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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECURITIZATION REFORM MEASURES

December 20, 2002

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NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON SECURITIZATION REFORM MEASURES[1]

I. Introduction

Securitization transactions are used to transform cash flows on mortgages, credit cards and other consumer and commercial receivables into payments on transferable securities of a type traditional capital market investors wish to buy. These transactions perform an important intermediation function—bringing together consumers and commercial borrowers seeking funds and investors with capital—that traditionally was undertaken primarily by financial institutions. Mortgage-backed securities ("MBS") and non-mortgage asset-backed securities ("ABS") represent a significant and growing component of the capital markets in the United States.[2] For example, they accounted for 45 percent of the volume of new issuances of debt in 2001, compared with 19 percent for conventional corporate debt.[3]

The tax law governing securitization transactions has developed over the years through the application of general tax law principles, the enactment of specialized statutory regimes for two types of securitization vehicles (real estate mortgage investments conduits or REMICs in 1986, and financial asset securitization investment trusts or FASITs in 1996), the

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1 This report was prepared by the Committee on Securitizations and Structured Finance, which is a new standing committee of the Tax Section. James M. Peaslee is the principal author and editor. Charles Adelman, Colman Burke, Ayano Kato, Bruce Kayle, Robert Kreitman, Tom Lyden, David C. Miller, David Z. Nirenberg, Peter Ritter and Paul Wysocki contributed to the report. Comments were received from Kimberly S. Blanchard, Micah Bloomfield, Samuel J. Dimon, Maxim Kulikov, Michael L. Schler, Janine Shissler and Willard Taylor.

2 In addition, the technology for securitizing assets has been exported around the world and it can be expected that over time there will be over time significant offerings of foreign MBS or ABS to U.S. investors. The legal structures used will vary depending on the requirements and practices of the jurisdictions involved.

3 Some statistics regarding securitization transactions may be found in Annex A to this report.

enactment of some more narrowly focused statutory rules, [4] and the adoption of regulations.[5] The main virtue of a REMIC or FASIT is that certain REMIC or FASIT interests are treated automatically as debt under the Code even though they otherwise might be considered equity. Debt treatment, of course, allows income on receivables to be passed through to investors as interest without an incremental tax on the debt issuer.

With the notable exception of the FASIT rules, the current patchwork of law generally works well, in the sense that it provides the right answers most of the time with sufficient clarity so that adverse tax consequences, or the fear of them, do not block commercial activity and transactions are rarely undertaken primarily to achieve a favorable tax result. There are, however, some rough spots where changes or clarifications are warranted. A letter sent to the Treasury in 2001 by James M. Peaslee and David Z. Nirenberg proposes a number of law changes relating to securitizations.[6] The central theme of the letter is that the FASIT regime should be abandoned ("thrown out the window" in the language of the letter) and replaced with a package of narrowly focused technical changes.

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4 Two specialized statutory provisions are section 1272(a)(6), which sets out a method (sometimes referred to as the prepayment accrual catch-up ("PAC") method) for taking prepayments into account in accruing discount; and section 7701(i), which defines a taxable mortgage pool ("TMP") and generally treats a TMP as a corporation that cannot join in a consolidated return. Except where otherwise noted, section citations herein are to the Internal Revenue Code of 1986 (the "Code") or Treasury regulations under the Code.

5 One important set of regulations is Treasury Regulation § 301.7701-4(c), which determines when an investment trust may be classified as a trust (and hence as a grantor trust) for tax purposes. The part of the regulations issued in 1984 and relating to multiple-class investment trusts is commonly known as the "Sears regulations."

6 See letter to Assistant Secretary Weinberger dated June 6, 2001, reprinted in 91 *Tax Notes* 2079 (June 18, 2001).

It is clear that the FASIT rules are not being used to any significant degree and accordingly are not achieving their purpose.[7] Indeed, although the private sector supporters of the legislation were primarily sponsors of credit card securitizations, to our knowledge no such sponsor has made a FASIT election.

There are three possible responses to the FASIT woes: do nothing, fix the FASIT regime, or address the problems that led to enactment of the FASIT rules in a different way. We support the third approach. Specifically, we recommend that the Treasury and the Internal Revenue Service (the "IRS" or "Service") take a number of small steps, not involving the FASIT rules, to improve and clarify the law. For the most part, the steps would consist of modifying regulations or issuing revenue rulings. Taken together, these measures would, we believe, go far enough in addressing the problems that led to enactment of the FASIT rules to allow them to be repealed.

We prefer a tailored set of reforms to doing nothing because in some areas the law does need clarification or repair and the affected market is large enough to make the effort worthwhile. Pursuing these reforms is a better choice than attempting to fix the FASIT regime because it is more feasible. The needed reforms are, as these things go, fairly easy to understand, evaluate and implement. We believe the changes can be implemented without legislation. By contrast, an attempt to fix FASITs would require both statutory amendments and regulations involving difficult policy and technical issues. FASITs failed in large part because of the

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[7] While there are no available statistics, based on our own experience, the primary use of FASITs today appears to be to facilitate cross-border tax arbitrage transactions in which a domestic corporation issues preferred stock to a foreign investor resident in a country that provides favorable tax treatment for equity investments. The stock qualifies in the United States as a FASIT regular interest taxable as debt and is treated in the investor's jurisdiction according to its form as equity.

difficulty in bridging conflicting objectives. The sponsors wanted an ironclad debt safe-harbor rule and flexibility. Government policymakers were unwilling to concede safe-harbor debt treatment in an open-ended, tax-transparent vehicle without safeguards to prevent inappropriate erosion of the corporate tax base (and, apparently, without also exacting a toll-charge in the form of up-front gain recognition). In the end, the safeguards and the toll charge led to a regime that is neither used nor useful. We are not optimistic that a workable FASIT alternative would emerge any time soon from a restarted legislative initiative. Also, any revised statutory safe-harbor rule would very likely continue to draw the line between debt and equity conservatively in a way that does not really help in hard cases. In our view, rules that do not provide absolute certainty but clarify the analysis of debt/equity issues and reduce the risks of being wrong would provide adequate guidance to taxpayers while at the same time avoiding the government concerns of unanticipated results that may accompany any rigid safe-harbor debt rule.

This report addresses the substantive areas covered in the Peaslee and Nirenberg letter.[8] We have also identified a number of additional areas where narrowly focused changes would be beneficial. For each proposal we have provided suggested language of a ruling or regulation implementing the proposal, both to clarify our intentions and to help in assessing how difficult it would be to take the suggested steps.

Part II of this report provides an overview of securitization transactions and the development of different transaction structures. The existing tax law is best explained through an historical approach that describes the different types of securities and their benefits and

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8 That letter sketches out a number of proposals but does not offer many details or provide a detailed rationale for the recommendations. Accordingly, while we have used the letter as a starting point, the discussion here stands on its own and does not identify differences between our approach and the proposals set out in the letter.

drawbacks and associated tax issues. Part II provides a brief summary of the REMIC and FASIT rules. It also describes the current financial accounting rules for QSPEs (defined below), which bear on the continuing relevance of the FASIT rules. Readers already familiar with these topics can skip ahead to Part III.

Part III summarizes our proposals. Parts IV through VII then describe and discuss in detail our recommendations for FASIT-related changes (including some modifications in the REMIC regulations), for changes affecting REMICs, for changes relating to the definition of a TMP, and for changes in other areas. Annex A contains statistics about the MBS and ABS markets in the United States. Annex B sets out a draft revenue ruling (the "Credit Card Ruling") providing guidance on the tax treatment of a typical credit card securitization trust.

II. Overview of Securitizations; Tax Issues and the Development of Different Structures

A. Description of a Securitization Transaction

Securitization transactions are the capital market's way of turning a sow's ear into a silk purse. These transactions use payments from a broad range of consumer and commercial receivables to support one or more classes of transferable securities that are in a form suitable for purchase by traditional capital market investors. The transactions are generally effected by transferring receivables to a special purpose, bankruptcy-remote entity (most often a local-law trust). The entity hires a servicing agent who collects payments due on the receivables and channels them to the appropriate securities class. The securities issued may consist of a single class representing pro rata interests in the underlying assets, or multiple classes divided by time (with a right to receive payments first, second, etc.), by credit risk (senior or subordinated in the event of defaults), or both. Also, rights to interest may be separated from rights to principal and interest may be carved up according to a formula.[9] The securities may take the legal form of debt (notes or bonds) or equity (usually certificates of beneficial interest in a trust). One or more security classes may benefit from third party credit support. The receivables pool may be a liquidating, fixed pool, or a revolving pool with a term (with cash receipts being reinvested over a fixed period of time). For obvious reasons, revolving structures are particularly suited to shorter-term receivables such as credit card balances.

A securitization transaction may be undertaken, as an alternative to straight debt financing or whole loan sales, for several reasons: to shift the risk and funding requirements for the receivables to long-term, capital markets investors in a form that is acceptable to them; to isolate investors from credit exposure to the sponsor and thereby potentially improve the quality of the investment compared with a conventional loan; or to achieve financial or regulatory benefits (typically taking assets off the books of the sponsor for accounting or regulatory capital purposes).

B. Tax Issues

Tax planning in the securitization area has mostly been defensive, to ensure that cash flows on receivables can be passed through to holders of securities without significant additional tax costs. For domestic issuers, there are two incremental taxes to consider: a U.S. corporate income tax if the issuer is classified as a corporation, and U.S. withholding taxes on income paid or allocated to foreign investors (including, for entities that are partnerships, the

[9] For REMICs, one common technique is to divide fixed interest mortgages into a floating rate security and an inverse floater (which may have an actual principal amount or only a notional principal amount).

withholding tax imposed by section 1446 on income effectively connected with a U.S. trade or business ("ECI")).[10]

For a domestic issuer, a corporate tax can be avoided in one of two ways: first, by ensuring that the issuer is classified as a tax transparent vehicle (a trust or partnership) in which the investors own equity and not as a corporation (or an association taxable as a corporation), or second, by issuing securities to investors that are treated as debt of the issuer so that income payments to investors represent deductible interest expense. Entity classification and debt/equity issues are part of the mainstream of the tax law. How those issues have been addressed in practice in securitizations is best described by considering the development of different types of securities. This history is the topic of the next section. That section also describes REMICs and FASITs. By statute, they combine the two approaches—debt treatment and tax transparency—to avoid an issuer-level tax. Any entity that seeks to qualify as a REMIC or FASIT obtains certainty on entity-level tax issues but in exchange must comply over its life with a host of technical rules.

Turning to U.S. withholding taxes imposed on the income of foreign investors, application of the taxes depends on whether the security held by an investor is classified as debt or equity. If it is equity, then it is also important to know how the issuer is classified for tax purposes and how active it is, and whether the underlying interest-bearing obligations comply with TEFRA registration requirements. The details are described in Part IV.D, below.

10 Securitization vehicles can potentially avoid U.S. taxation by being organized outside of the United States. Except for the recommendations relating to information reporting by foreign trusts, the recommendations set forth in this report are directed at U.S. vehicles and special issues raised by non-U.S. issuers are not addressed.

Entity classification and debt/equity issues affect domestic investors as well as issuers and foreign investors. Most significantly, pension plans and other tax-exempt investors that are subject to tax only on unrelated business taxable income ("UBTI") can hold debt or corporate stock without adverse tax consequences, but generally are subject to tax on income from equity interests in entities classified as partnerships if either the partnership is engaged in a trade or business (with some exceptions) or the partnership is passive but has outstanding debt (so that the debt-financed property rules in section 514 apply). Taxable domestic investors traditionally have preferred holding equity in a grantor trust or debt to holding equity in an entity classified as a partnership because of the complexity of partnership tax reporting.

C. The Development of Securitization Structures[11]

1. Single-class Pass-through Certificates

The earliest types of securitizations involved selling pass-through certificates that represented pro rata interests in fixed pools of residential mortgages and benefited from the guarantee of a government or government-sponsored agency. The pro rata feature meant that principal payments on the mortgages were passed through to investors as received, producing a series of principal payments over time. Prepayments could be predicted more readily for a large pool than for individual mortgages, but still were erratic. In 1970, the IRS issued two rulings holding that pools of this type would be taxable as grantor trusts owned by the certificate

11 This section provides a brief history of the development of different types of MBS and ABS and the tax-law reasons for creating them. For a more complete survey, see James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions* (3d Ed. Frank Fabozzi Assoc., www.securitizationtax.com), hereinafter Peaslee & Nirenberg, Chapter 2.

holders.[12] Accordingly, the issuing trust was ignored for substantive tax purposes and the investors were treated as if they owned pro rata interests in the underlying mortgages.

The rulings depended on the issuing trust being classified as a trust and not as an association despite its use in a commercial setting (as an investment vehicle for unrelated investors). The then-existing entity classification regulations distinguished between trusts and business entities (partnerships or associations) based on whether there were associates and an objective to carry on business. A fixed investment trust (one with a fixed portfolio of assets) was considered to lack associates and an objective to carry on business because of its passivity. Specifically, Treasury Regulation § 1.7701-4(c), reflecting the holding of the *North American Bond Trust* case,[13] provided that an investment trust would be classified as a trust and not an association so long as there was no "power to vary" the investment of certificate holders (in other words, no management power that could be used to acquire new investments).[14]

2. Fast-pay, Slow-pay Structures

The next major development, in the early 1980s, stemmed from the commercial desire to allocate cash flows from residential mortgages to classes of securities with differing maturities. The idea was that if mortgage principal was directed first to one class (a fast-pay class) until it was retired, and then to a second class (a slow-pay class), and so on for successive classes, the attractiveness of the securities as a group would be increased and the overall yield

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12 Revenue Rulings 70-544, 1970-2 C.B. 6, and 70-545, 1970-2 C.B. 7 (GNMA certificates). The status of certificate holders as "grantors" was considered to carry over to successor holders even though they played no role in transferring assets to the trust.

13 *Comm'r v. North American Bond Trust*, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942).

14 The power-to-vary test is far more restrictive than a requirement that the trust not engage in a trade or business. It prohibits any discretionary reinvestments even if they are incidental to an investment purpose and not part of a trading activity.

reduced. Specifically, shorter-term debt usually has a lower yield than longer-term debt, so buyers of the fast-pay class would require a lower yield. The lower yield produced a benefit to the borrower that more than offset any cost from extending the duration of the slow-pay classes. Holders of a slow-pay class would benefit from call protection (knowing that even with accelerated prepayments on the mortgages, they would not start to receive principal until prior classes had been retired).

To tax planners in the early 1980s, there appeared to be two possible ways to create a fast-pay, slow-pay structure. One was to have the securitization vehicle issue debt secured by the mortgages (so-called collateralized mortgage obligations or CMOs). The other, which was controversial, was to issue trust pass-through securities divided into multiple classes.

The CMO approach had four main drawbacks:

- There was a consensus among tax advisors that some level of equity was needed to provide reasonable assurances the CMOs would be recognized for tax purposes to be debt of the issuing entity rather than disguised equity.

- If the issuer was a corporation owned by a corporate investor, the investor needed to own 80 percent of the issuer's stock for the two corporations to consolidate for tax purposes. Ownership by the investor of a controlling interest in the issuer meant that the CMO debt had to be shown as debt on the consolidated financial statements of the investor.

- CMO debt did not qualify as a real property mortgage for tax purposes in the hands of an investor because such a mortgage was distinguished from debt secured by a real property mortgage. An investment's status as a real property mortgage was important for REIT investors and also for thrift institutions which enjoyed tax benefits if they owned certain amounts of real property mortgages and other qualifying assets.

- The issuer suffered from a mismatch in the timing of income and deductions that created positive taxable income in early years followed by offsetting tax deductions in later years. This "phantom income" problem arose from the fact that the assets—a fixed pool of mortgages or single class pass-through certificates—earned income at a constant rate over time, whereas the weighted average yield of all outstanding classes of CMOs increased over time as the shorter-term, lower-yielding classes were retired.[15]

The alternative, multiple-class trust structure was pioneered by Sears Mortgage Securities Corporation. The structure would have avoided all of these drawbacks. It involved issuing fast-pay, slow-pay classes of ownership interests in a trust holding mortgages rather than debt collateralized with mortgages. Because the pass-through certificate classes were equity, there was no need to mismatch cash flows to support debt treatment, no debt to put on anyone's balance sheet and no phantom income arising from a mismatch of income on mortgages against

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15 The term "phantom income" is sometimes used to refer to economic income that must be included in taxable income currently but is not payable in cash (for example, in the case of a partnership owning rental real property, net rental income in excess of depreciation that is used to amortize loan principal). The phantom income associated with CMOs is different. It arises solely from a timing difference and *never* corresponds to an item of economic income. Thus, it can exist even though, in the aggregate over time, cash receipts on the issuer's assets exactly match payments on the CMOs and the issuer's equity receives nothing. To give a simple illustration, suppose that a CMO issuer acquires $100 principal amount of mortgages bearing interest of 8 percent. The issuer issues Class A and Class B bonds, each bearing interest of 8 percent and having an initial principal amount of $50. Mortgage principal is applied first to pay principal on Class A until it is retired and then to pay principal on Class B. Thus, the Class A and Class B bonds are fast-pay and slow-pay classes, respectively. The Class A bonds are issued at a price of $51 (to produce a yield lower than 8 percent) and the Class B bonds are issued for $49 (to produce a greater yield). The aggregate proceeds of the bonds equal $100, and the mortgages are purchased for that price. Thus, the bonds fully fund the cost of the mortgages. Also, all cash flows on the mortgages are used to make payments on the CMOs. Thus, in the example, the equity of the issuer has an initial value of zero and never receives any distributions. For tax purposes, however, the issuer has positive taxable income followed by a matching loss. The income arises from the fact that interest accrues at a constant rate on the mortgages over their life but deductions are computed separately for each class of bonds and reflect their differing yields and maturities. Specifically, the $1 premium at which the Class A bonds are issued must be taken into income by the issuer over the term of Class A, whereas the discount at which the Class B bonds are issued is deducted over the longer term of Class B. In the example, the maximum cumulative amount of phantom income is realized at the time when Class A is retired and equals the portion of the discount at which Class B is issued that remains unaccrued at that time. The phantom income phenomenon also exists in the more realistic case where all CMO classes are issued at par and the lower yield of the shorter-term classes is reflected in their stated interest rates. For some real-life illustrations, see www.securitizationtax.com (article on Phantom Income by Thomas B. Lupo).

income on debt classes.[16] The sponsors took the position that the trust was properly classified as a fixed investment trust because trust assets were fixed in the same way as for a single-class trust. The structure was short-lived. The first public deal was in February 1984. In April 1984, the IRS issued the "Sears regulations." They amended Treasury Regulation § 301.7701-4(c) to provide that an investment trust with multiple classes of ownership interests would (with limited exceptions) be classified as a business organization rather than a trust. Under the entity classification regulations in effect at the time, a local-law trust that was a business organization generally was classified as an association.[17] A corporate tax was plainly an unacceptable cost (as the government well knew), so, as of the spring of 1984, the multiple-class trust structure died a gruesome death and CMOs became the only game in town.[18]

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16 The intent was that each class would be taxed based on its own cash flows under the bond stripping rules now found in section 1286, on the ground that each class represented a partial ownership interest in mortgages held by the trust. When a bond is stripped into components, each component is taxed based on its own yield. With a rising yield curve, the timing of income on all components together may be slower than the timing of income on the whole bond. In a bond stripping transaction, there is no mechanism for the tax system to capture the difference between the timing of income on the whole bond and on the components. Whether the stripping rules applied to the pass-through certificates was itself controversial because each class of certificates represented an interest in the underlying mortgages that changed as prepayments were used to pay principal not pro rata but only to the currently outstanding fast-pay class. For example, the class of certificates with the latest maturity date would ultimately receive principal from whatever mortgages happen to be left when all prior classes have been retired. Those remaining mortgages cannot be identified in advance.

17 A business entity was classified as a corporation rather than a partnership if it had three or more of the corporate characteristics of limited liability, centralized management, continuity of life and free transferability of equity interests. A typical local-law trust issuing pass-through certificates had all four of these factors.

18 The government's main complaint with multiple-class trust structures appears to have been uncertainty over how to allocate income among equity classes. The government's approach, however, was to stop the structure in its tracks rather than to fashion appropriate allocation rules. For multiple-class mortgage trusts, the explanation may be that an effort already was underway to clarify the tax rules through legislation (the REMIC initiative described below). Note that the Sears regulations were aimed not only at mortgage securitizations but also at the use of trusts to create non-pro rata interests in corporate stock. For an illustration, see Treasury Regulation § 301.7701-4(c)(2), Example (3) (trust creating securities that were promoted as PRIMES and SCORES).

The first issuers of CMOs were corporations. One improvement in the structure was to substitute as the issuer a trust (referred to as an "owner trust" to distinguish it from the indenture trust for the bonds). This approach allowed the equity of the issuer to be divided up without significant tax costs. (The owners were personally responsible for all non-CMO liabilities, and trust ownership interests were not freely transferable, so the trust was classified as either a trust or a partnership for tax purposes.) If no one person held a majority of the equity, for financial accounting purposes, none of the owners was required to consolidate the issuer and show the CMOs as their own debt. One practical drawback of this structure was the need to place equity with multiple owners. Also, it did not address the other three drawbacks of debt financing (the need for economic equity, the failure of CMOs to qualify as real property mortgages, and phantom income).

3. <u>REMICs and TMPs</u>

The obvious advantages of the Sears structure over CMOs led the securities industry to lobby for legislation that would effectively allow the creation of fixed investment trusts with multiple classes of ownership interests. This effort led to the enactment in 1986 of the REMIC rules (sections 860A through 860G). In short, those rules define a REMIC, exempt it from tax (except for certain penalty taxes) and state how holders of REMIC interests are taxed. A REMIC is a fixed pool of "qualified mortgages" and "permitted investments" that has outstanding only regular interests and a single class of residual interests and elects to be a REMIC. The permitted investments may consist of a qualified reserve to pay losses and expenses, foreclosure property, and cash flow investments, which are temporary investments of mortgage cash flows pending their distribution to holders of REMIC interests. A REMIC generally may acquire additional mortgages after it is formed only during an initial three month period.[19] All classes of REMIC interests must be issued when the REMIC is formed.

Significantly, a REMIC is defined functionally, as a mortgage pool and interests therein having certain economic characteristics; legal form is irrelevant. Thus, a REMIC can be any type of legal entity or a segregated pool of assets within a legal entity. REMIC interests can be in the form of debt, beneficial interests in a trust, or equity in an LLC or corporation.

In terms of substantive tax results, a REMIC is a hybrid between a grantor trust and an owner trust issuing CMOs. It is like a grantor trust in that REMIC assets must consist of a substantially fixed pool of mortgages and related assets (in other words, the power-to-vary test was substantially incorporated into the legislation). Also, a REMIC cannot sell performing assets over time but must generally hold them to make payments on REMIC interests. As noted above, after a REMIC is formed, it is forbidden from raising new financing, or even refinancing existing interests. Thus, a REMIC is a liquidating vehicle that holds mortgages and passes through cash flows as received. As is true with a grantor trust, a sale of REMIC securities triggers gain or loss for the sponsor, and REMIC securities are treated as ownership interests in the underlying REMIC assets for purposes of the REIT and thrift qualification tests.

On the other hand, the REMIC rules follow the owner trust/CMO model in allocating income from REMIC assets among the holders of REMIC interests. As noted above, a REMIC can have two types of interests, regular interests and residual interests. Subject to the

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19 The definition of qualified mortgage is generally limited to mortgages acquired on the REMIC's startup day (the date of formation) but also includes (1) mortgages purchased by the REMIC within the 3-month period beginning on the startup day under a fixed-price contract in effect on the startup day and (2) mortgages exchanged for qualified mortgages within such 3-month period, or mortgages exchanged for a "defective" qualified mortgage within the 2-year period beginning on the startup day.

discussion of specified portion classes below, a regular interest generally must have a principal amount and income payments resembling fixed or floating rate interest on conventional debt. Section 860B(a) and the regulations thereunder treat regular interests as debt of the issuing REMIC under the Code without regard to their legal form (specifically, pass-through certificates can qualify). There must be a single class of residual interests. That class functions as "tax equity" in that it is allocated the taxable income of the REMIC (gross income less deductions for interest payments on regular interests). Because REMIC income is computed in the same manner as income of an owner trust, where regular interests are issued with different maturities in a rising yield curve environment, there will be phantom income allocable to the residual interest followed by matching phantom losses.

An important goal of the REMIC legislation was to eliminate any tax requirement for "real equity" to support debt, and the REMIC rules do not require that a residual interest be entitled to any economic rights. There was a legitimate concern that tax on noneconomic residual interests could be avoided by transferring them to non-taxpaying investors, and the REMIC rules incorporate various safeguards to prevent this from happening. These safeguards include rules that ensure that a portion of the income from a residual interest will be subject to at least one tax (although not necessarily a corporate tax).[20] The portion is referred to as "excess inclusion" income. It equals the excess of taxable income for a calendar quarter over the income that would have been earned on the capital invested in the residual interest during that quarter if

[20] Specifically, excess inclusion income (defined below in the text) is UBTI in the hands of a tax-exempt entity, may not be offset with losses (a taxpayer's taxable income cannot be less than his excess inclusion income), and, in the case of a foreign investor, is not eligible for any statutory or treaty exemption from withholding tax. Also, residual interests cannot be transferred to (nontaxable) governments or to bankrupt entities.

it had earned a yield of 120 percent of the long-term Federal rate. Excess inclusions are intended to be a proxy for phantom income.

The 1986 legislation did not allow the issuance of regular interest classes with "disproportionately high" interest (i.e., an issue price significantly exceeding the principal amount). This ban was lifted in 1988 through an amendment to the statutory definition of regular interest (section 860G(a)(1)) that allowed regular interest classes to pay interest equal to a "specified portion" of the interest payments on qualified mortgages. Classes of this type need not have any actual principal amount and are often issued as interest strips.

The REMIC rules are elective. In order to prevent the avoidance of tax on phantom income through the use of non-REMIC structures owned by non-taxpaying entities, the 1986 legislation also added the TMP rules in section 7701(i). The section became effective only in 1992 to give time to determine the viability of REMICs. Section 7701(i) defines a TMP and treats it as a corporation that cannot join in a consolidated return. Thus, a TMP is generally subject to a corporate income tax and that tax cannot be offset in consolidation with unrelated losses or credits.

Section 7701(i) defines a TMP as an entity or portion of an entity that meets three tests: substantially all of its assets are debt obligations and a majority of those are real property mortgages (the "Asset Test"); the entity issues debt with multiple maturities (the "Maturities Test"); and payments on the debt issued by the entity bear a relationship to payments on debt held by the entity (the "Relationship Test"). The idea behind this definition is to identify the key features of a traditional pre-REMIC CMO structure in which principal receipts would be passed through as principal payments on debt and there would be phantom income because of the existence of fast-pay and slow-pay classes.[21]

One practical effect of the TMP rules is to deny the benefits of the more lenient check-the-box entity classification rules that became effective in 1997 in the case of mortgage securitizations with fast-pay, slow-pay features. Specifically, if an investment trust fails to be classified as a trust under the Sears regulations because it has multiple classes, then the normal consequence under the check-the-box regime is to treat the trust as a partnership (assuming no contrary election). However, if the trust holds mortgages and has debt or equity classes with multiple maturities, the alternative to trust classification is usually treatment as a corporation under the TMP rules.[22]

When the TMP rules were enacted, it was not known whether the REMIC regime would prove attractive to market participants. At present, REMICs are well established as the vehicle of choice for mortgage securitizations.

The 1986 legislation also enacted section 1272(a)(6), which requires the use of a prepayment assumption in calculating accruals of original issue discount on certain categories of debt (a shorter term results in faster recovery of discount) and also provides a mechanism to adjust for differences between actual and anticipated prepayments. This section applies to (1)

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21 The 1986 legislative history indicates that Congress had in mind owner trusts that were issuers of CMOs. Thus, after describing the definition of a TMP, the conference report indicates in a footnote that "certain arrangements that are commonly known as 'Owner's Trusts' would be treated as TMPs under the bill." See House Report No. 99-841, 99th Cong. 2d. Sess. ("1986 Conference Report"), II-226, footnote 25.

22 Trust equity classes that resemble debt may be treated as debt classes for purposes of the Maturities Test. See section 7701(i)(2)(D) and Treasury Regulation § 301.7701(i)-1(g)(1). As a result, a trust that holds mortgages and issues pass-through certificates with multiple maturities can potentially be classified as a TMP. However, an investment trust that has no power to vary and is classified as a trust (because it has only one ownership class or falls within an exception to the Sears regulations) is never treated as a TMP. See Treasury Regulation § 301.7701(i)-1(g)(2).

any regular interest in a REMIC or qualified mortgage held by a REMIC, (2) any other debt instrument (such as a non-REMIC CMO) if payments under such debt instrument may be accelerated by reason of prepayments of other obligations securing such debt instrument, and (3) as a result of a 1997 amendment, any pool of debt instruments if the yield on the pool may be affected by prepayments (this last change was aimed at pools of credit card receivables that have a higher yield if not prepaid). The automatic application of the section to REMIC regular interests reflects the understanding of Congress that REMICs would always have pay-through features, as indeed they do.

4. Credit Card Structures (Revolving Pools)

In addition to mortgages, another asset class that has figured prominently in securitizations is credit card receivables.[23] They are relatively short term and accordingly cannot be readily financed through fixed-pool securitizations. The most widely-used structure has been one in which a trust purchases receivables relating to designated accounts and finances them through the issuance of trust certificates. The trust reinvests cash receipts in new receivables during a specified period (a "revolving period"), after which principal receipts are applied to amortize trust classes. If certain financial tests are failed, or there is a failure to reinvest principal receipts in new receivables, the revolving period ends prematurely and principal is paid through to investors as quickly as possible. Trust certificate classes purchased by investors may receive credit support in various forms. These may include subordination of the sponsor's right to excess spread (interest earned on receivables at a rate higher than the trust certificate rate) and

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23 The discussion here focuses on credit card receivables as an ABS asset class because credit card securitizations are the paradigm example of the type of revolving pool structure that was supposed to benefit from the FASIT rules. There are, of course, other significant ABS asset classes in addition to mortgages and credit card receivables.

subordination of some trust classes issued to investors of other classes. The trust sponsor or an affiliate services the receivables and retains a limited right to modify them (for example, by changing interest rates).

Credit card trusts are generally "master trusts" that receive assignments of groups of credit card receivables (potentially all of the receivables owned by the sponsor of a certain type) and contemplate repeated issuances of trust classes over time, including issuances of new classes to refinance maturing classes. All trust classes are backed by all trust assets, so that there is a blending of credits between new and old classes.

Traditionally, trust classes have been issued in the form of certificates of beneficial interest (equity) in order to achieve a financial accounting advantage.[24] (The accounting rules have changed in the last few years as discussed below.) For tax purposes, however, trust classes have generally been treated by the parties as debt of the issuing trust (or of the party owning the residual interest in the trust). Trust certificates that are intended to be debt for tax purposes will be referred to herein as "pass-through debt certificates." Trust documents require consistent treatment of such certificates as debt for tax purposes by the issuer and holders.

The debt characterization of pass-through debt certificates is based on their traditional debt-like payment characteristics (fixed principal amount payable on or before a specified date and interest thereon at a fixed rate or at a floating rate based on an index) and the absence of other equity features (no participation in earnings or management rights, not held pro rata with sponsor). Further, unlike the pass-through certificates issued by a fixed investment

24 The advantage was the ability to treat the issuance of trust classes as a partial sale of receivables for accounting purposes rather than ownership of the receivables and the issuance of debt.

trust, there is not a close match between trust assets and the trust certificate classes sold to investors, either individually or as a group. Indeed, the revolving feature ensures that any given trust certificate class will continue to exist as underlying receivables are generated and repaid. The sponsor maintains control over the receivables and is responsible for taking actions to continue to generate new receivables over time. A proposed revenue ruling reflecting the terms of a typical credit card trust is set out in Annex B.

Although pass-through debt certificates are debt in economic substance, in form they are equity interests in a trust. One issue faced by tax advisors is whether the ability to treat such certificates as debt would be jeopardized by the *Danielson* doctrine (in short, taxpayers are sometimes stuck with the form of transactions they enter into). The consensus view is "no." All parties agree to act consistently to treat the certificates as debt for tax purposes, so the policy concerns underpinning *Danielson*—upsetting a bargained-for result and whipsaw of the government—are not present. Also, the form is at best ambiguous. The argument is set out in greater detail in Part IV.H, below.

Despite the strength of the arguments in favor of debt treatment, the lack of guidance on the issue combined with the potentially serious consequences of being wrong (see discussion below) has led a number of tax advisors to be more cautious in characterizing trust classes than would have been the case had those classes been cast in the form of debt. Specifically, a practice has developed of limiting "clean" tax opinions relating to the status of pass-through debt certificates as debt to classes with a low default risk (as evidenced, for example, by a rating of single A or better). This cut-off line is drawn far higher than it would be for instruments cast in the form of debt.

Caution is particularly advisable when the stakes are high. For a credit card trust, the consequences of treating a class of pass-through debt certificates as equity could be quite severe. They relate principally to entity classification and the tax treatment of foreign investors.[25]

Regarding entity classification, a credit card trust would have a power to vary and accordingly would not be classified as a trust for tax purposes. If it issued a class of pass-through debt certificates that were treated as equity, the trust might be classified as a corporation either (1) for periods before 1997, under the general Treasury entity classification regulations[26] or (2) under section 7704 (rules for publicly traded partnerships or "PTPs") if the equity class is publicly traded and interest earned on credit card receivables is considered to be derived from a financial business within the meaning of section 7704(d)(2)(A). Whether a credit card trust is property treated as engaging in a financial business is discussed further below in Part IV.F. There is no specific guidance on point.

Turning to foreign investors, if a non-U.S. investor purchased a class of pass-through debt certificates that were recharacterized as equity, the trust could be required to withhold tax with respect to income allocated to that investor, either at a rate of 30 percent under section 1441 or 1442 if the trust is not engaged in a trade or business and no treaty exemption

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25 Equity treatment for a class of pass-through debt certificates also could transform income on that class received by a tax-exempt entity into UBTI. This treatment would not, however, expose the trust itself to tax liability.

26 For periods before 1997, a trust with associates and a business objective was classified as an association if it possessed three or more of the following corporate factors: limited liability, centralized management, free transferability of interests and continuity of life. These factors were tested based on the characteristics of the entity's equity interests. As a result, the transformation of a class into equity could adversely affect classification (e.g., if a class of transferable certificates were recast as equity, the entity could possess free transferability of interests).

applies, or, if the trust is engaged in a trade or business, on ECI under section 1446. Again there is no guidance on whether a credit card trust would be considered to be engaged in a trade or business for this purpose. The 30 percent withholding tax and the tax on ECI are discussed further in Parts IV.D and IV.G, below.

The adverse consequences of recharacterizing a class of certificates as equity could be avoided by restricting trading and limiting the number of holders (so that there is no public trading) and prohibiting ownership by foreign persons. Restrictions of this type limit marketability and liquidity and must be paid for by offering a higher yield to investors. They are also burdensome to administer.

5. FASITs

The desire to avoid transfer restrictions and gain certainty regarding the tax status of freely transferable classes of pass-through debt certificates led sponsors of credit card trusts down the path to Congress in the early 1990s in search of a set of statutory debt-equity rules akin to those available to REMICs. The nut proved harder to crack than for REMICs because of the need to accommodate changes in pool assets—the revolving pool feature—and the changes in pool liabilities that are a common feature of master trusts. Tax policymakers harbored fears that a statutory debt safe harbor could be used inappropriately to allow income from an active business to be transformed into deductible interest that did not bear a corporate tax. A fixed investment trust holding mortgages (the model for REMICs) did not raise the same concerns.[27]

[27] The government chose in the Sears regulations to treat fixed investment trusts with multiple classes as business entities to avoid problems with allocating income among investors under the grantor trust rules, not because the trust was conducting an active business. The policy problems raised by the existence of multiple classes could be addressed simply by establishing a set of clear rules for allocating income among classes.

The sought-after regime was finally enacted in 1996 (as part of the Small Business Job Protection Act of 1996 or "SBJPA 1996"), in the form of the FASIT rules. A comprehensive description of those rules may be found in an earlier Tax Section report.[28] The basic tax model for a FASIT is a nonrecourse borrowing by a C corporation. However, unlike the pledge of assets to secure a conventional borrowing, the transfer of assets to a FASIT triggers the recognition of gain. A FASIT can have one or more classes of regular interests (including high-yield interests described below) that are taxed as debt. It also must have a single class of ownership interests that is owned at all times by one taxable C corporation. FASIT assets and liabilities are deemed assets and liabilities of that corporation. The corporation is allocated the taxable income of the FASIT (gross income from assets less interest on regular interests and other expenses) and cannot offset such income with unrelated losses.

A FASIT is allowed to hold revolving pools of assets and can issue regular interests over time. Concerns about overactivity were addressed by (1) requiring the ownership interest to be held by a taxable C corporation, (2) designating certain classes of regular interests as "high-yield interests" and also requiring them to be held by taxable C corporations, and (3) prohibiting a FASIT from "originating" loans. Also, FASITs can hold only noncontingent debt instruments and related assets and cannot trade their assets or earn services income.

Effectively, the transfer restrictions that sponsors sought to avoid were still there, but the dividing line was now based on whether an interest was a "high-yield interest." An interest meets the definition of high-yield interest if, among other factors, it has a yield on issuance of at least 500 basis points over the AFR. The definition also includes an interest with a

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28 See New York State Bar Association ("NYSBA") Tax Section, "Report on Suggested FASIT Regulations" (February 7, 1997), 97 *Tax Notes Today* 28-27 (February 11, 1997). See also Peaslee & Nirenberg, Chapter 16.

high *coupon* (regardless of its yield), so that the transfer restrictions apply to all interest strip classes.

Part IV.B, below, discusses in more detail the main drawbacks of the FASIT rules that have made them unworkable (interpretation risk, up-front gain recognition, and definition of high-yield interests).

In a credit card securitization (unlike most fixed pool securitizations), the sponsor retains the primary residual economic risks and benefits of the receivables. Economically, the transaction is more like a borrowing than a sale of a partial interest in receivables. The primary motive for the securitization is to achieve an accounting benefit. This fact was well know to Congress in evaluating the FASIT legislation. The legislative history of SBJPA 1996 makes it clear that Congress intended to foster securitizations that would allow sponsors to achieve accounting benefits without adverse tax consequences:

> The [Senate Finance] Committee understood that it is difficult to securitize revolving debt (such as credit card receivables) under present law without the imposition of a corporate tax if the sponsor of the securitization does not want to report the securitized assets and the interests therein on his financial reports. Accordingly, the Committee bill would create a new type of entity, known as a [FASIT], through which securitizations of all types of debt, including revolving credit debt, can be accomplished without the imposition of a corporate tax even though the securitized debt and the interests in the securitized debt are not reported on the financial statements of the securitization's sponsor.[29]

The FASIT legislation was enacted in 1996, but the effective date was delayed until September 1, 1997 to give the government time to issue implementing regulations. Proposed FASIT regulations were issued in February 2000. The Tax Section submitted a report that was critical of the proposed regulations and suggested substantial revisions.[30] The

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29 Sen. Rep. 104-281, 104^{th} Cong. 2d Sess.,140.

30 See NYSBA Tax Section, "Report on Proposed Regulations Relating to Financial Asset Securitization Investment Trusts" (May 5, 2000), reprinted in 2000 *Tax Notes Today* 93-17 (May

regulatory guidance plan for 2000 indicated that substantial work would be done on final FASIT regulations during 2000 with a view to completion in 2001. The plan for the period through June 30, 2002 made no mention of FASITs, however, and they are not included in the current plan for the year ending June 2003. We understand the project is no longer active.

6. Changes in Accounting Standards

At about the same time as the FASIT legislation was enacted, there was a change in financial accounting standards that for new issuers has largely eliminated the need to issue trust certificates in the form of equity. In June 1996, the Financial Accounting Standards Board (the "FASB") adopted Statement of Financial Accounting Standards 125 (since replaced with Statement 140). This statement sets out tests for determining when a transfer of financial assets will be considered a sale under generally accepted accounting principles ("GAAP"). Generally a sale requires, among other things, that the transferee have the power to dispose of the transferred assets. An exception was created for transfers to a passive entity referred to as a "qualifying special purpose entity" or "QSPE." For those assets, the requirement that the transferee be able to assign its interests is applied to the interests in the QSPE (whether equity or debt) rather than at the level of the assets transferred to the QSPE; effectively, the QSPE interests are considered to represent the financial assets. A QSPE may hold only financial assets that are "passive in nature" and certain "passive derivative financial instruments." To achieve the requisite passivity, the QSPE cannot be involved in making decisions other than "the decisions inherent in servicing." Additional restrictions bar a QSPE from selling or disposing of financial assets except automatically and in response to certain specified conditions. Permitted activities must be

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12, 2000) ("NYSBA FASIT Regulations Report"). For another critical analysis of the proposed regulations, see Peaslee & Nirenberg, Chapter 16.

spelled out in advance in the governing documents for a QSPE. The term "brain dead" is often used by accountants in describing QSPEs.

Aside from its significance in testing transfers, the status of an entity as a QSPE is also relevant in applying GAAP consolidation rules. A transferor of assets to a QSPE is *not* required to include the assets and liabilities of the QSPE in the transferor's consolidated financial statements even if the transferor owns a majority (or all) of the QSPE's equity interests. As a result, under current GAAP standards, if a sponsor transfers receivables to a trust that is a QSPE and the trust issues debt to investors (that is, notes or bonds, not pass-through certificates), the debt generally can be excluded from the transferor's financial statements. Specifically, although the trust's assets and debt would be shown on separate financial statements of the trust, the trust as a QSPE would not be consolidated with the sponsor. Credit card trusts provide for the reinvestment of cash receipts in new credit card receivables, but do not allow the trustee discretion in disposing of assets or making investment decisions. They can be, and typically are, structured to be QSPEs.[31]

Despite the change in accounting standards, master trusts formed before the effective date of the QSPE rules typically cannot contractually issue debt and will continue to issue pass-through debt certificates. Those trusts may continue in existence for an indefinite period.[32]

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31 For a discussion of Statement 140 and QSPEs, see Marty Rosenblatt, Jim Johnson, and Jim Mountain, *Securitization Accounting under FASB 140* (2d Ed., January 2002, Deloitte and Touche). Bank sponsors of credit card trusts are concerned not only about financial statements but also about regulatory capital standards. However, the relevant bank standards have now been conformed to GAAP.

32 Some trusts that are prohibited from issuing debt directly have done so indirectly by issuing pass-through certificates to a second entity that in turn issues notes backed by those equity interests.

In June 2002, in response to Enron-inspired concerns over possible abuses involving special purpose entities, the FASB issued an exposure draft of an interpretation of GAAP consolidation standards that would greatly expand the circumstances in which a special purpose entity must be consolidated with parties benefiting from it. The abuses involved entities that were more active than QSPEs and the exposure draft would not change the current nonconsolidated treatment of QSPEs.[33]

III. Summary of Recommendations

This Part III summarizes our recommendations, which are then discussed in detail in later sections. The recommendations fall into four groups: those that can be viewed as an alternative to FASITs (including a change in the REMIC regulations to allow REMICs greater flexibility in servicing loans); other proposed changes in the REMIC regulations; changes in the regulations defining a TMP; and a fourth set of proposed changes not relating to FASITs, REMICs or TMPs. In our view, if the first set of recommendations were implemented, the goals of the FASIT legislation would be adequately addressed, and the FASIT rules could be, and should be, repealed. The changes in REMIC rules are mostly intended to accommodate changes in practices since the REMIC regulations were issued in 1992, including in particular the greater use of REMICs to securitize large commercial loans. The general goal of the TMP changes is to better tailor the definition of a TMP to cases in which taxpayers have a REMIC alternative. The last topic relates to information reporting by U.S. persons holding interests in a fixed investment trust that is a foreign trust for tax purposes.

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33 See Financial Accounting Standards Board, *Exposure Draft, Proposed Interpretation, Consolidation of Certain Special-Purpose Entities, an Interpretation of ARB No. 51*, June 28, 2002, paragraph 8(a).

A. FASIT-Related Changes

1. Clarify that a securitization vehicle classified as a partnership can pass through income on interest-bearing receivables to foreign portfolio investors holding partnership equity interests without a withholding tax. The recommendation has three parts. First, clarify the regulations defining a registration-required obligation for TEFRA registration purposes so that a pass-through certificate representing an interest in a pool of receivables would be a registration-required obligation even if the issuer were classified as a partnership. The change would ensure that the TEFRA registration requirements that must be met for the portfolio interest exception to apply are satisfied if the certificate meets those requirements even if the underlying receivables do not. (This rule would be helpful not only in revolving pool structures but also in fixed pool securitizations that are treated as partnerships under the Sears regulations.) Second, clarify that if a securitization partnership receives interest income and allocates it to a foreign partner, that income will not fail to qualify for an exemption from withholding tax because it is paid out in the form of a guaranteed payment. Finally, clarify that foreign portfolio investors holding equity in a securitization vehicle T that receives interest income on a loan to company X will not lose the benefit of the portfolio interest exemption because of equity interests in X held by other persons holding equity in T under a rule that attributes to partnerships (but not to other partners) property owned by a partner.

2. Clarify that income from an interest rate swap or other notional principal contract entered into by a securitization vehicle will have a source outside of the United States if the income is allocated to a foreign investor even if the securitization vehicle is classified as a partnership, provided the securitization vehicle is not engaged in a U.S. trade or business.

3 Issue a revenue ruling clarifying that a typical credit card trust will not be considered to be engaged in a financial business within the meaning of section 7704(d)(2) so that interest received on credit card receivables is regarded as qualifying income for purposes of the section 7704 passive income test.

4. Issue a revenue ruling clarifying that a foreign person owning an equity interest in a credit card trust classified as a partnership will not be considered to be engaged in a trade or business within the United States within the meaning of section 864 by virtue of the activities of the trust. The ruling would be based on all facts and circumstances and on the securities trading safe-harbor rule in section 864(b)(2).

5. Issue a revenue ruling confirming that a class of beneficial interests issued by a credit card trust will be classified as debt if the interests have the economic and legal characteristics of debt (aside from the label) and the governing agreements require the issuer and holders to treat the class as debt for tax purposes. Again, the ruling would be based on all facts and circumstances set forth in the ruling.

6. Adopt a regulation under section 860G providing that a qualified mortgage held by a REMIC will not cease to be a qualified mortgage because the mortgage is modified, provided that the modification does not extend the term of the mortgage or increase its outstanding principal balance.

7. Adopt a parallel change in Treasury Regulation § 301.7701-4(c) that would permit an investment trust to have the power to consent to the same types of modifications to a real property mortgage without violating the power-to-vary test.

B. Other Changes in REMIC Regulations

8. Clarify the REMIC regulation relating to releases of real property collateral for a qualified mortgage to provide that a release will cause a loan to cease to be a qualified mortgage only if following the release the loan is no longer principally secured by an interest in real property.

9. Clarify the REMIC regulation defining a qualified mortgage to allow construction loans to be qualified mortgages.

10. Reduce the need to create multiple-tier REMIC structures by changing the definition of specified portion.

11. Clarify the funds-available cap rule to allow caps on specified portion classes. This change would reduce the need to create interest rate swaps or caps outside of a REMIC to accommodate basis risk.

12. Clarify the improper knowledge test that limits when property acquired on foreclosure of a mortgage can be "foreclosure property."

13. Clarify that a REMIC can hold a qualified mortgage that is integrated with a hedge and treated as a single indebtedness for general tax purposes.

14. Clarify that income earned on funds held pending the purchase of qualified mortgages within the 3-month period ending on the startup day is not subject to the 100 percent prohibited transactions tax.

C. Changes Relating to TMPs

15. Change the TMP regulations to narrow or clarify the definition of a TMP in four ways: provide that an asset is a real estate mortgage for purposes of the TMP Asset Test (described in Part II.C.3, above) only if it is a qualified mortgage that can be held by a REMIC

(subject to an anti-abuse exception); clarify that debt backed by revolving pools of loans does not meet the TMP Relationship Test; clarify that an entity does not meet the TMP Maturities Test if all debt of the entity is short term; and clarify that debt does not meet the Relationship Test if it provides for payments according to a fixed schedule.

D. Other Changes

16. Provide that new information reporting rules for widely held fixed investment trusts ("WHFITs") supersede reporting under section 6048 by U.S. persons holding interests in foreign trusts where the WHFIT reporting rules apply. Require a foreign trust to be subject to the WHFIT rules if it has as a trustee a domestic bank or U.S. government-owned or -sponsored agency, and allow a foreign trust to elect to be subject to those rules if it designates such a bank or agency as a person responsible for information reporting. Limit the scope of reporting under section 6048 for holders of interests in foreign investment trusts that are not U.S. controlled to better conform the reporting for such trusts and for foreign partnerships.

IV. Discussion of FASIT-Related Changes

A. Alternative Approaches

The technical problems that led credit card sponsors to seek the FASIT legislation are summarized in Part II, above, and then considered further in our recommendations below. Those problems are real and, FASITs to one side, have not been addressed. For the reasons summarized below, the current FASIT regime does not work. Its shortcomings are sufficiently great that with very few exceptions, FASITs are not being used.[34] The statute was created with credit card securitizations in mind, but to our knowledge no credit card trust sponsor has made a FASIT election.

[34] The primary use of the statute at the moment seems to be in cross-border transactions of the type described in footnote 7, above.

There are three basic approaches that could be taken to address some of the problems with the current non-FASIT tax rules governing revolving pool securitizations. One is to preserve the status quo (in other words, do nothing). A second approach is to try to fix FASITs through the adoption of regulations and changes in the FASIT statute (we do not think regulations would be enough). The third alternative is to adopt a group of technical changes that would address some of the main concerns that led to enactment of the FASIT rules. For the reasons given below, we favor the last approach.

The securitization markets would survive under the do-nothing approach. That is the situation today. We believe, however, there is a legitimate government interest in getting the rules right and clarifying tax results in important commercial areas, at least where the appropriate steps can be taken without undue use of government resources. One consequence of present law uncertainty is to limit free transferability of certain classes of securities backed by revolving pools. Securities that cannot be freely transferred are less desirable and more costly to issue. If the limits exist solely on account of tax concerns—which is often the case today—then the tax system is imposing real economic costs. We believe strong arguments can be made that those costs are unnecessary because the underlying tax problems can readily be fixed. There is recent precedent for the government taking action to address difficult debt-equity issues in the securitization area in the form of a notice addressing the financing of transition costs by investor-owned public utilities.[35]

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35 Revenue Procedure 2002-49, 2002-29 I.R.B. 172 (June 28, 2002), holds that nonrecourse debt issued by a special purpose entity owned by a utility and backed by ownership interests in rights to transition cost revenues (revenues collected under transition legislation and pursuant to the order of a regulator to compensate for costs that are left unrecovered upon conversion to a competitive market for power) will be recognized to be debt for tax purposes if certain conditions are met. One important consequence of debt treatment is that the utility avoids accelerating income through a sale of the revenue stream. Debt treatment is available even though: (1) the utility is not required to do anything to generate the revenues (they will be collected regardless of

Assuming a proactive approach, we do not favor an attempt to fix the FASIT rules. We are not optimistic that a resolution will ever be achieved that is satisfactory for both the government and taxpayers. The statute ended up as it did because of tension between, on the one hand, the desire of the sponsors for a safe-harbor debt rule combined with flexibility and, on the other hand, the desire of tax policymakers to ensure that the statute not be used improperly to reduce the corporate tax base.

The sponsors wanted a FASIT to be able to hold revolving pools of debt instruments and to issue debt or other securities repeatedly over time to finance its assets. Described that broadly, a FASIT has the potential to function as a bank or finance company, and income of such a company is generally supposed to bear a corporate tax. While banks and finance companies are of course allowed to deduct interest expense, they are subject to the same general tax law principles as other taxpayers for determining whether the securities they issue are really debt. It is quite difficult to draft a set of rules that will provide *certain* debt treatment for interests in a flexible securitization vehicle without either drawing the line so conservatively that the certainty provided by the statute is unnecessary (adds no material protection beyond what already exists under general tax principles) or raising legitimate policy concerns about leakage out of the corporate tax system of profits that should bear the corporate tax. Also, as a practical matter, statutory changes will never be made without active support from private sector sponsors

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who generates the power), (2) there is an absolute transfer of the right to the revenues (i.e., a full assignment of a property right, not a mere pledge) to a special purpose financing entity, and (3) the equity interest in the receivables retained by the utility sponsor is as low as one-half of one percent (i.e., there is a debt-to-equity ratio of 199 to 1). The securities to be issued are described as "bonds, notes, certificates of participation or beneficial interests or other evidences of indebtedness."

of securitizations, and FASITs have acquired such a bad reputation that any effort to revive them (as such) is unlikely to garner much support.[36]

By contrast, we are optimistic that the main concerns that led taxpayers to want the FASIT statute can be addressed through narrow technical changes in the law, specifically through rulings and regulations and not legislation. The changes we suggest are fairly easy to evaluate and implement. They do not involve the creation of a debt safe-harbor rule. The ultimate judgment on debt/equity questions would still need to be based on general tax law principles. Thus, the government need not fear that a safe-harbor rule could be taken out of context and misapplied. Further, while we believe our proposals are all worthy of serious consideration, they could be implemented separately or at different times and each would do some good on its own.

The next section, Part IV.B, summarizes the main drawbacks of the FASIT statute. Part IV.C then discusses the common goals of the proposals for FASIT-related changes, which are described in detail in Parts IV.D through IV.J.

B. Drawbacks of FASIT Statute

The premise of this report is that the FASIT regime is seriously flawed. This section outlines the main problem areas. They relate to interpretation risk and a number of

[36] Another possible issue is whether a FASIT rescue bill would be regarded as a revenue loser. The FASIT legislation was scored as a revenue raiser because of the up-front gain feature, and indeed was included in SBJPA 1996 under "Subtitle F—Revenue Offsets." It is difficult to believe, however, that any material revenue is now being raised from FASIT elections because there are virtually none.

features that impose costs on FASIT sponsors (principally the rule requiring up-front gain recognition and limiting ownership of high-yield interests).[37]

1. Interpretation Risk

The FASIT statute developed over a period of time and passed through the hands of a number of drafters. In the process, significant special rules were grafted onto the statute with little guidance as to their intended meaning. For example, section 860L(e)(2)(C) was added to prohibit loans "originated" by a FASIT, but the word, which has no established tax-law meaning, was left undefined both in the statute and in the committee reports. As another example, section 860I(b) treats non-FASIT assets that "support" FASIT interests as FASIT assets. Bringing outside assets in can have a range of consequences, including potential disqualification of an entity as a FASIT. The "support" term is again not defined in the statute, and its meaning is muddy. The FASIT statute was adopted with credit card trusts in mind, but little was done to address technical problems arising from the making of a FASIT election by an existing master trust. The drafters acknowledged the problem by providing a limited transition rule, but it is only a half measure and has not proven to be workable.[38]

Uncertainties in interpreting the statute could potentially be addressed through a comprehensive set of regulations. Indeed, the drafters may have understood that the statute needed work because they delayed the effective date a year to give the IRS the opportunity to issue regulations. The IRS got off to a good start by asking in 1996 for comments on topics to be

37 A more detailed discussion of these topics may be found in the NYSBA Tax Section reports referred to in footnotes 28 and 30, above, and in Peaslee & Nirenberg, Chapter 16.

38 The transition problem is a continuing one for credit card master trusts because once a master trust is formed, it continues to be used for many years and there is no point in time at which there are no trust classes outstanding in the hands of investors.

addressed in FASIT regulations.[39] A number of comments were received, including from the Tax Section.[40] No guidance was forthcoming, however, until February 2000, when a set of proposed regulations were issued. As discussed in our report on the regulations,[41] we believe they were very wide of the mark. They were not comprehensive and included a list of restrictive rules not contemplated by the statute or legislative history. Turning the regulations into a set of comprehensive, workable rules would be a significant undertaking. FASIT regulations are not in the current business plan (through June 2003) and we understand the regulation project is not currently active.

2. Gain Recognition

The FASIT statute requires the holder of the FASIT ownership interest to recognize gain upon the transfer of receivables to the FASIT. Whether or not gain recognition should be required as a policy matter may depend on the type of securitization involved. The FASIT statute is quite broad and can apply to revolving pool structures (such as a credit card trust) and to fixed pools. Where a sponsor issues a security in a revolving pool structure and retains the residual risks and benefits, the sponsor is economically borrowing against assets. Gain recognition is not required when assets are pledged and it seems inappropriate to require current gain recognition merely because debt status is confirmed under a safe-harbor rule. On the other hand, if the pool of receivables is fixed and FASIT securities represent a slice of cash flows from designated assets, it is more plausible to view the issuance of FASIT interests as a partial sale. (This is the rule for REMICs, which must hold a fixed pool.) At any rate, for credit

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[39] See Announcement 96-121, 1996-47 I.R.B. 12.

[40] NYSBA Tax Section, "Report on Suggested FASIT Regulations" (February 7, 1997), 97 *Tax Notes Today* 28-27 (February 11, 1997).

[41] See footnote 30, above.

card sponsors, at least, gain recognition has been considered too high a price to pay to achieve the benefit of the FASIT statute.

With respect to high-yielding asset classes (and particularly long-lived assets), the gain recognition problem is exacerbated by the rule in section 860I(d) requiring gain to be computed using a formula discount rate (120 percent of the AFR) in the case of debt instruments not traded on an established securities market.[42] The formula valuation rule has prevented use of the FASIT statute in commercial mortgage loan securitizations.[43] The FASIT proposed regulations did not accept the recommendation of a number of commentators that the artificial valuation rule be relaxed by broadening the definition of established securities market.

3. Problem with High-yield Interest Definition

The FASIT statute requires regular interests that are high-yield interests to be held by taxable domestic C corporations. Effectively this means that those classes cannot be freely transferred and cannot be purchased by significant groups of investors (for example, foreigners, tax exempts, mutual funds, and hedge funds organized as partnerships). A high-yield interest is generally defined in section 860L(b)(1) as a class of interests having a yield upon issuance equal to or greater than 500 basis points over the AFR. One problem with the formula is that market credit spreads have widened considerably since the date of enactment of the FASIT rules. Thus, the high-yield category is broader now than it was in 1996.[44] Also, for classes that are on the

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42 The rule applies not only to transfers of receivables to a FASIT at inception but also to receivables purchased by a FASIT from third parties. Thus, the holder of the ownership interest can recognize gain where a FASIT buys a receivable from an unrelated third party for cash if the receivable has a market yield exceeding the formula rate.

43 Alternative securitization structures for mortgages (REMICs or grantor trusts) would also result in the recognition of gain but based on market values, not a formula.

44 The Peaslee & Nirenberg letter of June 6, 2001 states that the average credit spread for a single B rated debt instrument was 433 basis points when the FASIT rules were enacted and was closer to 850 basis points at the time of writing of the letter.

borderline, there can be uncertainty up to the last minute regarding whether a class is or is not over the threshold. This uncertainty can pose real problems in marketing. Although the AFR is determined monthly in advance, the yield at which a class is sold depends on market conditions at the time of sale.[45]

The definition of high-yield interest also includes any interest that has an issue price exceeding 125 percent of its stated principal amount. This part of the definition has the effect of treating all interest-only ("IO") classes as high-yield interests. IO classes representing strips of interest taken off of other classes are very often created in commercial mortgage loan securitizations. The inability to create a freely-traded IO class is a significant drawback for this asset class.

C. Rationale for Proposed Changes

As indicated in Part II.B, the key tax goal in any securitization is to ensure that cash flows on receivables can be collected and passed through to investors without an entity-level tax or, in the case of foreign investors, withholding tax. The entity level tax is obviously avoided where investors receive deductible interest. Where they hold equity, the justification for not imposing a corporate tax is that the entity is not sufficiently active to warrant it. In the case of income allocated to foreign investors, the portfolio interest exemption provides the basis for not imposing withholding tax on interest income received from unrelated borrowers. With respect to swap income, the lack of withholding tax is based on a residence-based source rule.

Under current law, a domestic unincorporated securitization vehicle that issues equity securities to investors and does not elect to change its status will not be classified as an

[45] The fact that the test compares current market yields with a benchmark based on the AFR means that the test can become more restrictive in a rising rate environment because increases in market rates will not be immediately reflected in the AFR.

association subject to corporate tax unless it either is a PTP and fails to meet a passive income test or holds primarily mortgages and is a TMP.

Taking our proposals in the order in which they are presented, they would address a number of technical issues that could result in imposition of the 30 percent withholding tax on payments to foreign investors where interest or swap payments are paid through an entity classified as a partnership. The proposals relate to: application of the TEFRA registration rules to partnership interests (which is relevant to the portfolio interest exemption), the treatment of guaranteed payments, and the definition of 10-percent shareholder (which may apply differently to a partnership and grantor trust). A 10-percent shareholder is not eligible for the portfolio interest exemption.

Next, the proposals would clarify a number of points relating specifically to credit card trusts. The guidance would take the form of a revenue ruling. The ruling could be applied by analogy to non-credit card structures but only to the extent the facts are comparable. The ruling would hold that a typical credit card trust is not engaged in a financial business (so that interest it receives can be qualifying income for purposes of the PTP rules) and that income of the trust allocable to a foreign investor is not ECI. The ruling also would clarify that form is not a significant factor in classifying as debt or equity pass-through debt certificates issued by such a trust.

FASITs could have been very useful in securitizing commercial mortgage loans, and in particular in allowing more flexibility than a REMIC or grantor trust in making loan modifications. Broadly speaking, outside of the default area, under current law, a REMIC or grantor trust cannot consent to the modification of a loan if the modification would be regarded as a deemed exchange under section 1001. We recommend a change in the REMIC regulations providing that a qualified mortgage would not become disqualified because of a modification if the modification does not increase the mortgage's principal amount or extend its term. We propose a similar rule for fixed investment trusts taxable as grantor trusts.

D. Portfolio Interest on Obligations Held by a Partnership

1. Consumer Receivables

Generally, interest paid to foreign persons is exempt from U.S. withholding tax if the interest is portfolio interest.[46] To qualify for the exemption, among other requirements, the interest must be "paid on an obligation" which (1) is in "registered form" as defined in Treasury Regulation § 5f.103-1(c), or (2) is not in registered form but meets the "foreign targeting" requirements of section 163(f)(2)(B).[47]

Most consumer loans and receivables are not in registered form and do not meet the foreign targeting requirements.[48] Accordingly, interest on such obligations generally would not qualify as portfolio interest. Where the obligation is held by a grantor trust, however, the portfolio interest exemption may nonetheless be available under Treasury Regulation § 1.871-14(d). This regulation provides in effect that interest paid on a pass-through certificate qualifies as portfolio interest if the certificate itself meets the registration or foreign targeting requirements without regard to whether any obligation held by the related fund or trust meets those requirements. Treasury Regulation § 1.871-14(d) does not define the term "pass through certificate," but it likely has the same meaning as in Temporary Treasury Regulation § 1.163-

46 See sections 871(h)(1) and 881(c)(1).

47 See sections 871(h)(2) and 881(c)(2).

48 Consumer loans are not "registration required obligations" subject to the TEFRA requirements because they are either issued by a natural person or not of a type offered to the public. See section 162(f)(2)(A).

5T(d). This regulation applies the TEFRA registration requirements to pass-through certificates rather than to the underlying trust assets.[49] A pass-through certificate is defined for this purpose as a "pass-through or participation certificate evidencing an interest in a pool of mortgage loans [taxed as a grantor trust] (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust)."[50]

It is not always clear what types of arrangements may qualify as pass-through certificates.[51] However, under a literal reading of the quoted definition, if a certificate issuer were classified as a partnership rather than a grantor trust, interest payments on consumer obligations passed through to its partners may not qualify as portfolio interest.[52]

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49 The regulation was likely inspired by a statement in the legislative history of the Tax Reform Act of 1984. The Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), page 396, footnote 19, states that, "in determining whether an interest in certain intermediate investment entities, such as mortgage pass-through trusts, is registration-required under TEFRA, it is the nature of the interest itself that is relevant; if the interest is liquid and actively traded, it would pose compliance problems were it not registration-required."

50 Treasury Regulation § 1.871-14 is effective January 1, 2001. The prior version of the portfolio interest regulations included an explicit cross-reference to the definition of pass-through certificate in the section 163 regulations. See Treasury Regulation § 35a.9999-5(e), Q&A 21 (in effect before January 1, 2001). Although this cross-reference is not included in the current version of the portfolio interest regulations, the preamble to those regulations indicates that they were not intended to differ substantively from the prior version. See Treasury Decision 8734, 1997-2 C.B. 109, 111.

51 In P.L.R. 9548018 (December 1, 1995), the Service held that interests in a pool of loans that were identified and segregated on the books of the taxpayer (but not placed in a separate trust) could qualify as pass-through certificates for purposes of the portfolio interest rules. The loans were grouped together to create a pool and participants could purchase participations in each pool. The interest and principal payments were essentially passed through based on each participant's participation percentage in the pool. The participation interests were without recourse to the taxpayer. The taxpayer continued as the owner of record and servicer of the loans and was responsible for monitoring the borrower's compliance and effecting available remedies (at the taxpayer's discretion) where there was an event of default. This fact pattern illustrates an arrangement that is a "similar pooled fund," but provides no guidance generally about what arrangements may qualify.

52 The reference to "similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust" is ambiguous in that it is not clear if "treated as a grantor trust" modifies "pooled fund" as well as "pooled trust."

As a policy matter, we see no reason why a sharp distinction should be drawn between interest paid on a pool of receivables held by a partnership and one held through a grantor trust. In either case, interest allocated to an owner should be able to qualify for the portfolio interest exemption if the interest is allocated to an owner whose equity interest is in registered form or foreign targeted.[53] Indeed, partnership interests are subject to more extensive reporting than debt obligations, including a requirement under Temporary Treasury Regulation § 1.6031(c)-1T that nominees holding partnership interests on behalf of a beneficial owner identify the owner to the partnership.

To conform the treatment of partnerships to grantor trusts, we recommend that the definition of pass-through certificate in Temporary Treasury Regulation § 1.163-5T(d) be amended to read as follows:

> A pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under Subpart E of Subchapter J of the Code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar fund or trust holding a pool of mortgage loans or other secured or unsecured debt obligations and related assets, whether or not the composition of the pool may change over time) is considered a 'registration-required obligation' [rest of sentence as in original].

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53 Our proposal would apply the rule where partnership interests are either in registered form or in bearer form but foreign targeted. It is, of course, highly unusual to issue conventional partnership interests in bearer form, but the fact pattern could arise in a securitization setting where a class of securities that are intended to be debt and are foreign targeted are recharacterized as equity. To keep the proposal in context, it would apply only to partnerships consisting of pools of debt instruments and then would be relevant only in applying the TEFRA registration rules and the portfolio interest exemption. It would not otherwise affect partnership reporting obligations. The portfolio interest exemption would be relevant only to partnerships that were earning interest income and were not engaged in a U.S. trade or business (so that such income was not ECI subject to withholding under section 1446). While we believe it would be appropriate for the portfolio interest exemption to apply to income allocated to partnership interests that are foreign targeted and in bearer form as well as to those in registered form, if the IRS disagrees, a rule that applies only to partnership interests in registered form would still be desirable.

This definition differs from the original by deleting the requirement that the similar pooled fund or trust be a grantor trust and clarifying that a trust or pool may have a revolving feature and still be considered similar. The definition also states explicitly that the rule extends to pools of debt obligations other than mortgage loans (a conclusion we believe is implicit in the existing regulation). We also recommend that Treasury Regulation § 1.871-14 be amended to include a cross-reference to the temporary regulation under section 163 (or a successor) for the definition of pass-through certificate. Alternatively, the definition could be inserted directly into Treasury Regulation § 1.871-14.

2. Partnership Guaranteed Payments

Some question exists regarding the application of the portfolio interest exemption with respect to "guaranteed payments" paid by a partnership to a foreign partner. Guaranteed payments are payments to a partner for services or the use of capital, if those payments are not dependent upon the partnership's income.[54] Payments of income on a class of securities issued by a securitization vehicle may be guaranteed payments because, while they are very likely to be paid out of interest income or swap income, there may be no explicit limitation based on the net income of the issuer. This result is particularly likely for a class of securities that is intended to be debt but is recharacterized as equity for tax purposes.

Logically, guaranteed payments made to non-U.S. persons for the use of capital could be treated in one of three ways: as interest paid by the partnership,[55] as a distributive share of partnership ordinary income, or as an item of ordinary income that is neither interest nor a

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54 Section 707(c).

55 See GCM 36702 (April 12, 1976) (guaranteed payments made by a partnership to a real estate investment trust were characterized as interest income).

distributive share of partnership income.[56] The treatment of a payment as a distributive share of income would necessarily be limited to a payment that does not exceed the partnership income available to be allocated to it. A guaranteed payment treated as interest paid by the partnership would be eligible for the portfolio interest exemption so long as the partnership interest was in registered form or was foreign targeted and otherwise met the requirements of the exemption. A distributive share of income would be eligible for the portfolio interest exemption to the extent the underlying income would qualify.[57] Undifferentiated ordinary income could be characterized as U.S. source fixed or determinable annual or periodical ("FDAP") income that would be subject to the 30 percent withholding tax.[58]

The difficulty in characterizing guaranteed payments stems from the statute itself. Section 707(c) states that a guaranteed payment is considered as made to one who is not a member of the partnership, "but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)." This language implies a guaranteed payment could be treated as a distributive share of partnership income except to the extent doing so is inconsistent with treatment of the payment as an item of ordinary income. Regulations under section 707(c) generally confirm this view. They state that guaranteed payments are considered made to a non-partner for purposes of sections 61 and 162. The regulations state that the reference to section 162 does not affect the deductibility of guaranteed payments made to a retiring partner under section 736(a)(2) and such payments are not a profit share for purposes of various subchapter K provisions. "For the

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56 See Sheldon I. Banoff, "Guaranteed Payments for the Use of Capital: Schizophrenia In Subchapter K," 70 *Taxes* 820 (December 1992) (discusses all three possibilities).

57 See the discussion in Part IV.D.1, above, regarding TEFRA registration requirements.

58 Treasury Regulation § 1.1441-2(b) treats all income as FDAP with carve outs not relevant here.

purposes of other provisions of the internal revenue laws" the regulations continue, "guaranteed payments are regarded as a partner's distributive share of ordinary income."

Some authorities relating to guaranteed payments for the use of capital support a look-through approach.[59] On the other hand, the *Miller* case[60] applies an entity theory (characterizing a payment as if made to an non-partner) in determining the source of a guaranteed payment made to a law firm partner for purposes of applying the foreign source earned income exclusion in section 911. The case indicates that the choice between entity treatment and an aggregate approach (looking through to the character of underlying items) may depend on the purpose of the substantive tax provision under consideration. The court examines the purposes of section 911 (promoting foreign trade by removing tax barriers to U.S. citizens working abroad) and concludes that those purposes would be best carried out by applying the exemption to a guaranteed payment made to a partner in the same manner as if he were receiving compensation as an employee.

We believe that look-through treatment is appropriate in applying withholding tax rules to a securitization vehicle that is classified as a partnership. Such a vehicle is largely passive and it does not seem appropriate to impose a withholding tax on payments made to non-U.S. investors where the source of those payments is a type of gross income that is not subject to withholding tax (interest eligible for the portfolio interest exemption and swap income).

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[59] See P.L.R. 8728033 (April 13, 1987) (guaranteed payments made by a partnership to a real estate investment trust retained the character of the partnership's underlying income and were therefore rental income in the hands of the recipient) and P.L.R. 8639035 (June 27, 1986) (same); G.C.M. 34141 (June 25, 1969) (guaranteed payments from royalty income eligible for percentage depletion).

[60] *Andrew O. Miller v. Comm'r*, 52 T.C. 752 (1969). See also *Carey v. United States*, 427 F.2d 763 (Ct. Cl. 1970).

Recently adopted regulations under section 1441 appear to adopt a look-through approach for withholding taxes, but the language is not clear.[61]

A harder case is one in which a guaranteed payment for any taxable year exceeds the ordinary income for that year allocable to the payment. That excess amount must be considered made from partnership capital (including any capital gains allocable to other partners). We believe that in the setting of a securitization vehicle, income from capital that is not paid out of partnership earnings and is effectively guaranteed by the other partners is closely analogous to interest and should be regarded as interest for withholding tax purposes. Adding this second rule would avoid the need to consider closely how ordinary income is allocated among various classes of partnership interests. If, however, the IRS is not willing to take this step, we recommend at least that the status of guaranteed payments be clarified to the extent they are payable out of ordinary income. To implement these proposals, we suggest that a regulation be adopted as follows:

> For purposes of applying sections 871, 881, 1441 and 1442 to a pass-through certificate as defined in section 1.163-5T(d),[62] a payment described in section

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61 When a domestic partnership has foreign partners, the partnership acts as the withholding agent with respect to income it receives that is subject to withholding tax and is allocable to foreign partners. Treasury Regulation § 1.1441-5 lumps together for this purpose guaranteed payments and other distributions of partnership income. In each case, withholding is required to the extent the payments are attributable to partnership items subject to withholding.

> "A U.S. partnership is required to withhold under § 1.1441-1 as a withholding agent on an amount subject to withholding ... that is includible in the gross income of a partner that is a foreign person. Subject to paragraph (b)(2)(v) of this section [withholding not required on distribution if tax was previously withheld], a U.S. partnership shall withhold when any distributions that include amounts subject to withholding (including guaranteed payments made by a U.S. partnership) are made."

62 As discussed in Part IV.D.1, above, the pass-through certificate definition is used in determining when an interest in a pool of debt instruments is treated as a registration required obligation for purposes of the TEFRA registration rules. The cross-reference assumes that this definition has been amended as proposed herein to apply to interests in pools of debt instruments and related assets that are classified as partnerships.

707(c) made to a partner for the use of capital shall be treated as a distributive share of partnership ordinary income to the extent the guaranteed payment is deductible from the partnership ordinary income allocable to other partners, and otherwise shall be treated as interest paid by the partnership.

Any amount treated as interest payable by the partnership would qualify for the portfolio interest exemption only if paid to a person that is not considered to own a 10 percent or greater interest in the partnership's capital or profits.[63]

3. Interest Received by a 10-Percent Shareholder

Sections 871(h)(3)(A) and 881(c)(3)(B) both provide that the portfolio interest exemption does not apply to interest "received" by any "person" who is a "10-percent shareholder." In the case of an obligation issued by a corporation, a 10-percent shareholder is any person who owns 10 percent or more of the total combined voting power of all classes of voting stock of such corporation.[64] With limited exceptions (not relevant to this discussion), the attribution rules of section 318 apply for purposes of determining who is a 10-percent shareholder. Those rules include section 318(a)(3)(A), which attributes stock held by a partner to a partnership.

Withholding with respect to interest paid to a partnership is generally determined by applying the aggregate approach.[65] This is consistent with the literal language of sections 871 and 881, which on their face do not apply to a partnership that receives U.S. source income. Arguably then a partnership should also be treated as an aggregate and not as an entity for purposes of determining which "person" has "received" interest on obligations held by the partnership. However, there appears to be no guidance on point. An entity approach can

63 See sections 871(h)(3) and 881(c)(3)(B).

64 Section 871(h)(3)(B)(i). Similar rules apply to obligations issued by a partnership. See section 871(h)(3)(B)(ii).

65 See Treasury Regulations §§ 1441-5(b) and (c).

produce very harsh results where one partner is a 10-percent shareholder outside of the partnership. Consider the following examples.

> ***Example 1.*** T is a fixed investment trust (taxable as a grantor trust) that has outstanding a single class of pass-through certificates. T owns a portfolio of corporate debt instruments including a bond of a domestic corporation ("X"). One percent of the pass-through certificates are owned by F, a foreign investor. F does not own outside of the trust any interest in X. LB, a leveraged buy-out fund, owns 10 percent of the voting stock of X and also owns one percent of T. The status of F as a 10-percent shareholder is tested at the F level because, under the grantor trust rules, T is effectively ignored for substantive purposes. F is not a 10-percent shareholder of X and (assuming all other requirements are met) can qualify for the portfolio interest exemption with respect to its share of interest received from X.
>
> ***Example 2.*** Same facts as Example 1, except that T has a power to vary its investments and accordingly is classified as a partnership rather than a trust. If the 10-percent shareholder definition is still applied at the F level, then the result would be the same as in Example 1. On the other hand, if the test is applied at the T level, then interest allocated to F would be considered to be received by a 10-percent shareholder because the X shares owned by LB would be attributed to T under section 318(a)(3)(A).

Whether or not an aggregate approach to partnerships is taken generally in applying the 10-percent shareholder definition, we believe that attributing stock owned by one partner to the partnership and applying the 10 percent test at that level conflicts with the principles of section 318(a)(5)(C). This provision states that an entity shall not be considered to own stock attributed to it from an owner for purposes of reattributing that stock to another owner. Something akin to reattribution of stock ownership to F is required to impose withholding tax because the tax depends on F's status as a foreign investor.

Moreover, it appears, based on the legislative history of the portfolio interest exemption, that the Congressional purpose in enacting the 10-percent shareholder limitation was to prevent a borrower from being able to take a deduction for interest that is kept within the borrower's group and not taxed in the hands of the payee.[66] Allowing F the portfolio interest exemption in Example 2 would not frustrate this purpose given that F does not have any economic interest, directly or indirectly, in the X stock.

Accordingly, we ask the IRS to provide guidance (which could be a ruling) clarifying that under the principles of section 318(a)(5)(C) a partnership's constructive ownership of stock from one partner will not be taken into account in determining if the partnership is a 10-percent shareholder for purposes of applying the portfolio interest exemption to another partner.[67]

E. Source of Payments on a Notional Principal Contract

A securitization vehicle often holds, in addition to receivables, interest rate swaps that are used to better match interest receipts with payments due to investors.[68] In the event a foreign investor is considered to hold equity in a securitization vehicle that is classified as a domestic partnership, a question arises as to the source of swap payments allocated to the investor.

Payments on notional principal contracts are considered to be FDAP income (the type subject to withholding tax), but are generally sourced based on the residence of the payee as

66 Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* at 393-394.

67 We are not arguing that an aggregate approach should always be used in applying the 10-percent shareholder test to partnerships. For example, suppose F owns a 1 percent interest in a partnership that owns X bonds. The partnership also owns, alternatively, 10 percent or 100 percent of the voting stock of X. In either case, F would own on an aggregate basis less than 10 percent of the X stock. However, the argument for not treating F as a 10-percent shareholder is less sympathetic on these facts than in a case where F and the partnership own no economic interest in the stock of X.

68 The discussion in this section would apply equally to foreign currency hedges.

determined under section 988(a)(3)(B)(i).[69] Accordingly, payments made to a non-U.S. resident are not subject to U.S. withholding tax.[70]

The analysis becomes somewhat more complex where a non-U.S. person is a partner in a domestic partnership. Under section 988(a)(3)(B)(i), the residence of a domestic partnership is generally the United States, except that, to the extent provided in regulations, the determination of residence may be made at the partner level. Aside from an anti-abuse rule, the only regulation under this grant of authority is Treasury Regulation § 1.988-4(d)(3), which states that the determination of residence shall be made at the partner level "in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2)." Section 864(b)(2) provides a safe harbor rule under which a foreign person who is not a dealer will not be considered engaged in a U.S. trade or business because it trades in stocks, securities (broadly any debt instrument) or commodities for its own account or through an independent agent.

To recapitulate, a foreign partner in a domestic partnership that owns receivables and receives swap payments would be considered to derive foreign source income (not subject to withholding tax) from the swap if residence can be tested at the partner level. Residence is tested at the partner level in the case of a partner who is not engaged in a U.S. trade or business by reason of the securities trading safe harbor rules. A foreign partner in an investment partnership would not benefit from this rule if it were read literally because such a partner does not need the

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69 See Treasury Regulation § 1.863-7. This regulation provides that income from a notional principal contract that arises from the conduct of a U.S. trade or business is sourced in the U.S. and considered effectively connected to the trade or business. In such a case, however, the income would be subject to a net income tax and not a withholding tax.

70 See Treasury Regulation § 1.1441-4(a)(3).

protection of the safe harbor to avoid a U.S. business activity. It would be illogical, however, for a wholly passive investment vehicle to be less transparent than a slightly more active vehicle that trades. We believe the regulation should be construed to apply to any partnership holding stocks, securities or commodities and engaging in related activities so long as it is not considered to be engaged in a trade or business within the United States (either under the safe harbor or under general tax principles). The Credit Card Ruling set out in Annex B includes guidance on this point.

F. Definition of a Financial Business Under Section 7704

If a securitization trust that is classified as a partnership has outstanding a class of securities that are publicly traded and are not debt, then the trust will be a PTP. As a PTP, the trust will be classified as a corporation under section 7704 unless it meets a passive income test set forth in section 7704(c). The test requires that at least 90 percent of the PTP's gross income consist of "qualifying income" as defined in section 7704(d). Qualifying income generally includes interest or discount on receivables, and also income from swaps or other hedge instruments. However, under section 7704(d)(2)(A), interest is not qualifying income if it is derived in the conduct of a "financial or insurance business."

Most securitization vehicles are not engaged in any trade or business, much less a financial business. They hold receivables, collect cash payments thereon and distribute cash to investors—all relatively passive functions. However, where a securitization vehicle has revolving features or acquires newly originated receivables (including new credit card receivables generated through purchases or cash advances, or draws under lines of credit), the argument for finding a trade or business is stronger. There may also be a concern that the activities amount to a financial business, given the proximity to loan origination and the fact that credit cards are part of the sponsor's financial business.

As a starting point in evaluating this concern, it is worthwhile to consider the purpose of the qualifying income rule as well as the financial and insurance business exception. The legislative history of section 7704 gives a good summary:

> In general, the purpose of distinguishing between passive-type income and other income is to distinguish those partnerships that are engaged in activities commonly considered as essentially no more than investments, and those activities more typically conducted in corporate form that are in the nature of active business activities. In the former case, the rationale for imposing an additional corporate-level tax on investments in publicly traded partnership form is less compelling, because purchasers of such partnership interests could in most cases independently acquire such investments (or the income has already been subject to corporate-level tax in the case of dividends). Where the activity of the partnership does not fall into the category of generating passive-type income, however, it is less likely that direct interests in the activity would be available to investors; rather, it is more likely that such activities would be conducted in corporate form and would therefore be subject to corporate level tax before profits reached the hands of investors. In the case of other types of activities treated under the provision as giving rise to passive-type income (i.e., those where the provision more broadly defines passive-type income), the rationale relates to the traditional conduct of such activities in partnership form, and the consequent reluctance to impose entity-level tax in such circumstances.[71]

With respect to the financial or insurance business exception, the legislative history continues:

> [I]nterest is not treated as passive-type income if it is derived in the conduct of a financial or insurance business. Thus, for example, interest income from the conduct of a banking business is not treated as passive-type income, as deriving interest is an integral part of the active conduct of the business. Similarly, it is not intended that dividend income derived in the ordinary conduct of a business in which dividend income is an integral part (e.g., a securities broker/dealer) be treated as passive-type income under the provision.[72]

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71 H.R. Rep. No. 100-391, pt 2, at 1068 (1987).

72 Id. Although the legislative history refers to dividends earned by a securities broker/dealer, the statute itself carves out only interest. See section 7704(d)(2).

The legislative history gives two examples of a financial business: banking and acting as a securities broker/dealer. This approach is consistent with a large body of tax law (both cases and Code provisions) developed in other contexts.

In evaluating whether a taxpayer is engaged in a business because of its activities as an owner or seller of debt instruments, the tax law has traditionally distinguished between investors, traders and dealers. An investor seeks income from the holding of assets (mostly from interest in the case of debt instruments), a trader from buying and selling to take advantage of swings in the market, and a dealer from acting as a merchant who earns a mark-up by buying securities in bulk and selling them to customers. Investment activity is not considered a trade or business and hence could not be a financial business. Trading and dealing in securities, on the other hand, are both regarded as business activities. Nevertheless, gains and losses from trading are capital, not ordinary, and trading is clearly not a financial business.[73] The statutory basis for distinguishing a trader from a dealer is that a dealer holds property primarily for sale to its customers, and a trader sells to the market (see section 1221(a)(1)). A dealer maintains contacts with its buyers and actively solicits their business. Customers typically are unrelated parties.

A second type of financial business that involves a customer relationship is a loan origination or financing business. Rather than selling securities to customers, a bank or finance company sells money (loans) to borrowers.[74] In effect, it acquires funds at a lower price by

[73] This point is plainly acknowledged in the regulations issued in 1998 applying the qualifying income test. Treasury Regulation § 1.7704-3(a)(2).

[74] See *Jaeger Auto Finance Co. v. Nelson,* 191 F. Supp. 693, 695 (E.D. Wisconsin 1961) ("It must be noted at the outset that plaintiff is a special type of business corporation; namely, a finance company. The commodity in which plaintiff deals is not machinery, clothing, or food—it is money."); *Security Finance & Loan Co. v. Koehler,* 210 F. Supp. 603, 605 (D.C. Kansas 1962) ("Here the very business of the plaintiff is the borrowing of funds at one interest rate and loaning them at a higher rate. The plaintiff's business is 'buying and selling money.'")

accepting deposits or other borrowings and makes them available at a higher price to a group of borrowers, earning the spread between them. It may then either hold the resulting loans on its books or, more often these days, sell them. In general terms, a bank is always engaged in a financial business and is distinguished from other finance companies because, in addition to making loans, it accepts deposits and is regulated as a bank.[75]

The tax law has recognized in a number of settings that a loan origination business (or a banking business involving the making of loans) is distinct from trading and investing and falls into the category of an active business. Three of these settings are worth mentioning. Section 475 treats a bank or other finance company that originates loans for sale (to anyone) as a securities dealer. It describes such a company in the statute (section 475(c)(1)(A)) as a taxpayer who regularly purchases securities *from customers* in the ordinary course of a trade or business.[76] Second, case law treats loans held by an originating bank or thrift as "notes receivable acquired in the ordinary course of trade or business for services rendered" within the meaning of section 1221(a)(4), and hence as an ordinary asset, on the ground that a loan originator is rendering a service to the borrower by making a loan.[77] In other words, the lender has a fundamentally different relationship with the borrower than an investor who is looking only for interest income. Lastly, special rules in regulations under section 864 apply in determining

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75 See section 581 (which also treats a trust company as a bank).

76 See Treasury Regulation § 1.475(c)-1(c) (describes a taxpayer purchasing securities from customers in the ordinary course of a trade or business as including regularly making loans to customers in the ordinary course of a trade or business).

77 See *Burbank Liquidating Corp. v. Comm'r*, 39 T.C. 999 (1963), modified on other grounds, 335 F.2d 125 (9th Cir. 1964); Revenue Ruling 72-238, 1972-1 C.B. 65. More broadly, section 582(c) treats gains or losses from sales or exchanges of debt instruments by banks and thrift institutions as ordinary items. Cf. *American Express v. United States*, 2001-2 USTC ¶50,575 (Federal Circuit 2001) (credit card fees analogous to commitment fees and not for services).

whether income derived from the "active conduct of a banking, financing, or similar business" is effectively connected with such business.[78] A banking, financing, or similar business is defined to include "[m]aking personal, mortgage, industrial or other loans to the public." The regulation clarifies that a corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation or any other related person is not considered to be engaged in a banking, financing or similar business. Other rules make it clear that a financing business is an active, customer-driven undertaking.[79]

We believe there are two key factors that distinguish the activities of a typical credit card trust from a financing business conducted by a bank or finance company: the lack of a customer base and the lack of discretionary activity.

A key component of any lending business is customers. A bank holds itself out as a merchant of money and other financial services. It advertises its services to the public. It has an extensive infrastructure to address inquiries and process transactions. It has employees and offices and incurs material fixed and variable operating costs other than financing costs. A credit card trust does none of these things. It is invisible to customers and has no element of goodwill. All servicing with respect to the receivables it acquires is undertaken by a servicer for a fee.[80]

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78 See Treasury Regulation § 1.864-4(c)(5).

79 See, for example, (1) rules in sections 542(c)(6) and 542(d) that treat a company that derives most of its income from the active and regular conduct of a lending or finance business as other than a personal holding company and require substantial deductions for expenses among other tests; (2) an exception in section 954(h) from subpart F income for qualified banking or financing income of a controlled foreign corporation that is predominantly engaged in the active and regular conduct of a lending or finance business (including making loans) through transactions with unrelated customers; and (3) Treasury Regulation § 301.7701-2(b)(5), which automatically treats any state-chartered bank as a corporation if any of its deposits are insured under the Federal Deposit Insurance Act or a similar federal statute.

80 The FASIT rules prohibit a FASIT from holding loans it has originated. Proposed FASIT regulations provide that a FASIT can acquire loans under a contract with a loan originator

The vehicle does not have any ability to generate new receivables or accounts. Although the vehicle acquires and funds receivables, in substance it is a captive finance subsidiary that is providing funding to its parent by purchasing receivables from the parent.

Any active business requires the exercise of discretion and business judgment. A credit card trust is largely on autopilot. Although it can reinvest cash flows in new receivables, the ways in which it does so are determined in advance and set out in transaction documents.

The limited scope of the permitted activities of a credit card trust is highlighted by the fact that they generally are structured to qualify as QSPEs for accounting purposes. (QSPEs are described in Part II.6C.6, above.) Although tax law and accounting standards obviously differ in many ways, the QSPE rules represent an attempt to distinguish between a "brain-dead" asset pool and an operating business.[81] The fact that a credit card trust can meet the QSPE tests is powerful evidence that it is not engaged in business activity.

The sponsor of a credit card trust is very likely to be engaged itself in a financial business. One further issue to consider in analyzing a credit card trust is whether the participation in the trust arrangement by the sponsor may taint the trust. Stated differently, even if the trust standing alone is not engaged in a financial business, does the fact that the sponsor is engaged in such a business and is entangled in various ways with the trust cause the trust itself (as a partnership) to be engaged in a financial business?

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without having the originator's activities attributed to it. See Proposed Regulation § 1.860L-1(a)(3).

81 Statement 140 specifically indicates that the activities of a QSPE must be "significantly limited" and that "many kinds of entities are not so limited," citing as examples "any bank, insurance company, pension plan, or investment company," in each case because it has "powers that cannot be sufficiently limited for it to be a qualifying SPE." Paragraphs 35.c, 37.

We believe the answer should be "no." In thinking about this question, it may be helpful to identify two features of a credit card trust that are common to virtually all securitizations and that are not considered to cause a securitization vehicle to be engaged in a business (much less a financial one). The first is that the sponsor sets up the trust in order for the trust to acquire from the sponsor receivables originated in the sponsor's business. Merely buying receivables from an originator does not involve the buyer in the seller's origination activity. Indeed, it is very common these days for loan originators to promptly sell the loans they originate. Origination is a different type of commercial activity from providing the funds needed to hold the resulting loans. The second common feature is that the sponsor of the credit card trust or an affiliate is hired to act as the servicer of the receivables. A securitization vehicle never has its own employees and offices and therefore always hires someone else to administer the receivables it owns for a fee. The basic role of the servicer is to administer the receivables and collect amounts due, and only those activities should be attributed to the receivables owner.[82]

The two main features of a credit card trust that make it seem more active than some other securitization vehicles (for example, traditional fixed investment trusts) are that (1) it uses collections from receivables it owns to buy new ones, at least over some period, and (2) it may be the first person to fund new receivables it acquires. We do not think these features are sufficient to cause attribution to the trust of the customer-based activities of the sponsor. The trust is simply a funding vehicle, and its function and activities are not qualitatively different

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[82] The servicer of a portfolio of credit cards may be given the right to change the rates at which interest is charged on account balances, provided they cannot be lowered below a level providing certain coverage for outstanding pass-through debt certificates and the servicer cannot discriminate between similar accounts held inside and outside of the trust.

with respect to receivables initially acquired, those acquired in the future from the sponsor, and those generated through new purchases or draws by account debtors.

Stepping back and evaluating the arrangement overall, a credit card trust can fairly be described as a captive financing vehicle for the sponsor that allows the sponsor to raise funds while achieving certain accounting benefits. It could be argued that, as a captive finance company, the trust is under the thumb of the sponsor and accordingly the business of the sponsor should be attributed to the trust. We believe there are three answers to this point. First, viewing the trust as a captive finance vehicle argues against finding a financial business. If the trust is considered to be providing funding to the sponsor and not to the individual account debtors, the trust clearly is not engaged in a customer-based business. Stated differently, a person who lends funds to a bank to fund the bank's loan origination business is not thereby engaged in the bank's business. Second, the distinction between the sponsor and the trust has economic and legal significance. The very reason for establishing the trust is to separate trust assets from the sponsor so that they can be accounted for as non-balance sheet assets. The holders of interests in the trust will be repaid solely from trust assets (the receivables and ancillary assets) and not through a general claim on the sponsor and are expected to be insulated from bankruptcy of the sponsor. Finally, there is no general tax principle that attributes to a partnership activities of a partner, even one holding a controlling interest.

Based on the foregoing, we recommend that the IRS issue a revenue ruling that would describe a typical credit card trust and conclude that it is not engaged in a financial business for purposes of section 7704. A draft of a proposed ruling (referred to herein as the Credit Card Ruling) is included in Annex B. (The same ruling covers a number of other points.) We believe that a ruling is an appropriate form of guidance because of the factual nature of the question presented. The ruling, when combined with the reasoning set out therein, will be helpful in addressing the same issues in other types of securitizations, provided, of course, the facts are comparable in all material respects.

Issuing a revenue ruling (or other guidance) to clarify the definition of a financial business would be particularly worthwhile in finally addressing an issue that has simmered for a long time. Other commentators have asked for similar guidance in the past.[83] The preamble to the final section 7704 regulations issued in 1995, responding to various comments concerning the proposed regulations, indicated that the IRS and Treasury were "actively considering guidance on the definition of qualifying income and financial businesses for investment partnerships and other partnerships engaged in various types of securities transactions."[84] The 1997 and 1998 IRS business plans seemed to follow through on the preamble as well as respond to other commentary, listing as an agenda item "guidance under 7704 regarding passive income for purposes of the publicly traded partnership provisions."[85] Treasury Regulation § 1.7704-3, which addressed certain qualifying income issues, was proposed and finalized in 1997 and 1998, respectively, but without any mention of the financial business issue, and subsequent IRS business plans have made no further mention of section 7704. The topic temporarily receded

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83 See letter, dated August 15, 1995, from Michael L. Schler to Commissioner Richardson, 95 *Tax Notes Today* 166-12 (August 24, 1995) (recommends a rule that a securitization trust not be considered to engage in a financial business because of the reinvestment of cash collections in new receivables pursuant to existing contractual commitments), and letter, dated July 31, 1995, from Kenneth G. Whyburn to the Service, 95 *Tax Notes Today* 161-31 (August 17, 1995) (proposes a definition of financial business that carves out a partnership that serves primarily as a financing vehicle for affiliates).

84 1995-2 C.B. 315, 318.

85 1997 Priorities for Tax Regulations and Other Administrative Guidance, Joint Statement by Donald C. Lubick and Margaret M Richardson, reprinted at 97 *Tax Notes Today* 41-1 (28 February 8-97); 1998 Priorities for Tax Regulations and Other Administrative Guidance, Joint Statement by Donald C. Lubick and Charles O. Rossotti, reprinted at 98 *Tax Notes Today* 42-1 (3 March 3-98).

from view in light of the potential availability of the FASIT provisions, enacted in 1996, but has become current again in light of the disuse of that legislation.

G. U.S. Trade or Business, Sections 875 and 1446

Concluding that a credit card trust is not engaged in a financial business is important where such a trust has a class of traded pass-through debt certificates and, contrary to expectations, that class is recharacterized as equity. If the trust is not engaged in a financial business, then it will not be subject to the corporate income tax. However, the trust still would be exposed to a material risk of tax liability under section 1446 if foreign investors are or can become holders of the certificates and trust income allocated to them were considered ECI. (As noted earlier, section 1446 requires a partnership to withhold taxes on ECI allocated to foreign partners.) Addressing the classification of a trust under section 7704 without also considering section 1446 liability would be only a partial solution to the problem of entity level tax liabilities.

Section 875 treats a non-US person who is a member of a partnership as being engaged in any U.S. trade or business in which the partnership is engaged. Thus, if a credit card trust were considered to be engaged in a U.S. trade or business, any foreign holder of a pass-through certificate that is treated as equity would be treated as being engaged in the same trade or business and income related thereto generally would be ECI.[86] Section 1446 imposes on a partnership an obligation to pay withholding tax at the highest marginal tax rate on ECI allocable to foreign partners.

[86] If contrary to our view the trust were considered to be engaged in a trade or business on the ground that it makes loans to the public, then the special rules in Treasury Regulation § 1.864-4(c)(5) for determining ECI from the active conduct of a banking, financing or similar business could be relevant. See footnote 93, below.

The discussion above argues that a typical credit card trust is not engaged in a financial business. Many of the same arguments are also relevant in determining whether such a trust is engaged in a trade or business. The trade or business question is potentially harder, however, because a financial business may imply a greater level of activity than a mere trade or business, and in any event a financial business requires customers, which is not true of every trade or business. For example, the discussion above indicates that trading in securities is a business but not a financial business.[87]

We believe that the Code adds a gloss to the trade or business test in section 864 that leads us to conclude that a credit card trust that is not engaged in a financial business within the meaning of section 7704 also should not be considered to be engaged in a trade or business for purposes of treating income of foreign investors as ECI.

As the discussion above indicates, taxpayers effecting transactions in securities have traditionally been divided into three groups: investors, traders and dealers. Investors are not engaged in a trade or business, but traders and dealers are. Prior to 1966, a foreign taxpayer who owned U.S. securities and periodically changed his portfolio needed to determine under general tax principles whether his activities were only investing or crossed the line and became trading. The distinction was hard to draw in practice. To encourage capital flows into the United States, the Foreign Investors Tax Act of 1966 enacted the safe-harbor trading exemption in section 864(b)(2)(A)(ii). It provides that a foreign taxpayer is not considered to be engaged in a U.S.

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[87] Also, it is clear that a taxpayer need not always hold himself out to others as engaging in a trade or business in order to be so engaged. See *Comm'r v. Groetzinger*, 480 U.S. 23 (1987) (a full-time gambler was engaged in a trade or business even though he did not hold himself out as providing goods or services to others; emphasizes that there is no one universal definition of trade or business and that the issue needs to be resolved in the context of the specific Code provision involved).

trade or business because of trading activities whether or not a U.S. employee or agent has discretion to make decisions in effecting transactions. In effect, the safe harbor moves the line separating taxable activity from non-taxable from (i) a common law trade or business distinction (investing, not a trade or business, compared with trading and dealing, which are trades or businesses) to (ii) an active financial business distinction (investing and trading are nontaxable, dealing is taxable).[88] This is the same distinction found in section 7704. In practice, the safe harbor provides protection not only for active traders, who clearly need its protection, but also for taxpayers engaging in more passive activities that are probably investing but might be trading. They need not worry whether they cross the line.

Regulations under section 864(b) construe the safe harbor rule broadly to cover "effecting transactions" in stocks or securities (including any evidence of indebtedness) and other closely related activities, including entering into contracts to buy debt instruments, borrowing to finance securities positions, and entering into interest rate swaps or other hedges.[89] This language covers all types of buying and selling activity (both investing and trading), reflecting the purpose of the statute to eliminate the distinctions of prior law. However, if a taxpayer is a securities dealer anywhere in the world, the rule does not apply.

A securitization vehicle that simply holds a fixed pool of receivables would not be engaged in a trade or business of any kind. While a credit card trust is more active, we believe

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88 As originally enacted, the securities trading safe harbor did not apply to a corporation (with an exception for certain closely held corporations) the principal business of which was trading in stocks or securities for its own account if its principal office was in the United States. The principal office requirement was repealed in 1997.

89 Treasury Regulation § 1.864-2(c)(2)(i). Proposed Treasury Regulation § 1.864(b)-1 clarifies that the safe harbor rule also covers trading in derivatives. Prior to the issuance of this regulation, interest rate swaps entered into as a hedge could also qualify under the safe harbor as a closely related activity.

that it nevertheless is too passive to be engaged in a trade or business of any kind. If the issue were decided under general tax principles, however, the issue would be somewhat cloudy: an argument could be made that a credit card trust is engaged in a trade or business, given that it acquires new receivables over time and finances them with debt. *If* these activities constitute a trade or business, it consists of effecting transactions in receivables and closely related activities, and should fall within the safe harbor rule.

One response to this argument is that a securitization vehicle is simply not a trading vehicle and not what Congress had in mind in enacting the safe harbor. A credit card trust earns income from interest and not from selling positions at a profit. We agree that a credit card trust is not a traditional trading vehicle. It is more of an investor than a trader. However, if its activity in turning over pools of receivables crosses the line and becomes a business activity under general tax principles, it ought to derive protection from the safe harbor. Being more passive cannot be worse.[90]

One possible concern with this reasoning is that it proves too much. A bank also earns interest income and could be said to be "effecting transactions" in loans when it makes

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90 F.S.A. 200224003 (March 19, 2001) considers whether a factoring arrangement in which members of a U.S. group of companies sell operating receivables to a foreign affiliate ("A Corp.") causes A Corp. to be engaged in a U.S. trade or business. The U.S. sellers continued to collect the receivables from the obligors and were paid for their services by A Corp. The taxpayer argued that the activity was protected by the securities trading safe harbor. The IRS disagreed, on the ground that securities trading involved active buying and selling and the foreign buyer simply purchased the receivables and held them until they were collected. The F.S.A. goes on to conclude, however, that Corp. A was a passive investor and for that reason not engaged in a U.S. trade or business. Two facts cited in support of this conclusion were that Corp. A did not perform any substantial activities through the actions of its own employees and assumed little credit risk. A Corp. bought some of the receivables without recourse against the sellers in the event of defaults, but apparently the default risks with respect to those receivables was small. It is not clear why assuming material credit risk would change the conclusion because investors routinely invest in debt instruments with a high risk of default. The F.S.A. does not suggest that the business activities of the selling affiliates in generating the receivables should be attributed to Corp. A because the sellers were acting as collection agents for Corp. A.

them. Clearly, the drafters did not intend for the trading safe harbor to provide an exemption from U.S. tax for banks and finance companies operating a business through a U.S. branch. As noted in the last section, the section 864 regulations have special rules for determining when income from the active conduct of a banking, financing or similar business is ECI.[91] Those rules treat those activities as a trade or business.

The reason why the safe harbor does not protect the routine business activities of a bank or finance company is that such an enterprise does more than just acquire, hold and sell ("effect transactions" in) loans. It provides a service to customers by standing ready to make loans and performing the work needed to originate the loans.[92] The service element is reflected in the fact that banks and finance companies routinely receive points or fees when they originate loans and keep those amounts when they sell newly originated loans to a financial buyer (one that provides funding for the loans by purchasing them but does not itself participate in origination activities). Also, all banks offer a range of other services to their lending customers (e.g., checking accounts). Providing these services is not simply "effecting transactions" in debt instruments. A credit card trust does not offer any of these services.

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91 See text at footnote 78, above. The idea that special rules are needed in determining ECI from the active conduct of a banking, financing or similar business is also reflected in section 864(c)(4)(B)(ii), which provides that foreign source interest or dividends will be considered ECI only when derived in such a business or by a corporation the principal business of which is trading in stocks or securities for its own account.

92 Authorities described in footnote 77 above are quite explicit about the service element and go so far as to treat loans in the hands of originating banks as "receivables acquired in the ordinary course of trade or business for services rendered" within the meaning of section 1221(a)(4). Section 864(b) treats the performance of personal services within the United States as a trade or business within the United States for purposes of the sections imposing tax on ECI. Whether or not active loan origination is properly characterized as a service activity, it is an activity that requires more than just an extension of credit or accepting the risk of an extension of credit and the party engaging in the activity earns a return for engaging in the activity beyond what a purchaser of the originated loan would receive.

In determining the scope of activities of a credit card trust, it would be necessary to take account of activities undertaken by its agents, including the person who services receivables on its behalf.[93] As explained in the last section, however, the activities of a servicer do not include the type of customer-based activities that would cause the trust to be engaged in an active financial business. Other activities of the trust sponsor and its affiliates are not undertaken as the trust's agent and should not be attributed to the trust for the reasons given in the last section.[94]

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93 Section 864 has special rules for attributing agent activities to a taxpayer, but they would not apply here. Section 864(c)(4) limits the circumstances in which foreign source income is ECI. It generally requires such income to be earned through a U.S. office or other fixed place of business in order to be ECI. Under section 864(c)(5)(A), the office of an agent of a foreign taxpayer is disregarded for purposes of section 864(c)(4) unless the agent is a dependent agent that has, and regularly exercises, authority to negotiate and conclude contracts in the name of the foreign taxpayer or has a stock of merchandise through which it regularly fills orders on behalf of the foreign taxpayer. Similar rules are often found in treaties to limit when the office of a local agent will be treated as a permanent establishment of a foreign principal. These special agency rules do not apply for all purposes of section 864 and in particular would not be relevant in determining if a credit card trust is engaged in a U.S. trade or business as a result of the activities of a servicer, which in its servicing capacity would be an agent of the trust. Thus, the servicer's activities would be attributed to the trust even if the servicer is an independent agent who performs similar services for others in the ordinary course of business. Note that if (contrary to our view) a credit card trust were found to be engaged in a trade or business because of the involvement of the sponsor or its affiliates, the trust would likely be engaged in the active conduct of a banking, financing, or similar business so that the special rules for determining ECI from such a business would apply. Treasury Regulation § 1.864-4(c)(5)(ii) generally treats interest from a debt instrument as ECI only if the debt instrument arises from business conducted by the taxpayer through a U.S. office. Although not entirely clear, the special agency rules in section 864(c)(5)(A) are likely to be relevant in that context. The doubt stems from the fact that section 864(c)(5)(A) applies by its terms in determining if foreign source income is ECI and Treasury Regulation § 1.864-4(c)(5) addresses domestic source income. The regulation, however, is clearly based on the foreign source income rule in section 864(c)(4)(B)(ii).

94 For an F.S.A. supporting this conclusion, see footnote 90, above. See also T.A.M. 9611001 (December 4, 1995) (foreign corporation regulated as a bank was not engaged in a banking, financing or similar business, and specifically did not make "loans to the public," where it purchased loans originated by an affiliated bank acting as "agent" of the corporation under a management agreement and the foreign corporation had no employees of its own and no presence in the banking community).

Based on the discussion above, we recommend that the proposed revenue ruling relating to credit card trusts address the case in which a foreign investor unrelated to the sponsor is considered to own an equity interest in the trust and conclude, based on the facts of the ruling, that the trust is not engaged in a U.S. trade or business. The Credit Card Ruling in Annex B addresses this point.

The IRS issued (and later revoked) a revenue ruling addressing whether a foreign captive finance company was engaged in a U.S. trade or business. In Revenue Ruling 73-227,[95] the Service ruled that a foreign corporation that was a subsidiary of a U.S. parent and borrowed funds to make loans to its parent and other affiliates was engaged in a U.S. trade or business. A majority of the subsidiary's directors were U.S. citizens and the subsidiary had a U.S. office where all management and major policy decisions were made. The ruling does not describe the level of activity of the subsidiary, its capital, or how it managed financial risks. The ruling was pro-taxpayer in that it allowed the subsidiary to avoid U.S. withholding tax at the cost of a U.S. corporate tax on its spread income. The Service revoked the 1973 ruling in Revenue Ruling 88-3[96] on the ground that whether a taxpayer is engaged in a trade or business involves applying the law to the particular facts, and the earlier ruling simply expressed a conclusion without adequate factual support. We note that the facts of the proposed Credit Card Ruling are much more specific regarding the permitted activities of the trust. A conventional finance company would never be a QSPE! Also, the 1988 ruling presumably evidences a concern that the 1973 ruling was wrong because the finance company was not active enough to be engaged in a trade or business.

[95] 1973-1 C.B. 338.

[96] 1988-1 C.B. 268.

H. Pass-Through Debt Certificates as Debt or Equity: Significance of Form

As indicated in Part II.4, above, credit card trusts have traditionally issued pass-through debt certificates (certificates in the form of equity that the parties intend to treat for tax purposes as debt). This section discusses the rationale for treating the certificates as debt. It recommends that the IRS issue a revenue ruling clarifying that form is not a significant factor in determining whether pass-through debt certificates should be treated as equity or debt. The Credit Card Ruling in Annex B addresses this point.

The IRS has acknowledged the existence of pass-through debt certificates, but there are no authorities analyzing them in the credit card setting.[97] There are several rulings that treat equity interests in a trust as debt of the trust sponsor where the trust effectively holds a debt claim against the trust sponsor.[98] These rulings support the view that trust pass-through certificates should be characterized according to their economic substance. The facts of the rulings are somewhat different from credit card structures in that the certificate holder is relying primarily on a claim against the sponsor and not on third party receivables held by the trust.

97 In the preamble to proposed regulations issued in 1995 applying mark-to-market rules for securities dealers, the Service acknowledged the existence of securitization transactions in which a taxpayer transfers securities to a trust that issues certificates (or other forms of interests) that represent secured debt of the taxpayer rather than debt of the trust or ownership interests. See 1995-1 C.B. 923, 925. Also, in 1977, the Service issued a private letter ruling to one of the government-sponsored mortgage agencies approving the treatment of pass-through certificates with prepayment guarantees as debt, but the ruling was latter revoked on the ground that the economic significance of the mismatches between the certificates and mortgages was not adequately established. See P.L.R. 7725066 (March 24, 1977) and P.L.R. 8337016 (May 23, 1983). In the case of a credit card trust, the mismatches are clearly material.

98 See Revenue Ruling 76-265, 1976-2 C.B. 448, and Revenue Ruling 61-181, 1961-2 C.B. 21. See also T.D. 8080, 1986-1 C.B. 371, 372 (preamble to final Sears regulations, citing IRS Announcement 84-62, 1982-24 I.R.B. 29, and confirming that equipment trust certificate arrangements would not be regarded as ownership interests subject to the regulations). Cf. Revenue Ruling 97-3, 1997-1 C.B. 9 (investment in equity interests in a pool of loans guaranteed by Small Business Administration held to be in substance a loan to the guarantor).

The main argument for treating pass-through debt certificates as debt is that they are economically debt and should be taxed according to their economic substance. They provide for a fixed principal amount; interest is payable thereon at a fixed rate or a variable rate based on an interest rate index (without equity kickers or rights to convert into a participating equity interest); they have a maturity date that is not unreasonably distant in the future; they are not held pro rata with the sponsor's interest in the trust; they provide no management rights; and at their issuance it is reasonably expected that interest will be paid currently and principal paid in full on or prior to the maturity date.[99] If the issuing trust fails to make payments required by the trust documents, certificate holders have a right to sue the trust to compel payment.[100] The main legal

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99 In describing the classes of pass-through certificates that are held to be debt, the Credit Card Ruling reaches the conclusion that certain classes of pass-through certificates having the terms set out in the ruling will be classified as debt for tax purposes. The ruling states that it is reasonably expected at the time of issuance of those classes that principal and interest thereon at the stated rate will be paid in full on or prior to a specified maturity date. A "reasonable expectation" standard is found in a number of debt/equity cases. See *Mennuto v. Comm.*, 56 T.C. 910 (1971); see also *Lease v. Comm.*, 66 T.C.M 1121 (1993) (examines whether when stockholder made the advance, he could "reasonably expect the corporation to repay the loan in accordance with terms generally prevailing in the business community"); *Gooch Lumber Sales v. Comm.*, 49 T.C. 649 (1968) (examines whether there was "a reasonable expectation of repayment in light of the economic realities of the situation"); *Litton Business Systems v. Comm.,* 61 T.C. 367 (1973) (court asks "Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?"). The *Litton* formulation has been followed by a number of cases. See *LaStaiti v. Comm.*, 41 T.C.M 511 (1980); *Smithco Engineering v. Comm.*, 47 T.C.M 966 (1984); *Dungan v. Comm.*, 36 T.C.M 1307 (1977); *Wilkof v. Comm.*, 37 T.C.M 1851-31 (1978); *Leuthold v. Comm.*, 54 T.C.M 1308 (1987); *Dunn v. Comm.*, 60 T.C.M 317 (1990). See also Revenue Ruling 68-54, 1968-1 C.B. 69 (subordinated debentures of corporation X treated as debt even though the instruments had a number of equity features where "The earnings history of *X* indicates that it is reasonable for the debenture holders to anticipate payment of interest and principal.").

100 Pass-through debt certificates are generally payable out of funds available to the trust issuer according to a "waterfall" (a list of priorities for the application of available funds on a payment date). A holder of a pass-through debt certificate has a right to sue the trust if the holder fails to receive payments of available funds to which it is entitled under the waterfall. Limiting payments on a given date to available funds is a common trait of all MBS and ABS, whether in the form of equity or debt. Effectively it is a nonrecourse feature. The limitation on the source of funds is taken into account in the statement above that pass-through debt certificates are reasonably expected to be paid in full on or prior to their maturity date. A nonrecourse feature is relevant in determining the payment characteristics of an instrument (likelihood of payment and the timing

significance of the formal status of the certificates as trust equity is that they are structurally subordinated to claims of the trust's creditors. However, the terms of a credit card trust would prohibit the issuance of debt instruments senior to the trust certificates. Also, there is a long history of treating subordinated debt issued by operating companies as debt if there is a reasonable expectation of payment, which there would be in this case. That is true even where the debt is treated as equity capital for some non-tax purpose.[101] Pass-through debt certificates represent a more compelling case for debt treatment because they are not subject to the risks of an operating business.

Pass-through certificates issued by fixed investment trusts have many of the same debt features outlined above. They are taxed as debt instruments, but on the ground that they represent ownership interests in the trust assets (which are debt), not because they represent debt claims against trust assets. The key distinction is that the assets of fixed investment trusts are closely matched to the terms of the certificates they issue, which explains why the certificates are properly viewed as proprietary interests in those assets. By contrast, a credit card trust has

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and amount of payments) but should not cause an instrument to be recast as equity if, giving effect to the feature, the instrument has the economic characteristics of debt. That would be the case with respect to pass-through debt certificates of the type we are considering.

101 See Revenue Ruling 68-54, 1968-1 C.B. 69 (instrument treated as "net capital" for purposes of New York Stock Exchange regulations held to constitute debt); Revenue Ruling 73-122, 1973-1 C.B. 66 (same); *Harlan v. United States*, 409 F.2d 905 (5th Cir. 1969) ("surplus" notes payable only out of insurance company's surplus and not treated as liability on company's balance sheet constitute debt); Revenue Ruling 85-119, 1985-2 C.B. 60 (bank primary capital). Notice 94-47, 1994-1 C.B. 357, lists seven factors to be considered in determining whether an instrument is equity or debt. One of these is whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes. The notice indicates that no particular factor is conclusive. The weight given to any one factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account. The main purpose of the notice is to sound a cautionary note regarding the status as debt of purported debt instruments that have an unreasonably long maturity or principal that can be repaid with the issuer's stock. These two warning bells are not ringing in the credit card setting.

revolving assets so that it is necessary to view any certificates issued by the trust as a claim against the trust rather than an interest in identifiable receivables. Because the claim has debt characteristics and is not an ownership interest in trust assets, it should be taxed as debt of the trust (or of the owner of trust equity, if there is only one). The debt conclusion is also supported by the retention by the sponsor of entrepreneurial risk or rewards with respect to the receivables, the retention by the sponsor of some control over the receivables (including the right to change the economic terms of the receivables and in some cases to remove them from the pool), the fact that the production of future receivables depends on the sponsor's actions in conducting its credit card business, and the intention of the parties to treat the certificates as debt for tax purposes.

There is no doubt that typical classes of pass-through debt certificates (including subordinated classes) would be treated as debt if they were cast in the form of debt. The case is stronger than for a traditional CMO (a pay-through bond backed by a largely fixed pool of mortgages). The credit card trust structure requires significant equity to absorb default losses. Furthermore, there would be a substantial mismatch between the economic terms of the receivables and of the certificates. Thus, the main issue faced by tax advisors in determining the proper tax treatment of pass-through debt certificates is whether it is possible to overcome their form as ownership interests in the trust.

There is a tax law doctrine that limits the ability of a taxpayer to disavow the form of a transaction.[102] The most extreme statement of the doctrine is found in *Comm'r v.*

[102] For a general discussion of this topic, see William S. Blatt, "Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form," 70 *Oregon Law Review* 381 (1991); Robert Thorton Smith, "Substance and Form: A Taxpayer's Right to Assert the Priority of Substance," 44 *Tax Lawyer* 137 (1990); Victor O. Rosen, "Substance Over Form—A Taxpayer's Weapon," 1970 *So. Calif. Tax Inst.* 689. See also *Estate of Durkin v. Comm'r*, 99 T.C. 561, 571 (1992) (extensive discussion of taxpayer's ability to disregard form; finds against taxpayers who were seeking treatment different from tax return characterization of transaction after that characterization had been successfully challenged by IRS).

Danielson,[103] in which the court refused to allow a seller to depart from an agreed allocation of a portion of the purchase price paid for a business to a covenant not to compete absent facts that would allow the seller to avoid the contract in a suit between the parties. A milder version of the doctrine allows a taxpayer to disavow the form of a transaction if it produces "strong proof" that the substance of the transaction is different than its form and all parties consistently treat the transaction for federal income tax purposes in accordance with its substance rather than its form.[104]

We believe these authorities should not prevent the characterization of pass-through debt certificates as debt for two reasons. First, debt treatment would carry out the intentions of all parties rather than frustrating them. Also, because the parties have agreed to debt treatment, the government is not exposed to a risk of inconsistent treatment.[105] Second, the *Danielson* rule has not been applied where the terms of a transaction are ambiguous.[106] The

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103 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

104 See, e.g., *Illinois Power Co. v. Comm'r*, 87 T.C. 1417, 1434 (1986) (citing cases), acq. in result, 1990-1 C.B. 1.

105 Courts have declined to apply *Danielson* where the underlying policy concerns are absent. See, e.g., *Amerada Hess Corp. v. Comm'r*, 517 F.2d 75 (3d Cir. 1975) (case in same court that decided *Danielson* holding that rule is inapplicable where policy reasons underlying it are not present), rev'g *White Farm Equip. Co. v. Comm'r*, 61 T.C. 189 (1973), cert. denied, 423 U.S. 1037 (1975); *Strick Corp. v. United States*, 714 F.2d 1194, 1206 (3d Cir. 1983), cert. denied, 466 U.S. 971 (1984)). Other courts have also declined to apply the *Danielson* rule where its underlying policies are not implicated. See, e.g., *Comdisco, Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985) (declining to apply the *Danielson* rule "to situations in which the Government will never face conflicting claims"); *Rochester Development Corp. v. Comm'r*, 36 T.C.M. (CCH) 1213, 1217, n.1 (1977) (one factor in declining to apply *Danielson* or strong proof rule was fact that the counterparty to the transaction was a tax-exempt entity and therefore competing tax positions were not involved).

106 See, e.g., *Rochester Development Corp. v. Comm'r*, 36 T.C.M. (CCH) 1213 (1977); *Coulter Electronics, Inc. v. Comm'r*, 59 T.C.M. (CCH) 350 (1990), aff'd, 943 F.2d 1318 (11th Cir. 1991) (unpublished memorandum decision); *Watts Copy System, Inc. v. Comm'r*, 67 T.C.M. (CCH) 2480 (1994) (same); *Patterson v. Comm'r*, 810 F.2d 562, 572 (6th Cir. 1987) (a *Danielson* circuit) ("The *Danielson* rule can only be meaningfully applied in those cases where a specific

terms of the trust arrangement should be considered to favor debt treatment given the agreement of the parties to treat the certificates as debt and the economic and legal terms of the instruments.[107]

The status of the issuer as a trust rather than a corporation, LLC or partnership helps in concluding that a pass-through debt certificate may be treated as debt. Trusts are typically used to protect and conserve passive assets for beneficiaries and not to operate businesses. Indeed, one common use of a trust is to hold assets that collateralize debt. Although typically the collateralized securities take the form of debt, as indicated above, there are a number of authorities that treat trust certificates as debt.[108] Thus, the status of a credit card trust as a local law trust (rather than an LLC or partnership or, of course, a corporation) is a relevant factor.

We recommend that the IRS include in the Credit Card Ruling a holding that, based on the facts of the ruling, both a senior and a subordinated class of pass-through debt certificates will be treated as debt of the trust. The discussion should state that their status should be determined based on their economic and legal characteristics and that, based on the other factors present in the ruling, the fact that they are labeled as equity is not a significant factor in determining their tax status. The draft Credit Card Ruling in Annex B includes a debt/equity ruling along these lines.

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amount has been mutually allocated to the covenant as expressed in the contract. However, in this case, the parties are not seeking to *vary* the terms of the contract but to have the court *construe* terms which are obviously ambiguous.") (emphasis in original).

107 These include defining the interests in the trust so that the investors' interest remains a fixed amount despite changes in the amount of assets held by the trust and having a mechanism for accelerating principal payments upon the occurrence of default-type events.

108 See footnote 98, above.

It could be argued that the IRS should not at this point issue a ruling relating to the status of pass-through debt certificates because they are a relic of the past. Specifically, given the change in accounting standards, new securitizations are likely to take the form of debt issuances. We believe, however, that it would be desirable to address the point. Accounting standards can and do change. Existing master trusts will very likely continue to issue pass-through debt certificates for some time.[109] Also, as shown in Annex A, there were outstanding at the end of 2001 about $326 billion in credit card securities. While the source reporting this figure does not identify the form of those securities, we expect that most of them are pass-through debt certificates. Also, how to characterize pass-through debt certificates will remain a possible issue in past, open tax years for a long time to come. Congress clearly intended through the FASIT legislation to provide some greater clarity as to the status of pass-through debt certificates issued by credit card trusts. Even without a safe harbor rule, a published ruling that can be relied upon and confirms practices involving very large dollar amounts would be worthwhile.

I. Modifications of Commercial Mortgage Loans Held in a REMIC

When the REMIC legislation was passed in 1986, the mortgage-backed securities market involved exclusively residential mortgage loans. The thrift institution crisis of the late 1980s led to formation of the Resolution Trust Corporation which forced the liquidation of large thrift portfolios of commercial and multifamily mortgage loans. Those sales and the more limited availability of thrift buyers created a need for securitizations and gave birth to the

[109] Some existing trusts that cannot issue debt directly may be able to issue debt indirectly by issuing pass-through certificates to a second entity that in turn issues notes backed by those certificates. This approach is at best awkward and has not been employed by all trusts in this position. In our view, the existence of the technique does not argue strongly against addressing the status of pass-through debt certificates.

commercial mortgage-backed securities, or CMBS, market. The CMBS market, which was virtually nonexistent in 1986, is now a major source of capital for commercial real estate in the United States. The TMP and REMIC regimes, enacted prior to the development of the CMBS market, did not distinguish between commercial and residential loans. Given the carrot of the REMIC rules and the stick of an entity-level tax imposed on TMPs, it is not surprising that REMICs are the vehicle of choice for securitizing commercial mortgage loans.

The REMIC rules were implemented through regulations issued in 1992. Those regulations were written with residential loans mostly in mind. One significant difference between commercial and residential loans is the greater business need to make ongoing changes in the terms of a commercial loan to accommodate the needs of the borrower. Commercial mortgage loans are complicated, are relatively large in amount (sometimes in excess of $100 million) and increasingly involve multiple properties located in several jurisdictions. The loans often include complex financial covenants. The relationship between a borrower and its mortgage lender is a continuing one, with discussions about the loan and the real property collateral extending throughout the term of the loan as conditions change. Every month, lenders are approached by borrowers seeking something new.[110] Outside of the REMIC area, it is commonplace for lenders or servicers acting on their behalf to agree to changes that do not impair the lender's economic position, either for no consideration for routine matters or in exchange for concessions from the borrower.[111] As described below, the existing REMIC rules

110 To give a few examples, the borrower might want to: have an outparcel released or the grant of an easement approved, apply a cash reserve to make tenant improvements in a manner not contemplated by the original documents, consent to the substitution of parking lot A for parking lot B as collateral in a shopping center loan, waive a requirement that now-unobtainable insurance against terrorism be maintained, or change restrictions on prepayments.

111 For example, a lender may agree to allow release of a parcel of property in exchange for receiving an additional principal payment and increasing the rate of interest on the balance. A lender might

do not allow any modification that is "significant" according to section 1001 standards, with exceptions for default-related changes, assumptions and releases of encumbrances. Pooling and servicing agreements for REMICs are, of course, written to comply with the current REMIC rules and do not allow changes that cause a significant modification for REMIC purposes. Servicers must consult with tax counsel and often are constrained by contractual obligations, or feel constrained by prudence, to obtain opinions regarding waivers and modifications that are routine from a market perspective.

The existing limitations on loan modifications by REMICs are too restrictive for the commercial market and also unduly difficult to administer in practice. To address this problem, we propose that the REMIC regulations be revised to provide that a change in the terms of a qualified mortgage will not cause it to cease to be a qualified mortgage if the change does not increase the principal amount or extend the maturity of the mortgage. We believe this change would help significantly in simplifying the servicing of commercial mortgage loans, while at the same time not allowing a REMIC to engage in an active business in a manner Congress did not intend. Participants in the CMBS market had hoped that the FASIT rules would address the modification problem (because the FASIT rules would allow free substitutions of loans), but FASITs have proven to be infeasible for CMBS transactions for the reasons described in Part IV.B, above (including, most significantly, the need for sponsors to recognize gain based on artificial discount rates and the inability to create freely transferable IO classes).

Some background regarding the tax treatment of REMICs and debt modifications may be helpful in understanding the reasons for the proposal. A REMIC is generally required to

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also be willing to grant a concession to a borrower in exchange for the borrower not exercising a prepayment option.

acquire during the first three months of its existence all the qualified mortgages that it will hold, except that it may exchange a defective loan for a qualified replacement mortgage for up to two years. The question then arises whether or under what circumstances the modification of a loan may be regarded as the exchange of an old loan for a new one. If a modified loan is considered a new obligation and it is not a qualified replacement mortgage (which generally it will not be if the exchange occurs more than three months after the startup date), and the size of the loan together with other nonqualifying assets exceeds one percent of the REMIC's assets, then the modification may disqualify the entity as a REMIC with potentially disastrous consequences.[112] If the new loan comes within the *de minimis* rule, then any gain from the deemed disposition of the loan will be a prohibited transaction subject to a 100 percent tax. More significantly, that tax also will apply to any net income from the loan earned following the exchange.

Under general tax principles, for purposes of measuring gain and loss, the treatment of specific modifications as deemed exchanges is addressed in Treasury Regulation § 1.1001-3 (the "1.1001-3 regulations"), which were issued in response to the *Cottage Savings* case.[113] These regulations define a "modification" and then provide that a modification that is "significant" will be treated as a deemed exchange. In the context of commercial loans, the treatment of a modification as a deemed exchange is often unimportant outside of the REMIC setting. Under section 1274, the amount realized in the exchange is generally the face amount of the loan. For the original lender and for the borrower, an exchange at par produces no gain or loss. Thus, lenders and borrowers make frequent modifications without paying much attention to whether they are section 1001 exchanges.

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112 A failed REMIC would typically be a TMP and hence a corporation subject to corporate income tax.

113 *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 570 (1991).

Once a loan is put into a REMIC, however, it is a different matter. Treasury Regulation § 1.860G-2(b) states as a general rule that if an obligation is significantly modified, the modified obligation is treated as newly issued in exchange for the one it replaces. The regulations define a significant modification as a change in terms that would be treated as an exchange of obligations under section 1001 and the related regulations. (To some degree the drafters were flying blind. The 1.1001-3 regulations had been proposed but not finalized when the REMIC regulations were issued.) At the same time, the REMIC regulations acknowledge that the general section 1001 standards should not always provide the governing standard. They state that default-related modifications, assumptions, waivers of due on encumbrance clauses, and the conversion of an interest rate by the mortgagor pursuant to the terms of a convertible mortgage are not significant modifications for REMIC purposes whether or not they are under section 1001.

To summarize, under current law, if a loan held in a REMIC is significantly modified within the meaning of the 1.1001-3 regulations, subject to the four specific exceptions found in Treasury Regulation § 1.860G-2(b)(3), the loan will be treated as reissued and will cease to be a qualified mortgage, producing the potentially awful consequences described above.

The treatment of mortgage modifications by REMICs was not before Congress in 1986 when the REMIC rules were adopted. At that time, the most common type of collateral for CMOs was agency pass-through certificates, and the CMO issuer played no role in modifying underlying loans.[114] Also, as noted above, the underlying real property loans were in any event

[114] Treasury Regulation § 1.860G-2(c) provides that modifications of loans backing pass-through certificates are not modifications of the certificates, subject to an anti-abuse rule.

residential loans rather than commercial ones. Finally, *Cottage Savings* was decided in 1991 and the 1.1001-3 regulations were issued in final form in 1996.

When the REMIC regulations were issued in 1992, REMICs were used almost exclusively to securitize residential mortgages. The four types of modifications that are expressly allowed without regard to section 1001 cover the most common changes affecting residential mortgages, but not the range of likely changes in commercial mortgages. To accommodate commercial loans, we recommend that a REMIC be allowed to modify a loan without causing a deemed exchange for REMIC purposes so long as the principal amount is not increased or the weighted average maturity date extended.[115] This limitation will ensure that there is no increase in the credit provided to the borrower. Having the ability to agree to a modification that does not provide new credit should not be regarded as a power to engage in an active business that is inappropriate for a pass-through vehicle.[116] Because of the ban on new credit, a REMIC could not build customer relationships and would still be strictly a liquidating vehicle.

The test we propose would allow modifications that are clearly section 1001 exchanges. The current REMIC regulations already acknowledge that section 1001 standards are not always appropriate. Also, as a policy matter, the two tests should not inevitably be the same because they address different concerns. The 1.1001-3 regulations test whether a particular

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115 The rule would apply only for purposes of determining whether the modified loan continues to be a qualified mortgage, whether there is a disposition that is a prohibited transaction, and for other purposes of the REMIC rules. We understand that normal Code principles (including the 1.1001-3 regulations) would apply in determining the effect of a modification on taxable income of the REMIC and hence on the income of holders of the residual interest.

116 Indeed, REITs are pass-through vehicles that hold real estate mortgages and real property. There is no limitation on the ability of a REIT to modify loans. A REIT can dispose of loans freely as long as it does not act as a dealer.

change presents an appropriate occasion to measure gain or loss. The total amount of gain or loss of a taxpayer will be the same over time, and the issue is whether to take a snapshot and measure gain or loss on an interim basis when a modification takes place. Realization policies balance a desire to measure income accurately with administrative convenience. By contrast, the issue for a REMIC is whether a change is significant enough so that the REMIC should be regarded as an active lender rather than a passive vehicle and lose its tax exemption. Seen in that light, a rule that prohibits new credits but otherwise allows changes seems to us to reach an appropriate result because it forces the REMIC to be a liquidating vehicle.

In practice, the changes in loan terms that are proposed by borrowers to REMIC loan servicers are generally regarded as routine or not that material but nonetheless often are significant enough to raise concerns under the very low threshold of materiality imposed by the section 1001 rules. In theory, it would be possible to devise a new standard of economic materiality for REMIC modifications that would allow a broader range of changes but still impose some requirement that the change not be too big. We fear that such an approach would require the drafting of a new set of parallel rules addressing the myriad types of changes already covered in the 1.1001-3 regulations. The rule we propose has an implicit economic materiality test: Is the REMIC providing new credit? We believe a credit test appropriately focuses on a key difference between an active, ongoing business and a passive, liquidating vehicle. It also has the considerable practical advantage that it is a bright-line test that can be understood and administered by loan servicers without the need for sophisticated tax advice.[117]

[117] In addition, it is worthwhile noting that the proposed change in tax law will not result in a parallel change in the freedom granted to servicers to make changes. CMBS investors are very sensitive to the terms of the loans in which they invest and purely for commercial reasons will impose significant limitations on the types of modifications allowed. The proposed change in

The proposed test would allow the effective refinancing of a mortgage in a case in which a loan is currently prepayable and the borrower threatens to prepay unless the interest rate is lowered to a then market rate. While it can be argued that a modification in these circumstances is equivalent to a conventional refinancing, in fact it is quite different because both the lender and the borrower would be the same and the parties could not add new financing or extend the term. Instead, the parties are modifying the loan to reflect current market conditions to allow the funding to remain in place. They could have done the same thing by providing in advance for a downward rate adjustment on any prepayment date to reflect a drop in market rates. By contrast, in the more common case in which a loan is approaching its maturity date and the borrower is seeking refinancing, the REMIC could not provide it because the essence of the transaction would be to extend the maturity date.

The proposed rule would also allow substitutions of collateral. In current practice, commercial loans often are secured by pools of properties and the loan terms provide for substitutions at the borrower's option, subject to objective conditions. Borrowers may ask to change those conditions, and such changes would be modifications that result in substitutions that otherwise would not occur. We believe it is appropriate to allow modifications of this type. It is difficult to distinguish between modifications relating to substitutions of collateral that are broadly contemplated and those that are not, and we would not distinguish the two. Again, we believe that a ban on new credit is an adequate safeguard of the passivity of a REMIC. In practice, it is also highly unlikely that a REMIC would be granted much discretion in makings substitutions of collateral not contemplated by the loan terms. CMBS are sold to investors based

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regulations, however, would allow the market to think about modifications as a commercial issue rather than an intricate dance played to the tune of the 1.1001-3 regulations.

on the particular collateral involved. The offering circulars include detailed descriptions of the principal properties (often with color pictures showing buildings framed by sunsets or cloudless skies—it never rains). Substitutions are tightly regulated purely for commercial reasons. A REMIC could not modify a loan in a way that would convert a real estate mortgage into one not secured by real estate because of the release rule discussed in Part V.A, below.

The proposal could be implemented by adding the following new Treasury Regulation § 1.860G-2(b)(3)(v):[118]

> (v) Any other modification that does not increase the principal amount[119] or extend the remaining weighted average maturity of an obligation.[120] The period to maturity will include any period for which the borrower can extend the obligation if exercise of the extension right under the terms of the obligation would not be a significant modification (disregarding this clause (v)).[121] [This clause (v) may not be relied upon together with clause (ii) to allow a substitution of collateral that is part of a plan that includes an assumption and is intended to

118 The new clause (v) would overlap with some of the existing exceptions (except for clause (i), relating to defaults, which clearly could involve an extension of maturity and should not be changed). It is possible that clause (v) could simply replace clauses (ii) through (iv), but we are somewhat wary of upsetting established routines by removing them.

119 We intend that the principal amount referred to in the rule be the stated principal amount and not the adjusted issue price. A change that caused interest to be deferred or capitalized would be addressed by the rule limiting extensions of the weighted average maturity.

120 The weighted average maturity would be the period to the maturity date in the case of a bullet maturity loan and, for a loan that requires amortization prior to maturity, an average of the periods to the payment due dates weighted by the payments due. Anticipated or possible prepayments would not be taken into account (because they would not affect when the loan "matures"). The calculation should use actual periods (months and fractions of months) and not the whole year convention used in computing the weighted average maturity of a debt instrument under Treasury Regulation § 1.1273-1(e)(3). It would be appropriate to take into account all payments included in the stated redemption price at maturity (as does the regulation just cited). That approach would address modifications that defer stated interest in a way that transforms qualified stated interest into amounts includible in the stated redemption price at maturity.

121 If a borrower has a right to extend a loan without the lender's consent but with the payment of a specified fee (a common feature of commercial loans), the extended period should be taken into account. It is simply a matter of drafting whether the loan has a later maturity date and can be prepaid or a shorter maturity date with an extension right. The proposed rule would effectively include an extension period if the borrower's right to extend is a unilateral option within the meaning of Treasury Regulation § 1.1001-3(c)(3).

achieve the effect of replacing a loan to one borrower with a loan to a different borrower with substantially different collateral.][122]

If our proposal is not adopted, then we ask for the opportunity to discuss other additions to the list of permitted modifications that would be more tailored to the commercial loan market. In the end, however, only a broadly worded exception is likely to be effective given the wide range of possible changes that are routinely made (and anticipated by borrowers).

J. <u>Modifications of Commercial Loans Held in Grantor Trusts</u>

The problem of distinguishing between permitted and impermissible modifications of commercial mortgage loans described in Part I exists not only where those loans are held by REMICs but also where they are held by non-REMIC investment trusts that are intended to be taxed as grantor trusts.[123] Under current practice, a grantor trust is thought to have a power to vary if it can modify a loan in a manner that causes a section 1001 exchange and the loan is not in default or reasonably expected to default.[124] We believe that the test outlined above for REMICs would also be appropriate for fixed investments trusts as an interpretation of

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122 In theory, a rule that allows substitutions of collateral when combined with the existing rule permitting assumptions would permit a REMIC to effectively substitute one loan for another by having (1) a new borrower assume an existing loan, (2) the new borrower replace the old collateral with new collateral of equivalent value, and (3) the new borrower convey the original collateral to the original borrower. We believe such a plan would not be commercially feasible. As indicated in the text above, CMBS investors will not buy into a blind pool and the terms of a pooling and servicing document will severely restrict replacements regardless of what the tax law says. Further, such a plan would require one borrower to cooperate with another to effect a substitution of collateral and the happy coincidence that a new borrower wants to borrow for the remaining term of an existing loan at the time when an existing borrower wants to prepay. What possible incentive would a borrower have to agree to cooperate since the plan provides no benefit to it? At any rate, if the IRS were bothered about this case, it could be dealt with by including the bracketed language.

123 A number of lenders have entered into very large commercial mortgage loans (over $100 million) that allow the lender the flexibility to divide loan cash flows into separate notes at the time of a securitization. In these cases, the securitization may be accomplished by having a grantor trust hold all of the notes and issue classes that match exactly each of the notes. Also, of course, multiple commercial loans can be pooled into a conventional single-class grantor trust.

124 The default exception is based on Revenue Ruling 73-460, 1973-2 C.B. 424.

the power-to-vary test. A power to vary investments has been described as "one whereby the trustee, or some other person, has some kind of managerial power over the trusteed funds that enables him to take advantage of variations in the market to improve the investment of all the beneficiaries."[125] A power that is limited to changing terms on a loan without providing any new credit to a new borrower is a far cry from the powers normally given to a fund manager to make new investments.[126]

In evaluating our proposal, it may be helpful to keep in mind the limited stakes involved under current law (specifically under the check-the-box system in place since 1997). If a single-class investment trust does not have a power to vary and is classified as a grantor trust, then the holders of trust interests are taxed as owners of trust assets. By contrast, if the trust has a power to vary, it becomes a partnership and owners are taxed under subchapter K. In the present context, there is no real possibility of classification as a corporation.[127] Thus, the main issue is whether the possibility of loan modifications justifies importing all of the substantive rules of subchapter K.[128] We think it does not. Specifically, the fact that a loan modification

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125 Revenue Ruling 75-192, 1975-1 C.B. 384; see also Revenue Ruling 78-149, 1978-1 C.B. 448.

126 In Revenue Ruling 78-149, 1978-1 C.B. 448, a trustee was given the right to reinvest proceeds received from a prepaid municipal bond in any "medium grade" bond maturing no later than the last maturity date of the bonds originally deposited in the trust. The ruling holds that the reinvestment right was a power to vary investments. However, this power allowed the trustee to go out into the market and choose among new issuers. Also, the new investment could have a longer term than the prepaid bond as long as it did not extend beyond the latest maturity date of the bonds originally deposited in the trust.

127 A trust that holds a fixed portfolio of loans and in addition can modify the loans without extending new funding would almost certainly not be considered to be engaged in a financial business within the meaning of section 7704(d)(2)(A). Accordingly, it would not be classified as a corporation under the PTP rules even if it had publicly traded equity.

128 These include the deferral or acceleration of income due to mismatches between the taxable year of the entity and of the partners, the need to make and implement a section 754 election to adjust for differences between inside and outside basis, and the need to make tax elections (e.g., to amortize bond premium) at the entity rather than investor level. For a more detailed comparison of the treatment of partnerships and grantor trusts, see Peaslee & Nirenberg, Chapter 5.

could produce gains or losses under section 1001 would not be a reason to shy away from grantor trust treatment. A fixed investment trust can have discretion to dispose of assets (producing gains or losses to holders) without having a power to vary. Such a power requires reinvestment. The IRS has recently proposed expanded reporting rules for fixed investment trusts that would require additional information about trust dispositions of assets. See Part VII.A, below. The implementation of these rules should alleviate any possible concern over inadequate reporting of gains or losses.

The desired change could be accomplished by adding the following sentence to Treasury Regulation § 301.7701-4(c)(1):

> A power to modify the terms of a real property mortgage without increasing its principal amount or extending its weighted average maturity shall not be considered a power to vary the investment of the certificate holders.

V. Changes in REMIC Regulations

A. Release of Real Property Collateral

The definition of a "qualified mortgage" in section 860G(a)(3)(A) requires that an obligation be "principally secured by an interest in real property." With this requirement in mind, Treasury Regulation § 1.860G-2(a)(8) provides that a mortgage loan will cease to be a qualified mortgage in the hands of a REMIC if it "releases its lien on real property" unless the mortgagor pledges substitute collateral that consists solely of government securities (as defined) and meets certain other requirements. The defeasance exception benefits both mortgagors and investors in REMICs by allowing real property securing a mortgage loan to be sold or refinanced without a loan prepayment.

The basic "no release" component of the regulation could be read literally to provide that *any* release of real property collateral disqualifies a loan. We believe the rule should be applied more narrowly, as an anti-abuse measure, only in cases in which a release would prevent a mortgage from continuing to meet the principally secured test. The IRS apparently agrees.[129] Under this view, a release of real property should not disqualify a loan in the following circumstances: (i) if the released collateral was not needed to permit the loan to be principally secured, (ii) if a corresponding amount of principal is paid down so that the release does not decrease the ratio of real property collateral to outstanding principal to less than 80 percent (the basic requirement to be principally secured), or (iii) if new real estate collateral is substituted for the released collateral.

We believe the regulation should be changed to state clearly that releases are allowed as long as the loan that remains (after giving effect to any substitutions and pay-downs) is principally secured by real property. Taxpayers should be able to apply the test based on either current market values or the values originally used in determining that the loan was a qualified mortgage.[130] Our recommendation could be implemented by revising Treasury Regulation § 1.860G-2(a)(8) to read as follows:

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129 See P.L.R. 9833015 (May 18, 1998): "[Treasury Regulation] § 1.860G-2(a)(8) ... is an anti-abuse provision aimed at the prevention of the collateralization of a REMIC with obligations that are not qualified mortgages, required under section 860G(a)(3)(A) to be obligations principally secured by an interest in real property."

130 See Treasury Regulation § 1.860G-2(a)(1) (obligation is principally secured if value of real estate is at least 80 percent of the adjusted issue price of the loan as of the date of origination or contribution to the REMIC). Commercial loan agreements often allow for the release of individual properties if an amount of principal equal to the designated "release price" of the released properties is paid. We are concerned that if values can be measured only at the time of the release, releases that are contemplated by a loan agreement and that are based on original estimates of value would cause a loan to cease to be a qualified mortgage, even in cases in which the REMIC has no ability to block the release and the parties all intended that the loan would be adequately secured. For example, suppose that a loan in the amount of $100 is secured by properties A and B. A and B had values of $80 and $40 when the loan was made, and the loan agreement states that they can be released upon the payment of principal equal to $88 and $44, respectively. The borrower sells B for $50 and uses $44 of the proceeds to pay down the loan to $66. Suppose that while property B has flourished, A has performed badly and is worth only $50. If the REMIC were required to evaluate the release based on current values, the loan would fail to

(8) *Release of Collateral and Defeasance*. If a REMIC releases its lien on real property that secures a qualified mortgage, that obligation ceases to be a qualified mortgage on the date the lien is released unless—

(i) after giving effect to such release and any substitutions of collateral, and any required application of proceeds of the released real property and other funds to repay all or a portion of the mortgage, the fair market value of the interest in real property securing the mortgage is at least 80 percent of the adjusted issue price of the obligation. Such fair market value may be determined, in the discretion of the REMIC (but consistently for all real property securing the mortgage), either at the time of the release or, with respect to an interest in real property that secured the obligation when it was contributed to the REMIC, as of the date of origination of the obligation or as of the date of its contribution to the REMIC.

(ii) [defeasance exception now in clauses (i) through (iv)].

In evaluating this proposal and the one in the next section, it is appropriate to keep in mind the rationale for requiring that REMICs hold real property loans. The reason for limiting REMICs to real property mortgages was that the need for a multiple-class vehicle was greatest in that area, and tax policymakers wanted to proceed cautiously with a wholly new set of tax rules.[131] That being said, applying the principles of the REMIC rules to debt instruments that are

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be a qualified mortgage because the remaining collateral is worth less than $52.8 (80 percent of $66). A loan does not fail to be a qualified mortgage because of declines in the value of collateral after it is originated. Thus, if the loan had consisted of two separate loans in the amounts of $66 and $44 secured by properties A and B, respectively, the fact that A had declined in value to below $52.8 would not affect the status of loan secured by A. We do not think a fundamentally different approach should be used where a single loan is collateralized by different properties but the lender has limited cross-collateralization by allowing releases of individual properties based on release prices. We would be more sympathetic to a rule requiring the use of current values in testing the status of a loan following a release in a case where the release was not allowed by the loan documents.

131 The REMIC legislation was derived from S. 1959, 99th Cong. (1985), introduced by Senator Chafee. Hearings were held on the bill before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance on January 31, 1986. In the statement opening the hearings, Senator Chafee said the following:

> My bill is designed to clarify the tax treatment of mortgage-backed securities, which should facilitate investments in mortgages and thereby reduce mortgage interest costs for home buyers. I have limited my bill to mortgages primarily because there is more data and a better understanding of how mortgages and mortgage-backed securities behave than there is of other asset-backed securities.

unsecured or secured by personal property would not produce untoward results and it seems unnecessary to defend the line separating real property mortgages from other debt instruments to the last man.

B. Construction Loans

Although securitization has become a critical tool in the efficient financing of commercial real estate loans, a category of mortgage loan that has not benefited from the technique to a significant degree is construction loans. One factor among others for the dearth of securitizations is doubt as to the status of construction loans as qualified mortgages under the REMIC rules.[132] Construction loans are typically secured initially by land, construction materials, and a reserve fund consisting of a portion of the loan proceeds to be applied to

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> I am concerned that we clarify two important tax issues with respect to these securities. First, should an entity issuing these securities be subject to a separate level of taxation? Second, what are the tax consequences to investors in these securities? If we can agree on the tax rules governing mortgage-backed securities, then perhaps we could and should extend this treatment to other asset-backed securities. However, at this point I want to concentrate on making certain that the tax rules are correct.

The Treasury statement at the hearing by Dennis E. Ross, Acting Tax Legislative Counsel, was similar:

> We also believe it is appropriate that, as under S. 1959, multiple class arrangements for which the issuer is granted tax exemption would be limited to debt obligations in the nature of real estate mortgages or mortgage-backed securities. Although multiple class pools of auto loans, lease receivables, corporate bonds, and various other obligations would appear closely similar in concept to multiple class mortgage pools, we believe it appropriate to proceed with some caution in this area. Thus, we believe it appropriate that we gain experience with multiple class mortgage pools before extending the concept of issuer level tax exemption to multiple class pools of other debt obligations. Moreover, because of real estate mortgages' typically long term and significant incidence of prepayment, they present the most pressing case for the allowance of multiple class arrangements.

132 Another factor, of course, is that construction loans may involve greater risks than loans collateralized with completed real property.

construct improvements. Frequently, such a loan will not be "principally secured by an interest in real property" under Treasury Regulation § 1.860G-2(a)(1)(i) because the value of the land and existing real property improvements will not equal 80 percent of the amount of the loan at the time of origination of the loan or its contribution to a REMIC, even though the 80 percent test is expected to be met when construction is complete.

Treasury Regulation § 1.860G-2(a)(1)(ii) provides an alternative test for treating a loan as principally secured. The test is based on the use of loan proceeds. It requires that "substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation."[133] Read literally, this rule would not apply to a loan that is secured not only by real property but also by unspent construction funds or reserves. Also, it seems to require that the real property exist as of the origination date of the loan, which would defeat its purpose if it were aimed at construction loans. The preamble to the final regulations suggests that it was intended to permit the inclusion in a REMIC of home improvement loans without requiring a new appraisal when funds are disbursed and was not drafted with commercial construction loans in mind.[134]

133 For this purpose, third party credit enhancements are not viewed as additional security for a loan. Thus, it appears that a third party guarantee that is secured by a reserve fund or other personal property would not violate the rule.

134 See the preamble at 1993-1 C.B. 147, 148: "First, in addition to the current 80-percent test, the final regulations provide an alternative test for determining whether an obligation is principally secured by an interest in real property. Under the alternative test, an obligation is considered to be principally secured by an interest in real property if substantially all of the loan proceeds were used to acquire or to improve or protect an interest in real property and the interest in real property is the only property securing the loan. Thus, for example, a home improvement loan made in accordance with Title I of the National Housing Act would be considered to satisfy the principally secured standard even though one cannot readily demonstrate that the loan satisfies the 80-percent test because a property appraisal was not required at the time the loan was originated."

We recommend that the use of proceeds regulation be changed to accommodate construction loans. Doing so would conform the REMIC definition of qualified mortgage to the closely analogous REIT definition in section 856(c)(3)(B) of "obligations secured by mortgages on real property or interests in real property."[135] The REIT regulations provide that interest on a loan is considered fully derived from such an obligation if the "loan value" of the real property is at least equal to the amount of the loan. The loan value of real property is its fair market value as of the date on which the REIT is committed to make the loan. However, in the case of a construction or improvement loan, the loan value is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) that will be constructed with the proceeds of the loan and will secure the loan.

We think the REIT analogy is apt, and recommend that the first sentence of Treasury Regulation § 1.860G-2(a)(1)(ii) be replaced with the following:

> For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property if it is reasonably anticipated as of the date of origination of the loan that substantially all of the proceeds of the obligation (including income from temporary investments of proceeds) are or will be used to pay or reimburse the costs of acquiring, improving or protecting an interest in real property (including construction period interest and other capitalized costs of the financing allocable to interests in real property) that is security for the obligation or in the case of improvements will be security for the obligation.

135 Section 860G(a)(3)(A) defines a qualified mortgage as one "which is principally secured by an interest in real property." If anything, this test is more lenient than the REIT test because it contemplates a case in which the real property collateral may be worth less than the amount of the loan (as low as 80 percent under the REMIC regulations). By contrast, a REIT must treat interest on a loan secured by real property with a value below its face amount as only partly income from a real property mortgage. See Treasury Regulation § 1.856-5(c). The REMIC regulations acknowledge the REIT analogy in that they look to the REIT regulations for a definition of interest in real property. See Treasury Regulation § 1.860G-2(a)(4).

C. Definition of Specified Portion

It is very common in REMIC securitizations to create classes of regular interests that provide for interest payments consisting of a "specified portion of the interest payments on qualified mortgages" within the meaning of section 860G(a)(1)(B)(ii). Most specified portion classes are IO classes with only a notional principal amount, but they can also have principal. There is no requirement that actual principal bear any particular relationship to interest payments. Under regulations, a specified portion of interest payments is defined as a fixed proportion of the interest paid at a fixed or variable rate, a fixed number of basis points, or the excess of interest at a fixed or variable rate over a fixed number of basis points or a variable rate.[136]

Interest on specified portion classes may represent economically a strip of interest taken off of designated mortgages, a strip of interest taken off of other REMIC regular interests, or more broadly the net spread between the interest paid on a pool of loans and the interest paid on the REMIC regular interests financing the loans. This net spread is often expressed as a rate equal to the excess of the weighted average coupon, or "WAC," of some or all of the mortgages over the WAC of the regular interests.

Although these kinds of interests seem quite straightforward economically, creating them under current law can be quite complex, and may involve the use of multiple

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136 Treasury Regulation § 1.860G-1(a)(2). The variable rate referred to in the definition is a variable rate defined in Treasury Regulation § 1.860G-1(a)(3). Such a rate may be based on a qualified floating rate (a conventional interest rate index), a rate that is a weighted average of the rates of interest on one or more qualified mortgages, or a rate that is a combination of different fixed or variable rates in effect in different periods. In computing such a weighted average rate, the rate on any mortgage may first be adjusted by imposing a cap or floor, or by subtracting expenses, a fixed number of basis points or a fixed percentage of the rate. A variable rate so determined may be further adjusted by adding or subtracting a fixed number of basis points or multiplying by a fixed multiplier (which may be positive or negative).

REMICs. The reason is that section 860G(a)(1)(B)(ii) refers to a specified portion of the interest payments on qualified mortgages held by a REMIC. The types of IO classes that are commercially desirable consist not only of strips of interest taken from the underlying mortgages but also strips taken from other regular interests or strips representing the excess of interest on qualified mortgages over interest paid on regular interests. Thus the challenge is how to use the statute to create interest strips relating not only to qualified mortgages *held* by a REMIC but also to regular interests *issued* by the REMIC. The gap can be filled, and routinely is filled, using a multiple tier arrangement. An upper-tier (parent) REMIC issues regular interests and then holds regular interests issued by a lower-tier (subsidiary) REMIC that mirror (at least as to allocations of principal) the regular interests issued by the upper-tier REMIC. The lower-tier regular interests are qualified mortgages in the hands of the upper-tier REMIC.[137] Thus, regular interests issued by a REMIC are effectively transformed into qualified mortgages it holds.

To illustrate the types of classes that are now created through multiple tier arrangements, consider the following three examples (each REMIC in the examples has a noneconomic residual interest that is not described):

> ***Example 1.*** Bank holds a $100x pool of fixed rate mortgage loans each with a net rate of 7 percent. Bank intends to create a REMIC that issues to the public three classes of regular interests: Class A with a principal balance of $50x and a rate of 6 percent that is entitled to the first $50x of principal received, Class B with a principal balance of $50x and a rate of 7 percent entitled to principal after the Class A interest is retired, and Class IO entitled to 1 percent of a notional balance equal to the principal balance of Class A.

Currently, Class IO cannot be created in a single REMIC because the interest on Class IO represents a specified portion of interest on Class A and not on a qualified mortgage held by the REMIC. The problem can be solved by having two tiers of REMICs. The lower-tier

[137] See section 860G(a)(3)(C) (regular interests are qualified mortgages).

REMIC would hold the mortgages and issue Class AL and BL regular interests. They would have terms identical to Classes A and B, respectively, except that they would both bear interest at a rate of 7 percent. The upper-tier REMIC would hold Classes AL and BL as its qualified mortgages and issues the three desired classes. Interest on Class IO now represents a specified portion (fixed number of basis points) of the interest payments on Class AL, a qualified mortgage held by the issuing REMIC.

The next example illustrates a case in which it is desirable to be able to create a strip equal to the excess of interest on one or more qualified mortgages over interest paid on one or more classes of regular interests where the regular interests have a principal balance that is not a fixed proportion of the principal balance of the mortgages. Again this can be accomplished under current law using multiple tier arrangements.

> ***Example 2.*** A REMIC is formed consisting of two groups of fixed rate mortgage loans, Group 1 and Group 2, each having an initial principal balance of $100. The Group 1 loans bear interest at a rate of 6.5 percent and the Group 2 loans bear interest at a rate of 7 percent. The REMIC issues three classes of regular interests. There are two senior classes, Class A-1 bearing interest at a rate of 6.5 percent and Class A-2 bearing interest at a rate of 7 percent. Each has an initial $90 principal balance. There is also one class of subordinated regular interests, Class B, which has an initial $20 principal balance. Realized losses from either group first reduce the Class B balance until it is written down to zero, and then are allocated to Class A-1 or Class A-2 depending on whether the losses are attributable to Group 1 or Group 2. Class A-1 receives all payments of principal on the Group 1 loans until its principal balance is reduced to zero, and Class A-2 receives all payments of principal from the Group 2 loans until its principal balance is reduced to zero. Once Class A-1 is reduced to zero, all further payments of principal received from the Group 1 loans are paid to Class A-2 until its principal balance is reduced to zero. A corresponding rule applies if the Class A-2 is reduced to zero when Class A-1 is still outstanding. Once the principal balances of both Class A-1 and Class A-2 have been reduced to zero, principal will be paid to the Class B interests. The rate of interest on Class B represents economically the excess of interest received on the Group 1 loans over interest paid on Class A-1 and the excess of interest on the Group 2 loans over interest paid on Class A-2. That excess will represent a fixed rate of interest, 6.75 percent, so long as the excess is $10 for both Classes A-1 and A-2. However,

> once one of the two senior classes is retired, there will be a crossover between the two groups that will change the effective rate. For example, if $5 of principal from Group 1 is used to pay down the Class A-2 loans, the rate on Class B would equal 6.875 percent, reflecting a weighted average of $5 of Group 1 loan principal bearing interest of 6.5 percent and $15 of Group 2 loan principal bearing interest of 7 percent.

Interest on Class B can be created by creating a two-tier REMIC structure. The lower-tier REMIC would issue four classes of regular interests: Classes A-1L, A-2L, BL and WAC. The first three classes would have a principal amount equal to a small percentage (say, 1 percent) of the principal of the corresponding upper-tier classes and would pay down in proportion to the corresponding upper-tier classes. Classes A-1L and A-2L would bear interest at a rate of 6.5 percent and 7 percent, respectively, and Class BL would bear interest at a rate of 6.5 percent. Class WAC would have a principal amount equal to 99 percent of the principal of all of the mortgages and a rate of interest equal to the WAC rate on the mortgages. It would pay down in proportion to the mortgages as a whole. Interest on Class B would be a specified portion of the interest on Class WAC equal to (i) all of the interest on that class less (ii) a weighted average of the rates of interest on Classes A-1L, A-2L and BL, with the rate on BL being first reduced by 100 percent.[138]

[138] For a description of permitted specified portion rates, see footnote 136, above. Interest on Class B would equal interest at a variable rate on a qualified mortgage (Class WAC) in excess of interest at a different variable rate, which is a weighted average of the rates on Classes A-1L, A-2L and BL. In determining that weighted average rate, the rate on Class BL is first reduced by a fixed percentage (100 percent). This structure is somewhat inefficient in that it would leave a small amount in the lower-tier REMIC (the excess of interest accruing on the Class BL principal at the Class B rate over interest at 6.5 percent). That amount would be paid out to the lower-tier residual interest. The amount allocated to the lower-tier residual can, however, be held in reserve and used to absorb credit losses or extraordinary expenses before all other classes. Accordingly, the entitlement to that amount is likely to have virtually no value.

Another fact pattern is one in which it is desirable to be able to calculate a specified portion equal to interest on a qualified mortgage over interest at a weighted average of the rates of interest on some or all of the outstanding regular interests.

> ***Example 3***. A REMIC holds five large commercial mortgage loans. It combines the payments on those loans and issues three classes of regular interests, Classes A, B and C, that receive principal sequentially. The average rate of interest on the regular interests is lower than the rate on each of the mortgages. It is desirable commercially to create five IO classes representing a strip of interest from each loan. The reason is that the likely timing of prepayments may differ from one loan to another. The IO class for each loan pays interest representing the excess of interest on that loan over interest on the loan balance at a rate equal to a weighted average of the rates of interest on Classes A, B and C.

The desired strips can be created using two tiers of REMICs. The lower-tier REMIC issues Classes AL, BL and CL regular interests with small principal balances mirroring the Class A, B and C interests (and having the same rates of interest), and five classes corresponding to the five loans. Each IO is the excess of interest on the lower-tier regular interest relating to a loan over a rate equal to a weighted average of the rates on Classes AL, BL and CL.

The use of multiple tier REMICs is a well established practice and has been acknowledged in a number of settings by the IRS.[139] We are not aware of any unresolved tax policy issues relating to the securities classes created using the structure. The biggest potential challenge for IOs generally is how to compute income accurately given the fact that the returns on an IO class can be affected significantly by changes in prepayment speeds. This issue,

[139] See, for example, Treasury Regulation § 1.1275-2(c)(4), Example (2), which illustrates how an OID rule applies to a two-tier REMIC structure, and Treasury Regulation § 1.6049-7(b)(1)(i), which exempts a REMIC that issues all of its regular interests to a second REMIC from the requirement of filing Form 8811. For additional examples, see Peaslee & Nirenberg, Chapter 6, Part D.7.a. See also Chapter 7, Part F.2, for additional examples illustrating the use of two-tier REMICs.

however, is not unique to IO classes created in multiple tier structures. Doubts about whether IO classes should be taxed as debt instruments[140] led Congress to prohibit such classes in the original REMIC legislation enacted in 1986.[141] Those doubts were overcome and the specified portion language in section 860G(a)(1)(B)(ii) was added in 1988. The change apparently reflected a belief that, whether or not IO classes resemble conventional debt, they can appropriately be taxed under debt rules (specifically, those relating to debt instruments with original issue discount).[142] The main contingency affecting yield is prepayments, and section 1272(a)(6) provides a reasonable and administrable method for taking expected and actual prepayments into account. It should also be noted that the timing of income inclusions by holders of IO classes is matched by the deductions allowed to the REMIC, which are reflected in the taxable income reported by the holders of the residual interest.

The flexibility that multiple tier REMICs afford in creating different types of IO interests is important in meeting legitimate commercial needs. Further, the structure works technically under the statute and regulations and does not, we believe, raise tax policy concerns. The use of multiple tier structures, however, creates complexity and adds administrative costs.

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140 The value of an IO is directly related to interest rate levels (lower rates lead to higher prepayments which reduce the value of an IO). The effect of changes in rates on the yield of an IO is more dramatic than for a conventional debt instrument because of the lack of principal. Given these characteristics, there was a concern that an IO might be more analogous to an option or forward contract than a debt instrument.

141 The legislative history indicated that an interest in a REMIC could not qualify as a regular interest if the interest payments thereon were disproportionately high compared with its principal amount. See 1986 Conference Report at II-229. An IO having only notional principal would of course have disproportionately high interest. The rule is now reflected in Treasury Regulation § 1.860G-1(b)(5)(i), which applies to a class of interests having an issue price of more than 125 percent of their principal amount.

142 Note that taxing an IO as a debt instrument means that income is ordinary and accrues over time, unlike the treatment of an option or forward contract. Coupon strips created outside of the REMIC context by separating the ownership of rights to interest from rights to principal are, of course, taxed as debt instruments under section 1286.

We recommend that the definition of specified portion in the REMIC regulations be changed to allow directly in a single REMIC what can now be done using multiple tiers of REMICs. In particular, we recommend that the specified portion definition allow interest payments calculated by reference to the principal balances of and rates on the regular interests issued by a REMIC, as well as the qualified mortgages it holds. To this end, we recommend replacing Treasury Regulation § 1.860G-1(a)(2)(i) (definition of a specified portion) with the following:

> For purposes of section 860G(a)(1)(B)(ii), a specified portion of the interest payments on qualified mortgages means interest payments that can be expressed as—
>
> (A) interest accruing on a designated principal balance at a qualified rate; or
>
> (B) interest accruing on a designated principal balance at a qualified rate in excess of interest accruing on the same or a different designated principal balance at one or more qualified rates.[143]
>
> A designated principal balance shall mean the principal balance of some or all of the qualified mortgages held by the REMIC or some or all of the classes of regular interests issued by the REMIC, or the largest or smallest of two or more designated principal balances. In determining a designated principal balance, the principal balance of a qualified mortgage or class of regular interests may first be adjusted to equal the lesser of a fixed amount or such principal balance or by subtracting a fixed amount.[144] A qualified rate is a fixed rate or a variable rate described in paragraph (a)(3) of this section, except that for this purpose a

143 The commercial reason for using a different designated principal balance is illustrated by Example 2, above, where the rate on Class B is economically the excess of interest on the mortgages over the interest paid on Classes A-1 and A-2.

144 This rule reflects the fact that it is always possible using multiple tiers of REMICs to divide any qualified mortgage or regular interest class into fast-pay and slow-pay components (where principal would be applied first to pay down the fast-pay component and then to pay the slow-pay component). The slow-pay component would have a principal balance equal to the lesser of the principal balance of the qualified mortgage or the regular interest class and a fixed amount equal to the initial principal amount of the slow-pay component. The principal balance of the fast-pay component would equal the principal balance of the qualified mortgage or the regular interest less a fixed amount equal to the initial principal amount of the slow-pay component. The rule allows specified portion classes to be created based on a principal balance equal to the lesser of a fixed amount or the actual balance, or the actual balance less a fixed amount, without the need to use multiple tiers to create fast-pay and slow-pay components.

> weighted average rate under paragraph (a)(3)(ii) shall include a weighted average of the rates on some or all of the qualified mortgages held by the REMIC, determined in accordance with paragraph (a)(3)(ii) as if regular interests issued by the REMIC were qualified mortgages held by the REMIC.[145]

Another gap in the specified portion definition relates to the payment of interest on deferred amounts. It is clear under the REMIC regulations that once the entitlement to a specified portion amount has been created, the actual payment of the amount can be deferred, even in a non-default setting.[146] It is possible to define the entitlement of a specified portion class and then use the corresponding cash to pay principal on another class of regular interests. Thus, in Example 1, above, interest allocated to Class IO might be actually paid to Class A until it is retired in order to further accelerate that class. Where this is done, economically, the specified portion class should be paid interest on the deferred amounts. Further, the reduction in principal of the class that gets the cash frees up interest that can be used for this purpose. The ability to defer interest should carry with it the ability to pay interest on deferred amounts, but the regulations are silent on the point. We recommend that the point be addressed explicitly. This could be accomplished by amending Treasury Regulation § 1.860G-1(b)(3)(iv) to read as follows:

> (iv) Deferral of interest. An interest does not fail to qualify as a regular interest solely because that interest, by its terms, provides for deferral of interest payments (whether or not the deferred amounts themselves bear interest, provided such interest is computed at a fixed rate or a variable rate described in paragraph (a)(3)).

145 Example 3, above, illustrates a case in which it is desirable commercially to be able to subtract out a variable rate equal to a weighted average of the rates of interest on one or more regular interest classes.

146 See Treasury Regulation § 1.860G-1(b)(3)(iv).

D. Basis Risk Payments Payable From Specified Portion Classes

In commercial mortgage securitizations, a REMIC may hold floating rate mortgage Basis Risk s bearing interest at a range of floating rates (subject to varying caps) and issue floating rate regular interest classes with full principal amounts ("P&I classes") supported by those mortgages. It is common in such a case for each P&I class to bear interest at a rate equal to the lesser of a floating rate based on a rate index (e.g., LIBOR) or a mortgage WAC rate. An IO class would be created that is entitled to the excess of the WAC rate on the mortgages over the WAC rate on the P&I classes.

One drawback of this structure is that the IO class could receive payments at a time when the mortgage WAC cap is binding for some P&I classes. This can occur if for some classes the indexed rate is greater than the mortgage WAC rate but for other classes the indexed rate is lower than such WAC rate (for example, the rate would be lower on senior classes). In those circumstances, it is often desirable commercially to divert funds from the IO class to the capped class equal to the lesser of the amount received by the IO class and the amount that is not paid to the capped class because of the cap. Under current practice, this is often accomplished by having the holders of the IO class sell an interest rate cap agreement to holders of the capped class. The cap agreement is part of the transaction documents but outside of the REMIC.[147] Only nominal premiums are assigned to the cap agreement because the likelihood of payments is generally considered to be quite low (although not remote). This arrangement works technically, but is obviously messy. For example, it requires holders of the P&I classes to account separately for payments on regular interests and cap payments. It would be desirable to be able to create these cash flow allocations directly within a REMIC.

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147 The REMIC regulations contemplate such arrangements. See Treasury Regulation § 1.860G-2(i).

The REMIC regulations include a rule that allows payments on a class of regular interests to be subject to a funds-available cap.[148] Specifically, it allows a funds-available cap to be disregarded in determining if a rate on a class of regular interests is a qualifying variable rate within the meaning of Treasury Regulation § 1.860G-1(a)(3). A funds-available cap is a limit on the interest to be paid on a class in any period that is based on the total amount available to make payments. A funds-available cap does not include any cap or limit on interest payments used as a device to avoid the definition of a qualifying variable rate. Examples illustrating the rule indicate that the device exception was intended to prevent the use of a funds-available cap to pass-through to investors contingent interest payments received on mortgages. This could happen if a stated variable rate were set high so that the cap effectively determined the actual rate of interest and the qualified mortgages in the REMIC included mortgages paying contingent interest. The main economic purpose of the rule is to address cases in which (1) interest is paid on regular interests at a floating rate, (2) interest is paid on mortgages at a different floating rate (or the same rate reset at different times), and (3) the mortgage interest is expected to be sufficient to cover interest on the regular interests, but in some circumstances will fall short (even absent a default). The rule allows the rate accruing on the regular interests to be capped at the amount of mortgage interest available for payment.

The funds-available cap addresses a case that is very close to the one described at the beginning of this section involving P&I and IO classes. The indexed rates on the P&I classes are expected to be less than the mortgage WAC rate, but in some unlikely circumstances will not be. The P&I classes could be written not to have a WAC cap on their rates but rather to have a cap based on available funds. Such a cap would seem to qualify under the available-funds cap

[148] Treasury Regulation § 1.860G-1(a)(3)(v).

rule. It would also, however, be necessary to address the potential reduction in payments on the IO class.

Under the normal approach used in creating the IO class, that class would have an entitlement to the sum, taken over all P&I classes, of the excess, if any, of the mortgage WAC rate over the rate on the P&I class.[149] The commercial goal, however, is to reduce that entitlement by the excess for any P&I class of the rate on that class over the mortgage WAC class (i.e., to take the sum giving effect to negative numbers as well as positive ones). This could be done by imposing a funds-available cap on the IO class, where payments allocable to P&I classes with a higher priority would be considered unavailable to the IO class. The technical problem with this approach is that the funds-available cap rule in the regulations does not apply by its terms to specified portion classes.

We do not see a reason for distinguishing between specified portion classes and variable rate classes in applying the funds-available cap rule. Accordingly, we recommend that the rule be extended to specified portion rates. To clarify the intention, we further recommend that an example be added reflecting the IO and P&I class structure outlined above.

Our recommendation could be implemented by adding a new second sentence in Treasury Regulation § 1.860G-1(a)(3)(v)(A) to read as follows: "Similarly, interest payments are a specified portion described in paragraph (a)(2) of this section if they would be described in paragraph (a)(2) except that they are subject to a 'funds-available" cap." Also, in Treasury

[149] The IO class would normally be created using a two-tier REMIC in which the lower-tier REMIC issues regular interest classes that correspond to the P&I classes but bear interest at a rate equal to the mortgage WAC rate. The IO class would then be entitled to a specified portion of the interest on each of the lower-tier regular interests equal to the excess of the mortgage WAC rate over rate on the corresponding P&I class. That excess could not be negative. This technique is illustrated by Example 1 in Part V.C, above.

Regulation § 1.860G-1(a)(3)(v)(B), replace the reference to "paragraph (a)(3)(i) through (iv)" with "paragraph (a)(2) or (a)(3)(i) through (iv)." Finally, add a new example as follows:

> Example _. (i) A sponsor conveys a pool of mortgages to a trustee in exchange for three classes of certificates, Classes A, B and IO. Each of the mortgages pays interest at a variable rate described in paragraph (a)(3), although the rates are not the same for all of the mortgages. Classes A and B have an aggregate principal amount equal to the principal amount of the mortgages. Principal received on the mortgages will be allocated first to Class A and then to Class B. Classes A and B are entitled to interest at a variable rate described in paragraph (a)(3)(i) (a current interest rate), subject to a cap equal to the amount of interest payable on the mortgages. Class IO is entitled to interest on the mortgages in excess of interest paid on Classes A and B.
>
> (ii) The trust makes two REMIC elections, for a lower-tier and upper-tier REMIC. The upper-tier REMIC issues Classes A, B and IO. The lower-tier REMIC holds the mortgages and issues to the upper-tier REMIC Classes AL and BL regular interests. They are identical to Classes A and B except that they bear interest at a rate equal to a weighted average of the rates of interest on the mortgages. The IO class is entitled to a specified portion of the interest paid on Class AL over the rate paid on Class A and a specified portion of the interest paid on Class BL over the rate paid on Class B. However, the Class IO entitlement is limited to the excess of the interest received on Classes AL and BL over the interest paid on Classes A and Class B.[150]
>
> (iii) At the time when the Class A, B and IO interests are issued, the weighted average rate of interest on the mortgages exceeds the rate on Class A and the rate on Class B. Based on historical data, the sponsor does not expect the rate on either Class A or Class B to exceed such weighted average rate. None of the mortgages held by the lower-tier REMIC bears interest at a contingent rate, and therefore the limitations on the interest payable on all three classes are not a device to pass-through contingent interest. The limitations on the amounts payable on each of Classes A, B and IO is a funds-available cap.

150 The example reflects the current definition of specified portion. If our recommendations relating to the specified portion rate set forth in Part V.C, above, were adopted, it would be possible to create Class IO directly as the excess of interest on the mortgages at a WAC rate over interest at a WAC of the rates on the regular interests created by the REMIC. In that event, this example would not require a funds-available cap. As a general principle, however, we do not see a reason for distinguishing between a specified portion rate and a variable rate in applying the funds-available cap rule.

E. Improper Knowledge Test

To preserve the value of its mortgage assets, a REMIC must have the right to acquire collateral securing the mortgages in the event of a default.[151] This right is particularly significant for commercial mortgages. The REMIC rules address the point by treating "foreclosure property" as one of the types of "permitted investments" a REMIC can hold (in addition to qualified mortgages). See section 860G(a)(5). Section 860G(a)(8), in turn, defines foreclosure property under a two-part test to mean property which (i) would be foreclosure property for a REIT under section 856(e) and (ii) is acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC. The reference to section 856(e) incorporates Treasury Regulation § 1.856-6, which defines foreclosure property for purpose of the REIT provisions. Treasury Regulation § 1.856-6(b)(3) provides, in part, that property is not eligible to be foreclosure property "if the loan or lease with respect to which the default occurs (or is imminent) was made or entered into (or the lease or indebtedness was acquired) by the [REMIC] with an intent to evict or foreclose, or when the [REMIC] knew or had reason to know that default would occur ('improper knowledge')."

This regulation was devised for REITs. In applying it to REMICs, it is helpful to keep in mind the differences between the two. A REIT is a much more flexible vehicle than a REMIC. It is allowed to raise funding over time and can hold real estate as well as mortgages as a primary activity. The significance for a REIT of having property qualify as foreclosure property is that it avoids a concern about the REIT acting as a dealer with respect to the property.

151 A REMIC could enforce its rights as a creditor and avoid acquiring real property by forcing the sale of collateral to someone else in a foreclosure sale. However, it is generally considered commercially important for a mortgage creditor to be able to sell in two steps, by first taking control of a property by bidding in the loan and acquiring title, and then selling through a negotiated sale not subject to foreclosure procedures.

It comes at a cost, however, which is that certain income from the property is subject to a corporate tax. Because of this cost, property becomes foreclosure property only if the REIT so elects. By contrast, the failure of acquired real estate to qualify as foreclosure property is a death knell for a REMIC, at least if the size of the holdings is more than *de minimis* (generally 1 percent of the REMIC's assets).[152] If the property is *de minimis* then net income from the property is confiscated through a 100 percent prohibited transactions tax.

The "improper knowledge" regulation has two parts, a subjective intent test and a test based on defaults. Pooling and servicing agreements include a representation by the sponsor that it does not have the improper intent, and it would be remarkable if it did. A REMIC is a poor choice as a vehicle through which to hold real property, and it is highly unlikely that anyone would use one for that purpose voluntarily.[153] Turning to the default test, one reading of the test is that property acquired on foreclosure of a mortgage is not foreclosure property if the mortgage is in default (including a technical default) or a default is a foregone conclusion when the loan is transferred to a REMIC. This reading would be quite encompassing because loans may be in default for a host of reasons, including a late payment or one missed payment that is followed by a pattern of regular payments where the default has not technically been cured. We believe a

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[152] Specifically, the REMIC would fail the asset test in section 860D(a)(4). This provision requires that "substantially all" of a REMIC's assets be permitted assets, but the legislative history reads this to mean "not more than *de minimis*" and that reading is reflected in Treasury Regulation § 1.860D-1(b)(3).

[153] Among other constraints, a REMIC cannot issue new classes of "debt" over time, even to refinance existing debt, and must have a single class of equity that is subject to a number of special adverse rules. These include treating all income as ordinary and in some cases not allowing the income to be offset with losses. Foreclosure property cannot be held indefinitely and certain categories of net income from foreclosure property are subject to a corporate tax under section 860G(c). By contrast, a publicly traded partnership can hold real property even in a dealer capacity and collect rents (other than certain profit based rents) without being treated as a corporation under section 7704. See sections 7704(d)(1)(C) and (D).

more appropriate reading is that the default must be one that is serious enough so that it will likely lead to foreclosure. The IRS has followed this approach in private letter rulings. In Private Letter Ruling 9721005 (February 6, 1997), for example, the Service concluded that:

> [T]he type of default that is relevant for purposes of the REMIC provisions generally and Section 1.856-6(b)(3) of the regulations specifically is the type of default that would cause a reasonable lender to institute foreclosure proceedings against a delinquent borrower. The mere fact that a payment is late for an insubstantial amount of time or a minor covenant to a loan agreement is breached is usually insufficient to cause a loan to fail the improper knowledge test. In applying the improper knowledge test, it is appropriate to consider all the facts and circumstances, including payment delinquencies, debt-service coverage ratios, loan-to-value ratios, an underlying property's occupancy rate, a debtor's financial position and stake in an underlying property, and any communication from the debtor. Ordinarily, no single factor in and of itself is determinative.

We believe that this "facts and circumstances" approach to the improper knowledge test creates undue uncertainty in light of the serious adverse consequences of guessing wrong. The uncertainty is not needed to thwart evil given the complete lack of incentives for taxpayers to try to manage real property through a REMIC. Accordingly, we recommend that the REMIC regulations create a bright-line test limiting application of the default component of the definition of improper knowledge. The test would require a minimum period of delinquency as of the cut-off date for transferring loans to a REMIC before knowledge of a default leading to foreclosure would be considered to exist (assuming that foreclosure proceedings have not yet begun).[154] We suggest a minimum period of 89 days for residential loans and 59 days for commercial loans (the same period used in the TMP regulations in defining a "seriously impaired" loan).[155]

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[154] The cut-off date is the date used in a contract transferring loans to divide up the entitlement to loan cash flows between the transferor and transferee. It is essentially the date as of which the burdens and benefits of the loans shift to the transferee and representations regarding the payment history of loans are usually made as of the cut-off date.

[155] See Treasury Regulation § 301.7701(i)-1(c)(5)(ii).

The recommendation could be implemented by adding at the end of Treasury Regulation § 1.860G-2(g) the following:

> (4) *Foreclosure Property—Safe Harbor Rule.* An interest in real property securing a qualified mortgage held by a REMIC shall in no event fail to be foreclosure property on the ground that the REMIC knows or has reason to know that the mortgage will default unless as of the cut-off date for transfer of the qualified mortgage to the REMIC either (i) foreclosure proceedings or other process of law have commenced to compel the borrower to transfer the property to the REMIC (not including contacting a borrower or giving notice regarding late payments or defaults) or (ii) payments on the qualified mortgage are delinquent for a period of 89 days in the case of a single-family residential mortgage or 59 days in the case of a multi-family or commercial loan and the default arising from such delinquency has not been waived, formally or through a course of conduct.[156] A REMIC may establish that the conditions in (i) or (ii) do not exist with respect to one or more qualified mortgages based on the reasonable beliefs of the sponsor as of the cut-off date. A sponsor may base a reasonable belief on representations and warranties from the originator or servicer of the mortgages or evidence as to established servicing practices relating to the mortgages.

The safe-harbor rule addresses only the default component of the definition of improper knowledge. Thus, it would not prevent property from failing to be foreclosure property if it was acquired by the REMIC with the intent to evict or foreclose.[157]

While the proposed safe-harbor rule is generous to taxpayers, we believe it is appropriate given that taxpayers have no incentive to engage in the activity the improper knowledge test seeks to prevent. Also, highly unusual cases in which a taxpayer did have a plan to use a REMIC to hold property acquired through foreclosure would still be caught by the subjective intent component of the improper knowledge test.

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[156] The reason for the waiver language is to address a fairly common case for residential mortgages where a borrower skips a payment and then resumes making regular payments without ever making up the missing payment. The loan technically continues in default but effectively the default is waived.

[157] Presumably such an intent would not exist unless the REMIC either desired the foreclosure or eviction or the foreclosure or eviction was substantially certain to occur. In practice, the lack of the relevant intent would be established through a representation by the REMIC's sponsor. The REMIC, as such, is unfeeling.

F. Integration of Qualified Mortgages and Hedges

A REMIC can hold qualified mortgages secured by real property located outside the United States.[158] Payments on such mortgages will usually be in a currency other than the United States dollar, the most common functional currency of a REMIC. A REMIC cannot enter into a foreign currency hedge to convert non-dollar flows into dollars if the contract is considered an asset or liability separate from the related qualified mortgages.[159] Under general tax principles, a debt instrument and a related foreign currency hedge are considered separate items. However, Treasury Regulation § 1.988-5 allows a taxpayer to integrate a foreign currency hedge and a debt instrument if certain conditions are met. The effect of integration is to create a single synthetic debt instrument for tax purposes. We believe it would be appropriate in applying the REMIC rules to treat a hedge contract as part of the qualified mortgage to which it relates (and correspondingly, to treat the claim of the counterparty as not an interest in the REMIC) if the two are integrated under Treasury Regulation § 1.988-5.

We expect that a REMIC would almost always enter into a hedge at the time it acquires a qualified mortgage. If it did not, then we think it would be appropriate to treat the replacement of the original mortgage with the synthetic one as an exchange of one mortgage for another for purposes of determining whether the new one is a qualified mortgage. In practical terms this would mean that integration after the date on which a REMIC acquires a qualified mortgage could occur only during the 3-month period beginning on the startup day (the period

158 See Revenue Ruling 74-191, 1974-1 C.B. 170; Treasury Regulation §§ 1.860G-2(a)(4) and 1.856-3(c) and - 3(d).

159 A foreign currency hedge does not appear to qualify as (1) a permissible REMIC asset (to the extent the hedge is an asset) or (2) to the extent it is a liability, a permissible interest in a REMIC, which generally must be either a regular or residual interest. A foreign currency hedge would not qualify as a "credit enhancement contract" (broadly, a contract to protect against defaults or unexpected expenses that is treated under Treasury Regulation § 1.860G-2(c)).

during which a qualified mortgage can be freely exchanged for a qualified replacement mortgage). For simplicity, we recommend that post-acquisition integration not be treated as creating a new qualified mortgage but be subject to the requirement that it occur within such 3-month period.

A hedge contract could involve an up-front payment by the REMIC to the hedge counterparty. In that case, the synthetic debt instrument would be larger than the original loan by the amount of the payment. To ensure that the larger loan still meets the "principally secured by an interest in real property" requirement for a qualified mortgage,[160] we recommend that the test be applied to the original loan but giving effect to any added amount as if it were an amount included in the original loan proceeds (and added to its principal amount). For example, if a loan with a principal amount of $100 is integrated with a currency hedge that requires a payment of $5 by the REMIC, the loan would continue to be a qualified mortgage only if it would have been principally secured by real property if its issue price and proceeds had been $105.[161]

The same principles also should apply to a case in which an interest rate hedge is used to convert a qualified mortgage paying interest according to one index into another and the hedge and mortgage are integrated under Treasury Regulation § 1.1275-6. At present the issue is moot because this regulation does not apply to a debt instrument to which section 1272(a)(6)

160 See section 860G(a)(3)(A); Treasury Regulation § 1.860G-2(a).

161 To be more specific, Treasury Regulation § 1.860G-2(a)(1) provides that a loan will meet the "principally secured" test if either (1) the fair market value of real property collateral was at least 80 percent of the loan's adjusted issue price when the loan was originated or when it was contributed to the REMIC or (2) substantially all of the loans proceeds were used to acquire or improve real property. In the example, the test would continue to be applied to the qualified mortgage that results from the integration in the same way it applied to the pre-integration qualified mortgage, except that for purposes of applying clause (1) the adjusted issue price of the loan would be increased by $5, and for purposes of clause (2), the loan would be considered to have additional proceeds of $5 that were not applied to acquire or improve real property.

applies.[162] Those debt instruments include all qualified mortgages held by a REMIC, whether or not they are subject to prepayment. We expect that the exception for section 1272(a)(6) instruments was made to avoid thinking about them rather that due to a conviction that as a policy matter integration should not be available for such instruments.[163] At any rate, we see no basis for distinguishing one integration regime from another in applying the REMIC rules, and recommend that all those that could apply be covered.

To implement these suggestions, we recommend amending Treasury Regulation § 1.860D-1(b)(2) by adding at the end the following:

> (v) Certain hedges. The rights of the counterparty to a hedge are not an interest in the REMIC if the hedge is integrated with a qualified mortgage under § 1.988-5, § 1.1275-6 or any other substantially similar integration rule.

We also suggest amending Treasury Regulation § 1.860G-2(a) to add at the end thereof the following:

> (10) *Integrated Hedges.* A synthetic debt instrument resulting from integrating a qualified mortgage and a hedge under § 1.988-5, § 1.1275-6 or any other substantially similar integration rule shall itself be a qualified mortgage, provided such integration is effective either at or before the time when such qualified mortgage is acquired by the REMIC or no later than the end of the 3-month period beginning on the startup day and, if the hedge requires a payment to the hedge counterparty that is substantially contemporaneous with the issue date of the synthetic debt instrument,[164] the qualified mortgage included in such synthetic debt instrument would have been an obligation principally secured by an interest in real property if its issue price and proceeds had been increased by the amount of such payment.

162 Treasury Regulation § 1.1275-6(b)(1)(ii).

163 The exception is particularly hard to defend when applied to a loan that falls within section 1272(a)(6) solely because it is held by a REMIC or as part of a pool of loans; the loan itself is not changed by the company it keeps. The view that the carve-out was intended to avoid the need to address issues under section 1272(a)(6) is supported by the fact that there are similar carve-outs in other areas. See, e.g., Treasury Regulation § 1.1275-4(a)(2)(v) (exception to contingent payment debt instrument rules).

164 The substantially contemporaneous test is borrowed from Treasury Regulation § 1.1275-6(f)(4).

G. Pre-funding Accounts

A REMIC can hold (subject to the discussion below) only qualified mortgages and permitted investments. The definition of qualified mortgage includes, under section 860G(a)(3)(A)(ii), a mortgage that is purchased by a REMIC within the three-month period beginning on the startup day if such purchase is pursuant to a fixed-price contract in effect on the startup day. The funds needed to effect such a purchase would necessarily be raised on the startup day, because a REMIC must issue all of its interests on that day. The REMIC rules do not address directly the treatment of funds held by a REMIC in a pre-funding account pending the purchase of mortgages after the startup day. Although the definition of permitted investments includes cash flow investments, which are payments received from a mortgage and held temporarily pending distribution to holders of REMIC interests, there is no separate item addressing funds received on issuance of REMIC interests and held temporarily pending their use to buy mortgages.

The status of a pre-funding account as a permitted investment is significant primarily in determining the treatment of earnings on the account. The REMIC asset test in section 860D(a)(4) requires that substantially all of the assets of a REMIC consist of qualified mortgages or permitted investments, but only as of the close of the third month beginning after the startup day and at all times thereafter. Accordingly, holding funds that are not permitted investments in a pre-funding account for up to three months after the startup day would not jeopardize the status of an entity as a REMIC under the asset test. On the other hand, section 860F(a) imposes a 100 percent tax on income from prohibited transactions, and the definition of that term includes, in section 860F(a)(2)(B), the receipt of any income attributable to any asset which is neither a qualified mortgage nor a permitted investment. If funds in a pre-funding account are not a permitted investment, interest earned thereon would potentially be subject to a 100 percent tax. We do not believe Congress could have intended this result given the explicit right of a REMIC to purchase mortgages after the startup day.

In addition to cash flow investments, another type of permitted investment is a qualified reserve asset. This term is defined in section 860G(a)(7) as investment property held in a qualified reserve fund. Such a fund is generally a reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages or lower than expected returns on cash-flow investments. The types of expenses that can be funded through a qualified reserve fund are not limited to unanticipated expenses. The word "expenses" is not defined in the statute or regulations. The term is most often thought of as a charge against current earnings, but as a matter of English usage, it can be read more broadly to mean any type of expenditure or cost.[165] Given the clear intent to allow delayed purchases of mortgages, it is appropriate on policy grounds to read the word liberally to cover amounts paid to buy qualified mortgages, with the result that amounts reasonably required to be held for that purpose could be qualified reserve assets. We recommend that the REMIC regulations be amended to this effect.

Our recommendation can be implemented by adding the following sentence at the end of the definition of qualified reserve fund in Treasury Regulation § 1.860G-2(g)(2): "For this purpose, expenses of the REMIC shall include the cost of effecting a purchase described in section 860G(a)(3)(A)(ii) of qualified mortgages within the 3-month period beginning on the startup day."

[165] Webster's Third New International Dictionary defines expense to include "a financial burden involved typically in the course of an action or manner of living: cost (at his own [expense] he built a fort and persuaded others to join him there ...)."

VI. Changes in Taxable Mortgage Pool Rules

A. Overview

As indicated in Part II.C.3, a TMP is defined in section 7701(i) as any entity or portion thereof (other than a REMIC or a FASIT) that meets an Asset Test, Maturities Test and Relationship Test. A TMP is classified as a corporation but cannot join in a consolidated return.

As explained further below, the TMP rules were enacted as a backstop to REMICs to encourage taxpayers to make REMIC elections. In practice they cut a broader swath because a TMP may be found in circumstances in which no REMIC election is possible. Indeed, the existing TMP regulations state explicitly that the fact that a REMIC election is not available will not prevent an entity from being a TMP.[166] The costs of falling within the TMP rules (without a hope of escape through a REMIC election) can be severe. These include not only the corporate tax on income allocated to an equity interest, but also breaking consolidation and in some cases complexities arising from the addition or removal of an "extra" corporation in a structure. The problem is compounded by uncertainty in applying the rules. While some uncertainty may be unavoidable, it seems a bit anachronistic in a world with check-the-box classification rules.

We recommend four changes to the TMP regulations. Two of the changes are intended to better coordinate the TMP and REMIC rules by preventing the former from applying when no REMIC election is available. Other changes will provide clearer standards for

[166] Treasury Regulation § 301.7701(i)-1(a): "The taxable mortgage pool provisions apply to entities or portions of entities that qualify for REMIC status but do not elect to be taxed as REMICs as well as to certain entities or portions of entities that do not qualify for REMIC status."

determining when an entity is a TMP. All of the recommended changes are supported by the purpose of the TMP rules, which is discussed in the next section.[167]

B. Purpose of TMP Rules

As indicated in Part II, above, a typical offering of CMOs (a fixed pool of fixed rate mortgages supporting different classes of debt with multiple maturities) can produce phantom income in early years followed by matching losses or reduced income in later years. The REMIC rules ensure that phantom income that is allocated to a REMIC residual interest will be subject to one layer of tax (although not necessarily a corporate tax). We believe that Congress intended to ensure that the safeguards for taxing residual income not be avoided by the simple expedient of not making a REMIC election and adopted the TMP rules to encourage taxpayers to elect.

A number of factors support the view that TMPs are a backstop to REMICs. First, the legislative history directly links REMICs and TMPs and indicates that TMPs were aimed at issuers of the types of mortgage-backed securities that could be issued through REMICs.[168] Second, the effective date of the TMP rules was delayed by five years to ensure

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167 The recommended changes could be seen as related to FASIT repeal, but the link is somewhat weak. An entity is not classified as a TMP if it qualifies as a FASIT. If the FASIT rules were repealed, one possible avenue of escape from the TMP regime would be lost. Given, however, that the ownership interest in a FASIT must be owned by a taxable C corporation, the imposition of a corporate tax on net income is not a material difference between FASITs and TMPs. The main difference is that a FASIT could issue securities and be sure of an interest deduction and a TMP does not benefit from a safe-harbor debt regime.

168 See 1986 Conference Report II-239: "The conferees intend that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of taxation. Thus, the conference agreement provides that a 'taxable mortgage pool' ('TMP') is treated as a taxable corporation that is not an includible corporation for purposes of filing consolidated returns." The next paragraph in the 1986 Conference Report summarizes the definition of a TMP, and refers to the fact that owner's trusts (the vehicle then being used to issue CMOs) would meet the definition. The quoted language is somewhat vague because it uses the term "mortgage-backed securities" without defining it. However, it is plausible to believe that Congress had in mind those types of agency-backed MBS that were then being issued in the form

REMICs would be a viable alternative. Third, imposing a corporate tax on net income from a mortgage pool is difficult to understand in policy terms except as a means of forcing REMIC elections. The TMP rules obviously are not based on the resemblance of a TMP to a traditional corporation or other conventional entity classification tests.[169] Fourth, in a case where a REIT owns a TMP, the TMP is disregarded as a REIT subsidiary and no corporate tax is imposed. Instead, the REIT's stock is subject to rules analogous to those applicable to REMIC residual interests that are intended to ensure that holders are subject to at least one individual or corporate tax on phantom income.[170] Fifth, the TMP rules apply only to mortgage-related structures even though phantom income can also exist in non-mortgage securitizations. Finally, the corporate tax imposed on a TMP is typically a greater burden than the taxes imposed on the residual interest in a REMIC.[171] Thus, it is not likely that Congress anticipated that TMP structures would ever be used deliberately.

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of CMOs (fixed pools with pass-through features) and did not contemplate that the types of "mortgage-backed securities" that could be issued through REMICs would depart significantly from those covered by the TMP definition.

169 For example, the TMP definition does not distinguish between different types of issuers or between active and passive holdings of debt.

170 See section 7701(i)(3). Because a REIT is already a corporation that cannot join in a consolidated return, treating it as such under the TMP rules has no consequences. If a portion of the assets of a REIT is treated as a TMP, the resulting entity is generally a qualified REIT subsidiary that is ignored under section 856(i)(1). Congress could have imposed a corporate tax on income earned by a REIT from a TMP but chose instead the approach described in the text.

171 This is true for three reasons. First, a REMIC residual interest typically has no economic value and income thereon that is subject to tax is limited to noneconomic "phantom" income. By contrast, a non-REMIC issuer would not benefit from a safe-harbor debt rule and would need a material amount of equity. Under the TMP rules income on such equity would be subject to the corporate tax. Second, the REMIC rules do not require REMIC residual interests to be held by a corporation, so tax on income from such interests when earned by taxpayers other than C corporations is a final tax. By contrast, income on TMP equity is subject to a corporate tax and then a second tax when distributed out of corporate solution. Finally, the corporate tax imposed by the TMP rules is a liability of the issuer, which means that purchasers of securities of the issuer need to be assured that funds will be available to pay corporate taxes (even if, for example,

C. Real Estate Mortgage Definition

The Asset Test requires that substantially all of the entity's assets consist of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests therein) consist of real estate mortgages. Under the current regulations, the definition of "real estate mortgage" is broader than the definition of a "qualified mortgage" for REMIC purposes. It includes the following types of assets that would not be REMIC qualified mortgages:

- Obligations issued after December 31, 1991 that are secured by real estate mortgages, or by real estate mortgages and other assets.[172] With the exception of REMIC regular interests, such obligations would fail to be qualified mortgages under the REMIC rules.[173]
- Equity interests in various pass-through arrangements that are not grantor trusts.[174]
- REMIC residual interests.[175]

The preambles to the TMP regulations (proposed and final) do not explain the reason for having a broader definition of real estate mortgage. The rationale may have been to serve as an anti-abuse measure. If so, we believe the point should be addressed directly, carving out assets that could have been qualifying assets and are not because of steps taken to avoid the TMP rules.

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rates change or deductions are disallowed). The Senate version of the REMIC legislation had imposed a corporate tax on an amount of net income of a REMIC corresponding to excess inclusion income. See Senate Report No. 99-313, 99th Cong. 2d Sess. (Report of Senate Finance Committee on H.R. 3838), 795. The tax was changed in conference to a tax on the holders of the residual interest following protests that a potential entity-level tax liability would impair the rating of REMIC securities.

172 Treasury Regulation § 301.7701(i)-1(d)(3)(ii).

173 Treasury Regulation § 1.860G-2(a)(6).

174 Treasury Regulation § 301.7701(i)-1(c)(3); 1.860G-2(a)(6).

175 Treasury Regulation § 301.7701(i)-1(d)(ii); 1.860G-2(a)(6).

There can be uncertainty as to whether a mortgage is a qualified mortgage that can be held by a REMIC. The REMIC regulations address such uncertainty by allowing a taxpayer to treat a mortgage as a qualified mortgage based on reasonable belief.[176] We think it is inappropriate to apply the TMP rules in cases where a taxpayer reasonably believes the REMIC alternative is unavailable (provided again the taxpayer did not deliberately cause the uncertainty).

Another common case where a REMIC cannot practically be used is where a mortgage is impaired to the degree where the owner reasonably believes there is "improper knowledge" that would prevent property acquired on foreclosure of the loan from being foreclosure property under the REMIC rules. The improper knowledge test is discussed in Part V.E, above. In short, it says that if a REMIC knows or has reason to know at the time when a qualified mortgage is acquired that a default (or at least a default that will trigger a foreclosure) will occur, then property acquired in foreclosure of the mortgage will not be foreclosure property and cannot be acquired by a REMIC. Because a securitization must be structured to accommodate defaults, the inability to acquire such an asset on foreclosure generally makes it infeasible to place such a mortgage in a REMIC.

The TMP regulations include a helpful rule aimed at defaulted mortgages that prevents a mortgage from being considered a debt obligation if it is "seriously impaired."[177] Whether a debt obligation is seriously impaired is generally determined based on all facts and circumstances. There is a safe-harbor rule that treats a single-family residential mortgage and a multi-family residential or commercial mortgage as seriously impaired if payments on the

[176] Treasury Regulation § 1.860G-2(a)(3).

[177] Treasury Regulation § 301.7701(i)-1(c)(5).

mortgage are more than 89 days delinquent or 59 days delinquent, respectively. However, the safe harbor does not apply, among other cases, if an entity is receiving or anticipates receiving payments of interest or principal that are substantial and relatively certain as to amount. Thus, if a commercial mortgage is paying interest, but is expected to default on a principal payment in a year or two because the currently appraised value of the property is not enough to support new debt, the 59-day safe-harbor rule would not be available. We believe the regulations should include an additional safe-harbor rule that would treat a real estate mortgage as seriously impaired if a taxpayer reasonably believes property acquired on foreclosure of the mortgage would not be foreclosure property if the loan defaults.

Accordingly, we recommend that the TMP regulations be amended by deleting Treasury Regulation § 301.7701(i)-1(c)(3) (which includes an interest in pass-through entities in the definition of real estate mortgage) and amending Treasury Regulation § 301.7701(i)-1(d) to read as follows:

> (d) **Real estate mortgages or interests therein defined**. For purposes of section 7701(i)(2)(A)(i), the term real estate mortgage or interest therein means any obligation or interest therein that would be a qualified mortgage within the meaning of section 860G(a)(3) if being contributed to a REMIC on the startup day. A taxpayer may treat a mortgage as not a qualified mortgage for this purpose if he reasonably believes the obligation would not be such a qualified mortgage. However, if an asset would be such a qualified mortgage but for terms, conditions or arrangements that are created or undertaken with a view to avoiding application of section 7701(i) (including the holding of mortgages through a pass-through entity), then the asset shall be treated as a qualified mortgage for purposes of this paragraph (d).

We further recommend the addition to the regulations of a new Treasury Regulation § 301.7701(i)-1(c)(5)(ii)(D) safe-harbor rule reading as follows:

> (D) A mortgage shall be considered seriously impaired at any time if the taxpayer reasonably believes that if such mortgage were contributed to a REMIC at such time, and the REMIC later acquired property securing such mortgage in

connection with a default or imminent default, such property would not qualify as foreclosure property within the meaning of section 860G(a)(8).

D. Revolving Loan Pools

In order to qualify as a REMIC, an entity must have a fixed, and not a revolving, pool of assets.[178] There is no explicit requirement of a fixed pool for an entity to qualify as a TMP. We believe, however, that the Relationship Test should be applied taking account of all debt obligations held by an entity during the period liabilities are outstanding, with the result that the Relationship Test would not be met in a revolving pool structure. We recommend that the regulations clarify this point.

The Relationship Test is met if, under the terms of the entity's liability obligations (debt it issues) or an underlying arrangement, the timing and amount of payments on the liability obligations are in large part determined by the timing and amount of payments (or projected payments) on the debt obligations held by the entity (asset obligations).[179]

The Relationship Test is plainly met by a conventional CMO issuer that holds a fixed pool of mortgages and issues debt that is repaid through principal payments (scheduled payments and prepayments) received on the mortgages securing the CMOs. The principal payments on the asset obligations determine the principal payments on the liability obligations because principal received is used to pay principal on outstanding CMOs. The same is not true in a revolving pool structure where principal receipts are reinvested in new mortgages during a revolving period and passed through only after that period is over. Once the pool composition changes, the link is severed between the assets acquired with the liability obligations and

[178] REMIC assets generally must be contributed to the REMIC within three months of the designated startup day to be a qualified mortgage. Section 860G(a)(3)(A). An exception exists only for qualified mortgages contributed within two years of the startup day to replace a defective mortgage. Section 860G(a)(4).

[179] Treasury Regulation § 301.7701(i)-1(f).

payments on those obligations. In terms of the policy discussion above, we believe a revolving pool structure departs far enough from the kind of mortgage-backed security Congress had in mind so that it should not be caught by the TMP rules. A REMIC election is not available for a revolving pool and there is no need to force such an election. Also, revolving pools break the pattern of a fixed amount of income that is allocated among different liability classes in a way that causes a timing mismatch.[180]

In light of the foregoing, we believe the Relationship Test should be applied to an entity on a testing date giving effect only to payments on asset obligations that are held by an entity or that will be acquired in the future under a contract existing on the testing date where the contract substantially fixes the yield of the assets to the entity. A fixed-price purchase of floating rate assets or fixed rate loans that are newly originated at a current market rate would not fix the yield. Taxpayers should be allowed to use reasonable projections to determine the degree to which assets are rolled over. This rule would be subject to the anti-abuse rule in Treasury Regulation § 1.7701(i)-1(g), so that if a taxpayer sought to invest in one asset for a short period and replace it with another to avoid the TMP rules and not for commercial reasons, it would be subject to attack.

To implement these suggestions, we recommend that the TMP regulations be amended by including the following as Treasury Regulation § 301.7701(i)-1(g)(4):

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180 The type of phantom income that raises special policy concerns is income that is noneconomic because it will necessarily be offset with future losses. Noneconomic income can potentially be parked with non-taxpaying entities. Phantom income arises when there is a pool of assets with fixed cash flows, a pool of liabilities that will be paid with those receipts (in a highly predictable way) and a timing mismatch that produces first income and then an offsetting loss. By contrast, a taxpayer that realizes spread income by borrowing at one rate and holding assets with a higher yield (for example because of differences of credit quality or mismatches in the variability of rates) is taking real risks and earning real income.

(4) *Revolving asset pools.* (i) In determining whether payments on liability obligations of an entity bear a relationship to payments on asset obligations of the entity, there shall be taken into account only payments on asset obligations that are owned by the entity or that an entity has a contractual right to acquire on terms that substantially fix the yield of the asset obligations to the entity. The rate at which asset obligations are expected to be replaced through the reinvestment of cash receipts may be determined using reasonable projections.

(ii) *Example.* The following example illustrates the principles of this subparagraph (4):

Example (1). A trust owns a revolving pool of mortgage loans and issues two classes of bonds (Class A and Class B) backed by the mortgage loans. During a revolving period, principal payments received on the loans will be reinvested in new loans. The new loans will be purchased under a contract. The purchase price will equal the principal amount of the loans. The rate of interest on the purchased loan will equal a fixed rate equal to a market rate at the time of the purchase or will be a floating rate. The sponsor projects that more than half of the principal payments on the mortgage loans held by the trust at the time of issuance of the Class A and Class B bonds (initial mortgage loans) will be reinvested in new mortgages and will not be applied to make payments on the bonds. Those projections are reasonable based on historical experience, interest rate levels and other relevant factors. They are also consistent with information provided in the offering materials for the Class A and Class B bonds. The only payments on asset obligations taken into account in applying the relationship test are payments on the initial mortgages loans. The relationship test is not met because the timing and amount of payments on the A and B bonds are not determined in large part by the timing and amount of payments on the initial mortgage loans and they are the only asset obligations taken into account in applying the test.

In addition to addressing the treatment of a revolving pool, this example holds implicitly that the requirement in the regulations that payments on liability obligations be determined "in large part" by payments on asset obligations is not met unless at least half of the principal payments on the liability obligations are so determined. A 50-percent cut-off is implied in a safe-harbor rule in the regulations.[181] We believe it is appropriate to provide some more

181 Treasury Regulation § 301.7701(i)-1(f)(3)(iii) (special rule for liquidating entities requires that an entity plan to satisfy at least 50 percent of the total issue price of each of its liability obligations having a different maturity with proceeds from liquidation and not with scheduled payments on its asset obligations).

concrete guidance on the meaning of the test, either through an example or by replacing the "large part" language with a percentage. The TMP rules have serious consequences and apply to a range of commercial transactions that are not undertaken for tax avoidance reasons. Particularly in the context of applying the rules to revolving pools, some greater precision would be desirable. We think the cut-off percentage should be 50 or higher. By way of comparison, in a typical MBS structure, *all* principal payments on liabilities are determined by payments received on mortgages (i.e., the relevant percentage is 100). A full pass-through of principal receipts is required by the REMIC rules because they do not allow mortgage principal to be reinvested except for a temporary period pending distribution to REMIC interest holders.

E. Short-Term Debt

In a typical CMO or REMIC financing, a fixed pool of mortgages is transferred to an entity and the cash flows are passed through to investors. The purpose of the arrangement is to shift to capital market investors the risk of long-term fixed-rate funding. The classic CMO backed by residential mortgages has a term to maturity of close to thirty years and an average life of more than 10 years.

A very different fact pattern is one in which an owner of mortgages seeks to finance them temporarily, generally pending their sale to third parties. Debt may be issued that is secured by the mortgages. The amount of debt will go up or down depending on the amount of mortgages held at any time. Typically most of the debt is repaid with proceeds from sale of the mortgages, but any principal payments received may also be applied to repay debt. This fact pattern is more like the use of a bank line for warehouse financing and does not resemble a traditional mortgage securitization. The arrangement may fail to be a TMP due to the Relationship Test, but applying that test may be quite complex.[182]

We think that short-term funding arrangements are sufficiently different from a traditional MBS offering that there should be a clear-cut rule excluding them from the TMP definition. Short-term facilities typically involve revolving liabilities and assets so that the pattern of fixed assets and divided liabilities that produce timing mismatches is not present. At any rate, timing differences would be reversed over a much shorter period. As a policy matter, we think serious consideration should be given to excluding an entity from the definition of a TMP if all of its liability obligations have a term of three years or less. The argument becomes even more compelling if the liabilities have a shorter term, such as 13 months or less.

In the case of an instrument paying interest that is reset periodically based on a floating rate or auction, the relevant term of the instrument should be the length of the interval between reset dates rather than the stated term. This approach is analogous to a rule under section 1274 that determines whether the applicable Federal rate is the Federal short-term, mid-term or long-term rate based on the interval between reset dates.[183]

It is arguable that an exception for short-term debt would require a change in the statute. It could, however, also potentially be accomplished through a regulation interpreting the Maturities Test. The purpose of the Maturities Test is to identify the type of term structure of

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182 One complicating factor is that the TMP regulations count as payments received on mortgages for purposes of the Relationship Test proceeds of sales that are arranged at the time when debt is incurred. Treasury Regulation § 301.7701(i)-1(f)(2)(iii). In a program in which debt is incurred at frequent intervals and mortgages are often sold, it is not always possible to rely on the argument that the Relationship Test will not be met.

183 See Treasury Regulation § 1.1274-4(c)(2). See also Treasury Regulation § 1.1275-5(f) (instrument that provides for rate reset to a market rate considered to mature and be reissued for OID purposes).

liabilities that will give rise to phantom income. The proposed rule for short-term debt may be viewed as a rule of administrative convenience that essentially aggregates all such debt for purposes of applying the Maturities Test. By analogy, Treasury Regulation § 301.7701(i)-1(f)(3) has a rule that prevents an entity from being a TMP if in general it is formed to liquidate assets and within three years the entity either liquidates or ceases to have debt with different maturities (because all subsequent principal payments are paid on all classes pro rata).[184]

Based on the foregoing, we recommend that the TMP regulations be amended by adding the following as Treasury Regulation § 301.7701(i)-1(e)(4):

> (4) *Exception for short-term liability obligations.* For purposes of section 7701(i)(2)(A)(ii), debt obligations will not be considered to have two or more maturities if the term to maturity of all such debt obligations is not longer than [minimum period between 13 months and three years]. For purposes of determining the term of a debt obligation, the principles of section 1.1274-4(c)(2) and section 1.1275-5(f) shall apply.

We recognize that justifying such a change through regulations becomes harder the longer the permitted discrepancy in maturities. We believe, however, that the authority argument would be quite strong if the period were 13 months.[185] If a longer period could not be implemented through regulations, consideration should be given to legislation to implement an exception for longer-term debt.

F. Fixed Payment Schedule

The Relationship Test requires that the timing and amount of payments on liability obligations be determined in large part by the timing and amount of payments or

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184 The rule also contemplates that at least 50 percent of the issue price of its liability obligations be satisfied with proceeds of liquidation rather than scheduled payments. The rule is described as an interpretation of the Relationship Test.

185 A REMIC is allowed to hold cash-flow investments for a temporary period pending distribution to interest holders. As one possible analogy, Treasury Regulation § 1.860G-2(g)(1)(iii) limits the term of such investments to 13 months.

projected payments on asset obligations. We believe that in adopting the Relationship Test, Congress had in mind an arrangement in which payments on liability obligations were subject to change over time based on changes in payments on asset obligations. A dynamic pay-through feature was clearly present in all of the CMOs that were before Congress in 1986 and is also practically required for REMICs.[186] Section 1272(a)(6) was enacted to enable discount to be accrued on debt instruments that were payable based on the timing of payments on underlying collateral, and again Congress had a typical CMO in mind.[187]

The reference in the regulation applying the Relationship Test to "payments or projected payments" on asset obligations raises a question about the need for variable payments. It could be read to mean that if liability obligations are issued with fixed payment terms and those terms are set taking into account anticipated payments on asset obligations, the Relationship Test is satisfied even though the actual timing of payments on asset obligations is irrelevant to the debt holder. We do not know what the drafters had in mind. At any rate, we recommend that the regulations be amended to state clearly that the Relationship Test is not met

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186 It is never the case with residential mortgages and rare for commercial mortgages that payments are absolutely fixed with no prepayment or extension options. If payments on liability obligations were fixed and payments on the liability assets were not, it would be necessary to bridge the gap through some facility for selling assets at a fixed price, reinvesting or borrowing. Those features are not generally allowed in REMICs, which are essentially liquidating pools.

187 See generally the discussion in Part VI.B, above, to the effect that the purpose of the TMP rules was to force REMIC elections for structures in which REMIC-eligible securities were issued. In addition, the 1986 Conference Report at II-226 paraphrases the definition of a TMP as follows: an entity or arrangement used primarily to hold mortgages "where maturities of debt instruments that are issued by the entity in multiple classes, [*sic*] are tied to the timing of payments on the mortgages." The text at II-240 adds the following after describing the relationship test (and saying that the TMP definition covers owner trusts): "Typically, the relationship between the assets of the entity and its debt obligations would be such that payments on the debt obligations must be made within a period of time from when payments on the assets are received."

where the timing and amount of payments on a liability obligation are not by their terms linked to payments on asset obligations.

We acknowledge that phantom income can exist in structures in which an issuer holds a fixed pool of mortgages that provide for amortization of principal according to a fixed schedule and issues debt divided by maturity that has different entitlements to principal. The possible existence of phantom income is a relevant factor in applying the TMP definition. We believe, however, that a more important consideration is the resemblance of a structure to a traditional MBS transaction. After all, phantom income can exist in non-mortgage financings but they are not covered by the TMP rules. A pay-through feature is a key component of traditional mortgage-backed securities and REMICs. Another factor supporting our recommendation is a need for greater certainty in applying the Relationship Test. The "projected payments" rule creates considerable uncertainty. The existence or not of a pay-through feature can readily be determined and is an appropriate bright-line test.

The recommended clarification could be accomplished by adding to Treasury Regulation § 301.7701(i)-1(f)(1) the following sentence:

> In no event will the relationship test be considered met where, absent a default, the amount and timing of all payments on liability obligations are either fixed or are subject to change based on factors other than the timing and amount of actual payments on asset obligations (e.g., changes in an interest rate index).

VII. Other Changes

A. Foreign Trust Reporting

SBJPA 1996 substantially broadened the scope of section 6048. That section imposes reporting requirements on U.S. persons making transfers to or receiving distributions from a foreign trust. Ongoing reporting is also required for any U.S. person that is considered the owner of any portion of a foreign trust under the grantor trust rules (a "U.S. owner"). U.S. owners are also responsible for ensuring that a foreign trust files an information return and furnishes tax information to each U.S. owner and each U.S. person receiving distributions from a trust. There is no requirement that the interest of the U.S. owner exceed some threshold amount or percentage. Reports are made on Form 3520 by the U.S. owner and on Form 3520A by the foreign trust. If a foreign trust fails to file Form 3520A, each U.S. owner is responsible to complete and file a substitute Form 3520A to the best of his ability. The penalties for failing to comply with these rules are very severe and clearly not appropriate for a general information reporting system for investments.[188]

These expanded rules and the associated penalties were aimed at U.S. taxpayers (principally individuals) seeking to hide assets and income in foreign trusts. Under current law, however, the reporting requirements may apply not only to family or personal trusts but also to trusts that issue transferable pass-through certificates to passive investors who had nothing to do with establishing the trust and are investing in trust certificates in much the same way as if they had purchased tradable bonds. For these kinds of trusts, reporting under section 6048 is not

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188 Under section 6677, the penalty for failing to comply with a section 6048 reporting requirement is generally 35 percent of the "gross reportable amount," increased by $10,000 per month for a failure to report starting 90 days after the Service notifies the taxpayer of the failure (limited in the aggregate to the gross reportable amount). The percentage is reduced to 5 percent for failures to cause a trust to file under section 6048(b). In the case of a failure to report a distribution from the trust, the gross reportable amount is the amount of the distribution. For a failure to cause a trust to file, the gross reportable amount is the value of the U.S. owner's investment. Thus, if Form 3520 is not filed for any year in which a trust distributes to an investor cash income of 6 percent of his investment, the aggregate penalty would be 7.1 percent (5 percent of the investment plus 35 percent of the distribution) or 118 percent of his income. The penalty would increase if the taxpayer did not comply following notification from the Service. There is a reasonable cause exception.

simply an inconvenience; it is impossible. The information required by Form 3520 is not available.[189]

Although the rules only apply to "foreign trusts," as a result of a change in section 7701(a)(30)(E) made by SBJPA 1996 as implemented through regulations issued in 1999,[190] the rules may apply to trusts that are, to anyone but a tax specialist, obviously domestic because they are established under U.S. law with domestic trustees and hold domestic assets. Specifically, a trust is considered a U.S. trust only if U.S. persons control *all* substantial decisions of the trust. Regulations construe the term "substantial decisions" to include some matters that, for a fixed investment trust, are fairly minor, such as whether to remove or replace a trustee or whether to enforce debt claims held by a trust.[191] Also, under the regulations, U.S. persons do not control a decision if their decision can be blocked by non-U.S. persons, and it makes no difference whether decisions are made or blocked by persons acting as fiduciaries or by beneficiaries. Accordingly, if under the terms of a trust document, a trustee can be removed with the consent of 100 percent of the holders of a class of pass-through certificates, it would appear that if any

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189 Part II of the form requires each U.S. beneficiary to list the name, address and TIN for each person who is considered the owner of any assets of the trust under the grantor trust rules. Thus, each U.S. owner of any pass-through certificates issued by a foreign trust would have to identify each other U.S. owner holding any such certificates. For this purpose, the U.S. owner would be the tax owner, not the registered holder. Accordingly, where interests are held by a nominee, it would be necessary to look through the nominee to the ultimate owner. In a fixed investment trust targeted to retail investors, there may be several thousand investors whose interests are held through institutional nominees. There is authority under section 6034A to require nominee holders of beneficial interests in a trust to identify the beneficial owners, but it has never been implemented (and is not needed given Form 1099 reporting required by intermediaries making payments). The preamble to the recently reproposed reporting regulations for WHFITs (see footnote 193, below) acknowledges the existence of nominees: "Interests in [fixed investment trusts] are often held in the street name of a middleman, who holds such interests on behalf of the beneficial owners. Thus, trustees ordinary do not know the identity of the beneficial owners and are not in a position to communicate information directly to them."

190 Treasury Regulation § 301.7701-7.

191 Treasury Regulation § 301.7701-7(d)(1)(ii).

certificates of the class were held by a non-U.S. person, the trust would not be U.S. controlled and would be regarded as a foreign trust. If trust certificates can be traded, there is no way to know who the holders are, so that virtually all trusts that give even limited control rights to investors face a potential risk.

In 2001, in response to comment letters, the IRS amended the definition of a foreign trust to carve out fixed investment trusts (an investment trust classified as a trust under Treasury Regulation § 301.7701-4(c), meaning a trust that meets the no-power-to-vary test) if certain tests are met. To qualify, all trustees must be U.S. persons and one of them must be a bank or trust company or a U.S. government-owned or -sponsored agency, all sponsors must be U.S. persons, and the beneficial interests must be "widely offered for sale primarily in the United States to United States persons."[192] While this exception clearly helps, the last requirement may well not be met for many investment trusts, either because there are, say, 10 offerees (it is not clear what "widely offered" means) or a majority of the offerees are foreign. Also the problem will in any event remain for truly foreign trusts selling trust interests to U.S. investors.

Trust reporting for investment trusts has traditionally been done on Form K-1s to direct beneficiaries and Form 1099s to investors owning through intermediaries. Where trust interests are held through intermediaries, the last intermediary who makes a payment to an individual or other non-exempt payee is the party who must file a Form 1099. The IRS has recently proposed (for the second time) a new set of reporting rules for interests in investment trusts held through intermediaries (referred to in the regulations as widely-held fixed investment

192 Treasury Regulation § 301.7701-7(d)(1)(iv). This rule was a partial response to comments received from taxpayers (who had requested a broader exemption for investment trusts). See letter from Saul M. Rosen on behalf of the Securities Industry Association, "Re: Proposed Regulations Section 301.7701-7(d) and (e)," March 23, 2001, 2001 *Tax Notes Today* 70-29; letter from James M. Peaslee and Linda M. Beale, August 14, 2000, 2000 *Tax Notes Today* 185-17.

trusts or WHFITs).[193] The widely-held label is misleading. The regulations apply to any fixed investment trusts in which any interest is held by a middleman. The preamble acknowledges the comments that have been made relating to reporting by foreign trusts. At that point, however, the drafters punted. The new regulations apply only to domestic trusts, leaving section 6048 as the exclusive mechanism for reporting for foreign trusts. The preamble asks for comments on how Forms 3520 and 3520A could be adapted for use with foreign investment trusts.

We have the following comments. First, we believe that the appropriate system of reporting for investment trusts is the one set out in the proposed section 1.671-5 regulations which is parallel to the reporting done for other market securities.[194] This system places the responsibility for reporting on issuers and intermediaries and not on individual investors. Further, where this system applies, it should supplant any requirement to file returns under section 6048. Assuming the Service is not willing to expand the fixed investment trust exception in the regulations defining a domestic trust, we recommend that the definition of WHFIT be changed to include (1) any foreign trust that has at least one trustee that is a domestic bank or U.S. government-owned or -sponsored agency, and (2) also at the election of the foreign trust, a foreign trust that designates such a person as a person responsible for reporting obligations of the trust. We further recommend that any foreign trust that is treated as a WHFIT not be treated as a foreign trust for purposes of section 6048.

In the case of U.S. owners of fixed investment trusts that are truly foreign (are defined as foreign trusts and have no U.S. trustees that are financial institutions or governmental

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[193] Proposed Treasury Regulation § 1.671-5 (June 19, 2002).

[194] We are not commenting in this report on these proposed regulations but only making the point that the same basic reporting system should apply where possible to all investments trusts, including those that are technically foreign.

entities) the WHFIT system will not necessarily work. A trust that offers securities mostly in foreign markets may be unwilling to provide extensive U.S. tax information to accommodate U.S. investors. At that point, the question is how to make sure that U.S. investors are not allowed to hide income or assets but at the same time are not asked to provide information they do not have and cannot get.

It is instructive here to compare reporting for foreign trusts with reporting required for partners in foreign partnerships on Form 8865. That form requires reporting of detailed information relating to a foreign partnership only in the case of partnerships that are 50 percent or greater owned by 10 percent or greater U.S. partners, and the reporting is limited to those 10 percent or greater partners. This system (which is parallel to the reporting with respect to controlled foreign corporations on Form 5471) recognizes the fact that unless a foreign entity is controlled by U.S. persons, those with reporting obligations will not have the information necessary to file the required reports. Section 6048 does not distinguish between controlling and non-controlling beneficiaries. On the other hand, it was not written with fixed investment trusts in mind. We believe that the fact that an investment vehicle is classified as a trust rather than a partnership is not an adequate reason to effect a wholesale change in reporting obligations. Indeed, any foreign investment trust that knew about section 6048 could opt into partnership reporting by simply including in the trust documents a commercially insignificant power to vary. The same approach would not work for personal or family trusts because they can have a power to vary.

We recommend that the reporting system on Form 3520 as it relates to foreign investment trusts be made parallel to the reporting for foreign partnerships. In particular, we do not think a U.S. investor in a fixed investment trust should be required to provide information that goes beyond the distributions received by the U.S. investor unless the trust is controlled by U.S. 10-percent beneficiaries. For this purpose, the definition of fixed investment trust could be limited to trusts described in Treasury Regulation § 301.7701-4(c) (i.e., purely passive trusts with no investment discretion and generally only a single class of interests) in which interests are offered to investors unrelated to the sponsor and that were not established or availed of as part of an arrangement to allow U.S. persons to avoid reporting under section 6048. At any rate, U.S. owners holding small interests in foreign investment trusts should not be required to supply information about the trust or other U.S. owners unless such information is reasonably available to them.

ANNEX A

Size of MBS and ABS Markets in United States

Some statistics may be helpful to show the current and growing significance of securitization transactions in the U.S. capital markets.

The table below gives the volume of new issuances of debt in the United States for all debt (private and governmental) and for three specific categories of debt: MBS, ABS (both including credit card securities and with those securities broken out separately) and, for comparison, conventional corporate bonds and notes. The figures are for 2001 and 1996. The table also shows the total amounts outstanding in each category at the end of the year. As the table indicates, mortgage and other asset-backed securities accounted for 45 percent of new issue volume last year. The same figure for 1996 was 10 percent.[1] There were $362 billion in credit card securities outstanding at the end of 2001.

[1] It should be noted that the volume of residential MBS issuances is affected by interest rate levels and the figures for 2001 reflect significant mortgage refinancings.

U.S. Debt Market[2]

2001

	New Issuances		Outstanding at Year End	
MBS	$1,670	36%	$4,100	22%
ABS (Including Credit Cards)	419	9%	1,300	7%
Credit Card	76	2%	362	2%
Corporate	879	19%	3,800	20%
Total for All Categories	$4,600	100%	$18,500	100%

1996

	New Issuances		Outstanding at Year End	
MBS	$ 370	7%	$1,700	15%
ABS (Including Credit Cards)	154	3%	400	4%
Credit Card	48	1%	N/A	N/A
Corporate	449	8%	2,000	18%
Total for All Categories	$5,378	100%	$11,100	100%

2 Figures in billions. Source (available at www.bondmarkets.com): The Bond Market Association, Research Quarterly, February 2002; PSA, The Bond Market Trade Association, Research Quarterly, February 1997. Issuances of U.S. Treasuries were significantly higher in 1996 than in 2001.

ANNEX B
PROPOSED CREDIT CARD TRUST REVENUE RULING

Revenue Ruling 2003-__

ISSUES

This ruling addresses a number of issues relating to a trust established to securitize credit card receivables. The issues relate to (1) the status of pass-through certificates issued by the trust as debt or equity, (2) whether interest income and notional principal contract income earned by the trust is qualifying income within the meaning of section 7704(d), (3) whether a non-U.S. person holding equity in the trust would be considered to be engaged in a trade or business within the United States, and (4) whether income from notional principal contracts held by the trust would be sourced outside of the United States.

BASIC FACTS

A bank sponsor establishes a trust organized under the laws of a state and sells to the trust the right to all present and future receivables relating to designated credit card accounts. The receivables consist of a right to principal (principal receivables) and a right to finance and other related charges (finance charge receivables). The principal receivables must be paid by the account party, in accordance with the terms of the account, no later than a stated period after they are created. The bank may also from time to time be permitted or required to designate additional accounts and to sell the related receivables to the trust. The bank services the receivables under an agreement with the trust. The bank performs services consistent with normal servicing functions for similar receivables, such as collecting payments, sending out account statements and otherwise dealing with holders of credit card accounts. The bank also may have the right to change the rate at which finance charges are imposed so long as it does not treat differently accounts within and outside the trust. The trust pays the bank a fee determined under a formula and reimburses it for extraordinary costs but does not bear normal operating expenses of the servicer. The trust has no employees and does not advertise its services or hold itself out as offering credit cards to customers.

The trust issues two classes of trust certificates, A and B, that have a principal amount, provide for interest based on a fixed rate or a floating rate on their outstanding principal balance, and are issued at a price of par, at a discount or at a small premium. Principal may be reduced through principal payments or charge-offs allocated to the class. The certificates are sold to investors unrelated to the bank. The investors may include non-U.S. persons. Both classes of certificates are freely transferable and actively traded. Class B is subordinated to Class A and receives principal only after the principal amount of Class A is repaid (or otherwise provided for, for example, through reserve funds). The Class A and B certificates are entitled collectively to a right to principal receivables (the investor interest) equal to their initial principal amount less principal distributions thereon and less charge-offs after designated sources of credit enhancements have been exhausted. Because the principal balance of the receivables in the designated accounts will fluctuate over time, in order to create a fixed principal amount for the Class A and B certificates, the bank retains a nonsubordinated right to principal receivables (the seller interest) equal to the excess of the principal receivables held by the trust over the investor interest. The bank is required to maintain a designated level of seller interest and generally a payout event (described below) will be triggered if the seller interest drops below that level.

Interest on the Class A and B certificates is payable monthly out of collections of finance charge receivables, less certain expenses. Collections exceeding such interest and expenses (excess spread) may be retained by the trust in a cash collateral or other reserve account up to certain limits and otherwise are paid to the bank. Losses are allocated pro rata between the seller interest and the investor interest in the receivables but investor losses are then borne first by the excess spread and cash collateral account (with the Class B certificates being subordinate to the Class A certificates). The trust may benefit from other credit enhancements. The trust may enter into interest rate swaps qualifying as notional principal contracts to better match the rates of interest on receivables and rates on certificate classes.

During a revolving period, a portion of the principal receivables collected is used to acquire new principal receivables to replace the receivables that have been paid by the credit card obligors, a portion may be repaid to the bank until the seller interest is reduced to its minimum required level, and a portion may be retained in the trust. The revolving period ends (and the amortization period begins) at the earlier of a specified date or upon the occurrence of any one of certain events (payout events). Typically, the revolving period would be at least one year and the term of the Class A and B certificates would not exceed ten years (and generally would be shorter). During the amortization period, the investor percentage (which generally is the investor interest divided by all principal receivables at the beginning of the amortization period) of collections of principal receivables will be paid monthly as principal payments on the certificates (in some cases, subject to monthly limits, with carryovers of amounts not paid currently because of those limits). The payout events include the yield of the receivables (and thus the excess spread) dropping below a minimum level. The payout events are designed to increase the likelihood that the investors' principal balance will be repaid in full (albeit earlier than anticipated) in the event that the performance of the receivables pool is worse than expected.

It is reasonably expected at the time of issuance of the certificates that principal on each class of certificates and interest thereon at the stated rate will be paid in full on or prior to a specified future date (maturity date) (i.e., that any credit losses or mismatches between the return on the receivables net of expenses and interest on the certificates will be borne by the amounts otherwise payable to the bank).

The trust agreement states that the bank and the holders agree to treat the certificates as debt of the trust for federal income tax purposes.

The permitted activities of the trust are spelled out in the trust agreement. The trust cannot freely dispose of its assets but instead may do so only in limited circumstances (e.g., upon a default). The assets of the trust will be limited to receivables and related assets including credit enhancements, interest rate swaps, servicing rights and temporary cash investments. The trust is not allowed to raise funds by incurring indebtedness. The trust will not elect to change its classification for tax purposes under Treasury Regulation § 301.7701-3.

The trust is not registered under the Investment Company Act of 1940 as a management company or a unit investment trust and would not otherwise be described in section 851(a) if it were a corporation.

ALTERNATIVE FACTS

Same as the basic facts except that the Class B certificates are not reasonably expected to receive payments according to their terms or have other equity features not described in the basic facts.

ISSUE 1

Are the Class A and Class B certificates described in the basic facts properly characterized as debt or equity?

Whether an instrument is properly characterized as debt or equity depends on all the facts and circumstances. The Class A and B certificates have a number of characteristics that support their treatment as debt. They provide for a fixed principal amount; interest is payable thereon at a fixed rate or a variable rate based on an interest rate index (without equity kickers or rights to convert into a participating equity interest); they have a maturity date that is not unreasonably distant in the future; they are not held pro rata with the sponsor's interest in the trust; they provide no management rights; and when issued they are reasonably expected to be paid according to their terms. Because of their legal status as pass-through certificates, claims of certificate holders would be subordinated to claims of creditors of the trust. However, the terms of the trust prohibit the issuance of debt, and despite the subordination, the certificates are reasonably expected to be paid in full according to their terms.

The main issue presented in characterizing the certificates is whether they should be treated as equity because of their form as beneficial ownership interests in the trust. On the facts of the ruling, the form of the certificates should not be viewed as a significant factor in determining their status as debt or equity. Given the debt characteristics described above, the Class A and B Certificates would be treated as debt had they been issued in the form of debt and that conclusion should not change because they take the form of pass-through certificates.

It is a basic tax law principle that transactions should be taxed according to their substance rather than their form. However, taxpayers may in some circumstances be bound by the form of transactions they enter into. See, e.g., *Danielson v. Comm'r*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); *Estate of Durkin v. Comm'r*, 99 T.C. 561 (1992). The principles of these authorities do not prevent the treatment of the Class A and B certificates as debt for three reasons. First, the trust and holders have agreed to treat them as debt for tax purposes, so treating them as such would not frustrate the expectations of the parties or expose the government to a risk of inconsistent treatment. Second, the form is ambiguous. The certificates have a number of terms that are more indicative of debt than equity, including a right to a fixed amount of principal and payments thereon calculated like interest, a fixed interest in the trust despite changes in the amount of assets in the trust, acceleration of payments if default-like events occur, and the lack of management rights. Also, trust certificates have been recognized to be debt in other settings. See, e.g., Revenue Ruling 76-265, 1976-2 C.B. 448, and Revenue Ruling 61-181, 1961-2 C.B. 21. Although local-law trusts may be used to conduct active businesses, they are traditionally used to hold assets passively, including assets pledged to secure debt.

Pass-through certificates issued by fixed investment trusts are treated as ownership interests in the trust (and under the grantor trust rules, in the trust assets). See, e.g., Revenue Ruling 84-10, 1984-1 C.B. 155. The Class A and B certificates are distinguishable from certificates issued by fixed investment trusts because of the significant mismatch between the terms of the certificates (individually and collectively) and any identified assets of the trust. The mismatch exists because of the revolving nature of the receivables pool held by the trust and the fact that the principal amount of the certificates represents a changing fraction of the assets of the trust as assets are added or withdrawn.

During the amortization period, principal receipts are passed through as principal payments on the certificates as they are received. Given the other factors discussed above, including the existence of the revolving period, this feature is not inconsistent with debt treatment. Cf. section 1272(a)(6) (providing a method of accruing original issue discount on debt instruments with pay-through features).

Based on the foregoing, the Class A and B certificates will be treated as debt for federal income tax purposes.

ISSUE 2

Assume the Alternative Facts and that the Class B Certificates will be characterized as an equity interest in the trust, with the result that the trust is classified as a publicly traded partnership within the meaning of section 7704(b). In that event, is interest income and notional principal contract income earned by the trust qualifying income within the meaning of section 7704(d)?

Section 7704(a) of the Code provides that a publicly traded partnership shall be treated as a corporation.

Section 7704(c)(1) provides that section 7704(a) shall not apply to any publicly traded partnership for any taxable year if such partnership meets the gross income requirements of section 7704(c)(2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. For purposes of the preceding sentence, a partnership shall not be treated as being in existence during any period before the first taxable year in which such partnership (or a predecessor) was a publicly traded partnership.

Section 7704(c)(2) explains that a partnership meets the gross income requirements of this section for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year is qualifying income.

Section 7704(c)(3) provides with an exception not relevant here that subsection (c) shall not apply to any partnership that would be described in section 851(a) if such partnership were a domestic corporation.

Section 7704(d)(1) provides that the term "qualifying income" includes, among other things, interest, real property rents, and gain from the sale or other disposition of real property.

Section 7704(d)(2) provides that interest shall not be treated as qualifying income if (A) such interest is derived in the conduct of a financial or insurance business, or (B) such interest would be excluded from the term "interest" under section 856(f).

Section 7704(d)(4) provides that the term "qualifying income" includes any income that would qualify under section 851(b)(2) or 856(c)(2).

The legislative history to section 7704 explains that the purpose of the qualifying income exception is "to distinguish those partnerships that are engaged in activities commonly considered as essentially no more than investments, and those activities more typically conducted in corporate form that are in the nature of active business activities." H.R. Rep. No. 391 (Part 2), 100th Cong., 1st Sess. 1068. Interest derived from the conduct of a financial business, such as a bank, is thus excluded from the definition of qualifying income, because "deriving interest is an integral part of the active conduct of the business." Id.

Whether an entity is engaged in a "financial business" is determined based on the facts and circumstances surrounding the conduct of the entity's business. In light of the expressed legislative intent, the key question is whether a trust's activities are in the nature of an active business enterprise that is normally carried on by a corporation.

Here, the trust acts as a financing arm for its sponsor. It has no employees, customers or good will. It does not advertise. All dealings with holders of credit card accounts are undertaken by the bank acting as the servicer under a conventional servicing agreement. Also, engaging in a financial business requires the exercise of management discretion. The permitted activities of the trust are set out in its governing documents and the trust is not allowed to exercise significant discretion. Based on these factors, the trust is not engaged in a financial business. The fact that the trust may fund and be the first owner of a receivable does not cause it to be engaged in a financial business unless it also has an active customer relationship with the account holder. Also, finance charges are not contingent amounts described in section 856(f). Accordingly, interest earned by the trust on credit card receivables is qualifying income.

Treasury Regulation § 1.7704-3(a)(1) provides that for purposes of section 7701(d)(1), qualifying income includes income from notional principal contracts (as defined in § 1.446-3), provided that the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership. Also, under Treasury Regulation § 1.7704-3(a)(2), qualifying income described in paragraph (a)(1) does not include income derived in the ordinary course of a trade or business (including acting as a dealer or market maker, but not including acting as a trader or investor).

The notional principal contract entered into by the trust is an interest rate swap and accordingly relates to amounts (interest) that would be qualifying income if received directly by the trust. Also, the trust will use the contract to hedge interest rate risks relating to the receivables it owns or the certificates it issues and not as part of a market making or dealer activity. Accordingly, income from the notional principal contract is qualifying income for purposes of section 7704(d).

The trust is not prevented from relying on section 7704(c) under section 7704(c)(3) because it would not be described in section 851(a) if it were a corporation.

ISSUE 3

Assume the Alternative Facts and that the Class B Certificates are characterized as an equity interest in the trust and the trust is classified as a partnership. Assume further that a holder of the certificates, F, is not a United States person. Is F considered to be engaged in a trade or business within the United States because of the activities of the trust?

Section 875 treats a non-U.S. person who is a member of a partnership as being engaged in any U.S. trade or business in which the partnership is engaged. Accordingly, if the trust were considered to be engaged in a trade or business, then F also would be considered to be engaged in such trade or business.

Under general Code principles, whether an activity is a trade or business depends on all facts and circumstances. Also, the phrase must be construed in light of the purposes of the Code provision being applied and may not necessarily have the same meaning in all contexts. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

Section 864(b)(2)(A)(ii) provides that for purposes of rules governing the taxation of foreign persons, the term "trade or business within the United States" does not include trading in stocks or securities for the taxpayer's own account. This exception does not apply to a taxpayer that is a dealer in stocks or securities. Based on the activities of the trust described herein, it is not a dealer in securities.

Regulations under section 864 construe the definition of "trading" broadly to cover "effecting transactions" in stocks or securities (debt instruments) and other closely related activities. Treasury Regulation § 1.864-2(c)(2)(i). The trust is buying and holding receivables that are securities for purposes of section 864(b)(2)(A)(ii) and engaging in closely related activities. Accordingly, under section 864(b)(2)(A)(ii), the trust would not be considered to be engaged in a trade or business.

An entity that is an active bank or finance company that holds itself out as making loans to the public may be considered to be engaged in a trade or business because of the origination and other financial services it provides to its customer. See Treasury Regulation § 1.864-4(c)(5), which provides special rules for determining when income from an active banking, financing or similar business is effectively connected income. That regulation clearly assumes that such activity, if conducted in the United States, is a trade or business. The reasons given above for concluding that the trust is not engaged in a financial business also support the conclusion that its activities do not include providing financial services in addition to "effecting transactions" in securities and related activities. Accordingly, under section 864(b)(2)(A)(ii), the trust will not be considered to be engaged in a trade or business and F will not be considered to be engaged in a trade or business because of the activities of the trust.

ISSUE 4

Assume the Alternative Facts and that the Class B Certificates are characterized as an equity interest in the trust and the trust is classified as a partnership. Assume further that a holder of the certificates, F, is not a United States person and F is not considered to be engaged in a trade or business within the United States because of the activities of the trust. Is income from a notional principal contract held by the trust that is allocated to F sourced outside of the United States?

Income from notional principal contracts is sourced based on the residence of the payee as determined under section 988(a)(3)(B)(i), except that income attributable to a U.S. trade or business is U.S. source. See Treasury Regulation § 1.863-7. Accordingly, payments made to a non-U.S. resident that are not attributable to a U.S. trade or business are sourced outside of the United States and are not subject to tax under section 871 or 882. Payments thereon also are not subject to the withholding of tax under section 1441 or 1442. See Treasury Regulation § 1.1441-4(a)(3).

Income on a notional principal contract received by the trust is received in the first instance by a domestic partnership. Under section 988(a)(3)(B)(i), the residence of a domestic partnership is generally the United States, except that, to the extent provided in regulations, the determination of residence may be made at the partner level. Treasury Regulation § 1.988-4(d)(3) states that the determination of residence shall be made at the partner level "in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2)." This regulation is intended to apply to partnerships that hold or effect transactions in stocks, securities or commodities and are not engaged in a U.S. trade or business. The regulation applies to cases in which a partnership is not engaged in a trade or business because it is an investor, as well as to cases in which the lack of a trade or business depends on the application of section 864(b)(2). Because F is not considered to be engaged in a U.S. trade or business on account of the activities of the trust, income on a notional principal contract received by the trust and allocated to F is sourced outside of the United States.