, and clarification of, the proposed anti-abuse rule, it would be helpful if the final regulations provided more guidance regarding the relationship between potential abuses and remedies.

More difficult issues are presented by the imposition of penalties on unrelated holders of regular interests who are unaware of abusive purposes of the transaction. The possibility that penalties will be imposed on innocent holders who have not participated in the structuring of a FASIT transaction could adversely affect the securitization market, necessitating riskier higher yielding interests (which may be marketable to a smaller market segment) and ultimately resulting in fewer securitizations. The argument against imposing penalties on innocent third parties is that, in the context of an abusive FASIT transaction, these remedies can appropriately be targeted to the Owner, which will generally be credit-worthy. In addition, although third-party holders of interests in an entity typically bear the risk that an entity may lose favorable tax status if it fails to satisfy relevant statutory requirements, disqualification under an

anti-abuse rule seems qualitatively different. In that case, third-party holders may not know or be in a position to discover the circumstances surrounding an abusive transaction. This is particularly true in the case of FASITs because of the possibility of changes in asset pools and sales to additional regular interest holders after a regular interest holder has purchased its interests. Based on these concerns, one approach to protect holders of regular interests would be to provide a safe harbor under which the government could not treat a regular interest as other than debt of a FASIT unless the regular interest holders are implicated in or aware of the tax avoidance scheme. This limitation on remedies would apply only when the holders of the regular interests are not related to the Owner.

On the other hand, the argument against protecting innocent holders of regular interests is that the imposition of risk on investors will provide an incentive for Owners to disclose the full extent of any risk in the relevant offering documents. Assuming that the scope of the anti-abuse rule is narrowed and clarified as we recommend, it can be argued that the risk of recharacterization under the anti-abuse rule should not disrupt the market for securitization transactions.

Our Committee did not reach a consensus regarding which of the foregoing approaches should be adopted. We urge, however, that careful consideration should be given to the costs and benefits of imposing remedies on innocent third parties under the anti-abuse rule. In addition, we believe that remedies should be appropriately targeted to the relevant abuse. It would be helpful in this regard if the final regulations included examples of the proper imposition of remedies.

4. Examples

Based on the above discussion, we recommend that the final anti-abuse rule include a number of examples to illustrate the types of transactions that will be considered consistent with the intent of the FASIT provisions. We have provided several illustrative examples.

Example 1. A credit card bank wishes to create a securitization vehicle for its credit card receivables in order to have off-balance sheet financing. It arranges to transfer receivables and rights to future receivables in respect of a series of accounts into an entity that has no other assets. It issues regular interests in respect of a sizable portion of the pool of collateral, but approximately 12 percent of the pool provides over-collateralization at the time of initial issuance. Achieving the certainty of debt treatment while keeping transactions off-balance sheet is consistent with the purpose of the FASIT provisions.

Example 2. A sponsor wishes to issue debt securities through an entity that holds debt instruments. The cash flows on the debt securities will correspond very closely to the cash flows on the entity's assets. The entity would be considered thinly capitalized under general tax principles. The assets and liabilities of the entity conform to all of the FASIT requirements. The sponsor makes a FASIT election in respect of the entity. Using the FASIT provisions to ensure debt treatment for a thinly capitalized entity is consistent with the purpose of the FASIT provisions.

Example 3. A sponsor wishes to acquire heavy equipment loans over a period of several months and then issue several tranches of securities of a certain size and rating backed by those loans. In order to avail itself of the spot exception rule to gain recognition, the sponsor

establishes a FASIT with an initial pool of loans and some cash assets as a reserve fund. The sponsor warehouses the initial loans in the pool for a period of four months, until it has acquired sufficient assets to issue the proposed securities. Using the flexibility of the FASIT provisions to warehouse loans during a transition period prior to issuing securities is consistent with the purpose of the FASIT provisions.

Example 4. A sponsor makes a FASIT election in respect of a pool of mortgage loans and issues a series of classes of regular interests. The securitization is structured to provide a guaranteed prepayment speed for the classes. Using the flexibility of the FASIT provisions to change prepayment risks by permitting investment of prepayments as received in guaranteed investment contracts that will pay at the stated maturity date or by disposing of assets in order to liquidate an entire class of regular interests on the scheduled prepayment date is consistent with the purpose of the FASIT provisions.

Example 5. A sponsor wishes to structure a FASIT with callable classes, in order to re-optimize the structure in the event of changes in prevailing interest rates. Entire classes of regular interests will be retired by disposing of sufficient assets to make the required payments. Structuring securitizations to take advantage of the rules permitting dispositions of assets is consistent with the FASIT provisions.

G. Pre-Effective Date FASITs.

Section 1621(e) of the Act provides a transition rule for entities in existence on August 31, 1997.[165] If such an entity later elects to be a FASIT, special relief provisions apply to

[165] Prop. Reg. § 1.860L-3.

interests in the entity that were issued before the FASIT startup date. These interests are referred to as "pre-FASIT interests". In general, gain is not recognized on assets of the FASIT allocable to a pre-FASIT interest until the assets cease to be allocable to pre-FASIT interests. The purpose of this rule was to provide relief to revolving securitization entities, such as credit card master trusts, that were in existence on August 31, 1997. Absent the relief provision, an election by such a trust to become a FASIT would result in gain recognition on all its assets, including the assets allocable to the preexisting obligations of the trust that were not (and would never become) regular interests of a FASIT. The proposed regulation, however, defines a pre-FASIT interest in a manner that adds several conditions to the requirements of the Act itself. We see no good policy basis for these additional restrictions, and we believe these restrictions will severely limit the availability of the transition relief that Congress apparently intended to provide.

First, under the proposed regulation, a pre-FASIT interest must have been issued before February 4, 2000 (in contrast to the Act itself, which provides that the interest must have been issued before the startup date). Consider the most likely situation. A master trust, which already has debt outstanding, issues additional debt today, and elects FASIT treatment after adoption of final regulations. The debt issued today will not be a FASIT regular interest because it was issued before the FASIT election became effective. Nevertheless, the owner of the FASIT will have gain recognition, at the time of the FASIT election, on assets of the trust that are allocable to such debt. This result is illogical. We see no policy reason for gain recognition to arise for assets that are allocable to non-FASIT debt.

Second, under the proposed regulation, a pre-FASIT interest can qualify as such only if it is considered debt under general principles of Federal income tax law. However, in the past (as well as currently) many master trusts issued "certificates" that were intended to be debt

for Federal income tax purposes, but whose status as debt or equity is not completely clear. There is no significance to this question under pre-FASIT law, because the certificates are privately placed and are designed so that, even if the certificates are equity of the master trust for tax purposes, the master trust will not be a publicly traded partnership taxable as a corporation under Section 7704. However, if any interest in an existing master trust is not debt for tax purposes, under the proposed regulation that interest is not eligible to be a pre-FASIT interest. As a result, if the master trust makes a FASIT election in the future, gain recognition will be required for all assets allocable to that interest. We see no policy reason for this result, again because that interest is not a regular interest in the FASIT.

Third, under the proposed regulation, a pre-FASIT interest must not only be debt for Federal income tax purposes, but it must be debt of the Owner. However, as discussed above some of the interests in the master trust might be equity. If so, even the other interests in the master trust that in fact are debt for tax purposes become debt of the trust itself (which now has more than one equity owner), rather than debt of the owner of the trust (which would be the case if all the outstanding interests were debt for tax purposes). Under current securitization structures, it is generally accepted that the interests in the trust that are debt for tax purposes may be debt of the trust rather than debt of the Owner. However, the proposed regulation requires that a pre-FASIT interest be debt of the Owner. As a result, if any interests in the master trust are equity, none of the outstanding interests, even those that are truly debt for tax purposes, will qualify as debt of the Owner and thus as pre-FASIT interests. We see no logic or policy reason for this result. Moreover, because many large securitization trusts have many billions of dollars of outstanding certificates, and there is at least some risk that one or more certificates in many of these trusts are not debt for tax purposes, the Owner would risk a catastrophic tax liability if the

master trust were to make a FASIT election. We do not believe that this is what Congress intended by the transition rule.

H. Effective Date of Proposed Regulations.

The Proposed Regulations are proposed generally to be effective on the date final regulations are filed with the Federal Register.[166] However, the anti-abuse rule and the regulations allowing the deferral of gain on assets held by a pre-effective date FASIT are proposed to apply on February 4, 2000.[167] As a result of the proposed effective dates, the Proposed Regulations, if adopted as final regulations, would apply to FASITs that were formed prior to the issuance of the Proposed Regulations. Because the Proposed Regulations adopt various substantive rules that could not have been reasonably foreseen by taxpayers when they elected FASIT status, the final regulations should provide liberal transition rules to permit existing FASITs a reasonable period of time to conform to the substantive rules governing qualification as a FASIT by amending existing FASIT documents, disposing of non-permitted assets without being subject to the 100 percent penalty tax on prohibited transactions, liquidating within a reasonable transition period or taking other corrective measures. In the event the final regulations do not permit foreign FASITs or FASITs holding foreign debt, such FASITs should be permitted to unwind or restructure to comply with the final regulations on a tax-free basis. In addition, while we agree that the anti-abuse rule should be effective on and after February 4, 2000, it is critical that the scope of the rule be clarified and narrowed because the anti-abuse rule as currently drafted covers legitimate, non-abusive transactions. In order for the Proposed

[166] See Prop. Reg. § 1.860L-4 .

[167] Prop. Reg. § 1.860L-2(d) and -3(f).

Regulations not to have a chilling effect on the market prior to the issuance of final regulations, we recommend that the government issue an announcement to the effect that it intends (i) to provide liberal transition rules for FASITs formed before the issuance of the final regulations and (ii) to narrow and clarify the scope of the anti-abuse rule.

IV. TECHNICAL COMMENTS

We have the following technical comments on the Proposed Regulations:

1. The definition of a permitted debt instrument includes a certificate of trust representing a beneficial interest in an otherwise permitted debt instrument.[168] The final regulations should clarify that a FASIT may own a beneficial interest in a trust whether the trust is classified as a fixed investment trust or a partnership.[169] This appears to be contemplated by (although not clearly stated in) the Proposed Regulations. The Preamble discusses at some length the qualification of "participations" in pools of debt, and suggests that such arrangements, even though interests in revolving pools which would not normally constitute a fixed investment trust, should qualify to the extent distributions are paid in cash, the FASIT's percentage interest is fixed, and the underlying assets are themselves permitted assets. Thus, it is clear that participations need not qualify as interests in a grantor trust.

2. In order to facilitate the issuance of variable funding certificates, the final regulations should clarify that the principal balance of a regular interest is "specified" even if the principal balance is increased to reflect additional investments in the FASIT.[170]

---

[168] Prop. Reg. §1.860H-2(b)(1)(viii).

[169] See Prior Report at IV.F.2.

[170] See Prior Report at IV.E.2.

3. The Proposed Regulations authorize the Internal Revenue Service to calculate the value of debt instruments under the special valuation rule by disregarding in its entirety any assumption used by the taxpayer that is unreasonable or that fails the consistency test.[171] The Preamble states that this authorization is "[t]o encourage adherence to the consistency test". We believe that the Internal Revenue Service should be authorized to revalue the assets using only reasonable assumptions. This standard would be consistent with other Sections of the Code dealing with valuation issues, such as Section 482, and with existing penalty provisions that police unreasonable tax reporting positions.

4. The Internal Revenue Service may determine that a failure by a FASIT to satisfy one of the qualification requirements was inadvertent and permit the FASIT to continue as a FASIT or to reelect FASIT status.[172] In such cases, the Internal Revenue Service may require the FASIT and "each person" holding an interest in the FASIT "at any time" during the failure of the arrangement to qualify as a FASIT to make appropriate adjustments consistent with the treatment of the arrangement as a FASIT. Because the regular interests in a FASIT may be widely held, it may be difficult as a practical matter for all of the holders of the regular interests to agree to such adjustment (or, in some cases, even to identify the affected holders). We therefore recommend that any appropriate adjustments should be taken into account only by the Owner.

[171] Prop. Reg. § 1.860I-2(c)(4).

[172] Prop. Reg. § 1.860H-3(d).