Supplement
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To

Federal Income Taxation of Securitization Transactions
and
Related Topics

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About the Supplement

This Supplement is a cumulative supplement. It incorporates both changes in the law and new questions or topics that were not covered in the book.

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Types of Asset-Backed Securities

A. Introduction

1. Catalog of Securities

2. Avoidance of Entity-Level Tax

Add comment to Part A.2:

This section discusses how issuers of asset-backed securities avoid entity-level taxes. For non-REMIC issuers, the discussion distinguishes between an issuer treated as a corporation, which would be subject to an entity-level income tax (at least for a corporation that is domestic), and an issuer that is tax transparent. The main categories of transparent entities are grantor trusts, partnerships, and disregarded entities. The section states that income of a transparent entity is allocated and taxed only to its owners.

The last statement is true as regards the conventional income tax, but there are other taxes that may be imposed on partnerships. One is new and another has gained greater practical significant in recent years.

A new partnership audit regime enacted by the Bipartisan Budget Act of 2015 (often called the *BBA*), and first effective for partnership taxable years beginning on or after January 1, 2018, creates a risk going forward that virtually all entities classified as partnerships will be subject to liability for tax deficiencies relating to the partnership that are claimed by the IRS in audits. The new rules are described in Chapter 5, Part C.1 (in this Supplement). Some partnerships can elect out of the new regime, but only where there are fewer than 100 partners and none of the partners are themselves partnerships or trusts. There are mechanisms to limit the entity-level liability, but they require actions to be taken by either the partnership or the partners and may not be bulletproof. The actual level of risk will depend in part on how the new Code rules are implemented by the IRS. Also, the new rules may be revised through technical corrections. Of course, for any particular entity, the practical risks also will depend on whether the entity takes tax positions that are subject to challenge.

The second potential partnership liability arises under section 1446, which has been in effect since 1988. It requires a partnership that has ECI (income effectively connected with a U.S. trade or business) from its own activities to withhold tax on the portion of the ECI that is allocated to foreign partners (partners that are not United States persons). Withholding also applies where a foreign partner provides to a partnership a Form W-8 ECI identifying income from the partnership as income effectively connected with the partner's own U.S. trade or business.[3a]

For the withholding tax to apply based on activities of the partnership, there must be both a partnership trade or business in the United States and foreign partners. Conventional securitization vehicles are passive and not engaged in a trade or business anywhere. There is, however, one type of

[3a] See Chapter 5, footnote 135.

issuer that might be engaged in a business depending on the facts and has become more prevalent in recent years. It is an issuer of CDOs (described in Part H in this Chapter 2) that acquires loans and has, itself or through U.S. agents, substantial involvement in the origination of the loans. If the issuer were a foreign corporation and had ECI because of loan origination activities, then, as explained in Chapter 13, it would be subject to a corporate income tax and potentially branch profits tax on the ECI. If it were instead a partnership (whether foreign or domestic) and had foreign partners, then it would be subject to withholding tax on ECI allocated to the foreign partners. The way to be sure to avoid entity-level tax is to have the issuer be a partnership (rather than a corporation) and require that all direct partners be domestic. Such a structure has become fairly common. Chapter 13, Part J (in this Supplement) discusses special issues raised by offshore issuers that are partnerships.

To the extent there is, in a particular case, concern over potential tax liabilities of a partnership issuer of pay-through bonds (either under the BBA or for withholding taxes), one solution is to have the bond issuer be a disregarded entity. That option is available even in structures with multiple equity owners by using two tiers—having the bonds be issued by an entity wholly owned by a parent holding company that has multiple owners. Assuming that the separate existence of the bond issuer is respected under local law (as typically would be the case if appropriate steps are taken to ensure separateness), the IRS and other creditors of the parent would be able to impose liens on, or otherwise collect from, the parent's equity interest in the issuer, but not impose liens on or collect from the separate assets of the bond issuer.[3b]

3. Uses of Securities—Summary

B. Pass-Through Certificates

1. General Description

Beginning June 1, 2012, Freddie Mac will issue pass-through certificates backed by mortgages with a loan-to-value ratio greater than 125%. These pass-through certificates will receive a special "LTV>125%" designation. The loans underlying those certificates (and hence the certificates) likely could not be transferred to a REMIC because it will not be possible to establish that they are REMIC qualified mortgages.[13a]

2. Stripped Pass-Through Certificates

As an alternative to trading IOs and POs, market participants can enter into a swap or other derivative based on an IOS or PO index published by Markit. For information about the index, see www.markit.com.

3. Senior/Subordinated Pass-Through Certificates

4. Callable Pass-Through Certificates

[3b] The IRS has acknowledged in a number of legal advice memoranda that it cannot levy directly on assets of a properly organized and operated disregarded entity to satisfy tax liabilities of the entity's owner. See Chapter 4, footnote 91. A disregarded entity as such may owe employment or excise taxes, but a typical securitization vehicle would not incur those types of taxes.

[13a] An underlying loan might be a qualified mortgage despite the greater than 125% LTV based on the use of proceeds, or if the loan resulted from a default-related modification of a loan with an original LTV lower than 125%. The use-of-proceeds test and loan modifications are discussed in Chapter 6, Part B.2.a.(ii) and Part D.2.

The two-tier structure works best, of course, where the bond issuer is not subject to significant risk of recharacterization as a partnership on account of, for example, the possible recharacterization of deeply subordinated bonds as equity.

5. *LEGOs (Strips and Combinations at the Holder's Option)*

6. *Single Loan CMBS*

It has become fairly common to securitize a single large denomination commercial real estate mortgage loan by dividing the loan, according to its terms, into components shortly after origination and using the components to back corresponding classes of pass-through certificates (including IO Strips), which are sold to investors. The loan is often secured by multiple properties or so-called "trophy" properties, which justifies a loan amount sufficiently large for a stand-alone securitization.

In a typical transaction, a loan originator makes the loan to a property owner. The loan consists initially of a single debt instrument (evidenced by a single note) and bears interest at a conventional fixed or floating rate. The loan (particularly if it is fixed rate) may provide for a lock-out period in which prepayments are not allowed but permit the borrower during that period to sell individual properties and defease a corresponding portion of the loan.

The loan agreement allows the lender to provide a componentization notice to the borrower, which converts the loan into components with the terms specified in the notice. Following conversion, the components may be separately owned. Each component has a principal amount and interest rate. Principal payments on the loan are allocated among the components according to the priorities specified in the notice. Thus, components could receive principal in sequence (be fast-pay and slow-pay). The sum of the principal amounts of the components must equal the principal amount of the loan, and, at least at the beginning, the weighted average of the rates of interest on the components must equal the rate of interest on the loan. The lender has the right to require that the components be evidenced by separate notes.

The lender (or a banker) determines the best way to divide up payments on the loan based on market conditions at the time of a securitization (obviously, the way that maximizes value). After giving the componentization notice, the lender contributes the components to a trust (directly or through another sponsor). The trust issues pass-through certificates divided into classes. Each class with a right to principal corresponds to one component, so that the principal payments on each component are allocated to only one certificate class (and pro rata within the class). Each such certificate class also has a right to all or a portion of the interest paid on that component. The trust may issue one or more classes of IO Strips that are entitled to the interest on the components not allocated to the certificate classes with principal.[24a] The pass-through rates on the certificates are reduced to account for servicing fees, trustee fees and other trust expenses. The certificate classes may also have a senior/subordinated feature to supplement any ordering achieved through the creation of components whereby payment shortfalls are allocated in a specified order (and not pro rata) among certificate classes in the event of a loan default or delinquency.

The trust is a grantor trust despite the existence of certificate classes with different priorities to receive principal (including potentially a fast-pay, slow-pay feature), on the ground that the different principal entitlements are created under the original loan agreement and not through the trust. Stated differently, if a borrower issues debt divided into classes, separate trusts classified as grantor trusts could be formed to hold each class and to issue related pass-through certificates (including stripped certificates). The arrangement described here is the same except that all of the components of one loan are securitized using one trust document and in one offering.

[24a] Conceptually, the IO Strips are considered to be created by separating part of the interest on a component from the remaining interest and principal, and would need to be stripped coupons under section 1286 for the trust to be classified as a trust under the Sears regulations. See Chapter 4, text at footnote 230. Although the certificates with a right to principal would be stripped bonds if any related IO Strips are stripped coupons, typically those certificates would fall within special rules for stripped mortgage loans that would allow them to be taxed like conventional debt (and not as stripped bonds). See Chapter 8, text at footnote 92.

The structure allows time tranching of principal without the need to comply with the REMIC rules (described below in Chapter 2, Part E). For example, a borrower could be allowed to defease all or a portion of a loan at any time (a loan in a REMIC cannot be defeased within the first two years after securitization). Also, the loan need not meet the REMIC definition of a qualified mortgage, and there is no need to create a class of REMIC residual interests.

As compared with a direct offering of components to investors, the trust vehicle allows the components to be owned in a form that is easily transferable by investors and provides a mechanism for servicing the loan and dealing with defaults and foreclosure through one trust (and with one owner of record and one mortgagee). Also, the pass-through certificate form is well known to investors in mortgage-backed securities.

C. Pay-Through Bonds

D. Equity Interests in Issuers of Pay-Through Bonds

1. Economic Features

2. Tax Features

3. GAAP Treatment

E. REMICs

F. Pass-Through Certificates Taxable as Debt

1. Description and Overview of Tax Issues

2. Application to Mortgages

G. FASITs (Rise and Fall)

Add to the end of footnote 55: They were withdrawn by Announcement 2012-27, 2012-27 I.R.B. 10.

Although there is not often news these days about FASITs, there has been one development. A field attorney advice memorandum from 2014 analyzes a transaction reported as a FASIT and concludes that it did not work. F.A.A. 20150601F (April 4, 2014) involved a purported FASIT that was established to allow a domestic taxpayer to issue preferred stock to a foreign affiliate. The expectation was that the stock would be treated as a FASIT regular interest so that interest deductions would be allowed in the U.S. for the dividends paid. The dividends were expected to be taxed more favorably, as dividends, under a participation exemption in the payee jurisdiction. The advice concluded that the FASIT terms were agreed to after repeal of the FASIT statute so that the statute did not apply. Rather than simply declaring victory, the memorandum went on to say that the preferred stock did not qualify as a regular interest because the stock did not pay interest at a permitted variable rate. Specifically, although the dividend rate was expected to equal a weighted average of the rates of interest on the FASIT assets, dividends were payable in the discretion of the directors—apparently a requirement for the participation exemption—and thus could not accrue prior to liquidation of the issuer. The advice claims this was a fatal flaw, because income on regular interests must accrue like interest. The argument is not very persuasive given that the payment of interest on REMIC regular interests clearly can be deferred. See Chapter 7 at footnote 133. In any event, for the preferred to pay dividends at a WAC rate, it was necessary that any residual profits of the FASIT be paid to the holder of a class of debt that was intended to be the FASIT ownership interest.

However, as it turned out, the residual profits were more than expected and were paid instead to the preferred stock holder, causing the amount of dividends to be contingent. The advice dismisses other theories for qualifying the preferred as a regular interest. The memorandum concludes that without the benefit of the FASIT election, the arrangement was subject to general U.S. tax principles under which dividends paid on the preferred stock were not deductible.

H. Offshore Issuers

1. General Description of CDOs

2. Credit Default Swaps and Synthetic CDOs

On September 16, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would "clarify" that a CDS is a notional principal contract, even if it provides for physical settlement. The amendments will be effective for contracts entered into after the adoption of final regulations. It is not clear whether the IRS would also take the view that physical settlement is consistent with NPC status in the case of other types of swap contracts (e.g., a total return swap).

3. Catastrophe Bonds

On September 16, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would change the definition of NPC in several ways, effective for contracts entered into after the adoption of final regulations. Among other things, the amendments would expand the permitted indices on which payments may be based to include a non-financial index (any objectively determinable non-financial information that is not within the control of or unique to any party and is not reasonably expected to front-load or back-load payments accruing under the contract). An example of a non-financial index would be one based on weather.

I. Asset-Backed Debt Other than Pay-Through Bonds

For an article discussing tax and other issues posed by securitizations backed by customer receivables of solar companies (which the author suggests might best be structured to be collateralized borrowings for tax purposes to avoid accelerating income), see Laura Hegedus, "The Likely Features of Solar ABS," 2013 *Tax Notes Today* 157-3 (August 14, 2013).

1. NIMS

2. Asset-Backed Commercial Paper and SIVs

a. Description

b. Tax Issues

3. Covered Bonds

In September 2012, Royal Bank of Canada sold $2.5 billion of triple-A rated covered bonds in the first registered offering of such bonds to retail investors in the United States. See Wall Street Journal on-line, "Mom, Pop Get a Taste of an RBC Bond Deal," September 12, 2012.

Legislation is pending in Congress to provide a framework for issuing covered bonds. A bill that would enact the "United States Covered Bond Act of 2011" was introduced in the House of Representatives on March 8, 2011 by Representatives Garrett (Chairman of the Financial Services Subcommittee on Capital Markets) and Maloney (Ranking Minority Member of the House Financial Services Subcommittee on Financial Institutions). The bill was approved by the Financial Services

Committee on June 22, 2011. A similar bill (H.R. 5823) was introduced in 2010 but was not passed. Most significantly, the bill would provide additional safeguards for holders of covered bonds in an insolvency proceeding of the issuer. Covered bonds could be supported by different asset classes including certain residential mortgages, home equity loans, commercial mortgages, public sector assets, auto assets, student loans, credit or charge card assets, and small business assets. Covered bonds backed by assets in the first three of these categories would be qualified mortgages that could be held by REMICs, and under regulations would be real estate assets for a REIT. Under a special rule that could benefit offshore investment funds or securitization vehicles, the acquisition of a covered bond would be considered the acquisition of an investment security, and not an acquisition of an interest in a loan or otherwise as a lending transaction, for purposes of determining the character of any related trade or business activity of the acquirer or any asset held by the acquirer under the Code.

4. Stranded Cost Securitizations

J. Synthetic Variable Rate Tax-Exempt Bonds

Comment: There has been concern that the Volker Rule would prohibit banks from participating in synthetic variable rate tax-exempt bond structures. In a letter to the Federal Reserve Board, FDIC, Comptroller of the Currency, CFTC, and SEC dated June 13, 2014, SIFMA (the securities industry trade group) explains that market participants have reached a consensus that they can proceed under an exception in Section __.10(c)(3) for joint ventures (and the structure has correspondingly now become a "bond joint venture"). The authors understand that personnel from the Federal Reserve Board made it clear to industry participants informally that the joint venture exception was intended only for operating companies.

Add to the end of footnote 91: The 2011-2012 IRS Business Plan does not provide for any planned modification of Revenue Procedure 2003-84.

K. Securities Backed by Distressed Receivables

Add a new Part L at the end of Chapter 2:

L. Credit Risk Transfer Securities

In the midst of the financial crisis in 2008, both Fannie Mae and Freddie Mac entered into federal conservatorships, largely on account of exposure to mortgage-related credit risk. Post-crisis, the two Agencies continued to guarantee pass-through certificates, but sought to shift some of the risk of defaults on the underlying mortgage pools contractually to the private sector. To that end, in 2013, they began issuing to unrelated investors *credit risk transfer securities* or *CRTS*. CRTS as they have existed to date are a type of credit-linked note with a pay-through feature. Principal is written down to reflect losses from defaults and modifications of reference obligations, which are designated pools of residential mortgages backing pass-through certificates recently securitized and guaranteed by the CRTS issuing Agency. The issuing Agency typically does not own the reference obligations and the CRTS are not backed by those obligations. Thus, CRTS are not conventional mortgage-backed securities.

CRTS issued by Fannie Mae are called Connecticut Avenue Securities or *CAS*.[1] The Freddie Mac version is Structured Agency Credit Risk (*STACR*) Notes.[2] Like conventional mortgage-backed securities, CRTS are issued in tranches with different levels of subordination.

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[1] For a description and links to offering circulars, see http://www.fanniemae.com/portal/funding-the-market/credit-risk/conn-ave.html.

This Part L describes typical CRTS and their expected tax treatment. The terms of any particular securities may of course differ from this description, and terms may change over time.

The next section describes CRTS in the form in which they have been issued to date. The description of the expected tax treatment is based on the CAS and STACR Notes offering materials. Both Agencies have announced they are considering switching to REMIC versions of CRTS beginning some time in 2018 to allow marketing to a broader range of investors. The proposed REMIC version is discussed in the second following section.

1. *Pre-2018 CRTS as Corporate Debt*

CRTS in their traditional non-REMIC form are unguaranteed, unsecured debt with a term of 10-12 years, subject to an earlier call a few years before the stated maturity (and to a clean-up call when the reference pool drops to 10 percent of the initial balance). They have a principal amount and bear interest payable monthly, generally at a fixed spread over LIBOR without a cap. The timing and amount of principal payments on the CRTS are determined by the timing and amount of payments on the mortgages in the reference pool. If the reference mortgages experience credit losses, the losses are applied to write down CRTS principal (principal may also be written back up if there are recoveries).

CRTS are divided into classes with different subordination levels, which are typically Class A senior, Class M mezzanine, and Class B junior classes. Write downs are applied first to Class B, then to Class M, and finally to Class A. Class M and B securities are the ones that have been sold to investors. The Agencies retained (at least economically) the first and last risk classes and a share of each class that is sold.[3] Principal may be paid first on the more senior classes, creating a fast-pay, slow-pay bond structure. The Class B securities are aimed at domestic buyers, or foreign buyers resident in some treaty jurisdictions, because of the withholding tax risk described below. CRTS issued at one time may also be divided into classes that are linked to different reference pools (for example, pools with different loan-to-value ranges and thus different levels of risk).

CRTS may be eligible to be stripped or combined under the applicable Agency program for creating LEGO securities described in Part B.5, above.

Turning to the expected tax treatment, the CAS and STACR Notes offering materials take the position that the Class M notes are debt and that the interest accruing thereon is qualified stated interest (and thus not included in original issue discount or OID).[4] For the Class M notes, the possibility that principal or interest may be reduced on account of losses is disregarded in applying the OID rules, on the ground that the likelihood of such reductions is remote.[5] To the extent there is OID because the issue price is less than the principal amount, or because of payment reductions due to credit losses, income will be

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2 For a description and links to offering circulars, see http://www.freddiemac.com/creditriskofferings/stacr_debt.html.

3 The retained classes that are not sold investors are notional classes used to define payments on the classes that are sold.

4 The OID rules are described in Chapter 8, Part C. Qualified stated interest and other terms used in defining OID are discussed in Chapter 8, Part C.1.

5 For that reason, the contingent payment debt instrument (*CPDI*) rules described in Chapter 8, Part C.3.e, do not apply. See Chapter 8, footnote 47 (exception for remote contingencies). Although a debt instrument is not considered a CPDI because of default-related contingencies, the write down of principal on CRTS would not involve a default by the issuing agency. The exception to the definition of CPDI for a debt instrument subject to the PAC method of accruing OID under section 1272(a)(6) would not technically apply because CRTS are not secured by other obligations and thus are not described in section 1272(a)(6)(C)(ii). The PAC method is described in Chapter 8, Part C.4.

calculated using the principles of the PAC method under section 1272(a)(6) (with a floor of zero on the income accruing in any period) even though the method does not technically apply.[6]

While not entirely clear, the Agencies take the position that Class B notes will be treated as notional principal contracts (for purposes other than withholding tax). The initial payment made by the investor to acquire the Class B notes is a significant nonperiodic payment that is treated under the notional principal contract regulations as a loan.[7] The Class B notes would be notional principal contracts with contingent features so that under proposed regulations, income of U.S. holders could potentially be computed using a mark-to-market method. Income from notional principal contracts received by foreign persons is not generally subject to U.S. federal withholding tax, on the ground that the income is foreign source.[8] However, given the possibility that the Class B notes may be considered equity, some type of derivative contract other than a notional principal contract, or a guarantee contract, the Agencies treat coupon payments as U.S. source FDAP income and withhold accordingly on payments to foreign investors.[9]

2. CRTS as REMIC Regular Interests

On May 8, 2017, Freddie Mac and Fannie Mae announced that they were considering REMIC versions of STACR Notes and CAS.[10] The reason is to make both the Class M and Class B securities suitable investments from a tax perspective for REITs and foreign investors by having them qualify as regular interests.

The authors understand that the structure would work as follows:

Pools of residential mortgages that are now placed in a single grantor trust that issues a single class of pass-through certificates guaranteed by one of the Agencies would continue to be held by a trust issuing certificates, but the mortgages would be included for tax purposes in an internal REMIC or *I-REMIC*. The I-REMIC would issue one class of senior regular interests corresponding to each mortgage, and the trust would hold all of those senior regular interests in lieu of the mortgages. The senior regular interests would have the same cash flows as before (so a right to all of the principal and interest payments on the mortgages in the pool, less servicing fees and a number of basis points equal to the agreed guarantee fee). Accordingly, a sponsor exchanging $1,000 principal amount of mortgages for pass-through certificates would continue to receive $1,000 principal amount of certificates backed by those mortgages, and the pass-through rate of interest would not change. The use of the I-REMIC as a wrapper for mortgages is intended to be largely invisible to participants in the market for pass-through certificates.[11]

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6 See footnote 5, above. For a general discussion of how the PAC method is affected by bad debt losses, see Chapter 8, text at footnote 271.

7 For a discussion of the tax treatment of notional principal contracts, including those with significant nonperiodic payments and contingent payments, see Chapter 8, Part H.5.

8 For a discussion, see Chapter 12, Part C.3.a.

9 The 30 percent withholding tax on FDAP income paid to foreign investors is discussed generally in Chapter 12, Part C. The tax disclosure for these programs indicates that withholding may not apply to an investor that is entitled to the benefit of a treaty that eliminates withholding on all of other income, business profits and, in the case of the Fannie Mae disclosure, interest. They also indicate that a withholding agent may not agree and may withhold in any event.

10 See http://www.freddiemac.com/creditriskofferings/docs/STACR_REMIC_announcement.pdf and http://www.fanniemae.com/portal/funding-the-market/mbs/news/2017/connecticut-avenue-securities-mbs-prospectus-050817.html

11 One modest difference is that cash method investors would be required to report interest on a pass-through certificate backed by regular interests as the interest accrues. Under section 860B(b), amounts included in gross income with respect to a REMIC regular interest must be determined under an accrual method. Also, a sponsor exchanging mortgages for pass-through certificates would be exchanging mortgages for REMIC regular interests as a REMIC sponsor (rather than doing nothing from a tax perspective which would be the

The I-REMIC holding the mortgage pool also would hold Treasuries or other high-quality non-mortgage debt investments in a qualified reserve fund. It would issue classes of subordinated regular interests (without a guarantee for credit losses) having a principal balance equal to the amount of the reserve fund.[12] The subordinated classes would pay interest at a rate equal to a margin over an interest rate index appropriate for the risk.[13] Default losses on the mortgages would be charged against the reserve to the extent thereof. The losses would be absorbed by the subordinated classes.

Subordinated regular interest classes from different pools would be aggregated into new pooling REMICs (which could be called STACR or CAS REMICs or generically CRTS REMICs) and interests in the CRTS REMICs having substantially the same economic features as the pre-2018 CRTS would be sold as regular interests to investors.

The I-REMIC would have a mix of mortgage and non-mortgage assets, but the non-mortgage assets would be kept under 5 percent. Regular interests issued by a REMIC and the income thereon are considered qualifying assets for a REIT in full as long as mortgages or other qualifying REIT assets represent at least 95 percent of the assets of the REMIC.[14] Apparently, 5 percent is a large enough cushion to absorb the desired level of mortgage losses in an I-REMIC.

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treatment of an exchange of mortgages for pass-through certificates issued by a grantor trust), although the practical differences are not likely to be material. Chapter 15, Parts C and E, discuss the treatment of sponsors of pass-through certificates and REMICs.

[12] Qualified reserve assets are a type of permitted investment for a REMIC. See Chapter 6, Part B.2.b.(ii).

[13] The rate of interest on the subordinated classes would be funded partly by reducing the Agency guarantee fee. The lower fee is appropriate since the existence of the reserve fund and the issuance of subordinated regular interests reduces the Agency's risk of loss under the guarantee.

[14] See Chapter 11, footnote 26 and accompanying text. The 95 percent test is ongoing, and thus would have to be met over the life of the REMIC. In any event, section 860G(a)(7)(B) requires reserve assets to be "promptly and appropriately reduced" as the risk of loss from mortgages is reduced through mortgage repayments or other factors. It should be possible to reduce the reserve by making payments on regular interests. See Chapter 6, footnote 159.

Chapter 3

Sale/Financing and Debt/Equity Issues

A. Introduction

B. Issues Interrelated

C. Tests for Distinguishing a Sale From a Financing—Overview

1. Tax Ownership

2. Creditors' Rights Issues—A "True Sale" at Law

3. GAAP

Comment on footnote 23: The Deloitte pamphlet on securitization accounting is now in its 10th Edition (dated January 2017) and has a new group of authors. It is available to be downloaded at www2.deloitte.com/us/en/pages/risk/articles/securitization-accounting-insights.html.

D. Distinguishing a Sale From a Financing—Detailed Discussion of Tax Standards

1. Sources of Authority on Tax Ownership

a. Installment Obligations

Add the word "generally" before "no longer" in the text before footnote 37 and add the following at the end of footnote 37: Although pledges of installment notes generally accelerate gain under section 453A(d), that section has an exception, in section 453A(b)(3)(B), for notes arising from the sale of farm property. Owners of timber lands have been relying on this exception to engage in transactions in which they sell timber for an installment note to party A supported by a letter of credit from a bank and then borrow against the note from party B. F.A.A. 20123401F (July 18, 2012) blesses the arrangement, holding that it may not be attacked under substance over form or step transaction principles. For a discussion, see Robert Willens, "IRS Approves Timber Monetization Strategy," 2013 *Tax Notes Today* 90-8 (May 9, 2013).

b. Sale/Repurchase Agreements

Footnote 40 describes the *Calloway* case in which a taxpayer transferred stock to a promoter named Derivium Capital, which promptly sold the stock. The sale was allowed under the documents but the promoter had represented that it did not intend to sell. The Tax Court held there was a taxable sale. Three other cases involving the same promoter, similar facts and the same outcome are *Shao v. Comm'r,* T.C. Memo. 2010-189, *Kurata v. Comm'r*, T.C. Memo. 2011-64, and *Sollberger v. Comm'r,* T.C. Memo. 2011-78 (involving a transfer of debt rather than stock).

Calloway was affirmed, 691 F.3d 1315 (11th Cir. 2012). The opinion emphasizes the factual nature of any inquiry about transfers of tax ownership. It says there are three factors in particular that support treating Calloway as a seller: (1) the buyer had an unrestricted right to sell immediately; (2) Calloway was not able to reacquire the shares for three years, and thus could not for an extended period take advantage of swings in the price of the stock (for example, by selling the stock at a higher price and keeping the proceeds), and (3) Calloway had given up both down-side risk and, up to a cap, up-side benefits because the repurchase price exceeded the original value of the shares (it was 90 percent of the original value plus three years of interest on that amount at a rate over 10 percent). The appellate court went out of its way to distance itself from the Tax Court concurring opinion by Judge Halpern, which said that transferring title and a right of disposition was enough to have a sale. The appellate court said that this analysis could not be squared with the treatment of secured loans, where the secured party may have the legal right to dispose of collateral (albeit while promising to the lender that it would not do so). It also is not consistent with the treatment of brokerage accounts where the broker has the ability to lend or sell shares.

Samueli (described in the same footnote) was affirmed, 661 F.3d 399 (9th Cir. 2011). The appellate court indicated that a facts and circumstances approach should be applied in determining whether a securities loan with a fixed term falls outside of section 1058 and then concluded that the term was too long on the facts of the case. The court also indicates that gain arising from the fulfillment of a forward contract is not gain from a termination of the contract resulting in capital gain or loss under section 1234A. The language of the opinion on this point is not very clear and the second holding may be limited to cases in which a contract provides for physical settlement (which would result in short-term capital gain if the acquired property were resold immediately, as happened in the case).

A New York State Bar Association Tax Section report seeks to limit the potential damage that *Samueli*, *Calloway* and *Anschutz* (discussed at footnote 71, below) might have in applying section 1058 to conventional securities loans. See "Report of the Tax Section of the New York State Bar Association on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058," 2011 *Tax Notes Today* 112-22 (June 9, 2011). The report is discussed in the *Samueli* appellate decision.

c. Options

A.M. 2012-007 (June 27, 2012), a generic legal advice memorandum, holds that a parent corporation owning a majority but less than 80 percent of the stock of a subsidiary with publicly traded stock will not be considered the owner of stock of the subsidiary purchased from an unrelated counterparty for purposes of determining if the subsidiary is a member of the same affiliated group as the parent. The parent paid for the purchase price of the stock with a fixed-rate debt instrument having a term exceeding six years. The instrument was exchangeable at the holder's option back into the stock over a multi-day "Exchange Period" ending before the second anniversary of the sale. The interest rate was less than one-third the parent's normal borrowing rate for straight unsecured debt. The face amount of the debt equaled the market value of the stock at the time of sale. Parent pledged the stock to secure the debt and legal title to the shares was transferred to an agent related to the counterparty. The pledge terminated upon lapse without exercise of the exchange right. Parent had the right to substitute identical shares for the pledged shares. Parent could keep dividends paid on the shares, but the holder could exercise the exchange right prior to the Exchange Period if dividends slightly exceeded historic levels or the subsidiary paid a non-cash, non-stock dividend. Non-cash dividends were added to the pledged property and would be transferred to the debt holder with the shares on exercise of the exchange right. Parent could vote the pledged shares. The memorandum concludes that the purported sale did not shift tax ownership of the shares to parent because the seller retained the opportunity for gain and significant risk of loss from the shares and was very likely to reacquire them. The exchange right clearly gave the holder of the debt up-side benefits because it could during the Exchange Period acquire the shares at a fixed price. Also, by comparison with conventional exchangeable or convertible debt, the exchange price was the fair market value of the stock at the time of issuance of the debt, not a premium to that amount. The holder had down-side risk because when the Exchange Period ended, if the exchange right was not exercised, the holder would be left with a debt instrument with a value materially less than its face amount. The parent's right to vote the shares was insignificant because it already had majority control of the subsidiary. The parent's right to retain dividends was capped because the exchange right could be exercised early if dividends increased above predictable levels. The memorandum notes that its conclusion would be even stronger if the counterparty were borrowing the shares in an illiquid market and needed to get them back to cover the short.

T.A.M. 201142020 (July 12, 2011) involves call options on commodities written by a taxpayer that were modified to require the taxpayer to always sell the commodities at a price equal to the lower of the strike price or a current market price. The T.A.M. holds that the change was not a section 1001 event and did not change the contract from an option to a forward contract, because the economics of the contract were still consistent with an option (one way shift of a right to appreciation or depreciation in an asset) and the added requirement of a sale of a fungible commodity at a market price was not a significant change.

A.M. 2010-005 (October 15, 2010), a generic legal advice memorandum, analyzed a contract in the form of an option held by the taxpayer, a Delaware limited partnership hedge fund. The option allowed the holder to purchase from a foreign bank a basket of securities ("reference securities"). The reference securities were held in a prime brokerage account that was administered by the bank but managed by an affiliate of the holder. The memorandum concluded that the contract should not be treated as an option and the taxpayer should be treated as the beneficial owner of the securities.

The taxpayer paid an option "premium" of $1x to the bank, which funded 10 percent of the cost of the reference securities. The bank funded the remaining 90 percent (and effectively charged interest thereon to the taxpayer through the cash settlement amount, described below).

The option had a two-year term and gave the taxpayer the right to terminate it at any time. Upon termination, the taxpayer would receive a cash settlement amount equal to the $1x option premium, plus or minus any income or losses on the reference securities, less administrative and trading expenses, and a finance charge on the $9x provided by the bank to the account. The holder would receive back its premium of $1x upon an immediate termination, effectively making the option in-the-money upon issuance. There was also a "knock-out" feature that automatically terminated the option if the basket of securities experienced losses at least equal to the taxpayer's $1x option premium. The bank apparently had the right to compel the GP (described below) to conduct risk-reducing trades or cause an early termination of the basket (and thus the option) even before the option knocked-out. According to the memorandum, this combination of factors led the option holder to have the risk of loss and upside on the reference assets in a manner similar to the owner of property subject to a nonrecourse loan.

The securities held by the bank were selected and managed by the taxpayer's general partner (the "GP") pursuant to an investment management agreement between it and the foreign bank. The GP, in accordance with the agreement, conducted a short-term trading strategy whereby securities could be bought, sold, or replaced at the discretion of the GP, subject to investment guidelines. There could be numerous daily trades. Although the option technically was on a synthetic basket of securities (which consisted of the securities proposed by the GP), the bank executed all transactions submitted by the GP. The GP could direct the voting of the securities. The fee paid to the GP by the bank for such management service was nominal in comparison to those received by the GP (and other similar providers) for analogous services rendered to its limited partner feeder funds.

The IRS concluded that the security was not an option because, under the government's analysis of the transaction, (1) the interplay among the $1x premium, the cash settlement amount, and the knockout feature effectively compelled exercise of the option (while precluding its lapse), (2) the premium amount was determined not by conventional option pricing models, but rather, by the bank's finance department (which was more consistent with the contract being akin to a margin loan rather than an option), and (3) the taxpayer had the ability (through the GP) to alter the basket's underlying securities (which the IRS viewed as inconsistent with the notion that an option on property must reference specific property at a predefined price).

After concluding that the security was not an option, the IRS ruled that the taxpayer was the beneficial owner of the basket of securities, since it received all the gain and income from, had substantially all of the risk of loss of, and had complete dominion and control over, the basket.

The holding obviously depends on the particular facts.

For an article discussing the A.M., see David Mayo and Sam Chen, "Options Over a Managed Account," 2011 *Tax Notes Today* 31-8 (February 15, 2011).

A press article identifies Renaissance Technologies LLC as a hedge fund under attack for using techniques similar to those described in the A.M. See Zachary R. Mider and Jesse Drucker, "Simons Strategy to Shield Profit From Taxes Draws IRS Ire," Bloomberg (July 1, 2013).

On July 22, 2014, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs held a hearing on the use of basket options to avoid taxes and leverage limits. A report by the PSI staff released in conjunction with the hearing has detailed case histories of the use of such options by two taxpayers. The report is available on the PSI web site at www.hsgac.senate.gov/subcommittees/investigations.

Notice 2015-73 and Notice 2015-74 provide that, depending on the facts (including the date a transaction was entered into) transactions like these are either listed transactions or transactions of interest and thus reportable transactions for purposes of Treasury Regulation § 1.6011-4(b)(2) and § 1.6011-4(b)(6), respectively, and sections 6111 and 6112. The reportable transaction rules are described in Chapter 17, Part B.2. Notice 2015-73 and Notice 2015-74 revoked Notice 2015 47 and Notice 2015-48, respectively, which were to the same effect but modestly broader in scope.

In its most recent analysis of barrier options, Chief Counsel reached a similar conclusion to the 2010 A.M. in C.C.A. 201547004 (August 11, 2015) with respect to Cash-Settled Barrier Call Options on portfolios that were made up principally of interests in hedge funds. In the transaction discussed in the memorandum, the taxpayer purchased several contracts styled as "call options" from a bank. The contracts designated a corporation as portfolio manager to manage the basket of reference assets while the options remained open. The corporation was formed at taxpayer's request and operated by the taxpayer's former employee. In each contract, the premium was set at a percentage of the contract's initial notional amount. The "cash settlement amount" payable to taxpayer at maturity or early termination was set to equal the value of the portfolio minus the strike price, subject to a floor of zero. The strike price was 100 minus that same percent of the initial notional amount, as adjusted for interest-like charges and fees imposed by the bank on the reference portfolio, and as modified by the "barrier provisions" that were designed to protect the bank from loss. Under the barrier provisions, if the value of the portfolio dropped by more than a specified percentage from its starting value (representing less than half of taxpayer's "premium"), taxpayer was required to pay "additional premium" to reset the ratio (i.e., reduce the over-leverage). Otherwise, bank had the right to either "deduct capital" from the portfolio by adjusting the valuation of the portfolio downward, or terminate the contract. Capital could be "deducted" either by withdrawing cash, or by allocating to the bank a share of the gains from the portfolio.

The Large Business and International division of the Service (LB&I) has started a practice of identifying "campaigns" focusing on particular transaction patterns that warrant audit attention. One of the campaigns relates to the treatment of basket transactions. See www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns.

Chief counsel concluded that the options were not options for tax purposes because the taxpayer had (1) the opportunity for full gain and current income from the referenced assets (i.e., the economic benefits), (2) substantially all of the risk of loss and the burden associated with the referenced assets' lack of liquidity (i.e., the economic burdens), and (3) the effective power to direct the bank to acquire and redeem the referenced assets through the portfolio manager (who the IRS treated as not independent of the taxpayer). Chief Counsel further concluded that where the bank owned the reference assets, tax ownership of those assets was transferred to the taxpayer. Where the bank did not own the reference assets the taxpayer was treated as owning a forward contact that was subject to the constructive ownership rules of section 1260.

For a general discussion of the tax treatment of options, focusing on when the existence of conditions to exercise can prevent a purported option from qualifying as one for tax purposes, see J. Walker Johnson and Brigid Kelly, "Tax Restrictions Can Impede the Use of Options to Manage Risk," 2014 *Tax Notes Today* 222-10 (November 18, 2014).

One of the potential IRS arguments for taxing holders of options that relate to baskets of securities that can be changed through the exercise of discretion is that the actual use of the right triggers a realization event under section 1001 (akin to a significant modification of a debt instrument that is a realization event under Treasury Regulation § 1.1001-3). For a discussion of the topic focusing on changes made pursuant to the terms of an instrument, see Michael Shulman and Nathan Tasso, "Changes to Derivatives 'Pursuant to Their Terms'," *Tax Notes*, May 1, 2017, p. 653 (Part 1), and *Tax Notes*, May 8, 2017, p. 805 (Part 2). For a more general discussion of modifications of derivatives, see James M. Peaslee, "Modifications of Nondebt Financial Instruments as Deemed Exchanges," *Tax Notes*, April 29, 2002, p. 737. Modifications of debt instruments are discussed in Chapter 6, Part D.2.c.

Add after the first paragraph in footnote 43: P.L.R. 201230008 (April 25, 2012) follows Revenue Ruling 82-150 in treating warrants to purchase stock at a nominal price as stock.

Add at the end of footnote 43: Treasury Regulation § 1.761-3 was adopted as a final regulation by T.D. 9612 (February 4, 2013).

Add to the end of footnote 44: In the context of the wash-sale rules, section 1091(a) disallows losses on sales of stock where within 30 days the seller enters into a contract or option to acquire the same stock. Revenue Ruling 85-87, 1985-1 C.B. 268, holds that an in-the-money put option written by a taxpayer selling stock at a loss was in substance a contract to acquire stock: "In the instant case, at the time the put was sold there was no substantial likelihood that the put would not be exercised. Thus, for purposes of section 1091(a), the put sold by A is in substance a contract to acquire stock."

d. Guarantees

e. Equipment Trusts and Similar Arrangements

f. Pass-Through Certificates

g. Leased Property

Footnote 56: The 2009 Federal Claims Court decision in *Consolidated Edison Co. v. United States*, the one taxpayer victory in a LILO case, was reversed by the Federal Circuit on the ground that the user of the leased property was reasonably likely to exercise a sublease purchase option, with the result that in substance there was a lease and sublease of the same property with matching terms, amounting to nothing from a tax perspective. See "Federal Circuit Reverses Court of Federal Claims Grant of Refund in LILO Case," 2013 *Tax Notes Today* 7-10 (January 9, 2013). The court rejected the argument that certainty of exercise of the option was required to deny tax benefits to the taxpayer. For an article criticizing the lower "reasonably likely to exercise" threshold, see Randy Clark and Mark Regante, "*ConEd* LILO Decision: Bad Facts, Bad Law," 2013 *Tax Notes Today* 49-7 (March 13, 2013). See also, Toby Cozart, "'Reasonably Likely' Lessee Purchase Option Sinks ConEd's LILO," *Bloomberg BNA Tax Management Memorandum*, July 15, 2013. In *John Hancock Life Insurance Co. v. Comm'r*, 141 T.C. No. 1 (2013), the court again struck down both LILO and some SILO transactions on the ground that the transactions more closely resembled a loan of money to the property user from the taxpayer than a lease or sublease of property. The court looked at all facts and circumstances, including the fact that the property user's purchase option was reasonably likely to be exercised, use of and control over the property did not change, the property user was not required to pay for use of the property, and the taxpayer's limited risk. Interestingly, the court found that the transactions had economic substance and that the property user was not compelled by legal or other factors (aside from the economics of the option) to repurchase the property. In what may be one of the last LILO decisions, the court in *Exelon Corporation and Subsidiaries, et al. v. Comm'r*, 147 T.C. No. 9 (2016) crushed the hopes of a utility that sought to defer gain under the like kind exchange rules in section 1031. The utility exchanged (1) one power plant for (2) an interest in another power plant as a lessee-sublessor under a LILO structure. The court held that the acquired property was in substance a loan and thus not property of a like kind.

h. Conduit Arrangements

Treasury Regulation § 1.1366-2(a)(2)(i) (adopted by T.D. 9682, published in the Federal Register July 23, 2014) treats a shareholder of an S corporation as having basis in any "bona fide indebtedness" of the S corporation that runs directly to the shareholder for purposes of the rule limiting S corporation losses allowed to a shareholder to the shareholder's basis in the corporation's stock and debt. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general federal tax principles and depends upon all of the facts and circumstances. As illustrated by an example, general tax principles would determine whether to recognize the shareholder as a borrower and lender in a back-to-back loan transaction.

Two authorities take the view that an intermediary corporation can be ignored where the corporation was inserted for a tax avoidance reason and the claimed tax result distorts the applicable statute.

In *Barnes Group, Inc. v. Comm'r*, T.C. Memo 2013-109, aff'd by a nonbinding summary order of the Second Circuit on November 5, 2014, a Singapore corporation owned by a U.S. parent had undistributed earnings and excess cash and wished to make the cash available to the parent without triggering a taxable dividend distribution. It sought to achieve this result by investing in stock of a newly formed Bermuda corporation, which in turn invested in preferred stock of a newly formed domestic finance company which made a loan to the parent. The Bermuda corporation paid for part of the preferred stock by issuing its own stock to the domestic finance company. Normally, an investment by a foreign subsidiary in stock of a domestic affiliate would have been considered an investment in "United States property", which is considered a deemed dividend under section 956. However, under regulations, the amount of an investment in United States property is measured by a foreign corporation's tax basis in the investment, and because the Bermuda company paid for the preferred stock in part with its own stock (in addition to cash), there was a technical argument that its tax basis in the preferred stock was zero (under the reasoning of a revenue ruling). The court did not attack the technical conclusion but instead relied on the lack of business purpose for establishing the intermediaries (and some carelessness in adhering to the terms of the loan and preferred stock) as a basis for ignoring the structure and recasting the transaction as a cash dividend from the Singapore company to the parent.

C.C.A. 201320014 (January 18, 2013) involves an investment by a domestic parent corporation in a captive domestic RIC (that was not subject to tax because it could deduct dividends) through a foreign subsidiary. The parent claimed the dividends received deduction under section 245 based on a rule that allowed the deduction where a foreign corporation received dividends from a "domestic corporation". The advice argues that allowing the DRD in these circumstance would frustrate congressional intent (Congress had assumed the domestic corporation would be taxable), and seemingly that was enough to ignore the intermediary foreign corporation. There was also an argument relating to subpart F (which had to be avoided for the DRD to be available). For an article criticizing the reasoning of the advice, see Jasper L. Cummings Jr., "The Substance of Dividends Received Deductions," 2013 *Tax Notes Today* 151-5 (August 6, 2013).

i. Short Against the Box

j. Forward Contracts

C.C.A. 201104031 (September 17, 2010) involves a taxpayer that owned shares of a traded stock and entered into, as seller, a prepaid forward contract to sell shares of that class. The contract provided an initial payment based on a floor value for the stock and a right to receive an additional amount based on the market value of the stock on settlement. The contract was settled by the taxpayer in a way that was intended to defer gain. Specifically, the taxpayer borrowed shares and used them to settle the forward contract and then took the position that its gain could be calculated by comparing the forward price with the basis in the new shares (the conventional treatment for a short sale). The C.C.A. holds that the forward contract was a separate contract from the short sale and that settlement of it through delivery of shares resulted in realization of gain from the forward equal to the additional proceeds of the contract.

Footnote 71: Anschutz Co. v. Comm'r, 135 T.C. 78 (2010), was affirmed 664 F.3d 313 (10th Cir. 2011). A New York State Bar Association Tax Section report seeks to limit the potential damage that *Anschutz* and *Samueli* and *Calloway* (discussed in footnote 40, above) might have in applying section 1058 to conventional securities loans. See "Report of the Tax Section of the New York State Bar Association on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058," 2011 *Tax Notes Today* 112-22 (June 9, 2011).

Add at the end of section j: In *McKelvey*,[71a] the Tax Court addressed the tax treatment of an extension of a variable prepaid forward contract entered into by an individual (as the stock seller) with a bank (the buyer). The taxpayer received the sales price and agreed to sell a variable number of shares of a fungible class at a future date. He properly deferred gain in reliance on Revenue Ruling 2003-7. Before the forward contract expired, the taxpayer made a significant payment to the bank to extend the contract. The IRS argued that the modifications triggered gain under either section 1001 or the constructive sale rules of section 1259. The court held for the taxpayer, mostly on the ground that the extension did not undermine the original rationale for treating the contract as an open transaction. That rationale was the inability to determine taxable gain prior to identification of the particular shares (or cash) to be used to settle the contract.[71b] The extension also did not change the rationale for not applying section 1259 (uncertainty as to the number of shares to be delivered).

k. Timing of Sales

Add to footnote 72: C.C.A. 201414015 (November 12, 2013), supplemented by C.C.A. 201433013 (April 15, 2014) involving the same taxpayer and facts, concludes that a taxpayer corporation did not acquire ownership of shares of stock in a target corporation held in escrow pending closing of a sale where the taxpayer already owned a majority (but less than 80%) of the target's stock and had contracted to purchase the balance from sellers under a stock purchase agreement, at a formula price that had become fixed. The sellers retained the right to dividends on and to vote the escrowed shares. The taxpayer wanted to file a consolidated return with target before the closing, which required under section 1504 that it own 80% of the stock of target, by vote and value. The C.C.A.s concluded that taxpayer did not become the tax owner of the escrowed shares because the benefits and burdens of ownership had not shifted sufficiently to effect a tax sale. Specifically, the right to vote and to distributions and possession

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[71a] *McKelvey v. Comm'r*, 148 T.C. No. 13 (2017).

[71b] More technically, the court held that there was no realization event under section 1001 because that section addresses transactions in property, and the forward contract was an obligation of the taxpayer, not property. This line of argument raises the prospect of having asymmetrical treatment of two parties to a modified contract where the contract is an asset of one and a liability of the other; the court might apply section 1001 only to the asset holder. It is not clear why the court thought section 1001 provided the only rationale for finding a realization event under general tax principles. Perhaps that is how the government framed the issue.

and the right of disposition had not been transferred. Transferring the right to appreciation and the risk of depreciation through the fixed purchase price (and apparently the lack of material closing conditions) was not enough. The taxpayer had argued that the rights to dividends and to vote were meaningless, because it could block distributions on the shares and control board votes based on its outright ownership of a majority of the shares.

l. Stranded Cost Securitizations

m. Variable Life Insurance and Annuity Contracts

Correction to footnote 82: The correct citation to the Beers article is *Tax Management Memorandum*, Vol. 45 (Issue 3), p. 35, February 9, 2004.

Jeffrey T. Webber v. Comm'r, 144 T.C. 324 (2015), applies the investor control doctrine to conclude that the taxpayer, an individual, was the tax owner of assets in segregated accounts underlying private placement variable life insurance policies on the lives of two elderly relatives. The court deferred to the revenue rulings applying the doctrine. The doctrine applied because the taxpayer actively managed assets and dictated other actions to be taken in respect thereto, had the power to extract cash, and, the court found, maintained essentially the same ownership rights as those he would have possessed if the assets were held in his own name. The account was invested in private equity and startup investments chosen by the taxpayer. The court rejected multiple counterarguments, including that the investor control doctrine did not apply to life insurance policies and Congress intended section 817(h) to supplant the doctrine. For a discussion of the case, see Jonathan G. Blattmachr and William E. Keenen, "*Webber* and the Investor Control Doctrine," *Tax Notes*, August 1, 2016, p. 683.

n. Agent Owned by Principal

For a pre-*Bollinger* ruling holding that the *Union Carbide* test of agency was met through ownership of a housing project by a low income housing corporation on behalf of a partnership where the controlling partner owned stock in the corporation, see Revenue Ruling 75-31, 1975-1 C.B. 10.

2. Transaction Patterns

a. Transfer With No Strings

b. Standard Package of Ties

Add to the end of footnote 96: The 2011-2012 IRS Business Plan lists as a current project, "Guidance regarding the scope and application of the rescission doctrine." The New York State Bar Association Tax Section has prepared a report describing the doctrine and suggesting ways in which it could be clarified. See 2010 *Tax Notes Today* 156-10 (August 11, 2010). The IRS later indicated that it closed the project without publication of any guidance. See Fourth Quarter Update to the 2012-2013 Business Plan.

For securitizations of assets other than "qualified residential mortgages," and starting in the not-too-distant future, the standard package of ties likely will include a retained interest of at least 5 percent. The retention requirement is mandated by section 941 of the Dodd-Frank Act as a way of ensuring that "securitizers" (the unfortunate term used in section 941) share risk with investors. The section authorizes the adoption of rules requiring (generally) the sponsor of a securitization transaction to retain an at-risk interest in the securities issued of at least 5 percent, with an exception for securitizations of lower risk residential mortgages (referred to as qualified residential mortgages). Although residential mortgages were the focus of section 941, the retention requirement is not limited to them. Writing implementing rules has turned out to be a complicated and controversial undertaking. In August 2013, the federal banking and housing regulatory agencies jointly issued a revised set of proposed rules under section 941. The proposed rules would become effective one year after publication as final rules in the case of securitizations backed by residential mortgages, and two years after publication for securitizations of other assets. The rules would define a 5 percent interest by fair value (as determined under GAAP) and allow retention of a horizontal or vertical slice (or a combination) of issued securities. For a Cleary Gottlieb alert memorandum discussing the revised proposals and their implications for the RMBS, CMBS and CLO markets, see https://clients.clearygottlieb.com/rs/alertmemos/Credit_Risk_Retention.pdf.

c. Credit Support

d. Prepayment and Market Value Guarantees

e. Call Options and Rights of Substitution

f. Retention of Interest Rate Strips

E. Debt/Equity Issues

1. Overview of Tax Standards for Classifying Financial Instruments as Debt

Section 385 Regulations. On April 4, 2016, the IRS and Treasury issued controversial proposed regulations under section 385 that would in certain circumstances convert instruments otherwise qualifying as debt into stock. With remarkable dispatch, the proposed regulations were then adopted as final and temporary regulations on October 13, 2016.[15]

The regulations apply only to debt held by a person related to the debtor. More technically, the rules apply to debt between members of an "expanded group" (corporations, including disregarded entities owned by corporations, and certain partnerships controlled by corporations, connected through a direct or indirect 80 percent link, measured by vote or value, or for partnerships profits or capital).[16] Also, in a significant change from the proposed regulations, the final regulations do not apply to debt of foreign corporations or of S corporations and certain other pass-through entities.[17] They do apply where lender and borrower are both domestic (with exceptions for loans between members of a federal income tax consolidated group).

The regulations are not likely to have a significant effect on securitizations because typically investors who are debt holders are unrelated to issuers, REMICs are not covered (they are not corporations or partnerships),[18] corporate issuers are typically foreign, and partnership issuers typically are not part of an expanded group that includes a U.S. corporation. For that reason, they are summarized only briefly here. Also, it would not be surprising if the regulations are withdrawn or changed by the Trump Administration.

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[15] T.D. 9790. The October 13 package also included some temporary regulations. For convenience, the final and temporary regulations will be referred to as the regulations. In a letter dated July 6, 2015, the Structured Finance Industry Group submitted comments on the proposed regulations that focused on securitizations, including a request for an exception for securitization vehicles. It was not adopted. The letter may be found at 2016 *Tax Notes Today* 132-46.

[16] The definitions are in Treasury Regulation § 1.385-1. An expanded group is defined in Treasury Regulation § 1.385-1(c)(4).

[17] This is achieved by limiting the substantive rules to debt of a "covered member" which is only a domestic corporation. See Treasury Regulation § 1.385-1(c)(2). The definition of expanded group excludes subchapter S corporations, and REITs and RICs acting as parents of a group.

[18] See section 860A, which states that except as otherwise provided in the REMIC rules, a REMIC "shall not be treated as a corporation, partnership, or trust for purposes of this subtitle". Section 860F(e) states that a REMIC shall be treated as a partnership for purposes of subtitle F, but that subtitle deals with tax reporting and other procedural and administrative rules.

The regulations have two main substantive rules (a rule in the proposed regulations that would bifurcate debt was dropped). They are (1) a documentation rule in Treasury Regulation § 1.385-2 and (2) a general and funding rule in in Treasury Regulation § 1.385-3 for debt issued without a new infusion of capital. Both rules convert instruments that otherwise would be debt into stock. The documentation rule will apply only to debt issued on or after January 1, 2018. The general and funding rules can apply to debt issued after April 4, 2016 (but only with effect as of January 19, 2017). The rules have dollar thresholds so that they are limited to large taxpayers or large amounts.

The documentation rule generally converts a debt instrument to equity if there are failures to document that (1) the debt has the legal characteristics of debt (including an unconditional and legally binding obligation to pay a sum certain on demand or on fixed dates and creditor rights to enforce payment obligations), (2) the issuer reasonably expects to meet its obligations under the instrument, and (3) either payments are timely made on the debt over time or the creditor reasonably acts like an creditor in responding to defaults. The documentation must be prepared by the due date for tax returns for the year in which the reportable event occurs.

The general rule converts debt into stock if the debt is issued to an expanded group member in a corporate distribution, in exchange for expanded group member stock, and in certain asset reorganizations. Under the funding rule, debt is converted to stock if it is issued with a principal purpose of funding one of these transactions (to the extent the funded amount exceeds earnings for taxable years ending after April 4, 2016). Perhaps the most controversial part of the regulations is an accompanying *per se* rule that deems the principal purpose test to be met if debt is incurred within three years before or after a distribution or acquisition even if there is demonstrably no connection between the debt and the distribution or acquisition. The regulations have an exception for temporary acquisitions of debt by a dealer related to an issuer.[19]

2. Significance of Thin Capitalization and Asset/Debt Mismatches

a. Overview

b. High-Quality Receivables and Parity Classes

(i) ***The NIPSCO and Principal Life cases***

(ii) ***Entrepreneurial risk***

(iii) ***Relative ranking of claims***

(iv) ***Owner with no economic stake***

(v) ***Need for corporate tax***

(vi) ***Resemblance to multiple-class trust***

(vii) ***Summary and intentional mismatches for nonbelievers***

c. Lower-Grade Receivables and Junior/Senior Classes

(i) Is ***concentrated*** credit risk an entrepreneurial risk?

(ii) ***Is there a quality threshold?***

[19] See Treasury Regulation § 1.385-1(g)(3)(ii) (definition of qualified dealer debt instrument).

A Tax Court memorandum decision involving a loan (in the form of "loan notes") from a foreign parent to its domestic subsidiary rejects a government argument that an investment grade rating is required to show sufficiently high credit quality to sustain debt treatment. The court holds, based on an analysis of all facts and circumstances, that the loan notes were debt for tax purposes despite having a rating that could be as low as single B (the appropriate rating was in dispute). See *NA General Partnership & Subsidiaries v. Comm'r*, T.C. Memo. 2012-172 (2012).

(iii) *If equity is needed, how much is enough?*

In July 2013, U.S. bank regulatory agencies adopted final capital rules that overhaul existing capital adequacy rules to implement both the Basel III capital framework and certain requirements imposed by the Dodd-Frank Act. The final rule adopts a supplementary minimum 3 percent leverage ratio (for this purpose, leverage being defined according to Basel III standards as Tier 1 capital divided by the sum of on-balance sheet assets without risk weighting and some off-balance sheet exposures) for approximately 18 banks subject to "advanced approaches" capital rules. At the same time, the FDIC released an interagency notice of proposed rulemaking that would amend the final rule to significantly increase the required supplementary leverage ratio for U.S. banking organizations identified as global systemically important banks to 6 percent (5 percent for holding companies). Those organizations are currently Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street and Wells Fargo. A Cleary Gottlieb alert memorandum discussing the new rules may be found at https://clients.clearygottlieb.com/rs/alertmemos/75.-2013.pdf.

(iv) *F.S.A. 200130009*

3. *Characterization of High-Coupon Debt*

Comment on footnote 213: The distinction between nonperiodic payments that are significant and those that are not has been eliminated. Under new regulations, with limited exceptions, a notional principal contract with one or more nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and one or more loans. See Chapter 8, Part H.5.a (in this Supplement).

Comment on footnote 214: Schering-Plough Corp. v. United States was affirmed, sub nom. *Merck & Co., Inc. v. United States*, 652 F.3d 475 (3d Cir. 2011).

4. *Equity Interests Treated as Debt*

a. *Overview*

b. *Credit Card Trusts Issuing Pass-Through Debt Certificates*

c. *Ability of Taxpayers to Disavow Form*

d. *Other Debt-Like Equity Distinguished*

Footnote 251: The Second Circuit reversed the District Court holding, taking the view that an interest in a partnership that is debt for tax purposes is not a "capital interest" within the meaning of section 704(e), and the Second Circuit's earlier decision that what the banks owned was "overwhelmingly in the nature of an secured lender's interest" meant that they did not hold a capital interest. *TIFD III-E, Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012). For a discussion, see Monte A. Jackel, "Castle Harbour Rides Again," 2012 *Tax Notes Today* 34-22 (February 21, 2012). On remand, the District Court held that the taxpayer was not liable for negligence penalties. See *TIFD III-E, Inc. v. United States*, 113 AFTR 2d 2014-1557 (D. Conn. 2014). The Second Circuit had sustained a substantial understatement penalty, but the IRS discovered that the tax amount was not large enough to be substantial, so the government switched theories and asserted negligence. It was perhaps unsurprising that the District Court judge concluded that taking a position consistent with his earlier decisions was not negligence. The government has filed an appeal, so stay tuned. In *Historic Boardwalk Hall, LLC v. United States*, 694 F.3d 425 (3d Cir. 2012), the Third Circuit, reversing the Tax Court, followed *Castle Harbour* in holding that a purported partner in a partnership that owned an "iconic" exhibition hall generating historic rehabilitation credits was not really a partner (and therefore not entitled to the credits) because of the lack of risk and opportunity for gain. Oddly enough, the court thought that the lack of risk sharing was evidenced in part by tax indemnities and other safeguards negotiated to ensure the availability of the credits. The case is noteworthy for being insensitive to the different contexts of a rehabilitation credit and allocation of taxable income to tax-indifferent parties.

Add to footnote 256. Hewlett-Packard Co. v. Comm'r, T.C. Memo. 2012-135 (2012), appears to be an outlier in its analysis of corporate stock. It held that fixed term preferred stock issued by a foreign corporation to a domestic investor was properly treated as debt, not stock, despite the form of the instrument as stock. The issuer was a structured vehicle that was required under investment guidelines to hold high quality financial assets. The investor had a right to put the stock to another shareholder that was effectively at a fixed price. The court held that the issuer had an obligation to redeem the stock after a fixed term based on a contractual obligation to take actions "necessary or appropriate" to facilitate sales of the stock by the U.S. investor under the put right. It is not clear, however, why that contractual obligation would be worse, in terms of debt-equity analysis, than an explicit mandatory redemption obligation. The stock paid dividends in an amount based on net cash earnings (which were predictable in light of the assets). The court believed that the company was obligated to pay such dividends without director action. For a critical analysis of the case, see Jasper L. Cummings, Jr., "Preferred Stock and the Special Purpose Issuer," 2012 *Tax Notes Today* 122-9 (June 25, 2012). Right after the *Hewlett-Packard* decision was issued, the IRS issued a private letter ruling that seems at odds with the case. P.L.R. 201226026 (March 26, 2012) holds that preferred stock with a fixed term issued by mutual funds holding tax-exempt bonds is properly classified as stock. The stock paid dividends at a variable rate (subject to a cap) based on a tax-exempt interest rate. The rate increased if the shares were downgraded by a rating agency or if certain other events occur (such as, among others, a failure of the issuer to pay a dividend or redemption payment, or the breach by the issuer of certain covenants). The payment of dividends was subject to declaration by the board, although the dividends were cumulative. The shares could be redeemed by the issuer at any time. They were required to be redeemed at maturity or earlier if the issuer failed to meet certain financial covenants (including a best efforts undertaking to maintain a AAA rating). All dividends and redemption payments must be made out of legally available funds. The private letter ruling could be distinguished from *Hewlett-Packard* on the ground that the preferred stock holders in the ruling had no claims against parties other than the mutual fund issuer. For other recent informal authorities holding (or assuming) that preferred stocks in vehicles holding debt were preferred stock, see P.L.R. 201128008 (April 7, 2011) (auction rate preferred stock of mutual fund was stock), P.L.R. 201147020 (August 17, 2011) (same), F.S.A. 2012120201F (November 10, 2011) and F.S.A. 2012120202F (November 10, 2011) (denying dividends received deduction based on lack of holding period under section 246(c) due to existence of guarantees or put rights). In *PepsiCo Puerto Rico Inc. v. Comm'r*, T.C. Memo. 2012-269 (2012), the same judge who decided *Hewlett-Packard* upheld a taxpayer's intended equity treatment for U.S. tax purposes of advances that were treated as debt for Dutch tax purposes where the advances had some debt features but were exposed to real business risks of the issuer.

Chapter 4

Classification of Issuers Other Than REMICs

A. Introduction

B. Overview of Entity Classification Regulations

1. General

2. Per se Corporations

3. Default Rule and Mechanics of Election

Add to end of footnote 29: The validity of an election where the number of owners is uncertain is discussed in a letter to the IRS and Treasury from Paul Kugler and Deanna Walton Harris of KPMG LLP commenting on Revenue Procedure 2010-32. In the letter, Mr. Kugler and Ms. Walton suggest, among other things, that Form 8832 be amended to permit an election to be either (1) a corporation or (2) a partnership or disregarded entity, depending on the number of owners. The letter is available at 2011 *Tax Notes Today* 38-23 (February 24, 2011).

4. Effect of Elective Changes in Classification

5. Number of Owners

Add at the end of footnote 62: Revenue Ruling 99-6 treats a partner who purchases partnership interests from other partners and becomes the sole owner of a disregarded entity as purchasing partnership assets and not a partnership interest. In a letter to the IRS, the American Institute of Certified Public Accountants recommends that the IRS revoke Revenue Ruling 99-6 and treat such a purchaser as acquiring an interest in a partnership that then liquidates, rather than partnership assets. The AICPA requested other guidance if the IRS declined to revoke the ruling. See 2013 *Tax Notes Today* 191-21 (October 1, 2013).

Add to footnote 46: Two offshore CLO issuers have filed petitions with the Tax Court contesting deficiencies based on the view that they are partners in a domestic partnership because of their ownership of unexercised warrants allowing them to buy partnership units for no consideration. See *TELOS CLO 2006-1, LTD. v. Comm'r*, Docket No. 6786-17 (March 22, 2017), and *TELOS CLO 2007-02 v. Comm'r*, Docket No. 6779-17 (March 22, 2017). Under section 875, a foreign partner in a partnership is considered to be engaged in a U.S. trade or business in which the partnership is engaged. The issuers owned primarily debt and were not allowed to buy equity in partnerships engaged in a U.S. trade or business. The warrants were issued in connection with debt restructurings to allow the holders to make up for losses as creditors. The taxpayers received "distributions for the unexercised Warrants" that produced capital gains. The IRS argues that the gains are taxable as income effectively connected with a U.S. trade or business (ECI), based on the fact that as warrant holders, the taxpayers were partners engaged in a U.S. trade or business. Apparently, an IRS Form 8805 identifying the taxpayers as foreign partners receiving an allocation of ECI was filed by someone (apparently not the partnership), which likely is what led to discovery and the deficiencies. For a discussion of the taxation of ECI of offshore issuers, see Chapter 13, Part D.

Add to footnote 49: Charles Brumbaugh and C.E. Holifield v. Comm'r, T.C. Memo 2015-65 (2015) supports the view that a person may be a partner even if its interest is very small, at least if the partnership has filed a partnership return treating the person as a partner. The case turned on whether a partnership fell within the TEFRA partnership audit procedures, which in turn depended on whether a partnership through which the taxpayer claimed losses was a "small partnership" under section 6231(a)(1)(B)(i) (prior to amendment in 2015). A partnership cannot be a small partnership if it has a partner that is itself a partnership. The partnership at issue reported on its partnership returns that a .02% interest was owned by a partnership. The remaining partners were two individuals. The taxpayer argued that the partnership was in substance a small partnership, but the court held that it was not at liberty to fashion a *de minimis* exception to the definition of small partnership. In short, the taxpayer was stuck with the partnership's reporting position.

6. Treatment of Disregarded Entity

Add to footnote 63: Announcement 99-102, 1999-2 C.B. 545, states that a tax exempt organization must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return. Apparently, however, the IRS had not until recently provided clear guidance on whether contributions made to such an entity are treated the same as contributions to the parent. A New York State Bar Association Tax Section report recommends the same treatment for both. See "Report on Tax Deductibility of Contributions to Disregarded Entities Owned by Charities," 2011 *Tax Notes Today* 9-15 (January 12, 2011). Notice 2012-52, 2012-35 I.R.B. 35, fills in part of the gap by treating a contribution to a disregarded entity that is a domestic single-member limited liability company wholly owned and controlled by a U.S. charity as a contribution to the charity for purposes of allowing to the donor a charitable deduction. For an article discussing open questions remaining after the issuance of Notice 2012-52, see Richard R. Upton and Carl Merino, "IRS Allows Charitable Contributions to Disregarded Entities," 2012 *Tax Notes Today* 244-5 (December 19, 2012).

Add at the end of footnote 65: Cassady V. Brewer, "Due Regard for Disregarded Entities," *BNA Tax Management Memorandum*, Vol. 57 No. 8, April 18, 2016, p. 167.

A.M. 2012-001 (February 9, 2012) holds that a taxpayer may not allocate basis and other tax items among different classes of interests in a disregarded entity because those interests have no separate existence for tax purposes.

Treasury Regulation § 1.956-2(a)(3), issued in November 2016, treats an obligation of a disregarded entity as an obligation of its owner for purposes of section 956 (investments by CFCs of earnings in United States property).

a. Special Rules for Banks

b. International Tax Rules

The earnings stripping rules in section 163(j) can apply to certain debt guaranteed by a foreign "person." One well informed author takes the view that a company organized under foreign law that is a disregarded entity may be viewed as a "person" even though it is disregarded as an "entity" separate from its owner. The argument is based on the inclusion of a "company" in the definition of person in section 7701(a)(1) and the treatment of an "unincorporated organization or group" as a person in Treasury Regulation § 301.7701-6. See Philip D. Morrison, "Section 163(j) and Disregarded Entities," *BNA Tax Management International Journal* (April 8, 2011).

Footnote 76: The proposed regulations were adopted as final regulations by T.D. 9562 effective December 9, 2011. The treatment of disregarded entities under the conduit regulations (among other topics) is discussed in Peter M. Daub, "The Conduit Regulations Revisited," 2015 *Tax Notes Today* 81-6 (April 28, 2015).

In e-mailed advice E.C.C. 201447030, the IRS determined that interest paid to a foreign corporation by a foreign disregarded entity wholly-owned by a domestic corporation is U.S. source income and therefore subject to withholding.

c. Legal Separateness Counts

Add to the end of footnote 86: T.D. 9771 adopted Treasury Regulation § 1.108-9, which, effective for discharges of debt on or after June 10, 2016, applies the section 108 insolvency and bankruptcy exceptions to disregarded entities and grantor trusts at the owner level. The preamble says that the IRS had been asked to clarify if debt of a disregarded entity should be treated as recourse or nonrecourse debt for purposes of determining the amount of cancellation of debt income of the debtor (and also the amount realized upon a transfer of property in discharge of debt under Treasury Regulation § 1.1001-2, which is generally the full amount of debt discharged less cancellation of debt income). The preamble says the issue is still under study, but does clarify that debt of a disregarded entity for which the owner has no personal liability would be treated as nonrecourse debt in determining the amount by which the owner is insolvent for purpose of the section 108 insolvency exception under the principles of Revenue Ruling 92-53, 1992-2 C.B. 48. The ruling explains how insolvency is measured where there is nonrecourse debt.

Add to the end of footnote 91: On the right facts, applicable state law may allow a look through to LLC assets on the ground that the LLC owns property as a nominee for the members. For a case approving treatment of an LLC as a nominee for purposes of enforcing a federal tax lien, see *Berkshire Bank v. Town of Ludlow, MA*, 708 F.3d 249 (1st Cir. 2013).

d. Tax Collections and Administration

Add to the end of footnote 91: ; C.C.A. 201116019 (March 21, 2011) (substantially similar).

For a discussion of the fact that a check-the-box election to convert a recognized entity into a disregarded entity may not be considered a "liquidation or dissolution" of the entity for purposes of determining if the entity's status as a tax matters partner terminates, see Robert W. Wood and Dashiell C. Shapiro, "When the IRS Says a Liquidation is Not a Liquidation," 2013 *Tax Notes Today* 148-10 (August 1, 2013).

e. Other Federal Taxes

T.D. 9554 (November 1, 2011, corrected various dates) announced final and temporary regulations that will treat a disregarded entity as such, and not as a corporation, for purposes of sections 3121(b)(3), 3127 and 3306(c)(5) (FICA and FUTA exceptions for certain family members and members of certain religious faiths). See Treasury Regulation §§ 31.3121(b)(3)-1T(e), 31.3127-1T(d), and 31.3306(c)(5)-1T(e). The regulations were finalized by T.D. 9670 (July 14, 2014). See section 301.7701-2(a)(iv). T.D. 9554 also announced final and temporary regulations that will treat a disregarded entity as such, and not as a corporation, for purposes of backup withholding under section 3406. And, in case you were wondering, T.D. 9596 (June 25, 2012) adopts regulations (later revised by T.D. 9670 (July 14, 2014)) treating a disregarded entity as a separate entity for purposes of the indoor tanning services excise tax.

T.D. 9766 (May 3, 2016) adopts Treasury Regulation § 301.7701-2T(c)(2)(iv)(C)(2) to clarify that the separate treatment of a disregarded entity for employment tax purposes does not carry over to self-employment taxes. Accordingly, if a partnership owns a disregarded entity and the entity employs (as a non-tax matter) a partner of the partnership, the employment status of the partner is not recognized for tax purposes (based on the general IRS view that a partner cannot also be an employee).

7. Transition Rules

C. Existence of an Entity

1. Overview

P.L.R. 201305006 (October 15, 2012) holds that a Profit Participation Agreement (*PPA*) between the taxpayer, a domestic corporation, and its wholly owned foreign affiliate creates a foreign business entity that can elect to be a foreign corporation. Under the PPA, the affiliate acquired an X% interest in the capital and profits of branches of taxpayer in a region. No separate juridical entity was created by the agreement and taxpayer retained legal ownership of all assets, liabilities, and contractual obligations of the branches (and apparently did not disclose the arrangement to customers). The PPA will be signed outside of the U.S.. It will be governed by (and enforceable under) the law of a specified foreign country, and the parties agree to submit to the exclusive jurisdiction of the courts in that country to resolve disputes. The affiliate is entitled to nominate one member of a 10-member management committee that will oversee the branches. That committee will meet outside of the United States. The ruling does not state that the affiliate is a corporation, so it may have been a disregarded entity. Nonetheless, the foreign entity created by the PPA could elect to be a foreign corporation because a corporation can have only one recognized owner. While not stated in the ruling, perhaps the taxpayer was seeking to earn foreign active income through a controlled foreign corporation to achieve deferral advantages despite the fact that it was conducting foreign operations in branch form.

Largely for administrative reasons, foreign corporations may make shares of stock available to U.S. investors through arrangements under which record ownership of the shares is held by a bank that issues transferable receipts evidencing interests in the shares. The receipts are generally referred to as *American Depositary Receipts* or *ADRs*. In a typical arrangement, the ADR holder has full voting rights and is entitled to receive dividends paid on the shares (converted to dollars at spot rates by the bank). The holder may surrender an ADR at any time to the bank in exchange for the underlying shares. Revenue Ruling 65-218, 1965-2 C.B. 566, holds that a holder of an ADR will be treated for purposes of claiming foreign tax credits and the benefits of the Japanese-U.S. tax treaty (the share issuer was Japanese) as if he held the underlying shares directly. Although not stated expressly in the ruling, the analysis appears to be that the ADR mechanism is a custody arrangement (like a brokerage account) and not an entity.

For a discussion of uses of segregated portfolio companies, see Bradley T. Borden and Mathews Vattamala, “Series LLCs in Real Estate Transactions,” 46 *Real Prop., Trust & Est. L.J.* 255 (2011).

Add to footnote 109: Revenue Ruling 2013-14, 2013-26 I.R.B. 1267, relies on Revenue Ruling 92-105 to conclude that a passive Mexican land trust holding title to Mexican real property on behalf of a domestic owner is not a trust for federal income tax purposes because the trustee’s only duties are to hold title on behalf of the owner and to transfer the property at the owner’s request. The owner retains all rights of control and all rights to use and derive income from the property. The trust is used to comply with Mexican restrictions on legal ownership of certain Mexican real property by foreigners. For an earlier ruling to the same effect, see P.L.R. 201245003 (July 30, 2012).

Add to footnote 115: P.L.R. 201622008 (February 23, 2016) holds that fractional ownership interests in leased commercial real property will meet the tests in Revenue Procedure 2002-22 and be treated as co-ownership interests even though the fractional interests would be created through the exercise on one or more occasions over time of a put option to sell fractional interests. The buyer, who had no other interest in the property and provided no financing to the seller, also had the right to buy all remaining interests in the property following expiration of the put. For an article discussing the ruling, see Ann S. Levin-Nussbaum, “IRS Tackles Put and Call Options,” *Tax Notes*, May 29, 2017, p. 1333.

2. Segregated Portfolio Companies

For a good survey of state law developments relating to series LLCs, see J. Leigh Griffith and James E. Long, "Series LLCs–December 2013 Update on Recent State Legislative and Taxation Developments," *Tax Management Memorandum*, Vol. 55 No. 6, p. 83 (March 24, 2014). For another general discussion of the topic as of the end of 2016 by one of the same authors, see J. Leigh Griffith and Alberto R. Gonzales, "Series LLCs Part 1—Current Status, Multi-State Issues and Potential Uniform Limited Liability Company Protected Series Act," *Taxes—the Tax Magazine*, October 2016, p. 57.

For a description of a creative use of segregated portfolio companies to address an issue arising under a Dodd-Frank Act risk retention rule, see Chapter 16, Part H.2 (in this Supplement).

a. Revenue Ruling 2008-8

b. Notice 2008-19

c. P.L.R. 200803004

d. Proposed Regulations

Jasper L. Cummings, Jr., "Ownership, Series, and Cells," 129 *Tax Notes* 1129 (December 7, 2010) argues that the proposed regulations fail to recognize that separate entity status of cells should be based on their ability under local law to own property and earn income. For another more general analysis of the proposed regulations, see Carter G. Bishop, "The Series LLC: Tax Classification Appears in Rear View," 130 *Tax Notes* 315 (January 19, 2011).

The American Bar Association Section of Taxation has submitted comments on the proposed regulations. See 2011 *Tax Notes Today* 84-72 (April 29, 2011). The comments ask for (1) clarification of when a series organization may be treated as a mere title holding or nominee arrangement, (2) clarification of when a series terminates, (3) the adoption of information reporting that reduces duplicative reporting, (4) clarification of authority to sign returns and identification of a tax matters partner, (5) requirements for a member to be "associated with" a series, (6) clarification that the regulations apply to service organizations, (7) clarification that the analysis of a Delaware statutory trust in Revenue Ruling 2004-86 applies equally to a series formed under a series trust statute, (8) conformity in the application of employment taxes to the check-the-box regulations, and (9) clarification of transition issues (including treating series as having made check-the-box elections if one was made for the series organization absent a contrary election, and applying section 355 to avoid corporate gain if corporate subsidiaries are deemed spun out from a parent corporation as a result of the treatment of series as separate corporations). It is interesting that they see no need to clarify the basic rules for determining when a series is a separate entity for tax purposes.

The New York State Bar Association, Tax Section, also submitted comments on the proposed regulations. See 2011 *Tax Notes Today* 152-62 (August 5, 2011). The comments recommend, among other things, that the final regulations: (1) provide that an entity recognized under local law is ordinarily treated as a separate entity, (2) clarify the treatment of series of stock in a corporation, (3) permit protective elections for entities intended to be treated as a series of separate entities where the separateness of the series is not respected by the IRS, (4) provide that similar principles will apply to foreign series organizations not engaged in an insurance business, and (5) provide that general tax principles apply to employment tax and employee benefits issues.

For an article discussing the uses (and abuses) of foreign cell companies in the insurance area, see Lee A. Sheppard, "Offshore Incorporated Cells for Captive Insurance or Tax Evasion," 2012 *Tax Notes Today* 127-1 (July 2, 2012).

P.L.R. 201421001 (January 16, 2014) rules on a number of partnership tax issues. The ruling assumes that two series of a domestic series LLC are properly treated as separate entities (partnerships). The taxpayer represented that each series would qualify as a "series" within the meaning of Proposed Regulation § 301.7701-1(a)(5)(viii)(C).

D. Status of Investment Trusts as Trusts or Business Entities

1. Overview—Trust Defined

With little discussion, P.L.R. 201050011 (August 27, 2010) treats an entity organized under a foreign statute to provide disability, old-age and/or death benefits for certain covered employees as a trust. The entity was not taxed under local law. P.L.R. 201538006 (June 11, 2015) similarly holds with little analysis that an entity formed as a local law trust to provide superannuation benefits to its members is a trust.

Similarly, P.L.R. 201532023 (May 4, 2015) classifies as a trust an entity organized by a foreign corporation under a trust deed to segregate, hold and invest assets to ensure the corporation is able to meet obligations with respect to its business. The trust and corporation are regulated by several government bodies. The trust issued units to the corporation, which may not transfer them without trustee consent and which are not expected to be transferred. The trust has a duty to protect and conserve its assets for the benefit of the unit holder to ensure it has enough assets to engage in its business, and trust assets are invested in conservative assets, with advice from an investment manager, by the trustee (a special purpose company formed to act as trustee). All of trust's net income is required to be distributed annually to the unit holder. The trustee has discretion to distribute principal. The unit holder may redeem its interest in the trust at any time, although in certain cases, it may have to wait up to sixty days. The unit holder may also amend or revoke the trust.

Comment on footnotes 154 and 155: The custody arrangements described in Revenue Ruling 69-300 and in Revenue Rulings 70-544 and 70-545 are distinguishable from another well-known type of custody arrangement used to facilitate investments in foreign stocks. Largely for administrative reasons, foreign corporations may make shares of stock available to U.S. investors through arrangements under which record ownership of the shares is held by a bank that issues transferable receipts evidencing interests in the shares. The receipts are generally referred to as *American Depositary Receipts* or *ADRs*. In a typical arrangement, the ADR holder has full voting rights and is entitled to receive dividends paid on the shares (converted to dollars at spot rates by the bank). The holder may surrender an ADR at any time to the bank in exchange for the underlying shares. Revenue Ruling 65-218, 1965-2 C.B. 566, holds that a holder of an ADR will be treated for purposes of claiming foreign tax credits and the benefits of the Japanese-U.S. tax treaty (the share issuer was Japanese) as if he held the underlying shares directly. Although not stated expressly in the ruling, the analysis appears to be that the ADR mechanism is a custody arrangement (like a brokerage account) and not an entity. Certainly, there was no trust under the tax law definition. By contrast with ADRs, in Revenue Ruling 69-300, the custody arrangement was created by court order to hold shares in a land trust pending resolution of litigation surrounding ownership of the shares. The custodian had certain discretionary powers of administration and management, including voting rights. Also, of course, the owners could not terminate the arrangement on demand because their identities were in dispute. Similarly, holders of GNMA pass-through certificates cannot exchange them on demand for the underlying mortgages and the custodian or its agent assumes responsibility to service the mortgages and make related decisions.

2. Family Trusts, Business Trusts, and Investment Trusts

a. Family Trusts

b. Business Trusts

c. Investment Trusts

3. *Trusts Holding Real Property Mortgages as Business Trusts*

Add to footnote 165: A.M. 2013-001 (February 22, 2013) holds that real property acquired in foreclosure of a loan by the bank that originated the loan is not "property acquired for resale" within the meaning of section 263A(b)(2). That section requires capitalization of certain direct and indirect costs with respect to such acquired property if it is also inventory or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business under section 1221(a)(1). The bank treated the acquired real property as section 1221(a)(1) property, presumably so that any losses on resale would be ordinary. According to the A.M., there is a special rule which exempts a newly-originated loan from section 263A(b)(2), and the bank's acquisition and resale of real estate collateral for such a loan is properly viewed as an extension of the exempt loan origination activity.

4. *Permitted Activities of Investment Trusts*

a. *Existence of a "Power"*

b. *Power Under "Trust Agreement"*

c. *Assets Acquired After Formation*

Add to footnote 176: Trusts issuing LEGO certificates (see Chapter 2, Part B.5) allow investors on an ongoing basis to contribute additional property to the trusts in exchange for new certificates. The assets contributed to a trust must be identical to those already held by the trust. The Goldman Sachs ruling (and a second ruling following it) conclude that this feature does not prevent the issuing trust from being classified as a trust. For a discussion of the Goldman Sachs ruling and the more recent ruling, see Chapter 4, Part D.6.a (in the book and in this Supplement).

d. *Temporary Reinvestments*

e. *Modifications of and Distributions on Trust Investments*

(i) *No discretion*

(ii) *Discretion to approve or disapprove and impairment*

(iii) *Discretion to modify with impairment*

(iv) *Discretion to approve or disapprove without impairment*

(v) *Discretion to modify and no impairment*

f. *Partnership Interests and Loan Participations*

g. *Inside Reserve Funds*

h. *Nondiscretionary Reinvestments*

i. *Certificate Holder Approval*

j. *Incurrence of Debt*

k. *Swaps and Other Derivatives*

Add to footnote 219: With limited exceptions, nonperiodic payments on a notional principal contract are now treated as a separate debt instrument even if they are not significant. See Chapter 8, Part H.5.a (in this Supplement).

5. Multiple Ownership Classes

a. Overview

b. Reasons for Sears Regulations

Add at the end of the second sentence in footnote 240: P.L.R. 201234006 (May 24, 2012) (same).

6. Further Applications of "Incidental" Exception

a. Synthetic Floating Rate Interests

Add to the end of footnote 254: The IRS has issued to another taxpayer a ruling following the Goldman Sachs ruling. See P.L.R. 201229003 (April 19, 2012). The more recent ruling relates to an exchange trust that holds REMIC regular interests under a multi-class mortgage-backed securities program maintained by "Agencies" (presumably Ginnie Mae, Freddie Mac and Fannie Mae). Very likely, the taxpayer asked only about REMIC regular interests so that the ruling should not be read to imply that the structure works only if the underlying mortgages are REMIC regular interests.

Add a comment to the first full paragraph of the text on page 298: P.L.R. 201229003 (April 19, 2012) follows the Goldman Sachs ruling in concluding that floating rate and inverse floating rate certificates issued by a trust holding REMIC regular interests are stripped bonds or coupons, but has a more extensive discussion of the specified portion rules and the reasoning supporting the result. The ruling indicates that the specified portion rules can be used to issue floating rate and inverse floating rate REMIC regular interest classes with no principal amount. The taxpayer requesting the ruling represented that the trust certificates would pay interest comprising a specified portion of the interest payments on the regular interests held by the trust. As a result, they are certificates "otherwise allowable under § 860G" and achieve the same tax result (treated as newly issued debt to the extent there is a separation of interest from principal so that section 1286 applies) as if the trust certificates had been REMIC regular interests.

Add a comment to the first full paragraph of the text on page 300: The Goldman Sachs ruling has been used in Freddie Mac and Fannie Mae programs to create floating rate and inverse floating rate classes of certificates representing interests in residential mortgages that have loan-to-value ratios exceeding 125 percent and accordingly are not qualified mortgages eligible to be held by REMICs. Disclosure documents for an illustrative offering of such certificates from Freddie Mac can be found at http://documents.efanniemae.com/syndicated/documents/mbs/smbsprelim/415.pdf, and http://www.freddiemac.com/mbs/data/283om.pdf. For a discussion of the REMIC qualified mortgage definition (which generally requires a loan-to-value ratio at origination not exceeding 125 percent), see Chapter 6, Part B.2.a.(ii).

b. Reallocation of Payments on a Single Bond Following a Default

c. Serialization of Sinking Fund Bonds

d. Equity Strips

The government won a case challenging the use of equity strips to (1) generate losses and (2) create discount that resembled OID but was not taxable on an accrual basis. See *Principal Life Co. v. United States*, 116 Fed. Cl. 82 (2014). The case involved perpetual floating rate instruments treated as stock for federal income tax purposes, in one case stock in a money market fund and in the other case perpetual securities. Using various custody or trust arrangements, a perpetual instrument was carved up into a right to dividends for a long fixed term and a residual interest. Under a termination agreement, the holder of the term interest had a right, upon an early termination of the term interest, to a share of the value of the entire instrument corresponding to the value of its right to income for the balance of the original term.

The taxpayer entered into two types of transactions. First, it acquired the whole perpetual instrument, and sold a residual interest in the instrument while retaining a term interest. It then allocated its entire basis in the whole instrument to the residual interest and claimed a loss on the sale. Second, the taxpayer purchased a residual interest in a perpetual instrument at a discount and held that interest during the life of the corresponding term interest without reporting income.

The court held, in response to a summary judgment motion, that in the first variation the taxpayer was required by Treasury Regulation § 1.61-6(a) (which requires a basis allocation when part of a larger property is sold) to allocate its basis in the whole perpetual instrument between the residual and term interests in proportion to fair market value. The result was a denial of the claimed loss on sale of the residual. The court also held that the arrangement for creating the residual and term interests was a partnership rather than a trust or co-ownership arrangement. One consequence was that income from the whole instrument was determined at the partnership level and then allocated under section 704 to the term interest over its life. In determining that the arrangement was a partnership and not a trust, the opinion discusses the Sears regulations at length. The court concludes that the "incidental" exception does not apply because the term and residual interests differ significantly from ownership of the underlying perpetual instrument. That was true because of the differences in economic terms and the existence of the termination agreement. The court also places considerable emphasis on the fact that the partial interests in stock were not subject to the bond stripping rules in section 1286, and in that way were similar to the partial interests in stock in Example (3) in the Sears regulations.

The court does not address several potentially relevant provisions and lines of argument. One is section 305(e), which contemplates stripped preferred stock (which is how perpetual debt is treated for tax purposes). Another is section 1286(f), enacted after the years in question, which authorizes regulations (yet to be proposed) addressing the stripping of interests in stock. Although the court does not mention 1286(f), it does refer to the legislative history of that section, without mentioning that the legislative history states that no inference was intended as to prior law. See H.R. Conf. Rep. 108-755 P.L. 108-357, American Jobs Creation Act of 2004 House Conference Report No. 108–755, 1671-1672: "No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse." Further still, the court did not address the argument that even if any sharing arrangement were a partnership, the transaction should be treated as a sale of a partial, non-pro-rata interest in the seller's assets—which would be a taxable disposition of the sold assets—followed by a tax-free contribution of the assets to a partnership. Compare Revenue Ruling 99-5, situation 1 (sale of an equity interest in a disregarded entity treated as a sale of assets followed by contribution to a partnership).

7. Definition of Ownership Interest

Add at the end of footnote 282: P.L.R. 201234006 (May 24, 2012) holds that excess servicing spreads purchased from a mortgage loan servicer by a REIT and representing a fixed percentage of the outstanding principal amounts of the serviced mortgages are interests in mortgages on real property under section 856. The ruling indicates that the analysis is not affected by the fact that the excess servicing rights would end if the servicer were terminated for cause (which is described as a remote contingency), by the ranking of excess servicing spreads compared to the servicer's rights to compensation in the event of mortgagor defaults, by the existence of servicer advances of interest (including interest allocable to the excess servicing spreads), or by the fact that excess servicing spreads may be purchased in advance under forward contracts. For an article by an esteemed tax commentator discussing an array of tax issues raised by mortgage servicing rights or "MSRs", see Jasper L. Cummings, "Mortgage Servicing Rights", 2014 *Tax Notes Today* 23-5 (February 4, 2014). The tax treatment of transfers of MSRs is likely to receive greater attention in coming years if U.S. bank regulators adopt proposed Basel III capital requirements for mortgage servicing assets. According to bank trade groups, these requirements are likely to push regulated banks out of the servicing business in favor of non-bank servicers. See letter dated November 12, 2014 from the American Bankers Association and two other trade groups to the Federal Reserve, FDIC, and Comptroller of the Currency arguing against adopting these more stringent capital requirements. The letter is available at www.aba.com/Advocacy/LetterstoCongress/Documents/BaselIIITreatmentofMSRsJointLetter.pdf.

E. Taxable Mortgage Pools

1. Relationship to REMIC Rules

2. Definition of TMP

a. Asset Test

b. Maturities Test

c. Relationship Test

(i) *Payments on asset obligations*

(ii) *Terms of debt obligations or underlying arrangement*

(iii) *Required relationship*

(iv) *Examples involving revolving pools and debt issuances*

d. Portion Rule

e. Distressed Mortgages

In first line of first full paragraph on page 336, replace "in" with "is".

f. Testing Dates

g. Anti-Avoidance Rule

3. Effective Date Issues

F. Publicly Traded Partnerships

1. Overview

2. Definition of PTP

a. Interests

b. Traded

Add to footnote 389: Blakeney v. Comm'r, T.C. Memo 2012-289 (2012), holds that use of property 63 percent of the time in the Gulf Opportunity Zone is not "substantially all" of the use in applying the qualified Gulf Opportunity Zone property definition in section 1400N(d)(2)(A). The court said that the test could not be met where more than one third of the use was not qualified. Accordingly, the court did not need to decide whether to follow Notice 2006-77, 2006-2 C.B. 590, which defines substantially all as 80 percent or more.

Add to the end of footnote 423: See also *Kay v. Comm'r*, T.C. Memo 2011-159 (July 6, 2011) (individual was not a trader where, among other things, the individual's primary source of income was from an unrelated business, the majority of the stocks purchased by the individual were held for more than 30 days, and the individual rarely purchased and sold the same stock on the same day); *van der Lee v. Comm'r*, T.C. Memo 2011-234 (September 29, 2011) (similar).

3. Passive Income Exception

a. Qualifying Income—General Definition

Revenue Procedure 2012-28, 2012-27 I.R.B. 4, provides a safe-harbor rule under which the IRS will not challenge a PTP's determination that cancellation of debt income is qualifying income if the income is attributable to debt incurred in direct connection with activities of the PTP that generate qualifying income. The PTP may demonstrate that cancellation of debt income is attributable to such debt using any reasonable method (including tracing but generally not a method based solely on the ratio of qualifying gross income to total gross income).

The definition of passive income includes in section 7704(d)(1)(E) various types of income relating to minerals and natural resources. These income categories are not relevant to securitizations and therefore are not addressed in the book. The IRS has issued numerous private letter rulings under section 7704(d)(1)(E), and to slow the flow and provide guidance for the future, issued Treasury Regulation § 1.7704-4 on January 19, 2017. See T.D. 9817. These regulations finalized proposed regulations issued in 2015.

Add to footnote 389: For a discussion of the substantially all test generally, see Jasper L. Cummings, Jr., "How Much is Enough or Too Much," 150 *Tax Notes* 1025 (February 29, 2016).

Add to footnote 400: Proposed regulations issued September 27, 2016 would limit subpart F and PFIC income inclusions that may be treated as qualifying income to those specifically treated as dividends in section 851(b)(3) (meaning that the income must be distributed) by preventing such income from qualifying as "other income." See Proposed Regulation § 1.851-2(b)(2)(iii), which would be effective for taxable years beginning on or after the date 90 days after final regulations are published. Thus, undistributed non-cash income—such as OID—and undistributed cash income that is used to make non-deductible payments—such as principal on indebtedness—would not be qualifying income for a RIC when deemed distributed under the QEF or CFC rules, even though such income would be qualifying income if earned directly by the RIC. At the same time it issued the proposed regulations, the IRS issued Revenue Procedure 2016-50, 2016-43 I.R.B. 522, saying it would no longer ordinarily issue private letter rulings on any issue relating to the treatment of a corporation as a RIC under section 851 and related provisions if the rulings require a determination whether a financial instrument or position is a "security" under the 1940 Act.

b. Interest From a Financial Business

(i) *Traditional definitions of a financial business*

(ii) *Relevant factors*

(iii) ***Application to securitization vehicles***

Chapter 5

Taxation of Non-REMIC Trusts Issuing Pass-Through Certificates

A. Introduction

B. Grantor Trusts

1. Introduction to Grantor Trust Rules

2. Application of Grantor Trust Rules to Investment Trusts

3. Certificate Holders as Co-Owners of Trust Assets

On April 12, 2011, the IRS issued Proposed Regulation § 1.108-9, which, effective for discharges of debt after the regulations are issued in final form, will apply the section 108 insolvency and bankruptcy exceptions to disregarded entities and grantor trusts at the owner level. 76 F.R. 20593-20594, reprinted at 2011 *Tax Notes Today* 71-9 (April 13, 2011).

Section 1411 imposes a 3.8 percent tax, beginning in 2013, on the net investment income of individuals, trusts or estates. In the case of grantor trusts, the tax is imposed by attributing income of the trust to the person treated as the trust owner. See Proposed Regulation § 1.1411-3(b)(5).

Add to footnote 17: C.C.A. 201343021 (June 17, 2013) relies on Revenue Ruling 85-13 and other authorities to hold that assets of a grantor trust should be attributed to the grantor for purposes of applying sections 267(a)(1) and 707(b)(1) (which deny or defer losses on sales of property to related persons).

4. Income Reporting

5. Redemptions of Certificates

6. Trust Existence Given Some Effect

7. Senior/Subordinated Pass-Through Certificates

C. Trusts Taxed as Partnerships

1. Introduction and Summary of Subchapter K

Add to footnote 79: The IRS has issued extensive proposed regulations revising how gain is computed under section 751(b)). See REG-151416-06; 2014-47 I.R.B. 870; 79 F.R. 65151-65174

(November 3, 2014). The proposed regulations are reproduced at 2014 *Tax Notes Today* 212-17 (November 3, 2014).

Add to footnote 81. The Bipartisan Budget Act of 2015 (often abbreviated as BBA) revised the special Code rules governing partnership audits and related proceedings. Specifically, it replaced sections 6221 through 6234 (often referred to as the "TEFRA" partnership audit rules) with new sections 6221 through 6241. It also eliminated the special tax regime for large partnerships. The new rules generally will be effective for taxable years beginning after December 31, 2017, although partnerships can elect to apply them to earlier years. In January 2017, proposed regulations implementing the new rules were issued and then (because of procedural issues relating to the presidential transition) withdrawn. A technical corrections bill is pending in Congress that, if enacted, would change and clarify the new procedures. This section provides only a brief summary of the new rules.[20]

The thrust of the new rules is to treat a partnership more like a taxpaying entity for purposes of audits and related proceedings. New section 6221 states that adjustments to income and deduction items and credits, and a partner's distributive share thereof, shall be determined, and tax attributable thereto shall be assessed and collected, and related penalties shall be determined, at the partnership level. By default, all partnerships are subject to the new rules, although certain partnerships can elect out of the new regime as described below. The existence of potential liabilities for audit adjustments will place partnerships that cannot elect out of the BBA regime at a disadvantage compared with trusts or disregarded entities in terms of exposure to potential tax liability.

New section 6223 requires a partnership subject to the new rules to appoint one person as the partnership representative, who will have the sole authority to act on behalf of the partnership in an audit. There is no longer a "tax matters partner." Because the appointed partnership representative has sole authority to act for the partnership, and there is no statutory mechanism for other partners to receive notice of, or otherwise participate in, an audit, a partner who is not the partnership representative is effectively cut out of the audit process under the Code. That is true even though such a partner may be ultimately liable to pay taxes once adjustments are made. Partners can, of course, agree among themselves to require a partnership representative to take directions from or consult with them.

Under new section 6225, a partnership may itself be liable for a tax deficiency in respect of an IRS adjustment to partnership income or credits (a so-called "imputed underpayment"). For an increase in taxable income, the imputed underpayment generally equals the additional income times the highest marginal rate for any type of taxpayer. However, a partnership can reduce the imputed underpayment by showing that partners would owe less tax in respect of an adjustment based on their tax status and circumstances. Other pro-government assumptions are made in computing the imputed underpayments. For example, where income is shifted from partner A to partner B, the additional tax imposed on B is not reduced by the reduced tax owing by A. Further, when income is shifted from one year ("year X") to another year ("year Y") the additional tax imposed in respect of year Y is not reduced on account of the reduction in income in year X. This is true even if year Y is later than year X and the partnership was taking a more conservative approach to accounting than what the Service determined was ultimately correct.

The imputed underpayment can be computed disregarding an adjustment (so reducing what the partnership itself owes) to the extent the partnership follows procedures to show that its partners for the tax year to which the adjustment relates (referred to as the "reviewed year") have filed amended returns

[20] For further information about the BBA changes, see Willis & Postlewaite, *Partnership Taxation* (WG&L) ¶ 20.12; New York State Bar Association, Tax Section, "Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015" (May 25, 2016), available at 2016 *Tax Notes Today* 102-28 (May 26, 2016); and the Blue Book on the BBA prepared by the staff of the Joint Committee on Taxation, which is the *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16) (March 2016), available on the Joint Committee on Taxation web site, www.jct.gov.

for those years and paid any tax due with those returns. As discussed below, a partnership may also avoid paying the imputed underpayment altogether by electing under section 6226 to issue audit statements to its partners.

If, following an audit, tax is imposed on a partnership itself, the cost will be borne by the partners for the year in which the adjustment is made (the "adjustment year"), subject to any contractual rights they may have to collect from partners in the reviewed year or others. Thus, depending on how the contract rights and related collection efforts shake out, the burden of the adjustment may be allocated differently from how additional taxes would have been allocated if income or other tax items had been originally reported consistently with the IRS adjustments. In an extreme case, an adjustment year partner may not have been a partner at all during the reviewed year. In addition, due to the generally unfavorable assumptions made in computing the imputed underpayment, the tax liability of the partnership may be greater than what the individual partners would have paid as a group had they correctly reported the adjustments in the years to which they relate.

As an alternative, new section 6226 allows a partnership to avoid paying the imputed underpayment by electing to provide notices to its reviewed year partners and to the IRS showing those partners' allocable shares of the adjustments. A partner receiving such a notice owes additional taxes in the year of receipt of the notice, but the amount is calculated as if income, deductions or credits were adjusted in the reviewed year. Penalties (and presumably defenses) are generally determined at the partnership level. It is not yet clear how this mechanism will work where a partner is itself a partnership.

Under TEFRA, small partnerships (i.e., partnerships with fewer than 10 partners, not including other partnerships or nonresident aliens) were not subject to the partnership-level audit regime unless the partnership elected into the regime (see old section 6231(a)(1)(B)). New section 6221(b) provides that the BBA audit rules do not apply to a partnership for a taxable year if for that year, the partnership so elects. The election is only available to a partnership if (1) it sends Schedule K-1s to fewer than 100 partners for the year, (2) all of the partners are individuals, corporations or estates of deceased partners, and (3) the partnership identifies the partners to the IRS. (It is not clear whether disregarded entities will be ignored in testing the status of partners.) Thus, a partnership having a trust or partnership as a partner would not qualify. If an S corporation is a partner, its owners are counted toward the 100 partner limit. In what could be viewed as a step backwards, presumably partnerships that elect out of the regime will be audited at the partner level as they were prior to TEFRA's enactment.

2. Inside and Outside Basis

Add to the end of footnote 95: On February 3, 2014, the IRS issued proposed regulations implementing the substantial built-in loss rules. See http://www.irs.gov/irb/2014-6_IRB/ar07.html. The proposed regulations have a definition of securitization partnership, which (that) mirrors the definition in section 743(f)(2) (except that a "that" replaces a "which"). The proposed regulations also have rules for electing investment partnerships, which are based on interim guidance in Notice 2005-32, 2005-1 C.B. 895.

3. Allocations of Income

Add at the end of footnote 63: Revenue Ruling 99-6 treats a partner who purchases partnership interests from other partners and becomes the sole owner of a disregarded entity as purchasing partnership assets and not a partnership interest. In a letter to the IRS, the American Institute of Certified Public Accountants recommends that the IRS revoke Revenue Ruling 99-6 and treat such a purchaser as acquiring an interest in a partnership that then liquidates, rather than partnership assets. The AICPA requested other guidance if the IRS declined to revoke the ruling. See 2013 *Tax Notes Today* 191-21 (October 1, 2013).

4. Guaranteed Payments

5. Electing Large Partnerships

The Bipartisan Budget Act of 2015 repeals and replaces the TEFRA rules governing partnership audits, and as part of that reform effort, also repeals the special substantive and procedural rules for electing large partnerships, generally for taxable years beginning after December 31, 2017. The new rules are summarized in Chapter 5, Part C.1 (in this Supplement).

6. Disposition of Interests

7. Taxation of Pass-Through Debt Certificates as Partnership Interests

a. Foreign Investors

b. Tax-Exempt Organizations

8. Election Out of Partnership Rules

D. Other Differences

Chapter 6

Qualification and Taxation of REMICs

A. Introduction

B. REMIC Qualification Tests

Comment on short-term REMICs: A number of taxpayers holding mortgages or mortgage-backed securities with built-in losses have transferred them to a "short-term REMIC" with a view to triggering tax losses without an accounting loss, and converting capital losses to ordinary deductions taken over a relatively short term (a term shorter than the remaining economic life of the mortgages or securities). One such arrangement was analyzed and upheld in T.A.M. 201517007 (November 21, 2014). The IRS concluded that the arrangement qualified as a REMIC and the taxpayer's desired tax goals were met despite the facts that the transaction was, for non-tax purposes, a conventional secured borrowing and the taxpayer apparently had mostly a tax motivation in entering into the transaction. The T.A.M. notes in passing that the structure was a more costly form of financing than issuing a conventional unsecured corporate bond. Short-term REMICs and the T.A.M. are discussed in more detail in Part D.12, below, and Chapter 15, Part E.2 (both in this Supplement).

Add to the end of footnote 2: Although a regular interest may take the form of stock, a field attorney advice takes the position that preferred stock does not qualify as a regular interest because current dividend payments are paid in the discretion of the board of directors. See F.A.A. 20150601F (April 4, 2014) ("[u]nder the FASIT rules, and the REMIC rules by cross-reference, interest on qualifying regular interests must be subject to current accrual by an accrual basis taxpayer, in the same way as a debt instrument, not accrued by the holder that happened to hold the instrument on the date of declaration or liquidation [an apparent reference to increases in liquidation preference for unpaid dividends]"). The IRS appears to have created this extra-statutory requirement to further the requirement in section 860B(b) that a holder of a regular interest use the accrual method of accounting with respect to the regular interest. A less strained reading of section 860B(b) would be that it requires income to accrue on a regular interest as if it were a debt instrument. The F.A.A. is discussed more generally in Chapter 2, Part G (in this Supplement).

1. Interests Test

a. Definition of Interest

(i) Servicing

(ii) Stripped interests

(iii) Claims under credit enhancement contracts

(iv) Rights to acquire mortgages or other assets

(v) ***De minimis interests***

(vi) ***Rights of others in foreclosure property***

b. Definition of Regular Interest

c. Definition of Residual Interest

d. Timing of Issuance of REMIC Interests—Pre-Existing Entities

e. Other Requirements

2. Assets Test

a. Qualified Mortgages

Pending legislation on covered bonds would treat covered bonds secured by residential, commercial or home equity loans as qualified mortgages. See Chapter 2, Part I.3, in this Supplement.

Under the New York False Claims Act, a private citizen can bring a *qui tam* action against a taxpayer alleging that it made a false statement in filing a New York State tax return and seeking treble damages (and a piece of the reward). The Second Circuit has affirmed a decision by a district court rejecting such a claim brought against Wells Fargo. The claim rested on the ground that Wells Fargo falsely treated various mortgage securitization trusts as REMICs for federal purposes, and that the New York State tax exemption for the trusts was based on qualification for the federal tax exemption. See *State of New York et al. v. Wells Fargo National Bank N.A. et al*., 824 F.3d 308 (2d Cir. 2016). The Second Circuit agreed with the lower court holding that various alleged defects in underwriting mortgage loans would not undermine their status as qualified mortgages unless the defects prevented the loans from being obligations principally secured by real property, which was not the case. The defects related instead more to the creditworthiness of the mortgagors. The Second Circuit also considered without resolving an argument that the trusts were in fact “treated” as REMICs at the federal level, which is all that the New York tax exemption requires.

(i) ***Obligations (and interests in obligations)***

(ii) ***Principally secured***

Add to the end of footnote 101: Beginning June 1, 2012, Freddie Mac began issuing pass-through certificates backed by mortgages with a loan-to-value ratio greater than 125%. These pass-through certificates will receive a special “LTV>125%” designation. The loans underlying those certificates (and hence the certificates) likely could not be transferred to a REMIC because it will not be possible to establish that they are REMIC qualified mortgages.[109a]

(iii) ***Real property***

The desire to earn business income through pass-through entities such as REITs has lead a number of businesses to seek rulings from the IRS confirming that certain nontraditional categories of property qualify as real property under the REIT definition. Developments in the REIT area will directly affect the types of loans that can be qualified mortgages. The requests led the IRS to establish an internal group to

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[109a] An underlying loan might be a qualified mortgage despite the greater than 125% LTV based on the use of proceeds, or if the loan resulted from a default-related modification of a loan with an original LTV lower than 125%. The use-of-proceeds test and loan modifications are discussed in Chapter 6, Part B.2.a.(ii) and Part D.2.

review the real property definition. For an article discussing REIT conversions for companies operating data centers (and earning significant related income from providing power and server connections) and other nontraditional properties, and the REIT bubble more generally, see Lee A. Sheppard, "Can Any Company Be a REIT?," 2013 *Tax Notes Today* 160-2 (August 19, 2013). Another article discussing new categories of property that have been found to meet the definition of "real estate assets" for REITs in private letter rulings since 2007 is Steven F. Mount, "New Wine in Old Bottles: Has the Definition of 'Real Estate Assets' been Expanded for Real Estate Investment Trusts?", Bloomberg BNA, *Tax Management Memorandum*, October 7, 2013. The categories are electric transmission towers, gas distributions systems, an asphalt plant, cell and broadcast towers, billboards, an offshore oil platform, advertising signs, data centers and boat slips. The author concludes that the positions taken in the private letter rulings are consistent with earlier revenue rulings giving an expansive reading to the term real estate. The article also cites other recent commentary on the topic. For an article discussing the ruling practice and suggesting ways that the REIT expansion could be curbed (should one wish to curb it), see Peter E. Boos, "Runaway REIT Train? Impact of Recent IRS Rulings," 2014 *Tax Notes Today* 179-4 (September 16, 2014).

To reflect the results of the IRS internal review process and lessen the need for more private rulings, the IRS issued proposed regulations in 2014 and final regulations in 2016 (adopted by T.D. 9784) to clarify the definition of real property for purposes of the REIT rules. The final regulations are effective for taxable years beginning after August 31, 2016, but, reflecting the fact that they were intended only to clarify existing law, may be relied upon by taxpayers for earlier periods. Specifically, new Treasury Regulation § 1.856-10 replaces the existing definition of real property in Treasury Regulation § 1.856-3(d), which remains but has only a cross-reference to the new definition.

The final regulations largely track the proposed ones, and one author commenting on the proposed regulations agrees with the IRS and Treasury that the revised definition of real property is consistent with prior published and private rulings. Steven F. Mount, "Definition of 'Real Property' for Real Estate Investment Trusts—Prop. Reg. §1.856-10 'Codifies' Current Law," *Tax Management Memorandum*, October 6, 2014, p. 371.

The new definition applies for REMIC purposes. The REMIC definition of real property is linked directly to the REIT definition, through a cross-reference in Treasury Regulation § 1.860G-2(a)(4) to the definition "set out" in Treasury Regulation § 1.856-3(d). Treasury Regulation § 1.856-3(d) (resolving an ambiguity in the proposed regulations) states that "[a] regulation that adopts the definition of real property in this paragraph is to be interpreted as if it had referred to Sec. 1.856-10."

The revised regulations maintain the framework of the existing definition of real property, which is land and improvements to land (consisting of inherently permanent structures and their structural components). They clarify that land includes water and air space superadjacent to land (lying over or above), so boat docks and air rights are covered, as well as unsevered natural products and deposits.

The regulations generally exclude from real property distinct assets that serve an "active" rather than "passive" function, such as machinery or equipment.

The regulations expand the list of specific items that are real estate to respond to questions raised through the ruling process (some of the items are described below) and then, for distinct assets that do not serve an active function and are not on the list, adopt a facts and circumstances test based on a list of factors to determine if they are real estate (inherently permanent structures or structural components). These factors stress the permanency of an item and the difficulty of detaching it from the real estate.

A structural component is any distinct asset that is a constituent part of and integrated into an inherently permanent structure, serves the inherently permanent structure in its passive function, and, even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income. The structural component and real property interest must be owned together.

A distinct asset is tested separately and there is a list of factors to be used to determine if a properly item is a distinct asset.

A new rule treats an intangible asset (including one recognized under financial accounting rules when real property or an interest in real property is acquired) as real property or an interest in real property if it is inseparable from that real property or interest in real property and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. A license, permit or other similar right solely for the use, enjoyment, or occupation of land or an inherently permanent structure that is in the nature of a leasehold or easement generally is an interest in real property. A license or permit to engage in or operate a business is not because it produces income other than for the use or occupancy of space.

The regulations specifically identify as real property (as inherently permanent structures other than buildings) microwave transmission, cell broadcast, and electrical transmission towers; telephone poles, parking facilities, bridges, tunnels, roadbeds, railroad tracks, transmission lines, pipelines, fences, in-ground swimming pools, offshore drilling platforms, storage structures such as silos and oil and gas storage tanks, stationary wharves and docks, and outdoor advertising displays for which an election has been properly made under section 1033(g)(3) (an election to treat those displays as real property for purposes of the involuntary conversion rules).

Examples address the treatment of (among other things) fruit-bearing plants, marinas, indoor sculptures, bus shelters, a cold storage warehouse, a data center, partitions, a stand-alone solar energy site and one used to provide electricity for one building, a pipeline transmission system, an above-market lease on an office building, a land use permit, and a license to operate a casino.

Add to footnote 115: Revenue Procedure 2014-20, 2014-9 I.R.B. 614, provides a safe harbor under which the Service will treat debt secured by equity in a disregarded entity holding real property as "secured by" real property for purposes of section 108(c)(3)(A) if the following requirements are met:

(1) The taxpayer or a wholly owned disregarded entity of the taxpayer ("Borrower") incurs indebtedness.

(2) Borrower directly or indirectly owns 100% of the ownership interest in a separate disregarded entity owning real property ("Property Owner"). Borrower is not the same entity as Property Owner.

(3) Borrower pledges to the lender a first priority security interest in Borrower's ownership interest in Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in Property Owner.

(4) At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by Property Owner must be real property used in a trade or business and any other assets held by Property Owner must be incidental to Property Owner's acquisition, ownership, and operation of the real property.

(5) Upon default and foreclosure on the indebtedness, the lender will replace Borrower as the sole member of Property Owner.

Add to footnote 110: P.L.R. 201204006 (October 24, 2011) holds that a superstructure to hold a sign and a permanently affixed LED sign are inherently permanent structures and structural components of a building and therefore real property under the REIT definition.

(iv) *Acquisition of qualified mortgages*

(v) *Qualified replacement mortgages*

(vi) *Reasonable belief safe harbor and 90-day rule*

Comment to footnote 145: The *LaSalle Bank* case cited in footnote 137, above, holds, in construing a seller qualified mortgage representation in a mortgage loan purchase and sale agreement, that a carve out from the representation for the rule for defective mortgages in -2(f)(2) also prevented the seller from relying on the safe-harbor rule based on the sponsor's reasonable beliefs. "Because the two provisions are interrelated, we find it difficult to conclude, as did the district court, that the MLPSA's 'carve-out' for section 1.860G-2(f)(2) does not also preclude the defendants' reliance on the safe harbor. The safe harbor is, by its terms, operative only in conjunction with the provision for defective obligations. Since the 'carve out' requires the treatment of defective obligations as qualified mortgages to be disregarded—they are immediately 'not qualified'—the safe harbor is rendered irrelevant." 424 F.3d 209-210.

b. Permitted Investments

(i) *Cash flow investments*

For a discussion of the treatment as cash flow investments of payments received by a REMIC in settlement of contractual claims, see Part D.13, below.

(ii) *Qualified reserve assets*

Regarding the sentence ending with footnote 163, the reference to "the amount required by a nationally recognized independent rating agency to give the rating for REMIC interests desired by the sponsor" was deleted from the cited regulation effective on or after July 6, 2011 through the adoption by T.D. 9533 of a replacement temporary regulation that does not include the language. The change was part of a Dodd-Frank Act measure directing Federal agencies to expunge from regulations references to rating agencies.

(iii) *Foreclosure property*

Comment on page 491, text following footnote 177: P.L.R. 201623007 (March 3, 2016) allows a REMIC to complete construction of a wastewater treatment plant serving a mall without terminating the status of the mall and plant as foreclosure property on the ground that on the facts (which are described in detail in the ruling) enough progress had been made on the project before foreclosure (specifically, at least 10 percent of the costs had been incurred).

Add to footnote 172: The address to submit REIT and REMIC foreclosure property extension requests is set out in the updated IRS article "Where to File Certain Elections, Statements, Returns and Other Documents" (CFR Citation 1.856-6(g)). The article is available at http://www.irs.gov/file/article/0,,id=224931,00.html. A link to the article is provided by Notice 2010-53, 2010-31 I.R.B. 182.

3. Arrangements Test

C. REMIC Taxes

Although a REMIC is not generally subject to income tax, it may still be considered "liable to tax" in the United States for the purpose of being a resident of the United States under an income tax treaty. See Revenue Ruling 2000-59, 2000-2 C.B. 593, which discusses the phrase under treaties and quotes from a Treasury explanation of a U.S. model treaty which treats REMICs as being liable to tax and therefore U.S. tax residents.

1. Prohibited Transactions Tax

2. Tax on Contributions

3. Tax on Income From Foreclosure Property

D. Special Topics

In the first line, replace "nine" with "eleven."

1. Credit Enhancement Contracts

a. Definition of Credit Enhancement Contract

b. Treatment of Credit Enhancement Contracts and Similar Arrangements

(i) *Other arrangements*

(ii) *Credit enhancement contracts*

2. Modifications and Assumptions of Mortgages

a. General

b. Likely Modifications

c. Material Modifications

(i) *Definition of "modification"*

In an informal panel discussion on November 2, 2012, Stephen Larson, the IRS Associate Chief Counsel (Financial Institutions and Products), said that the IRS is reconsidering the standards for determining when there is a change in obligor in a "F" reorganization (a mere change in identity, form, or place or organization of one corporation) for purposes of applying the debt modification regulations. He said that it might make sense to treat a change in form of organization occurring under the laws of one state as not involving a change in obligor, at least if the state law treated the new entity as a continuation of the old entity. He indicated that may represent a relaxation of current ruling standards (which apparently treat even in-state reorganizations as a change in obligor). See 2012 *Tax Notes Today* 214-7 (November 5, 2012). A recent article argues that a change in form within one state is not a realization event and is thus a tax nothing without relying on the F reorganization rules. See Jasper L. Cummings Jr., "A General Theory of F Reorganizations," 2012 *Tax Notes Today* 238-7 (December 11, 2012).

Add to footnote 259: A.M. 2011-003 (August 18, 2011) concludes that a check-the-box election that changed the tax status of an insolvent subsidiary of a domestic corporation from a corporation to a partnership did not result in a significant modification of debt of the subsidiary, regardless of whether the debt was owing to the parent or to unrelated creditors. Curiously, the memorandum reasoned that the election changed the obligor for the debt, and hence caused a modification, but it did not matter because the modification was not significant under the tests for changes in obligor described in footnote 279, below. Specifically, in the case of recourse debt, the exception for transfers to successor entities was met because (among other things) the partnership acquired substantially all of the assets of the corporation. It is perhaps not surprising that the author decided to take the easy way out and test whether a modification would be significant, although a better analysis would have been to conclude that there was no modification in the first place given the lack of a change in legal rights.

Add to footnote 260: Revenue Ruling 2003-125, 2003-2 C.B. 1243, holds that a check-the-box election that converts an insolvent foreign corporation into a disregarded entity owned by its domestic parent corporation is an "identifiable event" that fixes the parent's loss with respect to the stock. The ruling states that creditors of the foreign corporation, including the parent, may be entitled to a deduction for a partially or wholly worthless debt under section 166.

Add to footnote 274: Although the significance of a modification of a CPDI is determined under the general facts and circumstances test, in P.L.R. 201431003 (January 28, 2014), the IRS determined that in the case of a CPDI "it is appropriate to apply a test similar to the change in yield test" by asking if what the IRS refers to as the "go-forward yield" is not more than 5 percent greater than the "original yield." P.L.R. 201546009 (August 12, 2015) is to the same effect (and appears to be a second ruling given to the same taxpayer).

Add to footnote 288: The proposed regulations mentioned in the footnote were finalized by T.D. 9513 (January 7, 2011). The amended regulations add Treasury Regulation § 1.1001-3(f)(7), which provides that all relevant factors will be taken into account in determining if a modification converts an instrument to something other than debt except that, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor, the deterioration of the financial condition of the obligor between the issue date of debt and when it is modified (as it relates to the obligor's ability to repay the debt) is not taken into account. These changes are of course aimed at modifications of obligations of entities rather than individuals. An amendment to Treasury Regulation § 1.1001-3(b) makes it clear that the rule applies not just in determining if there is a significant modification but also whether the instrument that exists following a significant modification is debt for federal income tax purposes generally. The amendments are effective for alterations of a debt instrument on or after January 7, 2011, but taxpayers may rely on the new rules for alterations occurring before that date. See Treasury Regulation § 1.1001-3(h)(2).

Add to footnote 292: In other settings, and in the face of different policy concerns, a facts and circumstances approach has been followed in distinguishing between recourse and nonrecourse debt. C.C.A. 201525010 (March 6, 2015) involves a limited liability company classified as a tax law partnership that issued notes secured by real property and any other assets acquired by the LLC. The notes were junior to other secured debt. The LLC debtor was a special purpose entity that held the collateral and nothing else of substance. The members of the LLC guaranteed the notes. Financial trouble came, and the notes were discharged for no consideration (the real property was deeded to the senior creditor). The taxpayer reported cancellation of indebtedness income equal to the amount of the notes. An IRS agent contended that the amount of the notes should be treated as additional proceeds of sale of the property. Who was right depended on whether the notes were considered recourse or nonrecourse debt under Treasury Regulation § 1.1001-2. Cancellation of indebtedness income would result if the notes were recourse. Under the regulations, debt is recourse if the borrower is personally liable for the debt. The notes did not say expressly if they were recourse or nonrecourse obligations of the LLC. The taxpayer argued that the notes were recourse because of the member guarantees, pointing to the regulations under section 752, which treat partnership debt as recourse debt of a partner who guarantees the debt. Section 752 provides for the allocation of partnership debt among partners and generally allocates debt to the partner who ultimately would bear the risk of loss if partnership assets are not sufficient to pay the debt. The C.C.A. concludes that the section 752 regulations are by their terms limited to section 752 and thus are not controlling in applying Treasury Regulation § 1.1001-2. Instead, a facts and circumstances analysis should be applied. The C.C.A. cites *Great Plains Gassification Assoc. v. Comm'r*, T.C. Memo 2006-276, as a case in which such an approach was followed. The court found that debt of a special purposes entity was in substance nonrecourse because all assets of the borrower were pledged to secure the debt and the debt could be collected only from the collateral. The C.C.A. indicates without deciding that the notes might be considered recourse under a facts and circumstances test because of the partner guarantees and the LLC's pledge of all of its future assets. Whatever approach is taken in applying Treasury Regulation § 1.1001-2, it should not be applied mechanically to the debt modification regulations given the differences in text, context and policies. P.L.R. 201644018 (July 28, 2016) holds that debt of a disregarded entity with no contractual recourse to the entity's owner is nonrecourse debt for purposes of measuring gain or loss realized upon a transfer of property of the entity to the creditors in discharge of the debt. Although some commentators have suggested that the ruling reverses earlier IRS views regarding the debt modification regulations (see Amy S. Elliott, "Checking the Box to Become Disregarded May Trigger OID, Gain," 2016 *Tax Notes Today* 240-3 (December 14, 2016)), there is no reason why the same standards need be or should be applied in the two areas. According to the article, the private letter ruling relates to the bankruptcy of Energy Future Holdings Inc. and did not come out the way the taxpayer wanted; it was seeking cancellation of debt income. In June of 2016, the IRS adopted Treasury Regulation § 1.108-9, which generally applies the bankruptcy and insolvency exceptions to the recognition of cancellation of debt income found in section 108 to debt of a disregarded entity at the owner level. The preamble (in T.D. 9771) states that the IRS is studying whether debt of a disregarded entity for which the owner does not have personal liability should be treated as recourse or nonrecourse debt in determining the amount of debt cancellation income (meaning presumably in applying Treasury Regulation § 1.1001-2).

In footnote 293, replace the reference to footnote 256 with footnote 259.

The sentence that carries over from p. 528 to p. 529 states that a nonrecourse loan typically provides for recourse to the owners in limited circumstances. The IRS caused a momentary furor by issuing C.C.A. 201606027 (October 23, 2105), which concluded that such "bad boy" guarantees (presumably "bad girl" as well in today's world) would cause the guaranteed debt to be considered recourse in applying sections 465 and 752. The guarantee the IRS was most focused on was one triggered by the guarantor admitting "in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due." A second memorandum, A.M. 2016-001 (March 31, 2016), calmed the waters by reaching the opposite conclusion, largely on the ground that the carve-outs were designed to prevent the guarantor from taking voluntary actions that would make collection against the collateral more difficult rather than to shift default risk. The memorandum has a list of conventional carve-outs. The second memorandum does not mention or revoke the first but presumably the last in time controls. For a discussion of the Service's thinking (saying that the key is whether the act triggering the guarantee is voluntary), see Amy S. Elliott, "Evaluate 'Bad Boy' Guarantees by Looking to Control of Guarantor," 2016 *Tax Notes Today* 89-15 (May 9, 2016).

(ii) *When modification is "significant"*

Some states have anti-deficiency statutes providing that if a creditor forecloses on property securing a loan or accepts a short sale (either generally or under certain circumstances), then the creditor may not assert a claim against the debtor for any unpaid balance. California adopted a revised version of such laws in 2011, which prompted California Senator Boxer to ask the IRS to clarify whether a short-sale that benefitted from the new rule would produce cancellation of debt (COD) income equal to the forgiven debt balance. COD income would result if the debt were considered recourse. On the other hand, if the debt were nonrecourse, the property would be considered sold for the full loan balance (generally a more favorable result). The IRS responded in a letter, which was later released as INFO 2013-0036, 2014 Tax Notes Today 4-16 (September 19, 2013). The letter states that a homeowner's obligation that is forgiven under the new anti-deficiency statute would be a nonrecourse obligation so that COD income would not be realized (the letter limits this conclusion to the realization of COD income). The IRS apparently later clarified the letter to limit its scope to certain purchase money loans falling within a particular rule under California law. A letter from members of the California bar discusses these developments and proposes that the IRS issue a revenue ruling or other binding guidance clarifying that a loan is nonrecourse (for purposes of measuring COD income at least) if at the time when the property is sold and the loan settled, a claim for the unpaid balance cannot be made under any California anti-deficiency law. See Douglas L. Youmans, N. Aaron Johnson, State Bar of California, Taxation Committee, 2014 Washington, DC, Delegation Paper (undated), 2014 *Tax Notes Today* 153-13 (August 8, 2014). The paper does not address possible consequences under section 1001 of switching debt from recourse to nonrecourse, although perhaps the change would be considered under section 1001 a step in settlement of the loan and not a modification of an ongoing debt instrument. Another entry in the IRS-Boxer correspondence addressing more technical points raised by Senator Boxer was dated June 20, 2014 and released as INFO 2014-0024. It is available on the IRS web site or at 2014 *Tax Notes Today* 194-19 (October 7, 2014).

d. REMIC Regulations

Comment on the rule for modifications described in the text at footnote 298: Revenue Procedure 2011-16 (which is described in Chapter 11, Part B.1, in this Supplement) adopts a similar rule allowing modifications of loans in default settings to be disregarded in applying REIT income and assets tests. The revenue procedure sheds some light on when a future default may be considered sufficiently foreseeable to count.

3. Release Rule

a. Before 2009

Correction to fourth line on page 535: Insert “not” before “to involve”.

b. Current Rule

c. Defeasance Exception

4. Convertible Mortgages

5. Prepayment Premiums

a. Mortgage Prepayments

b. Premiums on Regular Interests

6. Prepayment Interest Shortfalls

7. Distressed Mortgages

a. Post-Acquisition Defaults

b. Industry and Government Loan Modification Programs

Add to footnote 374: Revenue Procedure 2013-16, 2013-7 I.R.B. 488, provides detailed guidance on the treatment of loan modifications and subsidy payments under HAMP. HAMP contemplates a reduction over a three-year period in the principal amounts of mortgages payable by borrowers, subject to the mortgage remaining in good standing. Part of the principal reduction amount is forgiven with no payments (so that the investor suffers a loss) and part is paid by the federal government through a subsidy payment made to investors. The subsidy payment is treated for tax purposes as a payment received by the borrower and used by the borrower to repay principal. The revenue procedure indicates that when a mortgage is modified under HAMP, there is a deemed exchange of the old mortgage for a modified mortgage under section 1001. The issue price of the modified mortgage (which is used in calculating the borrower’s cancellation of debt income) excludes the amount of principal that is conditionally forgiven but includes the principal to be paid with subsidy payments. To the extent principal is paid through a subsidy, the borrower may exclude the subsidy amount from gross income under the general welfare exception if the property is used as a principal residence. Reporting of loan forgiveness by servicers under section 6050P is also discussed.

Comment on footnote 375: Compare Revenue Procedure 2011-16 (which is described in Chapter 11, Part B.1. in this Supplement), which allows modifications of loans to be disregarded in applying REIT income and assets tests if there is a significant risk of future default upon maturity or an earlier date.

c. Pre-Acquisition Defaults

(i) ***Qualified mortgage***

(ii) ***Foreclosure property***

d. REMICs Acquiring Mostly Defaulted Loans

8. Integration

a. Multiple-Tier REMICs

b. Outside Reserve Funds

c. Packaging REMIC Interests With Other Financial Instruments

9. Qualified Mortgages With Future Advances

10. Guaranteed Final Maturity Classes

11. Re-REMICs

Add new Parts D.12 and 13, as follows:

12. Short-term REMICs and Economic Substance Doctrine

Chapter 15, Part E.2, discusses how an owner of mortgages with a built-in loss can use a short-term REMIC to obtain an ordinary (or mostly ordinary) deduction for the loss over a relatively short period, all without disposing of the mortgages (as the owner sees it) or triggering a book loss. The owner achieves this happy result by issuing a relatively small amount of notes to a third party secured by the mortgages and electing to treat the borrowing arrangement as a REMIC. The details are in Chapter 15.

The tax loss should be acceptable on policy grounds in that it corresponds to the taxpayer's economic loss from underwater mortgage investments. In the 1980s, thrift institutions achieved similar results through mortgage swaps.

Specifically, thrifts exchanged one mortgage pool with a built-in loss for a second pool that was designed to be economically very similar. The taxpayers claimed that there was a realization event producing a tax loss even though no loss was recognized for book purposes because of the similarity of the pools. The Supreme Court upheld the claimed tax loss in its 1991 *Cottage Savings* decision.[21]

[21] *Cottage Savings Ass'n. v. Comm'r*, 499 U.S. 554 (1991). The court held that there was a realized loss because the two mortgage pools had different legal entitlements. For further discussion of the case, see Chapter 15 at footnote 22. Note that there is a special add back for losses from exchanges of debt pools in computing adjusted current earnings which is included in the tax base for the alternative minimum tax for corporations. See section 56(g)(4)(E).

Taxpayers have successfully pursued other strategies to achieve selective, self-help, mark-to-market treatment of debt instruments.[22]

In a 2015 technical advice memorandum, the IRS agreed with a taxpayer that a short-term REMIC could be used to accelerate a built-in loss from mortgages in a transaction that took the form of a secured borrowing.[23] The IRS examination team contended that the transaction should be taxed as a debt issuance and not a REMIC. The advice memorandum concludes that the REMIC rules were intended to be mechanical and exclusive, and could be relied upon by a taxpayer if their requirements were met.

Although the memorandum did not discuss the economic substance doctrine expressly, the holding rests on the view that the taxpayer acted in conformity with the REMIC rules and congressional intent, which is reason enough for not invoking the doctrine.[24] It cannot make sense to require a non-tax motive for a tax election, including one to treat an entity as a REMIC.

It is noteworthy, and likely significant to the conclusion reached in the T.A.M, that the REMIC rules in fact produce reasonable tax results, even as applied to a short-term REMIC, in that they allow to a taxpayer a loss deduction only to the extent it has suffered an economic loss.

13. Settlements for Contractual Breaches

A trustee acting on behalf of a number of REMICs obtained a private letter ruling confirming that the receipt and distribution to investors by the REMICs of money received in settlement of claims for breach of mortgage representations and warranties did not violate various REMIC rules.[25] Based on press reports, it appears that the trustee was Bank of New York Mellon and the claims were brought against Countryside and its parent Bank of America.[26]

The ruling states that institutional investors brought claims against a number of REMICs based on the failure of the "Seller" of mortgages to meet representations and the failure of a "Master Servicer" to meet servicing standards. The Seller was described as being Company C and one or more of its affiliates, which were all affiliates of Company A (apparently Countrywide). The sales were made to the REMICs

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22 Another example relates to mixed straddles. The regulations implementing the mixed straddle rules in section 1092(b)(2) (specifically, Treasury Regulation § 1.1092(b)-3T(b)(6)) have historically provided for debt to be marked to market (resulting in gain or loss as appropriate) immediately before the debt becomes part of a mixed straddle, even if the straddle is of short duration. During the five year capital loss carryforward period following 2008 (the year of the troubles), insurance companies used these rules to generate capital gains from appreciated debt instruments they continued to hold. In 2014, the IRS changed the mixed straddle rules (by adopting Treasury Regulation § 1.1092(b)-6, effective for positions established on or after August 18, 2014) to defer the recognition of built-in losses and gains from debt instruments until there is an actual disposition. Temporary regulations issued on August 1, 2013 would have ended the strategy immediately, but the effective date was delayed in response to industry complaints. In practical terms at least, Treasury accepted that the strategy worked under prior law. For a discussion, see Lee A. Sheppard, "News Analysis: Trouble With the Mixed Straddle Regulations," *Tax Notes*, October 28, 2013, p. 358.

23 See T.A.M. 201517007 (November 21, 2014), which is described further in Chapter 15, Part E.2.

24 The doctrine was codified in 2010 through the enactment of section 7701(o). The section applies to transactions only when the doctrine is found to be "relevant" under case law standards. When the doctrine applies, it requires a transaction to have both a non-tax motive and a non-tax effect to be upheld. The Joint Committee on Taxation staff explanation of the section states that it was not intended to deny tax benefits that are consistent with congressional intent. See Joint Committee on Taxation Staff, *Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination with the "Patient Protection and Affordable Care Act"*, JCX-18-10, March 21, 2010, p.152.

25 P.L.R. 20165001 (September 7, 2015). The IRS later issued two other private letters rulings that are substantially similar, P.L.R. 201713007 (December 30, 2016), and P.L.R. 201714017 (December 30, 2016).

26 See Lee A. Sheppard, "News Analysis: The Fashion in Mortgage Settlements," 2015 *Tax Notes Today* 173-1 (September 8, 2015).

through a depositor. The representations were made in the governing agreements for the REMICs and included representations about underwriting standards and conformity of the mortgages to descriptions in offering documents, and that the origination, underwriting, and collection practices of the Seller and Master Servicer met industry standards and conformed to the law. The agreements generally obligated the Seller to cure material breaches of representations by repurchasing the affected mortgages at their face amount.

Institutional investors asserted that there were material breaches triggering the repurchase remedy, and that the Master Servicer had failed to meet servicing obligations in various ways. The investors also asserted that Company I that had purchased Company A (apparently Bank of America) was also liable for the claims. The parties reached a settlement that received court approval. The settlement required Company A or I to make a cash payment, and also required improvements in servicing.[27] The payment was allocated among the REMICs in a way that was intended to be proportionate to net mortgage losses. The cash paid to each REMIC was then paid to investors in a way that was consistent with the distribution provisions in the REMIC documents, treating the payments as recoveries on loans for which losses had been taken or as unscheduled principal payments. The servicing improvements required compliance with objective standards and provided for the servicer to make payments if it failed to comply that would either offset reimbursements of advances or be allocated like the settlement payment.

The PLR describes the asset test for a REMIC, including the definition of cash flow investment, which includes "payments received on qualified mortgages." That term includes payments by a sponsor or prior owner of a mortgage in lieu of repurchasing a defective obligation. A defective obligation is one that was transferred to a REMIC in breach of a customary warranty. The PLR states that the settlement payments made to the REMICs arise from contract claims pertaining to the mortgages originally transferred to the REMICs and thus were not assets acquired after the REMICs startup date. Further the payments are "akin to" a payment received from a sponsor or prior owner for breach of representations and were considered payments on qualified mortgages for purposes of the cash flow investment definition.

The PLR also holds that since the settlement did not alter the terms of any REMIC interests and settlement payments were allocated in a manner consistent with their terms, the settlement did not cause any interest to fail to be a REMIC interest.

The settlement payments also were not contributions to the REMICs as they represented rights relating to the mortgage loans. The payments by the servicer also were not contributions to the REMIC or payments for services rendered by the REMICs (which would be income from a prohibited transaction) but were a reimbursement in connection with services provided to the REMIC.

The ruling is not surprising given that the definition of cash flow investment contemplates the receipt of settlements for breaches in lieu of repurchases. It is helpful in showing that the payments need not come strictly speaking from the sponsor or prior owner of mortgages and that parties can take some liberties in determining the character of payments in allocating them among investors where contractual terms do not provide specifically for the allocation of settlement payments.

A Second Circuit decision in a civil case brought against Wells Fargo as a REMIC trustee makes the point quite clearly that the existence of a defect in underwriting a mortgage (e.g., in verifying income) does not mean that the loan fails to be a qualified mortgage (so that REMIC status may be called into question or a prohibited transactions tax be imposed) unless the defect relates to one of the requirements of the definition of qualified mortgage. The case is discussed in Part B.2.a, above (in this Supplement).

E. REMIC Elections and Other Procedural Matters

[27] Presumably, the breaches of representations did not prevent any mortgages from continuing to be qualified mortgages.

1. Elections

2. Other Procedural Matters

a. General

The Bipartisan Budget Act of 2015, which was enacted on November 2, 2015, repeals the TEFRA rules governing partnership audits (sections 6221-6234) and replaces them with a new regime, effective beginning in 2018. The new rules are summarized in Chapter 5, Part C.1 (in this Supplement) and could in some cases result in entity-level liability for taxes imposed as a result of audit adjustments. It will be interesting to see if any special accommodations are made for REMICs.

Add to footnote 453: C.C.A. 201124023 (May 18, 2011) concludes that it is appropriate to have the REMIC tax matters partner file a partnership-level administrative adjustment request even if that person was not authorized to sign the original partnership return.

b. Payment of REMIC Taxes

c. Recordkeeping

Chapter 7

Definition of REMIC Regular Interest

A. Overview

In a Field Attorney Advice considering whether interests in a FASIT were regular interests, the IRS appears to have added an extra-statutory requirement that a regular interest be structured so that interest on regular interests is *by virtue of their form* subject to current accrual in the same way as a debt instrument (the advice involved preferred stock that paid dividends that were payable only upon declaration by directors). For a discussion, see Chapter 6, footnote 2 (in this Supplement). The advice is not likely to carry much weight in the REMIC area.

B. Fixed Terms

C. Permitted Interest Rates

1. Disproportionately High Interest

2. Fixed Rates

3. Variable Rates

a. Qualifying Index

b. Weighted Average Rates

(i) *Identification of mortgages*

(ii) *Determination of rate*

As the text at footnote 53 indicates, a floor may be applied as well as a cap to the rate of interest on a qualified mortgage before calculating a weighted average. By definition, this means that the interest taken into account with respect to a mortgage may exceed the rate actually payable on the mortgage. It should be possible, for example, to adjust the rate on a variable rate mortgage so that it equals a fixed rate by applying a cap and floor to the variable rate equal to the desired fixed rate. This approach has proven to be useful in structuring some regular interest classes.

(iii) *Calculation of average*

c. Rate Adjustments

d. Caps and Floors

e. Combinations of Rates

4. Specified Portions

a. Definition of Specified Portion

(i) *Fixed or variable rate*

(ii) *Individual mortgages or pools*

(iii) *Marker classes*

b. Interest Payments

c. Specified Portions Cannot Vary

5. Comparison of Specified Portion and Weighted Average Rates

D. Contingencies

1. Contingencies Affecting Principal

As the text at footnote 121 indicates, a REMIC interest does not fail to qualify as a regular interest because the amount and timing of principal payments are contingent on the absence of defaults. Technically, Treasury Regulation § 1.860G-1(b)(3)(ii) allows changes to payments "affected by defaults". As discussed in Chapter 6, Part D.2.d (at footnote 298), a REMIC may modify a mortgage without causing the mortgage to lose its status as a qualified mortgage if the modification is occasioned by default or a reasonably foreseeable default. If a REMIC modifies a mortgage by reducing required payments and the modification is occasioned by a reasonably foreseeable default (but not a default that has already occurred), the resulting changes in payments on regular interests should come within the language referring to changes affected by defaults. There is almost always a one-to-one correspondence between principal and interest payments on qualified mortgages and on regular interests, so the two rules should be read in tandem. The guidance issued by the IRS to bless the participation by REMICs in industry and government loan modification programs (see Chapter 6, Part D.7.b) states that loan modifications under those programs do not cause loss of qualified mortgage status or cause a deemed reissuance of REMIC regular interests. See, e.g., Revenue Procedure 2008-47, 2008-2 C.B. 272. Apparently, the drafters believed that a mortgage modification based on a reasonably foreseeable default would not affect the status of regular interests absent an accompanying negotiated change in terms of regular interest (which would not normally happen). That view is eminently sensible.

2. Contingencies Affecting Interest

E. Special Topics

1. Timing of Principal Payments

2. Non-Pro Rata Payments

3. Modifications

4. Stripping of Regular Interests

5. Stapling of Regular Interests

6. TEFRA Registration

7. Denomination in Foreign Currency

F. Examples

1. Single REMIC

a. Qualifying Variable Rates

b. Weighted Average Rates

c. Combination Rates

d. Specified Portion Rates

e. Variable Caps

f. Deferral of Interest

g. Prepayment Premiums

2. Two-Tier REMICs

a. Specified Portion Rates

b. Marker Classes

c. Variable Rates

3. Re-REMICs

4. Reverse Mortgages

Chapter 8

Taxation of Holders of Asset-Backed Securities Taxable as Debt

A. Introduction

Footnote 8 describes the rule in section 1271(a) treating amounts received on the retirement of a debt instrument as received in exchange for the instrument and thus potentially as capital gain. It is now settled law that a partial principal payment is considered a retirement of part of a debt instrument for this purpose, but that was not always the case. The government argued unsuccessfully in a series of cases in the 1940s applying a predecessor to section 1271(a) that retirement implied a full extinguishment of a debt instrument. See *Noll v. Comm'r*, 43 B.T.A. 496 (1941), and *Timken v. Comm'r*, 6 T.C. 483 (1946). These cases built on *McClain v. Comm'r*, 311 U.S. 527 (1941), a Supreme Court case which held that "retirement" was not to be given a technical meaning. To quote from the opinion in *Timken*: "The respondent's view that the payments here were not retirement means in effect that only the final payment on the notes, or a single payment of the full amount, can constitute retirement. We do not subscribe to such idea. Each payment upon the note *pro tanto* retired it. We see nothing in the statute to justify a contrary conclusion." A retirement of debt can occur even when the debt claim is a right to defaulted accrued interest that was purchased at a discount. Revenue Ruling 68-284, 1968-2 C.B. 464 (revoking an earlier ruling to the contrary).

There are proposals from Congress and the Obama Administration for legislative changes to the treatment of debt instruments. In brief, they would (1) cap the rate at which market discount accrues based on a formula (intended to limit accruals for highly speculative debt) and allow an ordinary deduction for a loss on sale up to the amount of accrued market discount, (2) put a floor on the adjusted issue price of debt issued in a debt-for-debt exchange where principal is not reduced equal to the adjusted issue price of the exchanged debt (to prevent the artificial creation of OID and cancellation of indebtedness income where the amount due is not reduced), and (3) provide for nonrecognition of gain or loss in debt-for-debt exchanges. For a description and analysis, see New York State Bar Association Tax Section, "Report on House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments and Corresponding Proposals by the Obama Administration," 2015 *Tax Notes Today* 45-102 (March 6, 2015).

B. Overview of Taxation of Discount and Premium

For an interesting discussion of how the wash sale rules affect the accrual of premium and discount, see Stevie D. Conlon, "Wash Sales Asymmetrically Affect Premium and Discount for Debt," 2014 *Tax Notes Today* 774 (April 22, 2014).

C. Original Issue Discount

1. OID Defined

a. Stated Redemption Price at Maturity

b. Issue Price

Add to footnote 28: Regulations adopted by T.D. 9599 (September 13, 2012) expanded the definition of qualified reopening, effective for debt instruments that are part of a reopening if the reopening date is on or after September 13, 2012. Specifically, the definition is expanded to include (1) reopenings of non-publicly traded debt where the additional debt instruments are issued for cash to persons unrelated to the issuer for an arm's length price and would meet the requirements for a reopening of publicly traded debt (issued within six month with a yield, calculated based on the cash purchase price, not greater than 110 percent of the original yield of the original debt instruments, or issued thereafter with *de minimis* OID), and (2) reopenings more than six months after issuance of the original debt instrument of publicly traded debt, or of nonpublicly traded debt issued for cash to persons unrelated to the issuer for an arm's length price, if the yield of the additional debt instruments is not more than 100 percent of the yield of the original debt instruments (or their coupon rate if they had *de minimis* OID). The qualified reopening rules, both before and after amendment, do not apply to tax-exempt obligations or CPDIs.

Add to footnote 29: Proposed regulations would replace the 10 percent rule with a safe harbor based on the prices at which at least 25 percent of debt instruments in an issue are actually sold (provided all orders placed at this sale price from the public are filled to the extent public orders at such price to not exceed the amount of debt instruments sold). See REG-148659-07, 78 F.R. 56842-56852 (September 16, 2013). The preamble suggests that the change is warranted (in the context of the municipal bond arbitrage rules under section 148) by a concern that small quantities of bonds are being sold at artificially low prices to boost permissible yields at which bond proceeds can be reinvested. The proposed regulations are reproduced at 2013 *Tax Notes Today* 179-16 (September 16, 2013). These proposals were not well received, and on June 24, 2015, the IRS issued revised proposed regulations that retain the 10 percent rule (based on actual sales, not expectations), but also have an alternative regime allowing the initial offering price to be used as the issue price if there are not orders placed by the public for a substantial amount of bonds as of the sale date and underwriters do not fill orders placed by the public prior to the issue date at prices higher than the offering price (unless, for orders placed between the sale and issue dates, the higher prices are justified by a market change). See REG-138526-14; 2015-28 I.R.B. 67; 80 F.R. 36301-36305 (June 24, 2015).

2. Debt Instruments Subject to the PAC Method

3. OID Accruals for Debt Instruments Generally

a. Constant Yield Method

b. Acquisition Premium

c. Specified Contingencies

d. Partial Prepayments

e. Variable and Contingent Rates

4. OID Accruals Under the PAC Method

a. Overview

b. Prepayment Assumption

c. Accruals of OID

d. Example

e. Variable Rates

D. Stripped Bond Rules

1. Definition of Stripped Bond or Coupon

Add to footnote 99: A notice addressing the treatment of stripped credit coupons contemplates the aggregation of all stripped bonds and coupons held by a single owner. See the paragraph preceding the paragraph that includes footnote 114, below.

2. Treatment of Stripped Bonds

Add to footnote 95: By way of analogy, *Bell v. Harrison*, 212 F. 2d 253 (7th Cir. 1954), allows a son who was the residuary beneficiary of a trust in which his parents had life estates to amortize the cost of purchasing the life estates over the life expectancies, rejecting an argument that the life and residual trust interests should be considered to merge.

3. Special Rules for Tax-Exempt Bonds and Tax-Credit Bonds

E. Market Discount

1. Overview

2. Detailed Discussion

F. Premium

1. Overview

2. Bond Premium Regulations

If there is a bond premium carryforward as of the end of a bond holder's accrual period in which the bond is disposed of, the holder treats the amount of the carryforward as a bond premium deduction for the year of disposition (rather than taking it into account in computing gain or loss on disposition). See Treasury Regulation § 1.171-2T(a)(4)(i)(C). This rule applies to a bond acquired on or after January 4, 2013. A taxpayer, however, may apply the rule to a bond acquired before that date.

3. PAC Method

G. Special Considerations for Pass-Through Certificates and Other Pools

1. Overview

2. OID in Residential Mortgages and Other Consumer Loans

a. Overview

The OID rules apply to a "debt instrument" as defined in section 1275(a)(1)(A). With an exception for certain annuities, a debt instrument is a "bond, debenture, note, or certificate or other evidence of indebtedness." Some consumer receivables are not evidenced by a note or other writing other than an agreement. One example might be an agreement setting up a credit card account. However, Treasury Regulation § 1.1275-1(d) treats all instruments or contractual arrangements that are debt for tax purposes as debt instruments in applying the OID rules. Accordingly, if a contract creates debt (as a credit card agreement would), the debt is a "debt instrument" under section 1275(a)(1)(A). The debt instrument may not be in registered form (which is critical in applying the portfolio interest exemption as discussed in Chapter 12), but that is a different issue.

b. Credit Card Fees

Footnote 187: The holding in *Capital One Financial Corp.* that the taxpayer could not change its method of accounting for late fees without obtaining IRS consent was upheld on appeal, 659 F.3d 316 (4th Cir. 2011).

The IRS has issued a revenue procedure allowing taxpayers to use a simplifying convention for calculating OID accruals for pools of credit card receivables. See Part G.4, below, in this Supplement.

C.C.A. 201205007 (October 18, 2011) discusses the source of various credit card fees. It concludes that the fees representing interest should be sourced based on the residence of the account debtor. Fees for processing customer transactions on third-party ATMs located outside of the United States represent income from personal services and on the facts under consideration were U.S. source because the processing was performed in the United States.

For an article discussing the tax treatment of credit card transactions from the perspective of the card issuer, see Joseph C. Mandarino, "Tax Treatment of Credit Card Transactions," *Journal of Taxation and Regulation of Financial Institutions*, July/August 2013, 43.

Add to footnote 189: The IRS pre-litigation view that interchange fees are not OID (because not sufficiently connected to the credit card issuer's extension of credit to the card holder) is explained in T.A.M. 200533023 (released August 19, 2005).

3. Application of PAC Method

a. Overview

b. Existence of a "Pool"

Revenue Procedure 2013-26, 2013-22 I.R.B. 1160, described in Part G.4, below, in this Supplement, allows a taxpayer to use a proportional method for computing OID with respect to one or more pools of credit card receivables. The revenue procedure does not say how pools are to be identified and maintained. It does, however, require that the manner in which pools are established and maintained not achieve a result that is unreasonable in light of the purposes of sections 1271 through 1275, which is a fairly loose standard. The revenue procedure contemplates that taxpayers may add or subtract receivables from a pool monthly.

c. Other Implementation Issues

4. Simplifying Conventions

a. Overview

b. Available Conventions

Revenue Procedure 2013-26, 2013-22 I.R.B. 1160, allows a taxpayer to compute OID accruals with respect to a pool of credit card receivables using a "proportional method" based on the portion of the pool's stated redemption price at maturity (*SRPM*) that is paid during a period. The receivables must be for credit cards that allow cardholders to access a revolving line of credit established by the taxpayer to purchase goods and services, or to obtain cash advances. The purchase transactions must not be treated as creating debt given in consideration of the sale or exchange of property, and the taxpayer must maintain one or more pools of receivables with respect to such credit cards. The taxpayer need not be the card issuer, and a taxpayer who acquires a pool of eligible receivables may apply the same proportional method to market discount or bond premium. A taxpayer changing to the proportional method from a different method can take advantage of an automatic consent procedure. A taxpayer must use the same method for all eligible pools it holds. The new method may be adopted for any taxable year that ends on or after December 31, 2012.

The proportional method requires a taxpayer to accrue OID for a pool of receivables in any month equal to unaccrued OID for the pool at the beginning of the month (*BEG_OID*) times a fraction equal to the SRPM payments for the pool for the month (*SRPM_P*) divided by the SRPM of the pool as of the beginning of the month (*BEG_SRPM*). Thus, absent SRPM payments, no accrual of OID is required. The payments that trigger OID accruals are gross payments. Thus, if SRPM payments are received on receivables in a pool, and new receivables are added to the same pool in at least the same amount so that the SRPM for the pool does not go down, the payments received still count.

The revenue procedure does not say how pools are to be identified and maintained. It does, however, require that the manner in which pools are established and maintained not achieve a result that is unreasonable in light of the purposes of sections 1271 through 1275. This standard, which appears to have been borrowed from the OID anti-abuse rule in Treasury Regulation § 1.1275-2(d), is fairly loose.

The revenue procedure states that BEG_OID and BEG_SRPM for a month (current month) must be increased or decreased, respectively, for the SRPM and unaccrued OID of any accounts that were added or removed from the pool during the preceding month. Unaccrued OID associated with an account added or removed during the preceding month may be determined by allocating unaccrued OID for the pool at the beginning of the preceding month among the accounts in the pool in proportion to their SRPM's as of the beginning of the preceding month. It is interesting that the revenue procedure refers to the addition or subtraction of "accounts" and not receivables. This may be inadvertent or may imply that all receivables with respect to any given account are expected to be located within a single pool.

Similarly, the revenue procedure says that BEG_OID and BEG_SRPM for a month should be reduced by the SRPM and unaccrued OID with respect to "credit card accounts written off" during the preceding month. Presumably, this means accounts that are treated as wholly or partially worthless for tax purposes, although the language could be clearer. Again, the revenue procedure refers to accounts not receivables.

The proportional method does not require the use of a prepayment assumption or yield calculation. It is somewhat ironic that after a few years of experimentation with the "sophistication" of the PAC method, the IRS is reverting to a simplified pro rata method that is based on cash receipts and does not require a prepayment assumption or use of a yield. It may well be that the sophistication was simply not worth the administrative cost.

The revenue procedure indicates that the proportional method generally produces the same results as the PAC method. It may be instructive to compare the formulas for computing monthly OID under the proportional and PAC methods, using the terminology used in the revenue procedure (with some additions):

SRPM, SRPM_P, BEG_SRPM, and BEG_OID are defined above

M_OID = Monthly OID

END_SRPM = BEG_SRPM – SRPM_P

PV_SRPM = present value at end of month of END_SRPM payments using prepayment assumption and PAC method yield

BEG_AIP = adjusted issue price at beginning of month

BEG_OID also equals BEG_SRPM –BEG_AIP

The monthly OID amounts under the two methods are as follows:

Proportional method:

M_OID = BEG_OID*(SRPM_P/BEG_SRPM)

= (BEG_SRPM – BEG_AIP)*(SRPM_P/BEG_SRPM)

= SRPM_P – BEG_AIP*(SRPM_P/BEG_SRPM)

PAC method:

M_OID =SRPM_P + PV_SRPM - BEG_AIP

Comparing the two formulas, they produce the same monthly OID amounts if

PV_SRPM = BEG_AIP*(1 – SRPM_P/BEG_SRPM)

Under the PAC method, beginning AIP is the present value as of the beginning of the month of future principal payments. PV_SRPM is the present value of future principal payments at the end of the month. Thus, the amounts produced under the two formulas would be the same only if after giving effect to the current month payment, the future payment stream as of the end of the month was the same as at the beginning of the month except that each future payment was reduced proportionately. On the other hand, if a debtor simply amortizes a balance, the likely effect will be to keep future payments the same but reduce the number of future payments. Eliminating the last principal payment in a stream of principal payments reduces the present value of that stream (PV_SRPM) by a smaller amount than a proportionate reduction based on principal amounts, resulting in a larger OID accrual under the PAC method. Stated differently, on those facts, the proportional method would slow down the rate of accrual of OID.

To show this with a simple example, consider a loan that has a principal amount of $100, pays interest of 20% per annum and provides for five annual payments of $33.44. The loan has an issue price of 97 (three points of OID) and a yield to maturity (assuming annual compounding) of 21.4%. OID accruals under the two methods would be as follows (with rounding):

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Principal Payments	13.44	16.13	19.35	23.22	27.86	100.00
PAC Method OID	00.76	00.73	00.66	00.53	00.32	3.00
Proportional Method OID	00.40	00.48	00.58	00.70	00.84	3.00
Difference (PAC minus Proportional)	00.35	00.25	00.08	(00.16)	(00.52)	0.00

Clearly, determining whether use of the proportional method would make a meaningful difference for a particular taxpayer would require some number crunching.

In an insightful article, one author shows that the proportional method produces the same effect as the PAC method where (1) the PAC method is applied anew each month, and (2) the prepayment assumption used for each month is that monthly principal will be repaid in each future month at a constant percentage of the principal outstanding at the beginning of the month, and (3) that percentage is the percentage of principal actually repaid in the current month. See David C. Garlock, “Time to ‘Un-PAC’? Simplifying the Amortization of Credit Card Fee Income”, *Journal of Taxation of Financial Instruments*, Vol. 1, Issue 1 (2006), p. 5. Thus, if in a given month (say January 2015), BEG_SRPM was 100 and SRPM_P was 5 (or 5% of the SRPM at the beginning of the month), the proportional method would produce the same accrual of OID as the PAC method if the PAC method were applied assuming that in each month after January 2015, principal will be paid equal to 5% of the principal balance at the beginning of the month (and this continued, in theory at least, forever, because the principal would never be repaid, although practically once the balances get small they could be cut off without affecting the calculation much). If in February 2015, 6% of the principal amount at the beginning of February was repaid, the PAC method would be applied again, but with the assumption that 6% of starting month principal balances would be repaid in each subsequent month. Using these prepayment assumptions, the condition indicated above for achieving a parity between the proportional method and the PAC method (that the principal payment made in the current month reduce each future payment proportionately) would in fact be achieved. The justification for applying the PAC method anew each month (and using a new prepayment assumption) is that credit card pools are not static, and there is no practical way to distinguish the new from the old, so starting over is reasonable. The assumption that future payments will track those made during any month may or may not be reasonable for any taxpayer and pool, but as a general proposition may be good enough for government work, and, perhaps more importantly, factoring in administrability, is a better overall choice than any alternative. At any rate, this line of argument likely influenced the IRS to allow the method.

Consistent with the Garlock approach, the court in *Capital One* allowed the taxpayer to treat a pool of credit card receivables as being reissued each month so that the PAC method could be applied using different yield and prepayment assumptions, based for any month on payments received during the month. See the discussion above in the book text at footnote 209.

The intention to issue a revenue procedure allowing use of the proportional method was announced in Notice 2011-99, 2011-50 I.R.B 847. An accounting firm suggested a number of changes many of which were adopted by the IRS. See letter to the IRS from PricewaterhouseCoopers LLP dated March 16, 2012, 2012 *Tax Notes Today* 78-75 (March 16, 2012).

c. Effects of Aggregation

(i) *Uniform loans*

(ii) *Loans not uniform*

H. Special Topics

1. Prepayment Losses Attributable to IO Interests

a. Overview

b. Effect of Prepayments on Bond Premium Amortization

c. Obstacles to Applying Section 171

(i) *Existence of premium*

(ii) *TRA 1986 legislative history*

d. Other Considerations

(i) ***Comparison with IO Strips***

(ii) ***Clear reflection of income***

(iii) ***Effect on residual interests***

e. The **Glick** *Decision*

f. Announcement 2004-75

Treating losses on an IO due to prepayments as bad debts deductible under section 166 would be a stretch because the section is aimed at losses arising from the debtor's inability to pay, not prepayments that according to the terms of a contract cut off an income stream. See *Quality Chevrolet Company, Inc. v. Comm'r*, 50 T.C. 458 (1968), aff'd 415 F.2d 116 (10th Cir. 1969), cert. denied, 397 U.S. 908 (1970), holding that a car dealer could not claim deductions under section 166 for finance charges that were rebated upon the prepayment of a loan. According to the Tax Court,

> The losses sustained by the petitioner as a result of the prepayment of the notes are not losses resulting from the worthlessness of a debt. A debt becomes worthless within the meaning of section 166 when it is uncollectible because the debtor is unwilling or unable to pay. However, the prepayment losses are not due to the debtor's unwillingness or inability to pay but occur because he chooses to satisfy the debts in advance of their maturity. 50 T.C. 465.

2. Distressed Debt

a. Overview

Claiming deductions for the partial worthlessness of REMIC regular interests has been a pressing issue for a number of taxpayers following the high levels of mortgage defaults in the recent troubled times. IRS examiners have resisted allowing deductions matching book charge-offs unless the taxpayer provides substantial information showing underlying mortgage defaults. There is a recent helpful IRS Large Business & International Division ("LB&I") directive on the topic benefitting insurance companies that allows tax deductions based on certain statutory charge-offs. There is also commentary on the subject arguing for IRS leniency.

The directive (LB&I-4-0712-009, July 30, 2012) tells IRS examiners to not challenge partial bad debt deductions claimed by a regulated life or property and casualty insurance company in respect of "eligible securities" to the extent the deduction is the same as the company's Statement of Accounting Principles ("SSAP") 43R credit-related impairment charge-off for the same securities as reflected in the company's Annual Statement filed with state insurance regulatory authorities. An "eligible security" is an investment in loan-backed and structured securities within the scope of SSAP 43R that is subject to section 166 (and not a "security" as defined in section 165(g)(2)(C) for which bad debt deductions are not allowed), and includes REMIC regular interests. This directive was issued in response to a request from a coalition of insurance companies. See letter to the IRS from Peter H. Winslow and Samuel A Mitchell dated September 30, 2010, 2012 *Tax Notes Today* 148-22 (September 30, 2010). The letter states that insurance companies had significant required statutory impairments of structured debt instruments, including REMIC regular interests, and that IRS auditors had routinely taken the position that the write downs did not meet the partial worthlessness standard under section 166 (for articles making the same observation, see below). The letter argues that the statutory write downs met the conclusive presumption of worthlessness test in Treasury Regulation § 1.166-2(d)(1), which applies to a bank "or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards" and to charge-offs made in obedience to specific orders by such authorities, or charge-offs under policies of such authorities that are confirmed in writing upon the first following regulatory examination of the taxpayer. The letter also argues that a deduction should be allowed for the full amount of the statutory charge-off, not just the part attributable to credit-related events. It states that the requirement of written confirmation of write-offs is burdensome given that insurance examinations cover multiple years and often, in the normal course, occur later than a tax audit. The LB&I directive does not state whether it agrees with the view that the conformity election applies, although the practical effect of the directive is conformity. Also, the directive limits partial bad debt deductions to the credit-impairment component of a statutory write-down.

Perhaps inspired by the adoption of a new regulatory conformity rule for insurance companies, the IRS in Notice 2013-35, 2013-24 I.R.B. 1240, asked for comments on whether changes should be made to Treasury Regulation §§ 1.166-2(d)(1) and (3), which establish a conclusive presumption that amounts charged off for certain bank regulatory purposes should be considered worthless for purposes of claiming bad debt deductions. The Notice asks for comments on whether changes that have occurred in bank regulatory standards and processes warrant changes to the regulations for banks, and also more generally on the types of entities that should be allowed to apply a conclusive presumption of worthlessness.

A directive to examiners from the IRS Large Business and International Division, LB&I-04-1014-008 (October 24, 2014), generally allows banks and bank subsidiaries to treat the credit-related component of charge-offs for GAAP and regulatory purposes as sufficient evidence of the worthlessness of debt instruments (including estimated selling expenses) for purposes of claiming deductions under section 166. The directive may be applied by a taxpayer for 2010-2014 taxable years, with a requirement for conformity in future years. The taxpayer must provide a Certification Statement confirming that the requirements of the directive are met.

A 2012 article argues that a holder of REMIC regular interests should be allowed to show that they are partially worthless under section 166 based on projections of future cash flows from underlying mortgages. The authors object to an IRS position being taken in audits that this method is akin to a reserve method that existed under prior law but is no longer allowed. See Michael Yaghmour and Jeffrey Maddrey, “Partial Worthlessness—Distinguishing the Use of Projections from the Reserve Method,” *Journal of Taxation of Financial Products* (July 2012).

One of the same authors has an earlier article in the same publication discussing more generally how the bad debt rules apply to REMIC regular interests. See Michael Yaghmour, “Bad Debts and REMIC Regular Interests,” *Journal of Taxation of Financial Products* (April 2011). He argues convincingly that holders of regular interests should be allowed bad debt deductions under section 166 (subject to the other requirements of the section) for losses on regular interests to the extent they become partially worthless or worthless if the cause is default losses (as distinguished, for example, from prepayment losses). In other words, the fact that the regular interests take the legal form of trust equity and are entitled only to payments out of available funds should not matter given that they are treated as debt for tax purposes and, as regular interests, must meet be a requirement under section 860G(a)(1)(A) that they unconditionally entitle the holder to receive a specified principal amount or similar amount. Compare the discussion in Chapter 9, Part D.1, in this Supplement regarding the application of section 108 to a REMIC. In support of the view that losses attributable to prepayments are not bad debt losses, the author cites *Quality Chevrolet Company, Inc.*, which is described in Part H.1.f, above, in this Supplement.

The author also argues that if the principal amount of a regular interest is eliminated as a legal claim against the REMIC through a write-down occurring under the contractual terms of the regular interest, then that amount might be treated as the worthlessness in whole or part of the regular interest (as distinguished from partial worthlessness of the whole). This distinction matters because of the requirement of a charge-off for a partial worthlessness deduction and the fact that partial worthlessness deductions are not allowed for nonbusiness debts of taxpayers other than corporations. The author says that he does not intend to address cases where the write down may be reversed under the terms of the contract, which likely would be true in most cases. There is some tension between taking the view that the legal form of a regular interest as trust equity does not matter in deciding if regular interests are the type of debt claims to which section 166 applies (an argument we find convincing) and then arguing that the loss of part of the value of the instrument due to credit losses should be treated differently from the partial worthlessness of conventional debt based on the legal mechanics of a write down which exist because of the equity form.

In an unsurprising Chief Counsel Memorandum, the IRS held that when a REMIC regular interest with respect to which bad debt deductions have previously been taken under section 166 is later sold, the taxpayer must allocate the amount realized first, to the taxpayer's remaining adjusted basis, second, to the amount previously deducted as partially worthless, and finally, to gain, if any, on sale. The amount of the recovery of the prior bad debt deductions is treated as ordinary income in the year of sale; the gain on sale is treated as capital gain except to the extent recharacterized as ordinary under section 860B(c). C.C.M. 20144801F (July 14, 2014).

For an article describing how current tax rules produce inappropriate results for market discount on distressed debt and evaluating reform options, see Ethan Yale, "Taxing Market Discount on Distressed Debt," 2013 *Tax Notes Today* 5-9 (January 8, 2013).

Both the New York State Bar Association and the American Bar Association have submitted reports discussing the anomalies in the current tax treatment of distressed debt and recommending changes. See New York State Bar Association, Tax Section, "Report on the Taxation of Distressed Debt," 2011 *Tax Notes Today* 226-20 (November 23, 2011), and American Bar Association, Section of Taxation, "Options for Tax Reform in the Financial Tax Provisions of the Internal Revenue Code," 2011 *Tax Notes Today* 234-35 (December 6, 2011).

The NYSBA report is directed to the Treasury and IRS and suggests changes in regulations that would define a category of distressed debt and tax that debt under special rules.

The ABA report proposes a number of legislative changes in the tax treatment of financial products, including distressed debt. One of the changes would cap the rate at which market discount would accrue on distressed debt. Some of the proposed changes were included (in modified form) in the financial products tax reform proposals released by the House Ways and Means Committee on January 24, 2012. Information about the proposals (and related comments) may be found on the House Ways and Means Committee web site at http://waysandmeans.house.gov/taxreform/.

There are also proposals (from Congress and the Obama Administration) for legislative changes to the treatment of market discount. In brief, they would cap the rate at which market discount accrues based on a formula (to prevent overaccruals for distressed debt) and allow an ordinary deduction for loss on sale up to the amount of accrued market discount. For a description and analysis, see New York State Bar Association Tax Section, "Report on House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments and Corresponding Proposals by the Obama Administration," 2015 *Tax Notes Today* 45-102 (March 6, 2015).

Add to the end of footnote 254: The 2011-2012 IRS Business Plan lists as a current project, "Regulations relating to accruals of interest (including discount) on distressed debt."

Regarding the requirement of a book charge off to obtain a bad debt deduction (top of page 769), in a panel discussion at the annual Bank and Capital Markets Tax Institute on November 3, 2011, an IRS counsel explained that in 2009, the FASB introduced the concept of other than temporary impairments (OTTIs). The current IRS view is that an OTTI may include anticipated future worthlessness and is therefore not a good standard to use for bad debt deductions. Guidance on the topic will be forthcoming. See Marie Sapirie, "Banks' Bad Debts Discussed by IRS Officials," 2011 *Tax Notes Today* 216-2 (November 8, 2011).

The practical effect of limiting partial bad debt deductions to the amount charged off for book purposes depends on what tests are employed in determining book charge offs. In June 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments—Credit Losses (Topic 326), which when effective (generally not before 2020) will require more timely recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The new method will eliminate the current GAAP requirement that delays recognition of a loss until it is probable that it has been incurred and require instead the recording of expected losses based on historical experience. The change grew out of inadequacies in reporting identified during the 2008 global financial crisis. Information regarding ASU 2016-13 may be found at www.fasb.org.

Add the following comment to footnote 266: Two revenue rulings not cited in the footnote are relevant to whether section 166(d) applies to a corporate partner. One is quite helpful. The other needs to be distinguished. First, Revenue Ruling 79-82, 1979-1 C.B. 141, obsoleted by Revenue Ruling 2003-99, 2003-34 C.B. 388, applies the now-repealed section 333 to determine the amount and character of income of a shareholder from a complete liquidation of a corporation. Section 333 limited the income from a liquidation recognized by a "qualified electing shareholder" to the greater of cash received or corporate earnings. The income was treated (1) as a capital gain in full for a corporate qualified electing shareholder, and (2) for noncorporate qualified electing shareholders as a dividend up to earnings, with the rest being a capital gain. In the ruling, the stock was owned indirectly by an individual and two corporations through a partnership. The ruling holds that the qualified electing shareholder was the partnership because the partnership was the actual shareholder. However, the ruling concludes that the character of the income from the liquidation (capital gain only for corporations or dividend and capital gain for others) is determined for each partner based on the partner's tax status, in reliance on section 702. The ruling is particularly relevant to section 166(d) because it involves a distinction between ordinary income and capital gain that is based on corporate or noncorporate status of a partner and the analysis relies on the general principles of section 702 rather than a specific rule pertaining to section 333. The ruling was "obsoleted" because of the repeal of section 333, but that should not affect the reasoning. Revenue Ruling 93-36, 1993-1 C.B. 187, analyzes how bad debts are treated by an S corporation. Section 1363(b) states that taxable income of an S corporation is computed as for an individual, with exceptions for items described in section 1366(a)(1)(A) having a special status in the hands of particular shareholders and certain other listed items (not including section 166). The language of section 1363(b) is very similar to section 703(a). The ruling holds that the exceptions do not apply to deductions under section 166. Accordingly, S corporation bad debts are treated as if earned by an individual and the limitations on nonbusiness bad debts apply. At the time of the ruling, however, a corporation could not be an S corporation shareholder (section 1361(c)(6) allowing certain tax-exempt shareholders was added in 1996), so in fact bad debts would be treated the same by all shareholders and the special status exception therefore would not apply.

The instructions to Form 1065 and to Schedule D to Form 1065 state in a potentially discouraging way that nonbusiness bad debts should be reported as short-term capital losses when debts become wholly worthless. This language might be explained in one of two ways. First**,** the main case on point in applying section 166 to partnerships is *Cole*, which is cited in footnote 266. It involved a partnership owned by individuals. The main issue in the case was whether partnership loans that went bad were connected with the partnership's business or were subject to the restrictions on nonbusiness bad debts. The court concludes they were nonbusiness loans (the partnership was in the real estate appraisal business). The Form 1065 instructions may have been inspired by the following language in the opinion about testing bad debt deductions at the partnership level:

> "There is no merit to the petitioners' position that, even though the losses here involved do not qualify as business bad debts of their partnership, such losses may nevertheless be deducted as business bad debts by the petitioners individually. In the case of S. Stanwood Menken, 8 B.T.A. 1062, we held that a taxpayer may not take as

> a bad debt deduction on his individual tax return, a proportionate part of a bad debt due to a partnership of which he was a member. We adhere to said principle; and we hold that the nonbusiness bad debts of the partnership are available to the partners individually, only as short-term capital losses, in accordance with section 702(a)(1) of the 1954 Code."

Section 702(a)(1) refers specifically to short-term capital gains and losses. *Menken* involved an individual who was a partner in a law partnership. The firm was owed a fee which was not paid, and the partner deducted his share of it on his individual return. The deduction was denied. The Board said that the deduction should have been claimed through the partnership. The taxpayer presented no evidence about the partnership's treatment of the item (whether it had been included in income or deducted as an offset to other income). So far as the court knew, the partner was seeking to deduct a receivable that had no tax basis because it had never been included in income or that had been included in income and already deducted through the partnership.

Cole did not address one way or the other the treatment of corporate partners. *Menken* is more about claiming a deduction arising from a partnership business without showing the item even existed at the partnership level.

Another explanation for the Form 1065 instruction language may be that the instructions were simply drafted with individual partners in mind. By way of comparison, IRS Publication 550, which deals with the tax treatment of investment income and expenses, also states that deductions are allowed for nonbusiness bad debts only upon full worthlessness and only as short-term capital losses.

In footnote 271, disregard the second paragraph (it is out of place).

b. Market Discount on Highly Speculative Debt

For recent commentary proposing changes to the tax treatment of distressed debt, including the treatment of market discount, see Chapter 8, Part H.2, in this Supplement.

Regarding footnote 274 and the accompanying text, see the comment on a possible Tax Court proceeding testing the scope of *Liftin* and *Underhill* in Part H.3, below, in this Supplement.

With respect to a debt instrument that is a capital asset, if gain on receipt of a principal payment is not treated as ordinary under the market discount rules or on the ground that it represents a payment of interest that has accrued while the debt is held by the taxpayer, then the gain would generally be a capital gain if section 1271(a) applies to the instrument. Specifically, it is clear that a partial principal payment on a debt instrument is considered a payment in partial retirement of debt that can qualify as a sale or exchange under section 1271(a). See the authorities cited in Chapter 8, Part A, in this Supplement. Section 1271(a) was first extended to obligations of individuals in 1997, so reliance on authorities in earlier tax years that assume that gains from the receipt of principal payments on residential mortgages or other consumer receivables are ordinary may be misplaced.

The discussion in the book focuses on the treatment of discount attributable to principal payments, but to avoid ordinary income, it is also necessary to establish that payments received on distressed debt are not considered payments of interest that accrued after the date of purchase. There is a strong argument that they should not be so treated to the extent post-purchase interest would not accrue under the uncollectibility standard. Treasury Regulation § 1.446-2(e) generally provides an ordering rule under which payments on a debt instrument are treated first as interest to the extent of accrued interest and then as principal. Revenue Ruling 2007-32, described above in footnote 260, applies the uncollectibility standard in testing whether interest accrues for purposes of this ordering rule. Thus, interest that accrues under the terms of a debt instrument in respect of a post-purchase period that would not be includible in income because of uncollectibility should be excluded from "accrued interest" in applying the ordering rule to payments received. Note also that Treasury Regulation § 1.446-2(e) measures accrued interest as of the date when a payment is due, not when it is made. Accordingly, in applying the payment ordering rule to a principal payment that is delinquent (which may include a case in which there was a default and acceleration of the maturity date), accrued interest should exclude interest accruing under the instrument after the date when the principal payment became due.

3. Cost Recovery Where Basis Allocation is "Wholly Impracticable"

In a conference call with investors on October 27, 2011 regarding 2011 third quarter earnings, Portfolio Recovery Associates, Inc. indicated that it expects to file a Tax Court petition in the fourth quarter to defend against a deficiency notice relating to the company's use of a cost recovery method to compute income from purchased portfolios of defaulted credit card receivables. According to the call, the company has argued that cost recovery is allowed under the authority of the *Liftin* and *Underhill* cases (cited in footnote 274, above). Interestingly enough, the IRS contends that income should be reported for tax purposes in accordance with GAAP. Under GAAP, a company would calculate a yield for a portfolio based on cost and projected collections and then accrue income using that yield. The yield would be periodically recalculated to reflect performance and updated projections. The Tax Court petition was filed November 3, 2011. The docket number is 25240-11. The petition states that the IRS is seeking a change in accounting method under section 446(b) on the ground that taxpayer's cost recovery method does not clearly reflect income. The petition indicates that Portfolio Recovery Associates, Inc. is one of a small number of buyers of extremely distressed credit card receivables, that it tends to buy portfolios with the highest level of delinquency, and that the average price paid is 3 cents on the dollar. On May 15, 2017, PRA announced that it had reached a settlement with the IRS under which it would in 2017 switch to a new method to recognize net finance receivable revenue starting in 2017, would pay no interest or penalties for prior years, and would include an adjustment in income to account for the difference between the old and new methods over four years (presumably an adjustment from a change in accounting method under section 481). See http://www.nasdaq.com/press-release/pra-group-agrees-to-settle-with-irs-20170515-00492.

Add to footnote 288: A District Court in Arizona, in a decision on two summary judgment motions, did not follow *Fisher* and rejected the argument of a taxpayer who exchanged insurance policies for new policies and stock in an insurance company demutualization that he should be allowed to use a cost recovery method in computing gain from a later sale of the stock. See *Dorrance v. United States*, 877 F. Supp. 2d 827 (D. Ariz. 2012). The court also rejected the government argument that no part of the premiums paid for the insurance policies was attributable to the stock. The court did not decide that cost recovery was never appropriate but said that it should not apply where the value of both parts of the consideration received by the taxpayer (the continuing policies and the stock) could be calculated so that it could be determined if the taxpayer had an overall gain. Also, the taxpayer's method would have allowed him to escape tax on gain realized from appreciation in the stock occurring after it was issued at the cost of reducing basis in insurance policies that likely would never result in additional gain. The District Court indicated that the parties in *Fisher* had framed the issue in that case artificially as a choice between the two extremes of no allocated basis or cost recovery, and in deciding the summary judgment motions the way it did, resolved to have a trial in which the parties could provide information allowing the choice of a middle ground. On appeal, the Ninth Circuit held that the taxpayer had not met its burden of showing that it had paid any amount to acquire membership rights as distinguished from insurance policies, so its basis in stock received was zero. *Dorrance v. United States*, 807 F.3d 1210 (9th Cir. 2015). A District Court in California also declined to follow *Fisher.* In *Reuben v. United States*, 111 AFTR 2d 2013-620 (DC CA 2013), an unreported decision, the court, in two summary judgment motions, held that where a taxpayer received shares in a demutualization and sold them some years later, the open transaction doctrine did not apply. Rather, gain was realized and was computed using a zero basis for the shares sold because the taxpayer was unable to show it had paid anything for the mutual company membership rights.

4. *Modifications of Discount Debt Instruments*

Regulations adopted by T.D. 9599 (September 13, 2012) eliminate the recent sales exception described in the text at footnote 315 where it otherwise would apply to determine the issue price of debt issued in a debt-for-debt exchange (which would include a deemed exchange arising from a significant modification). The change is effective for debt issued on or after November 13, 2012. The preamble notes, in rejecting a comment from one of the authors recommending that the change be delayed until distortions relating to distressed debt be resolved, that such distortions are the subject of a separate guidance project. The regulation is part of a larger package of changes (also effective for debt issued on or after November 13, 2012) that generally expand the circumstances in which debt may be considered publicly traded under Treasury Regulation § 1.1273-2(f) for purposes of the OID rules. However, the regulations have an arbitrary rule (for "small debt issues") in Treasury Regulation § 1.1273-2(f)(6) requiring that debt be part of an issue having an outstanding principal amount exceeding $100 million to be publicly traded. That threshold would almost never be met with respect to securitized receivables without a rule allowing aggregation in defining an "issue." There is no such rule in the regulations. The definition of "issue" is discussed in Chapter 8 at footnote 28 (which is updated in this Supplement).

There are proposals from Congress and the Obama Administration for legislative changes to the treatment of debt instruments. One change would provide for nonrecognition of gain or loss on debt-for-debt exchanges (including deemed exchanges through debt modifications) and thus resolve the problem of recognition of artificial gains. For a description and analysis, see New York State Bar Association Tax Section, "Report on House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments and Corresponding Proposals by the Obama Administration," 2015 *Tax Notes Today* 45-102 (March 6, 2015).

Add to footnote 327: Regulations have been proposed under section 453B that generally allow tax-deferred dispositions of installment obligations in nonrecognition transactions where the obligations are not transferred to the obligor and satisfied. See Proposed Regulation § 1.453B-1(c), REG-109187-11, 2015-2 I.R.B. 277.

5. *Securities Representing a Debt Instrument Combined with Another Financial Contract*

a. *NPCs Generally*

On September 16, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would change the definition of NPC in several ways, effective for contracts entered into after the adoption of final regulations. The amendments would (1) clarify that an NPC requires only two or more payments by one counterparty (and provide that a payment may include an amount fixed on one date even if paid or otherwise taken into account on another date), (2) add credit default swaps to the list of NPCs (even if they are physically settled), and (3) expand the permitted indices on which payments may be based to include a non-financial index (any objectively determinable non-financial information that is not within the control of or unique to any party and is not reasonably expected to front-load or back-load payments accruing under the contract). An example of a non-financial index would be one based on weather.

Section 1256(b)(2)(B) (as added by the Dodd-Frank Wall Street Reform and Consumer Protection Act) excludes from the definition of section 1256 contract "any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement." On September 16, 2011, the IRS issued proposed regulations under section 1256 that would exclude from the definition of section 1256 contract any contract, or option on such contract, that is an NPC as defined in Treasury Regulation § 1.446-3.

On May 7, 2015, the IRS announced temporary, final and proposed regulations that would eliminate the distinction between nonperiodic payments that are significant and those that are not. The temporary regulation is Treasury Regulation § 1.446-3T(g)(4), adopted by T.D. 9719, 2015-21 I.R.B. Under the regulations, with limited exceptions, a notional principal contract with one or more nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and one or more loans. The loan or loans are required to be accounted for by the parties independently of the swap. The time value component associated with the loan or loans is not included in computing income and deductions from the swap. Instead, it is treated as interest for all purposes of the Code. There is an exception (except for purposes of the debt-financed property rules in section 514 and the investment in U.S. property rules of section 956) for a swap with a term of one year or less. There is also an exception for a swap that meets detailed collateral requirements. This exception is generally based on the theory that there is no real loan if a nonperiodic payment is fully repaid through a transfer of collateral. Hopefully the detailed requirements of the collateral exception will be changed to better conform to market practices before the regulations become effective. The new regulations do not specifically address contingent nonperiodic payments (such as those on credit default swaps and total return swaps) or nonperiodic payments arising from payments between the assignee and assignor of an NPC. The new rules (as revised in October 2015 to push off the effective date) are effective for NPCs entered into on or after the later of January 1, 2017, or 180 days after the date of publication of final regulations, but may be applied by taxpayers to NPCs entered into prior thereto. Treasury Regulation § 1.446-3T(j)(2).

Add to footnote 334: The sections that can convert long-term capital gain from an NPC into ordinary income also include section 1260, relating to constructive ownership transactions (including total return swaps) on financial assets. Financial assets include, among other things, equity in a RIC, REIT, trust, PFIC or REMIC.

b. Contingent NPCs

Add to footnote 343: On September 16, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would "resolve uncertainty" by including CDS in the list in the regulations of notional principal contracts, and further clarify that CDS are NPCs even if they provide for physical settlement. The amendments will be effective for contracts entered into after the adoption of final regulations.

c. Call Options

d. Other Consequences of Separate Treatment

6. Integration of Debt Instruments and Hedging Contracts

a. Overview

b. Qualifying Debt Instruments

c. § 1.1275-6 Hedge

d. Identification Requirements

e. Effect of Integration

7. Payment Lags for REMIC Regular Interests

8. REMIC Regular Interests as Investment in United States Property

Add to the end of chapter 8, after part H.8.

9. Re-Pricing

Many CLOs and other non-REMIC securitization vehicles, permit the issuer of the securities to "re-price" the issued notes at a time when they would otherwise be subject to optional redemption. That is, the issuer, at the request of the collateral manager or the holders of the issuer's equity[387] may reduce the interest rate on the notes, in the case of floating rate notes typically by reducing the spread to the interest rate index. Note holders that consent to the re-pricing retain their notes with the new interest rate. Note holders that do not consent to the re-pricing are redeemed, typically at par, with the proceeds of the mandatory sale of their notes to consenting note holders that desire to purchase additional re-priced notes or to third parties in sales arranged by or on behalf of the issuer. Non-consenting note holders are not permitted to retain their notes at their original interest rates.

Assuming the change in interest rate is sufficiently significant, the re-pricing of a note will be treated as a significant modification and the deemed exchange of the "old" pre-re-pricing note for a "new" re-priced note.[388] Assuming such an exchange is not treated as a tax-free recapitalization (discussed below), a consenting holder of a re-priced note would recognize gain or loss equal to the difference between the issue price of the "new" re-priced note over the holder's basis in the "old" pre-re-pricing note. Although the issue price of the re-priced note will often be par, in certain circumstances, where the principal amount of the re-priced note is greater than $100,000,000, it will be the fair market value of the re-priced note.[389] A re-priced note may also be considered to be issued with original issue discount (or bond premium) if the issue price of the re-priced note differs from its stated redemption price at maturity (or par amount).

An exchange of debt instruments issued by a corporation that qualify as "securities" (generally medium to long-term debt) may qualify for non-recognition treatment under section 354 on the grounds that the exchange is a recapitalization under section 368(a)(1)(E). Because notes are subject to re-pricing typically only beginning at the time when they are subject to optional redemption they often will not qualify as securities.

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387 The equity may be in the form of debt instruments and denominated as "income notes" or "subordinated notes" but the equity is not subject to being re-priced. Instead, the benefit of re-pricing, in terms of reduced debt service on the re-priced notes increases the cash flow available to make payments on the equity.

388 The treatment of significant modifications of debt instruments as deemed exchanges is discussed in Chapter 6, Part D.2. A re-pricing would not be treated as a unilateral modification because the note holder is required to consent. See Treasury Regulation § 1.1001-3(c)(3)(ii), discussed in Chapter 6, footnotes 262-265 and accompanying text.

389 The rules for the determination of the issue price of debt issued in a debt-for-debt exchange are discussed in Chapter 8, Part H.2.b.4 (this supplement). Because the notes may not be re-priced without the consent of the consenting note holders and the sale of notes held by non-consenting holders, the new interest rate is likely to be set so that the fair market value of the re-priced notes is likely to be at or near par. So, as a practical matter, there is likely to be little discount or premium.

Chapter 9

Taxation of Holders of Equity Interests in Trust Issuers of Debt and REMIC Residual Interests

A. Introduction

B. Common Tax Characteristics

Add to footnote 9: P.L.R. 201220004 (February 14, 2012) holds that unamortized debt issuance costs are deductible as section 162 expenses, and are not taken into account in computing cancellation of debt income, when debt is discharged in a bankruptcy. That treatment was not changed by the adoption of Treasury Regulation § 1.446-5, which is a timing regulation.

C. Special Considerations Applicable to Trust Issuers

Add to the end of Chapter 9, Part C.

As discussed in Chapter 8, Part H.9 (this supplement), many securitizations, typically CLOs, permit the issuer of the securities to "re-price" the issued notes at a time when they would otherwise be subject to optional redemption. Assuming the change in interest rate is sufficiently significant, the re-pricing of a note will be treated as a significant modification and the deemed exchange of the "old" pre-re-pricing note for a "new" re-priced note.[27a] Assuming such an exchange is treated as a deemed exchange of the "old" pre-re-pricing note for a "new" re-priced note the issuer may have discharge of indebtedness income if the issue price of the new re-priced note is less than the adjusted issue price of the old pre-re-pricing note.[27b] Although the issue price of the re-priced note will often be par, in certain circumstances, where the principal amount of the re-priced notes is greater than $100,000,000, will be the fair market value of the re-priced notes.[27c]

D. Special Considerations Applicable to REMICs

1. REMIC Taxable Income

[27a] The treatment of significant modifications of debt instruments as deemed exchanges is discussed in Chapter 6, Part D.2. A re-pricing would not be treated as a unilateral modification because the note holder is required to consent. See Treasury Regulation § 1.1001-3(c), discussed in Chapter 6, footnotes 261-266 and accompanying text.

[27b] Section 108(e)(10).

[27c] The rules for the determination of the issue price of debt issued in a debt-for-debt exchange are discussed in Chapter 8, Part H.2.b.4 (this supplement). Because the notes may not be re-priced without the consent of the consenting note holders and the sale of notes held by non-consenting holders the new interest rate is likely to be set so that the fair market value of the re-priced notes is likely to be at or near par as a practical matter.

Proposed Regulation § 1.1411-4(g)(13), issued December 2, 2013, would treat REMIC taxable income allocated to the holder of a residual interest as income, and would treat REMIC losses allocated to the holder of a residual interest as an allocated deduction, in computing net investment income that is subject to the 3.8 percent unearned income Medicare contribution tax under section 1411.

At an American Bar Association, Section of Taxation meeting, John Rogers, a senior technical reviewer in the IRS Office of Associate Chief Counsel, argued that a REMIC recognizes ordinary income—but not cancellation of indebtedness income deferrable under section 108—when the REMIC discharges a regular interest at a discount, for example, as a result of a credit loss on a qualified mortgage. Rogers argued that *United States v. Centennial Savings F.S.B.*, 499 U.S. 573 (1991), controlled. In *Centennial*, the court found that a bank had ordinary income, but not discharge of indebtedness income, when a depositor exercised its option to retire a certificate of deposit prior to maturity and the bank imposed a penalty for early withdrawal. The court reasoned that "discharge…of indebtedness" within the meaning of section 108 conveys "forgiveness of, or release from, an obligation to repay" and not a payment contemplated under the agreement. The court contrasted the case before it with a typical discharge case, noting that in the case of a CD, the terms of the CD provide a formula, pursuant to which "the depositor and the bank have determined in advance precisely how much the depositor will be entitled to receive should the depositor close the account on any day up to the maturity date. Thus, the depositor does not 'discharge' the bank from an obligation when it accepts an amount equal to the principal and accrued interest minus the penalty, for this is exactly what the bank is obligated to pay under the terms of the CD agreement." Rogers comments are discussed in Lee A. Sheppard, "REMIC Bad Debt Deductions," 130 *Tax Notes* 608 (February 7, 2011).

In the case of a REMIC retiring a regular interest at a discount on account of a credit loss on the REMIC's mortgages, the question then is whether the failure to pay the full principal amount is more akin to (1) a penalty the holder chooses to accept to exercise an optional prepayment right, which would not give rise to discharge of indebtedness income, or (2) the failure of a debtor to make a required payment on a debt instrument that is fixed in amount solely on account of the debtor's inability to pay, which would. In the authors' view, the latter analysis is more compelling. Although it is true that regular interests often take the form of trust equity and are entitled only to distributions from available assets according to a payment waterfall, that does not mean that the amounts to which holders are entitled absent default are not considered due under the tax law in like manner to payments on conventional debt. Specifically, to qualify as a regular interest a REMIC interest must "unconditionally entitle the holder to receive a specified principal amount" and under regulations, interest payments must also be unconditional with limited exceptions. The fact that an instrument takes the form of equity does not cause payments thereon to be conditional if the issuer is obligated to pay absent a default on its assets. The existence of unconditional payments is part of the rationale for treating regular interests as debt for tax purposes under the REMIC rules. For a discussion of contingencies and regular interests, see Chapter 7, Part D.

2. Limitations on Using REMIC Losses

Add to footnote 60: C.C.A. 201306021 (July 9, 2012), an electronic chief counsel advice, describes in a straightforward way, and illustrates with an example, the loss carryover rule applied to different quarters within a taxable year and across two taxable years. The discussion makes it clear that a loss of a holder from a residual interest that is carried over to a future quarter in which there is otherwise positive taxable income from the residual interest reduces such taxable income for the future quarter for that holder and therefore reduces the amount of excess inclusion income in the future quarter. It also indicates that the taxpayer properly calculated income from residual interests by doing separate calculations for each residual interest and for each quarter within a taxable year.

3. Dispositions of REMIC Interests

Section 1260(a) treats gain from a constructive ownership transaction with respect to an underlying financial asset that otherwise would be long-term capital gain as ordinary income (and imposes an interest charge to compensate for deferral) to the extent such gain exceeds the net capital gain the taxpayer would have had if it had owned the underlying asset directly. Also, if a constructive ownership transaction is closed by taking delivery, the section is applied as if the transaction had been sold (section 1260(f)). Under section 1260(c), a "financial asset" includes an "equity interest in any pass-thru entity," and a REMIC is one type of pass-thru entity. Although not certain, a residual interest is likely to be considered an equity interest in a REMIC for this purpose. A constructive ownership transaction is generally a synthetic long position created under a swap, forward or futures contract, put/call option pair on matching terms, or other contract identified in regulations as having substantially the same effect (section 1260(d)). Because residual interests are generally noneconomic, it is not typical to create derivative interests in them, although they could be the subject of forward contracts.

Add a correction to footnote 66: It is clear that a residual interest is not a security that can be marked to market under section 475. Contrary to the statement in the footnote, the IRS did follow up on the statement in the preamble to the proposed section 475 regulations and issue later guidance holding that a taxpayer cannot use an inventory method under section 471 to account for residual interests, which is Revenue Ruling 95-81, 1995-2 C.B. 70. The ruling makes it clear that its conclusion regarding use of an inventory method does not prevent a residual interest from being property held primarily for sale to customers in the ordinary course of business under section 1221(a)(1) (which before amendment in 1999 was section 1221(1)).

Add to the text after footnote 71: In addition, the wash sale rules apply only where there is an acquisition of substantially identical property by "purchase or by an exchange on which the entire amount of gain or loss was recognized by law."[71a] Thus, the acquisition of a REMIC residual interest by a REMIC sponsor in exchange for qualified mortgages is not an acquisition that would cause the deferral of a loss on disposition of a different residual interest under the wash sales rules.[71b]

4. REMICs as Separate Entities

E. Phantom Income

1. Overview

2. Technical Description

3. Use of Phantom Losses

a. Acceleration of Net Remaining Phantom Losses Through Sales

b. Attempts to Duplicate Losses

4. Special Rules for REMICs—Excess Inclusions

a. Overview

Add a new sentence to the text after footnote 104:

[71a] Section 1091(a).

[71b] The treatment of the exchange by a sponsor of mortgages for REMIC interests is discussed in Chapter 15, Part E.

C.C.A. 201143018 (July 21, 2011) addressed a fact pattern in which a corporation had NOLs that would ordinarily reduce its taxable income to zero and excess inclusions. Its taxable income equaled under section 860E(a)(1) the amount of excess inclusions. The corporation also made charitable contributions. Under section 170(b)(2)(A), charitable deductions of a corporation are limited to 10 percent of a taxpayer's taxable income (defined for this purposes in section 170(b)(2)(C) as taxable income computed without regard to certain items, including carrybacks under section 172 but with no special mention of REMICs). Absent section 860E(a)(1), the corporation's taxable income under section 170(b)(2)(C) would have been zero. As a result, the corporation would not have been allowed a charitable contribution deduction. The contribution would be carried over for up to five years under section 170(d)(2) and allowed as a deduction, subject to income limitations, in the carryover years.

In C.C.A. 201143018, the IRS concludes that for purposes of calculating the 10 percent limitation, taxable income should be computed without regard to the section 860E(a) floor. The rationale given for this interpretation is that "[i]mporting the minimum amount taxed under § 860E(a)(1) into the definition of 'taxable income' under § 170(b)(2)(A) would not further the legislative purpose of ensuring that residual interest holders are currently taxed on a minimum amount of income." It is not clear why the IRS believed this to be true. Even if a charitable contribution were allowed as a deduction under section 170, the taxpayer's taxable income (as reduced by the section 170 deduction) would still equal the amount of excess inclusions. The issue then is not the amount that is currently taxed, but whether the current deduction for charitable contributions is limited by section 170 (and thus is allowed only as a carryover subject to the restrictions in section 170) or instead may be carried back or over under section 172.

C.C.A. 201143018 supersedes C.C.A. 200850027 (December 12, 2008), which had reached the opposite result relying on the plain meaning of the statute. The earlier C.C.A. reasoned: "Under section 860E, the taxable income of a holder of a residual interest in a REMIC is not less than the holder's excess inclusion. Taxable income for purposes of calculating the percentage limitation under § 170(b)(2)(A) on corporate charitable contributions is adjusted only by the items listed in § 170(b)(2)(C). Section 170(b)(2)(C) does not provide an adjustment for EII under § 860E. Therefore, the general rule that the taxable income of a holder of a residual interest in a REMIC is not less than the holder's excess inclusion applies." The 2008 C.C.A. had the stronger argument based on the language of the statute.

b. Definition of Excess Inclusion

Add to footnote 109: On the other hand, because previously disallowed losses of a residual holder carried over from prior periods reduce taxable income of the REMIC allocated to the residual holder, they also reduce excess inclusion income. This is obvious under the statute (which treats a carried over loss as incurred *by the REMIC* in the carryover period), and helpfully confirmed by C.C.A. 201306021 (July 9, 2012), which is described in Chapter 9, Part D.2, in this Supplement.

c. Pass-Thru Entities

d. Surrogate Taxes on Excess Inclusions Allocable to Certain Governmental Entities

(i) *Transfer tax*

(ii) *Tax on pass-thru entities*

e. Certain Tax-Motivated Transfers Disregarded

(i) *Transfers to U.S. persons*

(ii) *Transfers to foreign investors*

f. Flaws in Excess Inclusion Rules

5. Special Rule for REMICs—Negative Value Residual Interests

a. Ownership

b. Inducement Fees

Proposed Regulation § 1.1411-4(g)(13), issued December 2, 2013, would treat inducement fees included as income under Treasury Regulation § 1.446-6(a) as net investment income subject to the 3.8 percent unearned income Medicare contribution tax under section 1411.

c. Sale or Exchange

In *Pilgrim's Pride Corp. v. Comm'r*, 141 T.C. 533 (2013), a taxpayer claimed an ordinary loss from the abandonment of preferred stock in a corporation. The stock had a material (although reduced) value but still was abandoned to obtain an ordinary deduction. The obvious tax motivation may be what sparked the government's interest. The IRS argued successfully (after some nudging from the court) that the loss should be capital under section 1234A, as a loss from the termination of a right or obligation with respect to property. The IRS said that Revenue Ruling 93-80, cited in footnotes 182 and 184, allowing an ordinary deduction from the abandonment of a partnership interest, was effectively obsoleted by the 1997 amendment to section 1234A eliminating the requirement that underlying property be publicly traded. The Fifth Circuit reversed the lower court, holding that section 1234A applies to contractual or derivative rights with respect to stock but not to an ownership interest in stock. *Pilgrim's Pride Corp. v. Comm'r*, 779 F.3d 311 (5th Cir. 2015). The Fifth Circuit noted that the IRS had never revoked Revenue Ruling 93-80 and had continued to rely on it since the 1997 statutory amendment.

d. Negative Basis or Issue Price

Chapter 10

Taxation of Taxable Mortgage Pools and Holders of Equity Interests in Taxable Mortgage Pools

Chapter 11

Special Rules for REITs, Financial Institutions, Tax-Exempts, and Dealers

A. Introduction

B. REIT Income and Assets Tests and Thrift Assets Test

1. General

Comment: The IRS has issued proposed regulations clarifying the REIT definition of real property, mostly in response to questions raised in the private letter ruling process about new asset categories. They are described in Chapter 6, Part B.2.b.(iii), in this Supplement.

Add at the end of footnote 1: Revenue Ruling 2012-17, 2012-25 I.R.B. 1018, holds that a real estate investment trust's investment in a money market fund is an investment in "cash or cash items" for purposes of section 856(c)(4) based on the fact that investments are considered "cash items" under the Investment Company Act of 1940.

Add at the end of footnote 2: P.L.R. 201234006 (May 24, 2012) holds that excess servicing spreads purchased from a mortgage loan servicer by a REIT and representing a fixed percentage of the outstanding principal amounts of the serviced mortgages are interests in mortgages on real property under section 856. The ruling indicates that the analysis is not affected by the fact that the excess servicing rights would end if the servicer were terminated for cause (which is described as a remote contingency), by the ranking of excess servicing spreads compared to the servicer's rights to compensation in the event of mortgagor defaults, by the existence of servicer advances of interest (including interest allocable to the excess servicing spreads), or by the fact that excess servicing spreads may be purchased in advance under forward contracts.

Comment on footnote 2: Revenue Procedure 2014-51, 2014-37 I.R.B. 543, which modifies and supersedes Revenue Procedure 2011-16, 2011-5 I.R.B. 440, adopts two rules attempting to allow a REIT to avoid certain undesirable consequences in applying the REIT income and asset tests to distressed mortgages. The revenue procedure is effective for all taxable years.

The first rule relates to Treasury Regulation § 1.856-5(c), which provides for the apportionment of interest on a loan secured by real property and other property between the portion of a loan secured by real property and the portion not so secured for purposes of the 75 percent gross income test. The real property secured portion equals a fraction (not greater than one) equal to the "loan value of the real property" divided by the "amount of the loan". The loan value of the real property is the fair market value of the real property collateral determined when the REIT first has a binding commitment to make or purchase the loan. The amount of the loan is the highest principal amount of the loan outstanding during the taxable year. If a loan is significantly modified (triggering a deemed exchange of the old loan for a new one under section 1001)) at a time when the underlying real property has declined in value without a corresponding reduction in the loan balance, then under the formula in the regulations, the portion of qualifying interest could drop if the REIT were considered to acquire a new loan. To address this concern in a default case, the revenue procedure provides that a REIT may choose not to treat itself as making a new commitment to make or purchase a loan (requiring a redetermination of the "loan value of the real property") where a loan is significantly modified if (1) the modification was occasioned by default, or (2) based on all facts and circumstances, the REIT or servicer of the loan reasonably believes that (a) there is a significant risk of default of the loan upon maturity or at an earlier date, and (b) the modified loan presents a substantially reduced risk of default as compared with the pre-modified loan. Further, such a modification is not considered a prohibited transaction under section 857(b)(6), which, for a loan, is generally defined as a sale or other disposition of property described in section 1221(a)(1) (dealer property). The new REIT modification rule for distressed debt is similar to the REMIC rule described in Chapter 6, Part D.2.d (which preserves qualified mortgage status following a modification of a loan occasioned by a default or a reasonably foreseeable default).

The revenue procedure describes in some detail the facts that must support a reasonable belief of a significant risk of default:

> This reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the REIT or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is *per se* not foreseeable. For example, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

The second rule in the revenue procedure allows any REIT to treat a loan as a "real estate asset" for purposes of the 75 percent assets test in an amount equal to the lesser of (1) the value of the loan as determined under Treasury Regulation § 1.856-3(a) (which is current fair market value) or (2) the greater of the current value of the real property securing the loan or the loan value of the real property securing the loan. This rule allows a REIT that buys a loan at a discount and that must, under the regulations, revalue the loan over time (because its market value goes up) to take account of increases in the value of the underlying real property collateral (while still being allowed to ignore decreases) in determining how much of the loan qualifies as a real estate asset.

The revenue procedure does not fix the anomaly in the current regulations that determines the portion of the interest on a loan that qualifies as good income for purposes of the 75 percent gross income test by comparing the initial value of real property collateral with the principal amount of the loan (not its value). This formula can result in only a portion of the interest on a discount loan being treated as good income even though the value of real property exceeds or is close to the value of the loan. The IRS was well aware of the issue. Example 2 in the revenue procedure illustrates the problem, holding that when a REIT acquires for $60 a loan with $55 in value of real property collateral and a principal amount of $100, only 55% of the interest is considered income from a real property mortgage.

Revenue Procedure 2014-51 replaced Revenue Procedure 2011-16 to correct an anomaly that lead to the portion of a loan purchased at a discount that qualified as a real estate asset going down as the underlying real property collateral (and correspondingly the value of the loan) increased. The problem is described in Revenue Procedure 2014-51 and had been identified earlier in a letter dated February 3, 2011 to the IRS and Treasury from Tony Edwards of the National Association of Real Estate Investment Trusts. The letter is available at 2011 *Tax Notes Today* 38-23 (February 24, 2011). The 2011 revenue procedure and the broader topic are also discussed in a New York State Bar Association, Tax Section report, "Report on Revenue Procedure 2011-16 (Treatment of Distressed Debt of REITs under Section 856)," 2014 *Tax Notes Today* 49-15 (March 12, 2014).

Add at the end of footnote 3: By way of comparison, Revenue Procedure 2014-20, 2014-9 I.R.B. 614, provides a safe harbor (based it appears in substantial part on Revenue Ruling 2003-65) under which the Service will treat debt secured by equity in a disregarded entity holding real property as "secured by" real property for purposes of section 108(c)(3)(A)) if certain requirements are met. Those requirements are described in Chapter 6, Part B.2.a.(iii), in this Supplement.

Add to the end of footnote 26: Revenue Procedure 2012-14, 2012-3 I.R.B. 296, allows a REIT holding a residual interest in an eligible REMIC (as defined in Notice 2012-5, discussed in Chapter 14, Part E in this Supplement), that reports holding at least 80 percent real property mortgages to treat 80 percent (or the higher reported number) of the residual interest as a real estate asset. The same principle applies to a regular interest except that it can use the 80 percent number as a floor whether or not the REMIC reports on Schedule Qs that it meets the 80 percent threshold.

2. *Uses of REIT Subsidiaries*

C. Tax-Exempt Organizations

D. Life Insurance Companies

E. Debt Instruments Held by Banks and Thrift Institutions

Add to footnote 47: As a complement to section 582(c), section 582(a) allows an ordinary deduction to a bank under section 166 for the worthlessness in whole or in part of "securities" (generally corporate or governmental debt in registered form or with interest coupons) despite the rules in sections 165(g) and 166 that otherwise would allow only a capital loss when a security becomes wholly worthless. For a discussion of section 165(g), see Chapter 8, text at footnote 262. The relevant definition of "bank" is in section 581. It defines a bank as a domestic bank or trust company, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. In *Moneygram International, Inc. & Subsidiaries v. Comm'r*, 144 T.C. 1 (2015), the court held that MoneyGram could not claim ordinary loss deductions on account of the worthlessness of non-REMIC asset-backed securities that were securities under section 165(g) because MoneyGram is not a bank under section 581. Moneygram is engaged in the "money services business," which involves the movement of money primarily through money transfers, money orders, and payment processing services. It is regulated by the U.S. Treasury among others as a person engaged in the money services business but is not regulated as a bank and does not accept deposits. According to the court, Moneygram does not possess the essential characteristics of a bank and a substantial part of its business does not involve receiving bank deposits or making loans. On appeal, the Tax Court decision was reversed and the case remanded in an unpublished decision, 664 Fed. Appx. 386 (5th Cir. 2016). The appellate court said that the Tax Court had adopted overly narrow definitions of deposits and loans, specifically by requiring that they exist for an extended period of time, and remanded the case for further consideration in light of the revised definition (and also to consider the requirement of section 581 that a bank make "loans and discounts" not just loans).

F. Mark-to-Market Rules for Securities Dealers

1. *Overview*

2. *Definition of Dealer*

C.C.A. 201238025 (May 29, 2012) analyzes whether a taxpayer may claim mark-to-market losses under section 475 with respect to positions it held in trust preferred securities ("TruPs"), on the ground that it was a dealer in securities as a result of purchases and sales of TruPs as part of a securitization program. Taxpayer is the holding company for a number of subsidiaries, including Company B, a registered broker-dealer. Taxpayer and Company B were involved in securitizing TruPs. TruPs were instruments that were classified as debt for federal income tax purposes but given some equity credit for non-tax purposes when issued by banks. Taxpayer bought the TruPs from regional bank issuers, held them on its balance sheet for some period, and then sold them to Cayman Island trusts. Company B participated in forming the trusts. The trust assets were used to back different classes of CDOs, which were sold by Company B to unrelated investors. Taxpayer held the TruPs it purchased until enough buyers were found to justify an issuance of CDOs. Taxpayer purchased and sold the TruPs at their face amount, which equaled fair market value. It was compensated for its services by receiving a warehousing fee from the CDO co-issuers. In years 1 and 2, taxpayer did not report income from the TruPs except for interest and the fee. In years 3 and 4 when the financial crisis hit, taxpayer was unable to resell the TruPs and they declined in value in its hands. Taxpayer claimed that even though it had not reported mark-to-market gains or losses in years 1 and 2, it was a dealer in securities in those years and recorded zero gains or losses because factually there were none. As a result, claiming losses in years 3 and 4 did not require IRS approval for a change in accounting method. The CCA accepts the argument, subject to checking taxpayer's explanation for why it had no mark to market gains in years 1 and 2 and establishing that the Cayman trusts, after issuance of the CDOs, were unrelated to taxpayer.

The C.C.A. notes that dealer status is tested on an entity by entity basis so that the securitization or other dealer activities of Company B are not taken into account in determining if taxpayer is a dealer. The definition of dealer in securities in section 475(c)(1)(A) is a person who regularly purchases securities from or sell securities to customers in the ordinary course of a trade or business. The C.C.A. concludes that taxpayer was purchasing TruPs from the regional banks as customers because it stood ready to buy them in anticipation of securitizations. The trusts also qualified as customers (assuming they were unrelated following the issuance of CDOs). The fact that taxpayer's income took the form of fees rather than a trading profit is not fatal to the claim of dealer status. The fees could represent compensation for performing a market making role and intermediating between the banks and trusts. The dealer definition requires regular activity in buying from or selling to customers. The CCA states that the level of required activity depends on the nature of the dealer activity. If the only type of dealer activity is securitizations (as was apparently true for taxpayer), the required activity is less than for other types of dealer activities because of the time required to effect securitizations. The fact that activity slowed down in years 3 and 4 due to market distress did not prevent taxpayer from being a dealer. "The Service should not take the position that a taxpayer no longer qualifies as a dealer because it held securities rather then [sic] sold them at severely distressed market prices during this time." It did not matter that in years 3 and 4 the TruPs were held on the balance sheet as "long investment to corporate bonds" rather than as inventory because they were not identified as held for investment when acquired. The fact that taxpayer was not a registered broker did not matter because section 475) extends beyond broker-dealers.

C.C.A. 201423019 (January 22, 2014) also involved a taxpayer who sought to be a section 475 dealer in order to recognize mark-to-market losses, although the IRS disagreed with the taxpayer's view. The taxpayer was a partner in a partnership that originated and securitized mortgages. The partnership was a section 475 dealer in securities. The partnership transferred some mortgages to Delaware trusts ("DE Trusts") that issued debt to investors under an indenture. The mortgages were serviced by servicers and subservicers under what appear to be conventional loan servicing contracts. The DE Trusts were treated as disregarded entities owned by the partnership (there were some REMICs, but they were not involved in the transactions under review). The partnership sold its ownership interest in the DE Trusts to the taxpayer. In a later year, a subservicer for the mortgages modified some of the loans in response to defaults. The taxpayer argued that this amounted to the origination of new loans, which caused it (as the tax owner of the DE Trusts) to be a dealer in securities.

The C.C.A. disagrees on several grounds. It concludes (correctly) that the partnership's activities in originating loans were not attributable to the taxpayer as a partner. It also concludes that the modification of loans in a default setting was not a dealer activity for the taxpayer. The borrowers likely were customers of the partnership and not the taxpayer, and the modifications were not equivalent to making new loans or sufficiently regular business activities to meet the dealer definition (which requires (1) regularly purchasing loans (2) from customers (3) in the ordinary course of a trade or business). Further, the C.C.A. argues that the servicers were "independent contractors" and not agents of the taxpayer under the applicable tax law standard. The C.C.A. also concludes that the partnership was allowed at its option to follow Proposed Regulation § 1.475(a)-2, which treats the disposition of securities as an occasion for marking them to market. In that case, the partnership would recognize gain or loss from the mark but not from the sale.

3. Definition of Securities

Rep and warranty obligations in mortgage sale contract are not puts: C.C.A. 201529006 (April 8, 2015) holds that book reserve losses of a mortgage originator and seller from breaches of conventional representations and warranties in mortgage sales contracts ("W&R Obligations") could not be treated as section 475 losses on securities. Specifically, the C.C.A. rejects the taxpayer's argument that the W&R Obligations were securities because they were puts (options) on the mortgages (debt instruments) that were sold. The IRS gave four related reasons for this conclusion. The first was the form; the W&R Obligations were not broken out as separate securities in the sales agreements and were conventional terms for sale contracts. There was no separate option premium paid. Further, the agreements committed the parties to report the sales for tax purposes as sales. Taxpayers generally are stuck with their form. (For a general discussion of a taxpayer's ability to disavow form, see Chapter 3, Part E.4.c.) Second, a purchaser could derive value from the W&R Obligations only by following procedures to establish a breach, so the cost of the obligations to the taxpayer depended on factors other than the value of the mortgages. As stated in the C.C.A.: "Thus, unlike the value of options or similar derivative financial instruments, the value of the W&R Obligation is generally driven by non-market forces including things like discovery of a breach, failure to cure, negotiations and the quality of appeal arguments." Third, case law cited in the C.C.A. showed that taxpayers have not been allowed to treat completed sales of property under sales contracts as the granting of options (so that gains could be deferred or not recognized) on the ground that liquidated damages clauses allowed the buyer to default and return the property in exchange for limited payments. Finally, the C.C.A. cites authorities on convertible securities for the proposition that the IRS and courts have refused to treat embedded rights in contracts or financial instruments as options. For a discussion, see Chapter 16, Part E.2.b. The C.C.A. notes that the W&R Obligations were not separately assignable and were mutually dependent on the sales contracts (serving to preserve the bargain struck in the contracts). Fundamentally, the C.C.A. objects to the fact that the taxpayer was seeking to use section 475 to deduct a reserve for conventional warranty claims, which is not generally allowed.

On a similar note, C.C.A. 201132021 (April 26, 2011), involves an owner of an electric generating plant that is an electing dealer in commodities under section 475(f)(2) and a party to a power supply contract. The advice holds that certain provisions in the supply contract that provide for the supply of electricity and payments therefor cannot be separated from the rest of the contract (which is a services contract) so as to be marked to market by the dealer, even though electricity is a commodity.

Structured notes as securities: As noted at footnote 93, the definition of securities does not include a debt instrument issued by the taxpayer. Sometimes securities dealers issue structured notes that have sufficient principal protection to be classified as debt but nonetheless have embedded positions in property (other than debt) so that they change in value based on the value of that property and not traditional debt factors (interest rates and credit spreads). It should be possible for a dealer to mark structured notes of this kind (or at least the non-debt component) to market despite the carve-out for borrowers. This position could be supported by three alternative theories.

First, it seems highly likely that the drafters of the exception in the regulations (which had its origin in the 1993 legislative history) had in mind traditional debt. They simply were saying that section 475 was not intended to change the traditional treatment of funding instruments, which are carried for tax purposes as liabilities based on their adjusted issue price (not a varying amount that depends on market value). Structured notes by contrast are a package consisting of a conventional funding instrument and an embedded derivative. It would be possible to say that the exception is not relevant for that reason or to tease out the position in the derivative and mark it to market separately. As to the latter argument, embedded derivatives within debt instruments are treated as separate positions in property in several areas of the tax law.[100a]

Second, if the structured notes hedge other positions that are marked to market, then Treasury Regulation § 1.446-4 would generally require a matching of the timing of income and deductions from the two positions (either both mark to market or both realization) in order to clearly reflect income.[100b] Often taxpayers would not identify structured notes with a hedge on the ground that it is not necessary, but the IRS has taken the view that identification is not essential under the hedging timing rules.[100c]

Third, mark to market treatment could be justified on the ground that, despite the carve-out in section 475, taxpayers are allowed to use mark-to-market accounting where that method clearly reflects income. This view would be based on (1) the authorities that allow the IRS to force a taxpayer using an accounting method to use a different method only if the taxpayer's accounting method is inconsistent with the Code

[100a] See, e.g., Chapter 16, footnote 87, and Part F.3 (discussing the application of the straddle rules to CPDIs); section 1092(d)(7) (an interest in a nonfunctional currency denominated debt obligation is a position in the nonfunctional currency); Treasury Regulation § 1.246-5(b)(3) (a derivative embedded within a debt instrument is a separate position for purposes of section 246).

[100b] Treasury Regulation § 1.446-4(b) ("To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the timing of income, deduction, gain or loss from the item or items being hedged."). If the mark-to-market gain or loss on offsetting hedged positions is not taken into account on a consistent, matched basis, potentially significant timing distortions of income and loss could arise. See *Bank One Corporation, et al., v. Comm'r*, 120 T.C. 174, 293 (2003), *aff'd in part, vac'd in part & rem'd sub nom. JPMorgan Chase & Co. v. Comm'r*, 458 F.3d 564 (7th Cir. 2006) ("The only practical way to eliminate these large and unpredictable timing distortions arising from a book of short-dated hedges and long-dated customer contracts is to adopt a mark-to-market method of tax accounting.")

[100c] See Revenue Ruling 2003-127, 2003-2 C.B. 1245 (holding that the matched timing rules of Treasury Regulation § 1.446-4 mandatorily apply to every hedging transaction, even if the taxpayer does not satisfy the identification and recordkeeping requirements of Treasury Regulation §§ 1.1221-2(f) and 1.446-4(d)).

and fails to clearly reflect income,[100d] and (2) the authorities that allowed dealers to mark-to-market property before there were specific rules allowing it.[100e]

4. *Exceptions to Mark-to-Market Requirement*

The IRS has undertaken a project to clean up the section 475 regulations. In a comment on this project, the ABA suggested that the special rules in the proposed regulations relating to the identification of securities received by a dealer-sponsor in a securitization would work better if they allowed a new identification of all such securities. See American Bar Association Section of Taxation, "Section 475 "Clean-Up Project," 2015 *Tax Notes Today* 89-17 (May 7, 2015).

5. *Treatment of Gains and Losses*

Add to the end of footnote 116: C.C.A. 201423019 (January 22, 2014), which is described in Part F.2, above, concludes that a securities dealer that sold securities during a taxable year was allowed at its option to follow Proposed Regulation § 1.475(a)-2 and to mark the securities to market immediately prior to the sale.

6. *Securitization Transactions*

7. *Issues in Valuing Securities*

Effect of nonrecourse debt on valuation. Under general tax principles, where property that is collateral for nonrecourse debt is disposed of subject to or in satisfaction of the debt, the amount realized cannot be less than the amount of the liability. See Treasury Regulation § 1.1001-2(a)(1) (amount realized from the disposition of property includes the amount of liabilities from which the transferor is discharged, with an adjustment, if the liability is recourse debt, for cancellation of indebtedness income). Section 7701(g) codifies this rule by providing that in determining the amount of gain or loss with respect to property, the fair market value of the property shall not be treated as being less than the amount of any nonrecourse debt to which such property is subject. C.C.A. 201507019 (June 30, 2014) applies these principles in valuing securities for purposes of section 475. In the advice, the taxpayer, a section 475 dealer in securities, acquired mortgages that were subject to nonrecourse debt and included the amount of the debt in the initial basis of the mortgages. The year-end value of the mortgages (determined without regard to the debt) dropped to less than their basis and less than the balance of the nonrecourse debt, and the taxpayer claimed a loss based on the lower value. The C.C.A. holds that the amount of the debt places a floor on the fair market value of the mortgages for purposes of determining the deemed sale price under section 475(a). The conclusion was based on section 7701(g) and on the classic Supreme Court cases holding generally that nonrecourse debt is included in basis and in the amount realized when property is acquired or sold subject to the debt. The cases are *Crane v. Comm'r*, 331 U.S. 1 (1947), and *Comm'r v. Tufts*, 461 U.S. 300 (1983).

[100d] See, e.g., *Bank One*, 120 T.C. at 288 ("The fact that the Commissioner possesses broad authority under section 446(b), however, does not mean that the Commissioner may change a taxpayer's method of accounting with impunity. For example, the Commissioner may not change a method of accounting which clearly reflects income to another method that the Commissioner believes reflects income more clearly… Nor may the Commissioner change an accounting method that clearly reflects income to a method that does not clearly reflect income."); *Bressner Radio Inc. v. Comm'r*, 3 AFTR 2d 1530 (2d Cir. 1959) ("The problem is not to decide what kind of a system the Commissioner, the Tax Court or the appellate courts might choose to have a taxpayer adopt. The sole question is: does the system actually employed clearly reflect income? Conversely, the question is not: would some other system have been better? Petitioner's accounting method met the statutory test.").

[100e] Prior to the enactment of section 475, common law authorities dating back to the 1920s permitted dealers in commodities and securities to mark their positions to market. See A.R.M. 135, 5 C.B. 67, 69-70 (1921); A.R.M. 100, 3 C.B. 66 (1920); Revenue Ruling 74-223, 1974-1 C.B. 23.

a. Fair Value Accounting for Illiquid Securities

b. Book-Tax Conformity

On April 6, 2011, the IRS issued a highly significant field directive to examiners in LB&I to not challenge the use of values reflected in SEC filed financial statements in calculating fair market values of property under section 475. For SEC filing companies, this directive effectively expands the reach of the book-tax conformity regulations to all valuations reflected in the statements. The directive requires a taxpayer to certify that tax values are consistent with those reported in qualifying financial statements. See 2011 *Tax Notes Today* 68-20 (April 6, 2011).

Chapter 12

Taxation of Foreign Investors

A. Introduction

B. TEFRA Registration Requirements

1. Overview

On March 8, 2012, the IRS issued Notice 2012-20[18a] relating to the HIRE Act changes to the TEFRA rules. The Notice provides that regulations incorporating the guidance described therein will be effective for obligations issued after March 18, 2012, the effective date of the repeal of the Eurobond exception (section 163(f)(2)(B)). Although U.S. borrowers cannot after March 18, 2012 issue debt in bearer form, the Notice provides limited transition relief by reviving the rules for foreign-targeted registered obligations with respect to obligations issued after March 18, 2012 and before January 1, 2014.[18b] This will allow the portfolio interest exemption to continue to apply without a need to collect all of the documentation normally required for registered form obligations. This change is likely to be particularly significant in Japan.

Among other things, the Notice addresses the requirements for a dematerialized or immobilized obligation to be considered to be issued in registered form. In this context, an obligation is "dematerialized" if no physical securities are issued and "immobilized" if a physical security is issued but only to a clearing organization and, in each case, absent certain specified triggering events, no physical securities are made available to investors. The Notice clarifies how issuers that want to issue debt instruments that are nominally in bearer form, which is often required for reasons unrelated to U.S. tax, may arrange for them to be treated as issued in registered form for U.S. tax purposes.

The Notice provides that the Treasury and IRS intend to issue regulations providing that an obligation will be considered to be in registered form if it is issued through either (i) a dematerialized book entry system in which beneficial interests are transferable only through a book entry system maintained by (or on behalf of) a clearing organization or (ii) a clearing system in which the obligation is effectively immobilized. An obligation will be considered to be effectively immobilized if: (1) the obligation is represented by one or more global securities in physical form that are issued to and held by, or on behalf of, a clearing organization for the benefit of purchasers of interests in the obligation under arrangements that prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms; and (2) beneficial interests in the underlying obligation are transferable only through a book entry system maintained by, or on behalf of, the clearing organization. There is no requirement that the clearing organization maintaining the book entry system for a dematerialized or immobilized obligation be an agent of the issuer.[18c]

[18a] 2012-13 I.R.B. 574.

[18b] See Chapter 12, footnote 5, and Treasury Regulation § 1.871-14(e).

[18c] Compare Treasury Regulation § 5f.103-1(c)(1), discussed in Chapter 12, footnote 5, which requires that a register or book entry system be maintained by the issuer or its agent. Clearing organizations typically operate

Notwithstanding the requirement that transfers of beneficial ownership in an obligation must be effected through a book entry system, holders are permitted to have the right to get physical bearer certificates in the following circumstances without jeopardizing the registered form status of the obligation: (1) termination of the clearing organization's business without a successor; (2) default by the issuer; or (3) at the issuer's request upon a change in tax law that would be adverse to the issuer but for the issuance of physical certificates in bearer form.

Upon the occurrence of a triggering event that would permit a holder to get physical bearer certificates, an obligation becomes a bearer obligation for tax purposes from that point forward, regardless of whether the option to obtain a physical bearer certificate has actually been exercised. The Notice provides no guidance regarding the consequences of the change in status, so they are somewhat uncertain. For an issuer, it appears that the most significant consequence of an obligation becoming bearer for U.S. tax purposes would be the prospective loss of interest deductions. This is a concern for U.S. issuers and CFCs, whose deductions ultimately may flow through to U.S. shareholders. For a non-U.S. investor, the most significant consequence would be the loss of the portfolio interest exemption, although the issuer may bear the cost of a withholding tax through a gross-up. For a U.S. investor (including certain indirect U.S. investors), the most significant consequence would be the denial of deductions for any loss on the obligation and the conversion of any capital gain to ordinary income.[18d]

The excise tax under section 4701 applies only to a person that "issues" an obligation in bearer form. Thus, although the notice is not clear, it is likely that the conversion of an obligation from registered to bearer form pursuant to the delivery of definitive bearer form obligations as described above would not result in the imposition of the excise tax.[18e]

2. Asset-Backed Securities

In P.L.R. 201504004 (October 3, 2014), the IRS concluded that the special rule for pass-through certificates applied to commercial mortgages held by a trust that issued beneficial ownership interests in registered form, despite the fact that the trust was a disregarded entity (owned by a partnership) and not a grantor trust. The interests in the partnership were also in registered form. The ruling indicates that it is not addressing application of the portfolio interest exemption, but it is very likely the taxpayer sought the ruling in order to confirm that the exemption applies. A New York State Bar Association letter analyzes the ruling and requests that its holding be confirmed (1) through a change in the definition in regulations of the term "pass-through certificate" or (2) by issuing new regulations treating as a book entry system an investor-established arrangement for holding debt that is not registration required. See New York State

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as agents of the holders, not the issuers. The Notice as originally issued included a cross-reference to the prior law definition of a book entry system that was read by some to import the requirement that the system be maintained by an agent of the issuer, but the cross-reference was deleted when the Notice was published in the Internal Revenue Bulletin, apparently to remove any doubt.

Prior to the issuance of Notice 2012-20, when issuers needed to issue securities nominally in bearer form but in registered form for U.S. tax purposes, some issuers persuaded some clearing organizations to act as agents of the issuer as well.

[18d] The sanctions for U.S. holders are discussed in Chapter 12, footnote 9. As discussed therein, exceptions apply if the issuer is subject to the excise tax discussed immediately below in the text and in Chapter 12, footnote 8 and if certain other limited exceptions apply.

[18e] Because the conversion to bearer is treated as occurring upon the occurrence of a triggering event (without regard to whether any holder exercises the right to acquire physical certificates), the conversion is likely to be treated as an alteration occurring by operations of the terms of the debt instrument under Treasury Regulation § 1.1001-3(c)(2) and thus not a modification. Even if the conversion were treated as a modification, because no payment or other economic terms of the debt instrument are changed, it is likely that the conversion would not be "economically significant" within the meaning of Treasury Regulation § 1.1001-3(e)(1). Hopefully, future regulations will confirm this analysis.

Bar Association Tax Section, "Systems for Holding Consumer and Privately Negotiated Loans in Registered Form to Qualify for the Portfolio Interest Exemption," 2015 *Tax Notes Today* 58-18 (March 25, 2015). Two more recent rulings applying similar reasoning are P.L.R. 201614026 (January 5, 2016) (partnership holding student loans) and P.L.R. 201610015 (November 24, 2015) (performing, re-performing, and non-performing mortgages). The IRS is actively working on regulations to update the definition of registered form and the topic is on the 2016-2017 Business Plan under Financial Institutions and Products. See www.irs.gov/uac/priority-guidance-plan.

C. Withholding Tax

1. Overview

Add to the end of footnote 38: The special rules for RIC dividends in section 871(k) were made permanent (after some interim extensions) by the Protecting Americans from Tax Hikes Act of 2015.

Add to footnote 50: To meet the certification requirements to avoid withholding taxes, a foreign partnership must provide an IRS Form W-8 IMY that includes certifications from its partners. See Part C.4, below, in this Supplement.

2. Portfolio Interest Exemption

3. Swaps, Rents, Options, and Debt-Related Fees

a. NPC Income

Add to footnote 87: The IRS has issued a series of final and temporary regulations under section 871(m) that may be found at Treasury Regulation §§ 1.871-15 and 1.871-15T. There are also related regulations regarding tax withholding under section 1441. The latest batch were issued on January 19, 2017 and adopted by T.D. 9815. The IRS also issued Notice 2016-76 at the end of 2016 to describe effective dates and a transition period for implementation of section 871(m) and related withholding rules. A detailed description of these regulations is beyond the scope of this book. In broad terms, section 871(m) itself treats as dividend equivalent payments (the type of payments that are subject to U.S. withholding tax) payments on certain NPCs identified as specified notional principal contracts in section 871(m)(3). They are generally contracts that are linked in certain ways to underlying U.S. stocks. The regulations expand the categories of contracts that produce dividend equivalent payments to include notional principal contracts and other instruments linked to stock that have a delta (measuring variations in the value of the instrument compared with the underlying stock) as of the date of issuance or significant modification of at least 0.8. Subject to an anti-abuse rule, withholding is generally required for these additional contracts if they are entered into on or after January 1, 2017 and have a delta of one, and otherwise are entered into on or after January 1, 2018.

Add to footnote 89: On September 16, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would "resolve uncertainty" by including CDS in the list in the regulations of notional principal contracts, and further clarify that CDS are NPCs even if they provide for physical settlement. The amendments will be effective for contracts entered into after the adoption of final regulations.

b. Rents

c. Option Income

On September 18, 2015, the IRS published final and temporary regulations under section 871(m). The regulations may apply to options the exercise price of which is adjusted to take account of dividends, including taking account solely of extraordinary dividends. The regulations apply to payments on or after

January 1, 2017 for options issued on or after such date. For purposes of section 871(m), the lapse of an option is treated as a payment.

d. Debt-Related Fees

For a general survey of the types of debt-related fees and their tax characterization, see David H. Shapiro, Michael Yaghmour, and Ryan Schneider, "A Tax Field Guide to Debt-Related 'Fee' Income," 2014 *Tax Notes Today* 106-8 (June 3, 2014).

Replace first sentence in the last paragraph on page 987 with: Commitment fees are paid by a prospective borrower for an agreement of a prospective lender to lend on agreed terms.

Comment on footnote 105: In addition, in F.A.A. 20151704F (November 21, 2014), the IRS determined that a payment made to note holders for consenting to amendments to the indenture for the notes was a payment on the notes, and under Treasury Regulation § 1.1275-2(a), first a payment of previously accrued OID and second a payment of principal. Similarly, P.L.R. 201105016 (October 19, 2010) holds that fees paid to holders of notes to consent to a business reorganization were "payments under a loan" within the meaning of Treasury Regulation § 1.446-2(e)(1), and therefore first payments of interest to the extent of accrued and unpaid interest and then a payment of principal, where the fee payment and other changes did not amount to a significant modification under section 1001. The principal repayment reduced the adjusted issue price of the notes, with the result generally that the fees would ultimately be treated as additional income (perhaps OID) on retirement of the notes. See Treasury Regulation § 1.1272-1(b)(4)(ii) (OID allocable to final accrual period is the excess of the amount payable at maturity over the adjusted issue price). Under this analysis, the consent fees generally would not be subject to withholding tax because they would be treated as either a return of capital or as interest eligible for the portfolio interest exemption. P.L.R. 201431003 (January 28, 2014) also treats the payment on a CPDI of a consent fee in connection with a reorganization as an additional payment on the notes which, under the CPDI rules, when added to other amounts received and compared to the notes' projected payment schedule, is treated as additional OID.

The Tax Court's decision in *Container Corporation v. Comm'r*, discussed in footnote 108 and the accompanying text, has been affirmed by the Fifth Circuit in an unpublished decision (Docket No. 10-60515, May 2, 2011).

Treasury Regulation § 1.863-10, adopted on February 21, 2012 by T.D. 9579, effectively exempts from withholding tax "fails charges" paid to compensate a purchaser of certain "designated securities" for a failure to deliver the security in settlement of a trade if the payment is made in accordance with a trading practice or similar guidance approved or adopted by either an agency of the United States government or the Treasury Market Practices Group. The regulation sources the fee income based on the residence of the payee (or of a qualified business unit of the payee), unless the income is effectively connected with a U.S. trade or business. The definition of designated security includes debt of the U.S. Treasury, Fannie Mae, Freddie Mac, or any Federal Home Loan Bank, and pass-through mortgage-backed security guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. The relief is available for fails charges paid or accrued after December 8, 2010. Earlier guidance was limited to U.S. Treasury debt.

Replace Chapter 12, Part C.4 with the following:

4. Withholding Agents |Heading 3|ZZMPTAG|

The tax on U.S. source FDAP income is required to be collected and paid over to the government by any person that makes a payment to a foreign person or its agent.[28] There may be more than one

[28] See Treasury Regulation §§ 1.1441-1(b)-1T(b) (general rules of withholding) and -7(a) (definition of withholding agent). The rules for withholding of income taxes on nonresident aliens and foreign corporations discussed in this Part C.4, sections 1441-1446, are codified in chapter 3 of subtitle A of the Code.

withholding agent, but the tax need be collected only once.[29] No withholding is required with respect to payments to certain classes of non-U.S. persons (most often foreign financial institutions or partnerships) that have assumed responsibility for the withholding of U.S. tax in the manner prescribed in regulations.[30]

A withholding agent may treat a payment as exempt from withholding tax, or may withhold at a reduced rate, only if the agent can "reliably associate the payment with documentation" showing that the payee is a U.S. person or is eligible for the exemption or reduced rate.[31] The documentation used to establish entitlement to either the portfolio interest exemption (where a debt obligation is in registered form) or a reduced rate of tax under a tax treaty is most often a Form W-8BEN (for individuals) or Form W-8BEN-E (for entities).[32] An entity claiming treaty benefits is required to certify that it satisfies the "limitation on benefits" article of the relevant treaty and is deriving the income as a resident of the relevant jurisdiction.[33] A taxpayer identification number is required to claim a treaty exemption, with an

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Accordingly, this type of withholding is sometimes referred to as *chapter 3 withholding.* The rules for withholding under FATCA, which are described in Part E, below (in this Supplement), are codified in chapter 4, and FATCA withholding is sometimes described as *chapter 4 withholding.*

29 Treasury Regulation § 1.1441-7(a).

30 See Treasury Regulation §§ 1.1441-1(b)(1), (e)(5), -5(c)(2) and (e)(5)(v). These regulations allow foreign partnerships and foreign simple and grantor trusts to enter into agreements with the IRS to become a "withholding foreign partnership" or "withholding foreign trust" and assume direct responsibility for withholding taxes and related reporting. Revenue Procedure 2017-21 has the current version of the withholding foreign partnership agreement and withholding foreign trust agreement.

31 Treasury Regulation § 1.1441-1(b)(1). When a form (referred to in the regulations as a withholding certificate) such as a Form W-8BEN or W-8BEN-E, discussed below in the text, is not provided, documentary evidence may in many cases be used to claim treaty benefits. The documentary evidence that may be used for an individual includes any documentation that includes the individual's name, address, and photograph, is an official document issued by an authorized governmental body (e.g., a government or agency thereof, or a municipality), and has been issued no more than three years prior to presentation to the withholding agent. For a person other than an individual, documentary evidence for this purpose is any documentation that includes the name of the entity and the address of its principal office in the treaty country, and is an official document issued by an authorized governmental body. Treasury Regulation § 1.1441-6(c)(4).

Similar rules apply for purposes of portfolio interest, in the case of interest paid outside the United States with respect to an "offshore obligation." See Treasury Regulation §§ 1.871-14(c)(4), 1.1441-1(e)(1)(ii)(2) and 1.6049-5(c)(1). For this purpose, an "offshore obligation" is (1) an account maintained at a non-U.S. office or branch of a bank or other financial institution, or (2) an obligation, contract, or other instrument with respect to which the payor is either engaged in business as a securities broker or dealer or a financial institution that engages in significant activities at a non-U.S. office or branch. The types of documentary evidence that may be used for such purpose differ somewhat from that described in the preceding paragraph for treaty purposes. See Treasury Regulation §§ 1.1471-3(c)(5)(i) and 1.6049-5(c)(1)(i).

32 See Treasury Regulation §§ 1.871-14(c)(2) and 1.1441-1(b)(4)(i) (portfolio interest); Treasury Regulation §§ 1.1441-1(b)(4)(xv), (e)(2), -6(b)(1) and -6T(b)(1) (treaties); see also instructions for Forms W-8BEN and W-8BEN-E. Form W-8ECI is used to avoid withholding tax where a foreign investor receives income effectively connected with a U.S. trade or business. Form W-8EXP is used by certain foreign tax-exempt entities, including governments and governmental entities that are exempt from tax under section 892. Form W-8IMY is discussed below in the text.

The forms used to avoid chapter 3 withholding tax are also used for purposes of establishing an exemption from withholding under FATCA, discussed in Part E, below, although some of the specific rules and periods of validity differ in the two contexts.

33 These additional certifications are incorporated into the treaty certifications in Form W-8BEN-E. Entities relying on documentary evidence to establish treaty eligibility must provide these certifications in addition to the documentary evidence. Treasury Regulation §§ 1.1441-6T(c)(5)(i) and 1.1441-6(c)(5)(ii).

exception for interest income paid on debt obligations that are "actively traded."[34] In the case of asset-backed securities backed by underlying receivables that are taxed on a look-through basis, it is not clear if the actively-traded test would be applied only to the securities (which would make sense as a policy matter), or also to the underlying receivables (which often would not themselves be actively traded).

A Form W-8BEN or W-8BEN-E is generally effective for the year in which received and the following three years, or for an indefinite period (other than for the purpose of claiming treaty benefits or an exemption for effectively connected income) if the beneficial owner provides documentary evidence of its foreign status.[35] A withholding agent may not rely on certifications which the agent knows or has reason to know are unreliable or incorrect.[36]

A withholding agent may make payments to an intermediary who will pay or distribute the income to the ultimate beneficial owner (the person treated as the taxpayer for U.S. tax purposes). Where the intermediary has become a *qualified intermediary*—by entering into an agreement with the Service setting forth procedures for collecting information from those beneficial owners and agreeing to specified audit procedures—then, the withholding agent may accept a certification from the intermediary to the effect that the relevant exemption or tax reduction is available.[37] The certification does not identify the beneficiaries to the withholding agent, and the intermediary is responsible for maintaining records identifying the beneficiaries and establishing their entitlement to the exemption.[38]

Entities that are classified as partnerships generally do not file a Form W-8BEN-E.[39] Instead, they file Form W-8IMY.[40] That form must include a withholding statement containing, among other things, the name, address, TIN, if any, and the type of documentation (e.g., Form W-9 or type of Form W-8) for every person from whom documentation has been received by the partnership and whether that person is a U.S. exempt recipient, a U.S. non-exempt recipient, or a foreign person. Documentation (e.g., Form W-8BEN) from the partners generally must be attached to, or otherwise associated with, the partnership's

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34 Treasury Regulation §§ 1.1441-1(e)(4)(vii)(A) and -6(c). For income that does not qualify for the "actively traded" exception, a foreign taxpayer identification number may be provided in lieu of a U.S. taxpayer identification number. Treasury Regulation § 1.1441-6(c)(1).

35 Treasury Regulation §1.1441-1(e)(4)(ii). Very generally, a payor may treat a payment as exempt from withholding if it has been provided a withholding certificate (such as a Form W-8BEN or W-8BEN-E) *or* has other documentary evidence of status of the payee. For Form W-8BEN or W-8BEN-E to be valid indefinitely, however, the payor must have documentary evidence in addition to the form. In addition, in the case of documentary evidence submitted by an individual, the withholding agent must not have certain specified information that could contradict a claim of foreign status (e.g., a current U.S. residence address). See Treasury Regulation §1.1441-1(e)(4)(ii)(B)(1).

36 Treasury Regulation §§ 1.1441-6(b)(1), and 1.1441-6T(b)(1)(i). A withholding agent should not be required, however, to make substantial inquiries in determining whether a non-U.S. payee is entitled to a claimed reduction in the withholding tax rate. See *The Int'l Lotto Fund v. Virginia State Lottery Dep't*, 800 F. Supp. 337 (E.D. Va. 1992), rev'd on other grounds, 20 F.3d 589 (4th Cir. 1994). See also P.L.R. 9237004 (April 8, 1992).

If a withholding agent receives a Form W-8BEN or W-8BEN-E after a payment is made, that form may, in certain cases, be valid to establish the relevant withholding tax relief. See Treasury Regulation §1.1441-1(b)(7)(ii)(A).

37 The current version of the Qualified Intermediary Agreement is in Revenue Procedure 2017-15.

38 Treasury Regulation §§ 1.1441-1(e)(3)(ii) and (5)(v).

39 But see footnote 20, below, and accompanying text. In certain circumstances, foreign partnerships that are not treated as fiscally transparent in their home jurisdictions may claim treaty relief in their own name, by filing Form W-8BEN-E. See Treasury Regulation § 1.894-1(d)(1) and (5), Example 3.

40 Intermediaries, including qualified intermediaries (discussed above in the text), that hold securities on behalf of others also file Form W-8IMY but the withholding statements differ. Most notably, a qualified intermediary is not required to identify the beneficial owners for whom it receives payments.

Form W-8IMY.[41] In addition, the withholding statement must allocate each payment, by income type, among the partners and must specify the rate of withholding to which each partner is subject, the partner's country of residence and, if a reduced rate of withholding is claimed, the basis for that reduced rate (e.g., treaty benefit or portfolio interest exemption).[42] In general, a Form W-8IMY remains valid indefinitely, until there is a change in circumstances that makes the information on the certificate no longer correct. The indefinite validity period does not extend, however, to anything else associated with the certificate, such as the partners' withholding certificates and the withholding statements.[43]

In general, a disregarded entity does not provide a withholding agent with a Form W-8BEN-E or W-9. Instead, the sole owner of the disregarded entity provides the withholding agent with the form appropriate to that sole owner.[44]

Foreign trusts issuing pass-through certificates are rarely used in securitizations. Where one is used, whether it uses a Form W-8BEN-E or W-8IMY or forms provided by its tax owners (under the grantor trust rules) depends on how it is classified. If it is a corporation, then it would provide a Form W-8BEN-E on its own behalf. If it is a partnership, then the rules described above requiring use of a Form W-8IMY apply. If it is a grantor trust, then it appears that for purposes of chapter 3 withholding, the payees of payments made to the trust would be the persons who are considered trust owners under the grantor trust rules rather than the trust itself.[45]

The treatment of non-U.S. holders of equity in a TMP is discussed in Chapter 10, Part C.

D. FIRPTA

Add to the text following footnote 126: In the case of a publicly traded REIT, section 897(k), added by the PATH Act of 2015, increases the maximum portion of the stock that may be owned to ten percent.[126a]

E. FATCA Reporting and Withholding Tax

1. Introduction

The FATCA regime (more formally the Foreign Account Tax Compliance Act) was enacted in 2010 by the HIRE Act and generally became effective in 2014. FATCA requires certain foreign financial institutions and other foreign entities to provide information to the IRS regarding U.S. persons who hold financial assets, directly or indirectly, through the reporting entities. The regime uses the threat of a withholding tax on U.S. source income as the lever to compel reporting. The FATCA rules are found in

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41 Treasury Regulation § 1.1441-5(c)(3)(iii). Documentation from the partners is not, however, required to be attached to a form from a partnership if the partnership is a withholding foreign partnership or if the relevant income is effectively connected income. Treasury Regulation § 1.1441-5(c)(2)(i) and (3)(iii).

42 Treasury Regulation §§ 1.1441-1(e)(3)(iv)(C), -5(c)(3)(iii) and (iv).

43 Treasury Regulation § 1.1441-1(e)(4)(ii)(B)(10).

44 A disregarded entity is sometimes required to use a Form W-8IMY to avoid withholding under FATCA (discussed in Part E, below, in this Supplement). See Treasury Regulation § 1.1471-3(a)(3)(v)-(vii); Instructions to Form W-8IMY.

45 Treasury Regulation § 1.1441-5(e)(3)(i). For a discussion of the grantor trust rules, see Chapter 5, Part B. The treatment of trusts under FATCA is discussed in Part E, below (in this Supplement).

126a The PATH Act of 2015 also added section 897(l) to provide that FIRPTA does not apply to sales of stock in, or distributions from, a REIT to a "qualified foreign pension fund." The exemption from withholding for distributions paid by a REIT to a qualified foreign pension fund applies only for purposes of FIRPTA. Section 897(l) does not exempt from withholding taxes generally dividends paid by a REIT to a qualified foreign pension fund.

sections 1471 through 1474 and voluminous regulations thereunder, in other IRS guidance, in related agreements between the United States and other countries, and in implementing rules in the other countries.

This Part E.1 provides an introduction to FATCA. The remaining sections of Part E discuss: the practical effect of FATCA on securitization vehicles, FATCA definitions, FFIs, NFFEs, and IGAs (all terms of art described in this introduction), and effective dates (including grandfather rules that apply generally, and also specifically to securitization vehicles).

FATCA imposes a 30 percent withholding tax on certain "withholdable payments" made to a "foreign financial institution" (*FFI*), whether or not the FFI is the beneficial owner of the payment, unless the FFI enters into an agreement (*FFI Agreement*) with the Service that obligates it, among other things, to collect and report to the Service information about United States accounts, or an exemption applies.[46] One of the most important exemptions is for an FFI that complies with a law in its home country requiring it to report similar information to that country's taxing authority, which then is obligated to forward the information to the Service pursuant to an intergovernmental agreement (*IGA*) between the United States and that country.[47]

The definition of FFI includes, in addition to conventional financial institutions, a broad range of entities holding investment assets with professional managers, and thus most foreign securitization vehicles.

Withholdable payments generally are payments of U.S. source FDAP income (thus including interest or dividends).[48] However, they also include the gross proceeds of sale of property that produces withholdable payments in the form of interest or dividends. Also, an FFI may be required to withhold on certain "passthru payments" it makes to an FFI or account holder not complying with the FATCA rules. Passthru payments are payments made by an FFI that are attributable to withholdable payments received by the FFI.

FATCA also imposes a 30 percent withholding tax on a withholdable payment made to any foreign entity that is not an FFI (referred to as a "non-financial foreign entity" (*NFFE*)) that is the beneficial owner of the payment, unless the withholding agent receives a certification as to the ownership of the NFFE by U.S. persons or an exception applies.[49]

Under either an FFI Agreement or the modified rules of an IGA, FFIs are generally required to (1) register with the Service and obtain a "global intermediary identification number" (*GIIN*), (2) collect information from their clients and investors, (2) perform diligence on them to determine their U.S. or foreign status (and in some cases the U.S. or foreign status of their clients' and investors' investors), (3) report to the Service (or, pursuant to an IGA, their home country taxing authority) information about the accounts and investments of their U.S. clients (and in some cases the U.S. investors of their clients and investors), and (4) in some cases, withhold on passthru payments made to non-compliant account holders. For financial institutions with a large retail client base, complying with these requirements can be extremely burdensome. It is less of a burden for securitization vehicles for the reasons given below.

The withholding tax generally became effective in 2014, with a grandfather rule for obligations outstanding on July 1, 2014.[50] FATCA withholding on gross proceeds is delayed until 2019. Withholding on ''foreign pass-thru payments" will start only after regulations are adopted addressing those payments.

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[46] Section 1471(a).

[47] See Section 1471, Model 1 IGA.

[48] FDAP income is defined in Part C.1, above, and in the Glossary.

[49] Section 1472.

[50] A more detailed description of effective dates (with citations) is in Part E.7, below.

The FATCA withholding tax is distinct from the regular 30 percent withholding tax on U.S. source FDAP income paid to non-U.S. investors, which is discussed in Part C, above. To show their separateness, they are in different chapters of subtitle A, the income tax subtitle of the Code (Chapter 3 for the regular withholding tax, Chapter 4 for FATCA).

Unlike Chapter 3 withholding, FATCA focuses on payments to foreign entities (not individuals), and has as its goal identifying ultimate U.S. (not foreign) owners of the payments (both individuals and closely held corporations) who may be hiding behind foreign entities. Consistent with this goal, the rules generally require the reporting to the Service of the identities of the U.S. owners and the existence and size of accounts and gross payments rather than income amounts.[51] Further, the required reporting is not limited to U.S. source payments. Thus, an FFI receiving U.S. source payments may be compelled by the threat of withholding on those payments to report on accounts of U.S. persons earning foreign source income. Congress clearly viewed the withholding taxes on U.S. source income as a club to impose a broader range of reporting and withholding obligations.[52]

Chapter 4 taxes that are withheld may be refunded or credited if the beneficial owner is entitled to a reduced rate of withholding pursuant to an income tax treaty with the United States, or, in the case of a beneficial owner that is an NFFE, it certifies that it does not have any substantial U.S. owners, identifies its substantial U.S. owners or provides documentation establishing that withholding was not required.[53]

The FATCA regime is a blend of domestic and international law. The Code rules are modified by IGAs. The IGAs now in effect are based on one of two models, Model 1 and Model 2. For a country that enters into a Model 1 IGA (a *Model 1 Partner Country*), a country resident FFI (a *Model 1 FFI*)[54] must register with the IRS and get a taxpayer identification number, but it is not required to enter into an FFI Agreement. Instead, the Model 1 FFI is required to comply with the reporting, withholding, and other obligations delineated in the applicable IGA. Two versions of the Model 1 IGA were released. One provides for an automatic reciprocal exchange of information by the United States and the Model 1 Partner Country. The other, non-reciprocal version provides for a flow of information only from the Model 1 Partner Country to the United States. For a country that enters into a Model 2 Agreement (a *Model 2 Partner Country*), a country resident FFI (*Model 2 FFI*) must still register with the Service and enter into and comply with an FFI Agreement, but it is permitted and required by its home country law to do so.[55] The two types of IGAs are discussed in more detail in Part E.6, below.

The United States and the United Kingdom entered into the first IGA, based on the reciprocal version of the Model 1 IGA, on September 12, 2012.[56] Since that date, the United States has negotiated 113 additional IGAs.[57] The Cayman Islands, the most significant place of organization for offshore

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[51] Section 1471(c).

[52] A report by the staff of the Joint Committee on Taxation, Tax Compliance and Enforcement Issues with Respect to Offshore Accounts and Entities (JCX-23-09), March 30, 2009, which is available at www.jct.gov, describes the issues, and certain abuses, that led to enactment of the FATCA rules.

[53] Treasury Regulation § 1.1474-5(a).

[54] U.S. Treasury Department, Treasury Releases Model Intergovernmental Agreement for Implementing Foreign Account Tax Compliance Act to Improve Offshore Tax Compliance and Reduce Burden (July 26, 2012), available at http://www.treasury.gov/press-center/press-releases/Pages/tg1653.aspx.

[55] Model 2 IGA, Article 2.1(a).

[56] U.S. Treasury Department, Treasury, United Kingdom Sign Bilateral Agreement to Improve Tax Compliance, Combat Offshore Tax Evasion and Implement FATCA (September 14, 2012), available at http://www.treasury.gov/press-center/press-releases/Pages/tg1711.aspx.

[57] As of May 24, 2017, there were a total of 77 IGAs in effect (71 Model 1 IGAs and 6 Model 2 IGAs). An additional 19 IGAs (16 Model 1 IGAs and 3 Model 2 IGAs) have been signed but not yet fully brought into effect. The United States also has reached an agreement in substance with an additional 17 countries (13 in respect of Model 1 IGAs and 4 in respect of Model 2 IGAs), although definitive agreements have not yet been

securitization vehicles holding U.S. assets, has also entered into a Model 1 IGA, and a new tax information exchange agreement. The agreements paves the way for automatic exchange of FATCA information between the two governments. Luxembourg and Ireland, the location of many securitization vehicles holding predominantly European assets, have also entered into Model 1 IGAs. Thus, securitization vehicles in these three jurisdictions are not required to enter into FFI Agreements to be FATCA compliant.

2. *Practical Consequences for Securitizations*

Broadly speaking, FATCA can affect an issuer of securities in two ways. First, if the issuer makes withholdable payments, then any person acting as a withholding agent with respect to those payments must now receive documentation to establish that the payee either is domestic or, if foreign, is not subject to withholding under chapter 4 as well as under chapter 3. This requirement applies broadly to any type of domestic resident issuer and is not in any way unique to securitizations.

In practice, both chapter 3 and chapter 4 taxes are avoided by such an issuer by obtaining standard form documentation from payees, most often an IRS Form W-9 from a U.S. person and a Form W-8BEN-E from a foreign entity (FATCA withholding does not apply to payments to foreign individuals). Form W-8BEN-E is an expanded version of the Form W-8BEN, with many boxes added to indicate the basis for an exemption under or compliance with FATCA. Any foreign entity buying U.S. securities must determine its FATCA status and come to terms with Form W-8BEN-E, but once that has been done, the Form can be completed quite easily and doing so is routine. Also, for securities held through a clearing organization, the burden of collecting the forms from investors falls on the clearing organization (or brokerage firms) and not on the issuer.[58]

FATCA falls most heavily on a securities issuer if it is an FFI that must comply with the terms of an FFI Agreement or with comparable requirements under an IGA. The task of collecting, verifying, and reporting account information is extremely burdensome for both domestic and foreign banks, insurance companies, securities dealers, and money managers. It is, however, only modestly onerous for typical securitization vehicles.

Although a foreign securitization vehicle (which would meet the definition of an FFI) must collect, verify and report account information, for most issuers, the collection and verification exercise can be accomplished by asking all investors for an IRS Form W-9, W-8BEN or W-8BEN-E or some other variation thereof, just as if the issuer were domestic. Typically, investors in these vehicles are used to providing these forms, and the vehicle can expect to achieve very high compliance with the requests. Also, the number of investors for which separate reporting is required is likely to be modest. This is true because of large denominations and limited trading, and also because often securities are mostly held through a clearing organization.[59]

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executed. A current list of IGAs, including links to the text of all of the IGAs that have been signed, is on Treasury's website at https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx (last updated March 29, 2017).

In Announcement 2016-27, the IRS stated that on January 1, 2017, the Treasury will begin updating the IGA list to remove certain jurisdictions that have not brought their IGA into force. To remain on the list, a country is required to provide a detailed explanation of why it has not yet brought the IGA into force, together with a step-by-step plan (with expected completion dates) that it intends to follow to sign the IGA (if it has not yet done so) and bring the IGA into force. A jurisdiction also could be removed from the list if fails to meet the timetable it provides.

[58] See footnote 98, below, and accompanying text.

[59] As noted below at footnote 31, accounts for which FATCA reporting is required exclude equity or debt interests in investment vehicles that are regularly traded on an established securities market, but interests in

A foreign securitization vehicle that is an FFI (and typically a Model 1 FFI) generally would comply with FATCA by hiring the manager or one of the professional service providers working on the transaction (or one of their affiliates) to register the vehicle with IRS, collect the forms described above, and report collected information as required to the local tax authority. Further, it is typical for securities documentation (1) to require the issuer to be FATCA compliant, (2) to require investors to provide standard form IRS beneficial ownership documentation (or more broadly, any forms necessary to avoid withholding on payments to them or for the issuer to comply with FATCA), (3) to provide that withholding is permitted (without the payment of any sort of gross-up) if required under FATCA, and (4) often to allow a redemption or forced transfer of the securities held by any investor who does not comply with requests for information or whose ownership would otherwise cause the issuer to fail to be FATCA compliant.[60] These contractual terms are now fairly standardized and therefore not substantially revisited in individual deals. At one point it was common to allow a tax call (an early redemption of debt for tax reasons) based on FATCA compliance costs exceeding some amount, but that is no longer standard.

Besides FATCA, securitization vehicles may be subject to the common reporting standards (*CRS*) or UK FATCA. Discussions of CRS and UK FATCA are beyond the scope of this book, although each is briefly summarized below.

Securitization vehicles established in most countries other than the United States, but including the Cayman Islands, Ireland, and the Netherlands (the countries where most securitization vehicles established outside the United States are established), are subject to CRS, or as it is more formally known, the Standard for Automatic Exchange of Financial Account Information. CRS was published by the OECD in 2014, and information about it (including detailed implementation guidance) is available on the OECD web site. It calls on participating jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions annually. It sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions. CRS is modeled after the information reporting features of FATCA, but lacks the enforcement mechanism of withholding. CRS is being phased in at different times by different countries, with the earliest reporting period being 2016.

To date, the United States has not signed on to CRS. According to IRS and Treasury representatives, the reasons are in part because the U.S. already has so many IGAs, and in part because of concerns over the statutory authority of the IRS to provide the account information required under CRS.[61]

In addition, prior to the adoption of CRS, all the crown dependencies and overseas territories of the UK entered into automatic tax information exchange agreements with the UK. These agreements are modeled after the information exchange portions of FATCA (without withholding) and are sometimes referred to colloquially as *UK FATCA*. UK FATCA is being phased out as CRS phases in.

3. FATCA Definitions

The FATCA rules use a number of defined terms. This summary begins by defining the most significant ones, using the Code definitions as modified by Treasury regulations. Some of the terms are

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securitization vehicles generally would not meet the test (and there would be no assurance that it would be met over the life of the interests).

60 An investor that it not FATCA compliant may cause an issuer to fail to be FATCA compliant. See footnote 95, below, and accompanying and following text.

61 See, e.g., Letter from Jacob Lew, Secretary of Treasury, to Paul Ryan, Speaker of the U.S. House of the Representatives (May 5, 2016), available at https://www.treasury.gov/press-center/press-releases/Documents/Lew%20to%20Ryan%20on%20CDD.PDF (noting the number of existing IGAs and asking the Congress to pass legislation to provide FATCA partners with reciprocal information about U.S. financial institutions).

defined slightly differently in IGAs. The terms and FATCA rules as modified by the IGAs are considered second.

A *withholdable payment* is the kind of payment to which the chapter 4 withholding tax applies.[62] It is defined as U.S. source FDAP income, and gross proceeds from the sale or other disposition of property (occurring after December 31, 2018) of a type which can produce U.S. source interest or dividends (including dividend equivalent payments under swaps).[63] Thus, it includes income amounts not normally subject to withholding, such as gains on the sale of property and amounts representing a non-taxable return of capital. There is an exception for an item of income (not payments) effectively connected with a U.S. trade or business.[64]

A *passthru payment* is a withholdable payment and any foreign passthru payment. A withholdable payment that is received by an FFI but owned by and paid to another person would be a passthru payment as a withholdable payment (since its character would not change as a result of receipt and payment by the FFI). Although FATCA regulations have been finalized, Treasury has yet to draft a definition of foreign passthru payment.[65] Defining the term is challenging as it requires some kind of attribution of payments made by a FFI to withholdable payments it received as a principal. Previously, the Service proposed to allocate payments made by an FFI based on the portion of the FFI's assets that were U.S. assets, but that approach was heavily criticized and abandoned (at least for now).[66] Withholding on foreign passthru payments and on the gross proceeds portion of withholdable payments (i.e., obligations of a type that could produce U.S. source interest or U.S. source dividends) has been delayed until at least 2019 to give Treasury more time to consider how withholding should be applied to such payments.[67] A bar report argues that there is no current need to finalize the definition as the problem at which it is aimed (the use of an FFI as a blocker) likely will be adequately addressed through the network of IGAs.[68]

A *withholding agent* is a person required to withhold from withholdable payments and is broadly defined as any person, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of a withholdable payment or a foreign passthru payment.[69] The term is not limited to U.S. persons.

A *foreign financial institution* or *FFI* is the type of foreign entity that must agree to report on its accounts or suffer withholding on all withholdable payments it receives.[70] Except as provided in an IGA, FFIs generally include the following foreign entities: [71]

- banks
- broker-dealers and other entities conducting custodial businesses
- certain foreign insurance companies

62 Treasury Regulation § 1.1473-1(a).

63 Treasury Regulation § 1.1473-1(a)(1).

64 Treasury Regulation § 1.1473-1(a)(4)(ii).

65 Treasury Regulation § 1.1471-5(h)(2) (definition reserved).

66 See Notice 2011-34, obsoleted by T.D. 9610.

67 Notice 2015-66.

68 See New York State Bar Association Tax Section, letter dated January 19, 2017 re "Reserved Portions of the FATCA Final Regulations: Foreign Passthru Payments Withholding," Tax Analysts Document No. 2017-891.

69 Treasury Regulation § 1.1473-1(d).

70 Treasury Regulation §§ 1.1471-5(d)-(e), 1.471-5T(e).

71 Treasury Regulation § 1.1471-5(e), 1.1471-5T(e).

- certain holding companies and treasury centers that are part of financial groups or that are "formed in connection with or are availed of" by investment vehicles
- entities that conduct one or more of the following activities on behalf of customers: (1) trading in money market instruments, securities, currencies commodities and certain derivative instruments, (2) portfolio management, or (3) otherwise investing, administering or managing funds, money or financial assets, and
- professionally managed investment funds (i.e., entities whose gross income is primarily attributable to investing, reinvesting or trading in financial assets) or other entities that function or hold themselves out as collective investment vehicles that are established to invest, reinvest or trade in financial assets (e.g., hedge funds, private equity funds, securitization vehicles and virtually any other private or widely held investment entity), and generally including an investment fund that uses a professional management entity for any of its assets.

An FFI is generally a *participating FFI* or a *deemed-compliant FFI* if it has entered into an FFI Agreement or is otherwise FATCA compliant (for example, by complying with home country law in the case of a Model 1 FFI) and otherwise is a *nonparticipating FFI*.

A *non-financial foreign entity* or *NFFE* is any foreign entity that is not a financial institution.[72]

A *financial account* with respect to any financial institution is a depository or custodial account, and also, somewhat surprisingly, certain equity or debt interests in the financial institution, other than interests which are regularly traded on an established securities market.[73] The FATCA regulations exclude from the definition of financial account plain vanilla debt and equity securities of banks, brokerage firms, investment managers, and insurance companies, even if not publicly traded.[74]

A *United States account* generally is any financial account held by one or more specified United States persons or United States owned foreign entities.[75] To avoid duplicative reporting, a United States account does not include an account in an FFI if it is held by another FFI that has a FATCA compliant agreement with the Service or if the holder otherwise is subject to information reporting requirements that would make FATCA reporting duplicative.[76] This exception may be very helpful to an offshore issuer in avoiding (or more accurately shifting to others) reporting burdens.

A *recalcitrant account holder* is any holder of a financial account in an FFI (that itself is not a FFI) which, unless an exemption is available, fails to comply with reasonable requests to provide information needed for the FFI to determine if the account is a United States account or to meet its FATCA reporting requirements if it is a United States account (including waiving any foreign law that would prevent the FFI from reporting the information).[77]

A *specified United States person* is any United States person with certain exceptions.[78] The exceptions include, most significantly, corporations whose stock is regularly traded and their affiliates, governmental and charitable entities, banks and common trust funds, REITs, RICs and registered broker-

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72 Treasury Regulation § 1.1471-1(b)(80).

73 Treasury Regulation § 1.1471-5(b)(1).

74 Treasury Regulation §§ 1.1471-5(b)(1)(iii)(C), 1.1471-5(b)(3)(v). This exclusion is subject to an anti-abuse rule.

75 Treasury Regulation § 1.1471-5(a)(2).

76 Section 1471(d)(1)(C). An FFI is also not required to report payments made to an FFI in a Model 1 Partner Country. See Treasury Regulation § 1.1471-5(f)(1) (a reporting Model 1 FFI that complies with the registration requirements of a Model 1 IGA is treated as a registered deemed-compliant FFI).

77 Treasury Regulation § 1.1471-5(g)(2).

78 Treasury Regulation § 1.1473-1(c).

dealers.[79] There is no general exception for corporations that do not have regularly traded stock, which is not surprising given the purpose of the statute.

A *United Stated owned foreign entity* is any foreign entity with one or more substantial United States owners.[80]

A *substantial United States owner* is a specified United States person that has a required ownership interest.[81] The required interest is generally a 10 percent direct or indirect interest (by vote or value for a corporation and by profits or capital interest for a partnership).[82] However, for an FFI that is an investment fund (including a securitization vehicle) or a specified insurance company, any ownership interest is considered to be substantial.[83] For a grantor trust, all specified United States persons who are treated as owners under the grantor trust rules are considered substantial owners.[84] This rule, while significant in other contexts, is not significant for grantor trusts in securitizations because an investment trust that is a grantor trust would be an FFI that is required to report on all U.S. holders in any event.

An *expanded affiliated group* is a group of corporations (domestic or foreign) connected through more than 50 percent ownership links (by vote and value), and also includes other entities controlled by members of such a group.[85]

A number of definitions are used in defining when one person can perform FATCA responsibilities on behalf of others:[86]

A *lead FI* is a financial institution that undertakes the FATCA registration for any affiliated member FI that chooses to have the lead FI undertake the registration for it.

A *member FI* is a financial institution that has a lead FI undertake the member FI's FATCA registration.

A *sponsored entity* is an entity that has a sponsoring entity perform its FATCA due diligence, withholding, and reporting obligations.

A *sponsoring entity* is an entity that will perform the FATCA due diligence, withholding, and reporting obligations of one or more sponsored entities.

4. Foreign Financial Institutions

A withholding agent making withholdable payments to an FFI (other than to an FFI in a Model 1 Partner Country, or an FFI that is exempt from or treated as deemed compliant with FATCA) must withhold a 30 percent tax unless the FFI meets the requirements of section 1471(b) described below.[87]

An FFI meets the requirements of section 1471(b) if it properly registers with the Service and agrees to comply with the terms of the FFI Agreement, which incorporates the requirements set forth in the final

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79 Id.

80 Treasury Regulation § 1.1471-5(c).

81 Treasury Regulation § 1.1473-1(b)(1).

82 Treasury Regulation §§ 1.1473-1(b)(1)(i), (ii).

83 Treasury Regulation § 1.1473-1(b)(5).

84 Treasury Regulation § 1.1473-1(b)(1)(iii).

85 Treasury Regulation § 1.1471-5(i)(2)-(4).

86 Financial Institution (FI) Types, IRS, available at https://www.irs.gov/businesses/corporations/fatcahelp104 (last modified Jan. 4, 2017).

87 Treasury Regulation §§ 1.1471-2(a), 1.1471-3(d)(4), 1.1471-5(f)(1).

FATCA regulations. Very generally, an FFI that enters into an FFI Agreement will be required to do the following:

- withhold on payments to recalcitrant account holders and nonparticipating FFIs[88]
- obtain information regarding its account holders to determine whether such holders are specified United States persons, recalcitrant account holders, or nonparticipating FFIs in accordance with the applicable due diligence procedures[89]
- report annually to the Service certain information with respect to United States accounts and accounts held by recalcitrant account holders, and where a foreign law would otherwise prevent the reporting of information with respect to an account, attempt to obtain a waiver of the law or close or transfer the account,[90] and
- adopt a FATCA compliance program under the authority of a responsible officer, who will be required to certify periodically to the Service on behalf of the FFI.[91]

In the case of an FFI that is a qualified intermediary (*QI*), these requirements technically are in addition to those imposed under the QI agreement, although the IRS has revised the standard QI agreement to coordinate the requirements.[92]

An FFI need not register on the IRS portal directly. A "member FI" may have an affiliated financial institution, referred to as a "lead FI," register for it. Similarly, an FFI need not perform its required due diligence, withholding and reporting obligations itself.[93] It may have a "sponsoring entity" undertake those activities on its behalf.[94] Because they typically do not have employees, many securitization vehicles have sponsoring entities perform all of their FATCA related duties.

The requirements of section 1471(b) are not met with respect to an FFI unless they are also met by each FFI that is a member of its expanded affiliated group.[95] Thus, an FFI could go out of compliance if more than half of its equity, by vote and value, were acquired by a corporate parent that is also an FFI but that is not compliant with FATCA. That could be a significant practical issue for a securitisation vehicle having transferable equity with a relatively small value. In light of this, many securitization vehicles and investment funds permit the forced sale or redemption of any equity held by any person whose holding of such equity would cause the securitization vehicle or investment fund to fail to qualify as a participating or deemed-compliant FFI.

An FFI must agree to report the following information annually to the Service with respect to each United States account: the name, address, and taxpayer identification number (*TIN*) of each account owner which is a specified United States person (or, in the case of an account held by a United States owned foreign entity, the entity's name and the name, address, and TIN of each substantial United States owner of such entity); the account number; the account balance or value; and payments made with respect to the account.[96]

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88 Treasury Regulation § 1.1471-4(a)(1).

89 Treasury Regulation § 1.1471-4(a)(2). Special rules apply to securities issued in bearer form. See Treasury Regulation § 1.1471-4(c)(3)(ii); Treasury Regulation §§ 1.1471-5(f)(1)(i)(C)(2), (D)(2), (D)(6).

90 Treasury Regulation § 1.1471-4(a)(3).

91 See Treasury Regulation §§ 1.1471-4(c)(7), (f)(3).

92 Treasury Regulation § 1.1471-4T(d)(8), Revenue Procedure 2017-15.

93 See IRS Publication 5118, "FATCA Online Registration User Guide."

94 Id.

95 Treasury Regulation § 1.1471-4(e).

96 Treasury Regulation § 1.1471-4(d)(3)(ii), (iii).

The required reporting on account balances, receipts and withdrawals differs from conventional information reporting applicable to U.S. payees of certain categories of income under sections 6041 (FDAP income paid by a business), 6042 (dividends), 6045 (broker reporting of gross proceeds), and 6049 (interest), which requires the reporting of income amounts and sales proceeds. An FFI may elect to report income amounts under these sections rather than account balances and payments on the accounts.[97]

The exclusion from the definition of "United States account" of accounts held by other FFIs with FATCA-compliant agreements means that an FFI that cannot practically undertake investor-level reporting obligations (for example, with respect to non-traded debt or equity) could avoid them by requiring that debt or equity be held through (1) an FFI that meets the requirements of section 1471(b) and does not elect to pass withholding obligations to its payor FFI, or (2) a publicly held domestic institution (which would not be a specified United States person). Also, it appears that if all of the debt or equity were held through certain clearing organizations, either no reporting would be required or, if it were required, it would be fairly simple. The FATCA regulations have a section entitled "Payments to an account held with a clearing organization with FATCA-compliant membership." However, the section is reserved.[98]

The Service has an online web portal, called the FATCA Registration System (*Portal*).[99] An FFI uses the Portal to enter into an FFI Agreement electronically and register its FATCA status with the Service. Once an FFI has registered, it will receive a GIIN. An FFI generally can avoid FATCA withholding by providing its GIIN to a withholding agent.[100] The withholding agent is required to confirm the FFI's FATCA status by checking the FFI's GIIN against a list published by the Service.[101]

U.S. financial institutions generally are not required to register with the Service under FATCA but sometimes do, for example, to register a foreign branch as a Model 1 FFI or to act as a lead FI.

5. *Non-Financial Foreign Entities*

Section 1472 requires a withholding agent to withhold a 30 percent tax from withholdable payments to a NFFE if the beneficial owner of the payment is an NFFE (either the payee or another NFFE) that is not exempt from withholding, unless the withholding agent receives (1) a certification that the beneficial owner does not have any substantial United States owners, or (2) the name, address, and TIN of each substantial United States owner of the beneficial owner.[102] NFFE reporting generally relates to particular payments.[103]

There are no specific withholding obligations for a NFFE (unless it is otherwise a withholding agent with respect to withholdable payments).

A withholding agent must not know or have reason to know that information it receives is incorrect in order to rely on it.[104] Amounts that are withheld from payments to a NFFE are potentially refundable if

[97] Treasury Regulation § 1.1471-4(d)(5).

[98] Treasury Regulation § 1.1471-2(a)(4)(vii). See also flush language to Treasury Regulation § 1.1471-2(a)(4) (circumstances in which a withholdable payment is not subject to withholding).

[99] FATCA Foreign Financial Institution Registration, IRS, available at https://www.irs.gov/businesses/corporations/fatca-foreign-financial-institution-registration-tool (last updated May 24, 2017).

[100] Treasury Regulation § 1.1471-3(d)(4).

[101] Treasury Regulation §§ 1.1471-3(d)(4)(iii)(B), 1.1471-3(e)(3).

[102] Sections 1472(a)-(c).

[103] Treasury Regulation § 1.1472-1(b)(1). See Treasury Regulation § 1.1474-1(i)(2) for additional reporting requirements with respect to payments owned by NFFEs with substantial U.S. owners.

[104] Treasury Regulation § 1.1471-3(e).

the NFFE qualifies for the benefits of an income tax treaty with the United States, and, otherwise, the required information is reported to the Service.[105]

Certain NFFEs are exempted from these rules. These include (1) corporations the stock of which is regularly traded on an established securities market (and their affiliates), (2) "active NFFEs" (entities whose gross income or assets are predominantly non-passive), (3) certain holding companies, treasury centers and captive finance companies that are members of nonfinancial groups, (4) nonfinancial start-up companies, (5) certain nonfinancial entities that are liquidating or emerging from reorganization or bankruptcy, and (6) non-profit organizations.[106]

6. Intergovernmental Agreements

As discussed above, the United States has entered into a great number of IGAs and expects to enter into more. There are two Model IGAs, 1 and 2, and several variations within the models.[107] Also, the model agreements are periodically updated to reflect changes in the basic FATCA rules and negotiations with other governments. The models have a most favored nation clause allowing a signatory to get the best deal allowed under agreements with other countries. The Model 1 IGA and Model 2 IGA are discussed in the next two sections.

a. Model 1 IGA

Under a Model 1 IGA, a Model 1 FFI is not required to enter into an FFI Agreement with the Service. Instead, it must comply with the reporting, withholding, and other obligations in the IGA as implemented by each Model 1 Partner Country's internal laws.[108] This approach should resolve any concerns on the part of an FFI that the reporting and withholding it undertakes will comply with local laws (including privacy laws), and also ensures that any withholding will be required "pursuant to law" of the Model 1 Partner country, as that term is used in transactional documents.

Model 1 FFIs generally will still be required to conduct due diligence to identify their direct and indirect U.S. account holders and to report on those accounts to the Model 1 Partner Country, which will then report such information to the United States.[109] However, the requirements may be less burdensome than those required by the FATCA regulations absent an IGA. In general, the diligence rules will be more closely aligned to existing practices.

Model 1 FFIs will be required to withhold on or collect certain information with respect to accounts held by certain nonparticipating FFIs.[110] Model 1 FFIs will not, however, be required to withhold on payments to, or close accounts held by, non-FFI account holders that fail to comply with requests for identifying information, provided that the Model 1 FFIs report on such accounts to their own

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[105] Treasury Regulation § 1.1474-5(a)(3).

[106] Treasury Regulation § 1.1472-1(c).

[107] Variations of the Model 1 and Model 2 IGAs have been developed for countries that do and that do not have in place a tax information exchange agreement (*TIEA*) or double tax convention (*DTC*) with the United States. Currently, there are three variations of the Model 1 IGA and two variations of the Model 2 IGA: Reciprocal Model 1A, Preexisting TIEA or DTC; Nonreciprocal Model 1B, Preexisting TIEA or DTC; Nonreciprocal Model 1B, No Preexisting TIEA or DTC; Model 2, Preexisting TIEA or DTC; and Model 2, No Preexisting TIEA or DTC. Further, the model agreements were updated slightly after July 1, 2014, the date FATCA generally came into effect. The Model IGAs are discussed generally below and any differences in citations to the particular versions of a Model 1 or Model 2 IGA are specifically noted. Otherwise, a reference to a Model 1 or Model 2 IGA applies to all variations of the relevant IGA.

[108] Model 1 IGA, Article 4.

[109] Model 1 IGA, Article 2.

[110] Model 1 IGA, Article 4.1.

governments.[111] Further, Model 1 FFIs are not required to withhold on payments of U.S. source passive income made to non-participating FFIs, provided that the Model 1 FFI provides its immediate payor the information required for the payor to perform the necessary withholding and reporting.[112] However, Model 1 FFIs that are acting as qualified intermediaries and have assumed U.S. withholding and reporting responsibilities with respect to an asset will be required to withhold on payments on such asset.[113]

The Model 1 IGA delays withholding for foreign passthru payments and gross proceeds until such future time as an agreement requiring such withholding is reached between the governments.[114] It is unclear if a future agreement will modify, and if so, to what extent, the withholding obligations of Model 1 FFIs on payments of such other amounts to nonparticipating FFIs.

A Model 1 FFI that fails to meet the reporting, withholding, or other requirements of the relevant Model 1 Partner IGA becomes subject to FATCA withholding only after it has been identified and designated as non-compliant by the IRS after a cure period.[115]

The reciprocal version of the Model 1 IGA requires the United States to pursue legislative and administrative actions to achieve reciprocal and automatic exchanges of information between the United States and a Model 1 Partner Country with respect to accounts maintained by U.S. financial institutions.[116]

A modified affiliate rule effectively adopts as a permanent rule the transition rule in the FATCA regulations that allows affiliated FFIs to not comply with FATCA in full if they are not allowed to do so under local law. This protection will not extend to other affiliated FFIs that are not themselves Model 1 FFIs.

As indicated above, under the FATCA regulations, debt or equity of banks, investment managers, insurance companies and custodial institutions will not be subject to FATCA reporting and withholding unless the value of the debt or equity is determined by reference to U.S. assets or the interest is issued with a principal purpose of avoiding the requirements of FATCA.[117] The Model 1 IGA, however, requires that both conditions be met (i.e., references to U.S. assets and issued with a bad purpose) in order to fall outside the exception.[118]

Annex II of the Model 1 IGA identifies country specific categories of exempt beneficial owners or FFIs or categories of financial accounts and products that will be exempted from reporting under the IGA.

b. Model 2 IGA

The Model 2 IGA is similar to the Model 1 IGA except that instead of reporting to its home country revenue service, a Model 2 FFI is permitted and required by its home country law "to register on the IRS

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[111] Model 1 IGA, Article 4.2.

[112] Model 1 IGA, Article 4.1(e).

[113] Model 1 IGA, Article 4.1(d). In addition, Annex I of the Model 1 IGA provides detailed due diligence obligations for Model 1 FFIs.

[114] Model 1A, Preexisting TIEA or DTC, Article 6.2; Model 1B, Preexisting TIEA or DTC, Article 6.1; Model 1B, No Preexisting TIEA or DTC, Article 6.1. See, e.g., the UK IGA, which defers on withholding with respect to non-U.S.-source income and gross proceeds.

[115] Model 1A, Preexisting TIEA or DTC, Article 5.2; Model 1B, Preexisting TIEA or DTC, Article 5.2; Model 1 B, No Preexisting TIEA or DTC Agreement, Article 5.3.

[116] Model 1A, Preexisting TIEA or DTC, Article 6.1.

[117] See footnote 74, above, and accompanying text.

[118] Model 1A, Preexisting TIEA or DTC, Article 1.1(s)(2); Model 1B, Preexisting TIEA or DTC, Article 1.1(q)(2); Model 1B, No Preexisting TIEA or DTC, Article 1.1(q)(2).

FATCA registration website with the IRS within 90 days of the Determination Date, and comply with the requirements of an FFI agreement….”[119]

Because an agreement patterned on the Model 2 IGA requires direct reporting of information to the Service, the Model 2 IGA requires each Model 2 FFI as a condition of opening a new account to obtain consent of each holder of a new account that is identified as a U.S. account to report information to the Service.[120] A similar requirement applies to new accounts of nonparticipating FFIs where the Model 2 FFI expects to pay a “foreign reportable payment” (a payment of FDAP income that would be a withholdable payment if it were paid from sources within the United States).[121] In addition, a Model 2 FFI must request consent of pre-existing account holders to report to the Service.[122] In order to encourage pre-existing account holders to consent, each Model 2 FFI must also inform pre-existing account holders that even if an account holder does not consent, the Service can request and obtain information about the account from the Model 2 Partner Country’s revenue service.[123]

A Model 2 FFI generally is not required to withhold on payments to a recalcitrant holder.[124] However, unlike the Model 1 IGA where the requirement for such withholding has not yet been determined, the Model 2 IGA does not necessarily indicate that such withholding is yet to be determined.[125]

The Model 2 Agreement does not provide for reciprocity. The Model 2 Agreement for countries with a preexisting TIEA or DTC does, however, indicate that the United States is willing to negotiate a reciprocal reporting obligation subject to a determination that the standards of confidentiality and other prerequisites for cooperation are fulfilled.[126]

7. Effective Dates and Grandfather Rules

The FATCA regulations have grandfather rules for obligations generally and additional special effective date rules for, among others, certain “foreign passthru” obligations, certain debt securitization vehicles in existence at the end of 2011, and certain affiliates.[127]

a. Obligations Generally

The chapter 4 withholding tax generally became effective in 2014.[128] A grandfather rule provides that withholding is not required for payments in respect of obligations outstanding on July 1, 2014.[129] The

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119 Model 2 IGA Article 2.1(a) (updated Nov. 11, 2014). The “Determination Date” depends on the date the relevant jurisdiction signed an IGA. It is either June 30, 2014, November 30, 2014, or the date of signing of an IGA. Model 2 IGA, Annex I, VI.B.6 (updated November 30, 2014).

120 Model 2 IGA, Article 2.1(d).

121 Model 2 IGA, Article 2.1(e).

122 Model 2 IGA, Article 2.1(b)-(c).

123 Model 2 IGA, Article 2.1(b)-(c).

124 Model 2 IGA, Article 3.2(a). Such withholding will be required, however, in the case of a recalcitrant holder whose information is not passed on to the IRS by the Model 2 Partner Country’s revenue service within six months of request. Model 2 IGA, Article 3.2(b).

125 The Model 2 IGA has in brackets the language delaying withholding for foreign passthru payments and gross proceeds until such future time as an agreement requiring such withholding is reached between the governments, with a footnote to consider whether to include. Model 2 IGA, Article 5.

126 Model 2 IGA, Preexisting TIEA or DTC, Article 7 (in brackets).

127 There is also a special effective date rule for certain obligations that produce “dividend equivalent” amounts under section 871(m) (such as payments corresponding to dividends under certain equity swaps), but they are not likely to be significant in securitizations. Treasury Regulation § 1.1471-2(b)(2)(i)(A)(2).

128 Treasury Regulation § 1.1471-2(a)(1).

grandfather rule also applies to all related collateral.[130] Grandfathering also applies to substitute interest payments on collateral that is a grandfathered obligation.[131] While a grandfathered obligation is not subject to withholding, it is generally not exempt from reporting. An obligation will lose its grandfathered status if it is materially modified after June 30, 2014, which for a debt instrument means that it is treated as reissued under section 1001.[132] In addition, the FATCA regulations provide that grandfathered obligations include (1) revolving and other lines of credit provided that the applicable agreement fixes the material terms (including a stated maturity date) on or prior to the grandfathering date, and (2) derivatives entered into on or prior to the grandfathering date (for this purpose entering into refers to entering into a confirmation, not merely a master agreement).[133]

FATCA withholding on gross proceeds from the sale or other disposition of property that can produce U.S. source interest or dividend income will apply only to sales or exchanges after December 31, 2018.[134]

b. Foreign Passthru Obligations

A grandfathered obligation includes any obligation that produces (or could produce) a passthru payment but cannot produce a withholdable payment, provided that the obligation is outstanding as of the date that is six months after promulgation of final regulations defining the term "foreign passthru payment."[135] In addition, any such withholding will not apply prior to January 1, 2019.[136] These rules apply to obligations that may give rise to foreign passthru payments, but not to withholdable payments.[137] Effectively, the Service took steps to alleviate concerns over potential withholding on foreign passthru payments unless and until it develops and announces a workable definition of the term.

This grandfathering rule is significant for securitizations because it applies to debt securities of non-U.S. issuers (such as foreign corporations issuing CDOs). Accordingly, investors in debt issued by non-U.S. issuers can expect the debt to be grandfathered as long as it is outstanding as of the grandfathering date (and not materially modified after that date).

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129 Treasury Regulation § 1.1471-2(b)(2)(i)(A)(1). The original statutory provisions would have required withholding to apply to payments after December 31, 2012 and the original grandfathering date would have been a much earlier date of March 18, 2012. P.L. 111-147, §§ 501(d)(1), (2).

130 Treasury Regulation § 1.1471-2(b)(2)(i)(A)(3). Where collateral secures both grandfathered and non-grandfathered obligations, a pro rata share of the collateral will be grandfathered.

131 Treasury Regulation § 1.1471-2(b)(2)(i)(A)(4).

132 Treasury Regulation § 1.1471-2(b)(2)(iv). The tests for determining when there is a "significant modification" of a debt instrument and therefore a reissuance under section 1001 are described in Chapter 6, Part D.2.

133 Treasury Regulation §§ 1.1471-2(b)(2)(ii)(A)(2),(3). The IRS is likely to take the view that an *uncommitted* line of credit is not grandfathered even if the applicable agreement fixes the material terms on or prior to the grandfathering date. Cf. F.A.A. 20150601F (April 4, 2014) (in determining whether an exception to the repeal of the FASIT rules applied, a FASIT regular interest was not treated as outstanding on the relevant grandfathering date when the maturity of the regular interest was extended pursuant to a contractual provision that allowed the term of a FASIT regular interest to be extended if *each of the* parties agreed). Interestingly, in determining whether a notional principal contract has a term of one year or less, Treasury Regulation § 1.446-3T(g)(4)(ii)(A)(1) provides that the term of a notional principal contract includes "any extensions (optional or otherwise) provided for in the terms of the contract, without regard to whether any extension is…subject to approval by one or both parties…."

134 Treasury Regulation § 1.1473-1(a)(1)(ii).

135 Treasury Regulation § 1.1471-2(b)(2)(i).

136 Notice 2015-66.

137 Id.

c. *Pre-existing Securitization Vehicles*

Because equity securities never benefit from grandfathering, a special category of deemed-compliant FFIs, referred to as "limited life debt investment vehicles" (*LLDIs*), was established by the FATCA regulations to protect pre-existing securitization vehicles. The key features of an LLDI include that: it be an investment entity that issued one or more classes of debt or equity interests to investors pursuant to a trust indenture or similar agreement and all of such interests were issued on or before January 17, 2013;[138] it was in existence as of January 17, 2013, and has entered into a trust indenture or similar agreement that requires the entity to pay to investors holding substantially all of the interests in the entity, no later than a set date or period following the maturity of the last asset held by the entity, all amounts that such investors are entitled to receive from the entity.[139] Further, the FFI must have been formed and operated for the purpose of purchasing or acquiring specific types of debt instruments or interests therein and holding those assets subject to reinvestment only under prescribed circumstances until maturity, and substantially all of the assets of the FFI must consist of debt instruments or interests therein.[140] All payments made to the investors of the FFI (other than holders of a *de minimis* interest) must be cleared through certain clearing organizations, FATCA compliant FFIs or U.S. financial institutions.[141] The FFI's trustee or fiduciary must not be authorized, through a fiduciary duty or otherwise, to fulfill the obligations of a participating FFI and no other person can have the authority to fulfill the obligations of a participating FFI on behalf of the FFI.[142]

Some commentators had proposed changes that would have made the rule more workable but they were not adopted.[143] Because most securitization vehicles are established in Model 1 Partner Countries and their securities are held through clearing organizations, the practical effect of FATCA applying without grandfathering to pre-existing securitization vehicles has been relatively minor, as discussed above in Chapter 12, Part E.2, above (in this Supplement).

d. *Expanded Affiliate Rule*

As indicated above, an FFI will not be a participating FFI unless each member of its expanded affiliated group that is an FFI is itself a participating FFI or otherwise FATCA compliant.[144] The FATCA regulations generally provide a transition period that lasted until January 1, 2017 for the full implementation of this requirement (the period extends indefinitely in the case of FFIs in countries with IGAs).[145] During this transitional period, the existence of an FFI affiliate in a jurisdiction that prohibits the reporting or withholding required by FATCA will not prevent other FFIs within the same expanded affiliated group from entering into an FFI Agreement, provided the FFI in the restrictive jurisdiction agrees to perform due diligence to identify its U.S. accounts, maintain certain records, and meet certain other requirements.[146]

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[138] Treasury Regulation § 1.1471-5(f)(2)(iv)(A).

[139] Treasury Regulation § 1.1471-5(f)(2)(iv)(B).

[140] Treasury Regulation §§ 1.1471-5(f)(2)(iv)(C), (D).

[141] Treasury Regulation § 1.1471-5(f)(2)(iv)(E).

[142] Treasury Regulation § 1.1471-5(f)(2)(iv)(F).

[143] See November 11, 2013 letter from Thomas Prevost on behalf of the North American Tax Committee of ISDA to the Treasury and IRS, 2013 *Tax Notes Today* 224-23 (November 11, 2013), which has the earlier letters attached.

[144] Treasury Regulation § 1.1471-4(a)(4).

[145] Treasury Regulation §§ 1.1471-4(a)(4), 1.1471-4(e)(2)-(3); Model 1 IGA, Article 4.5; Model 2 IGA, Article 3.5.

[146] Treasury Regulation §§ 1.1471-4(a)(4), 1.1471-4(e)(2)-(3).

Chapter 13

Offshore Issuers

A. Introduction

B. Definition of Foreign Corporation

Add to footnote 11: P.L.R. 201305006 (October 15, 2012), described in Chapter 4, Part C.1, in this Supplement, holds that a Profit Participation Agreement under which a domestic corporation will share profits and losses of its foreign branches with a foreign affiliate will create a foreign entity (that can then elect to be a foreign corporation). The facts given in the ruling that presumably supported the "foreign" nature of the entity were that the agreement will be signed outside of the United States and governed by and enforceable under the laws of a foreign country, and the joint venture will be managed by a committee that will meet outside of the United States.

Add to footnote 16: Final regulations replacing section 1.7874-2T were adopted by T.D. 9591 (June 12, 2012). Also, T.D. 9592 (June 12, 2012) adopted temporary regulations (section 1.7874-3T), which revised significantly the substantial business activities exception. That exception is not relevant for passive securitization vehicles.

C. Summary of Tax Rules for Foreign Corporations

D. Taxation of Effectively Connected Income

1. Trade or Business—Common Law Definition

A recent case raises a question about when investing can become a business activity (potentially triggering tax for foreigners by causing them to be engaged in a U.S. trade or business) because of active management. *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 129 (1st Cir. 2013), cert. denied, 134 S. Ct. 1492 (2014), holds that private equity funds were potentially liable for pension plan withdrawal obligations of a bankrupt portfolio company, Scott Brass, which the funds owned. Liability turned, under the facts and pension law, on whether the funds were engaged in a trade or business under common control with Scott Brass within the meaning of section 414. Sun Capital (through a management company affiliate of the funds) actively managed Scott Brass, including with respect to certain day-to-day activities. Sun Capital received a management fee from Scott Brass, which was offset against management fees otherwise payable by one (or perhaps both) of the private equity funds to Sun Capital. The court held that Sun Capital's management of Scot Brass was a trade or business that should be attributed to the funds under an "investment plus" standard. The fee offset appears to have been an important factor in the decision. Whether the court's approach will be followed in defining a trade or business in other Code settings (such as in taxing foreign investors) remains to be seen. For a discussion of the case, see Robert Willens, "A Private Equity Fund Is a Trade or Business," 2013 *Tax Notes Today* 171-4 (September 4, 2013), Lee A. Sheppard, "The *Sun Capital* Decision in Perspective," 2013 *Tax Notes Today* 184-1 (September 23, 2013), and Steven M. Rosenthal, "Private Equity is a Business: *Sun Capital* and Beyond," 2013 *Tax Notes Today* 184-19 (September 23, 2013).

Two offshore CLO issuers have filed petitions with the Tax Court contesting deficiencies based on an IRS assertion that the issuers are partners in a domestic partnership because of their ownership of unexercised warrants issued by partnerships that allow them to buy partnership units for no consideration. See *TELOS CLO 2006-1, LTD. v. Comm'r*, Docket No. 6786-17 (March 22, 2017), and *TELOS CLO 2007-02 v. Comm'r*, Docket No. 6779-17 (March 22, 2017). Under section 875(1), a foreign partner in a partnership is considered to be engaged in a U.S. trade or business in which the partnership is engaged. The issuers owned primarily debt and were not allowed to buy equity in partnerships engaged in a U.S. trade or business. The warrants were issued in connection with debt restructurings to allow the holders to make up for losses as creditors. The taxpayers received "distributions for the unexercised Warrants" that produced capital gains. The IRS argues that the gains are taxable as income effectively connected with a U.S. trade or business (ECI), based on the fact that as warrant holders, the taxpayers were engaged in a U.S. trade or business. Apparently, and unfortunately for the taxpayers, an IRS Form 8805 identifying the taxpayers as foreign partners receiving an allocation of ECI was filed by someone (apparently not the partnership), which likely is what lead to discovery and the deficiencies.

2. *Securities Trading Safe Harbor*

Regarding the definition of a "note, bond, debenture or other evidence of indebtedness" (see footnote 44), the same phrase (with the addition of "certificate") appears in section 1275(a)(1)(A). In that setting, Treasury Regulation § 1.1275-5(d) construes the language quite broadly to include any contractual arrangement treated as debt for federal income tax purposes.

Add to footnote 45: On the other hand, if a partnership limits its activities to those allowed under the securities trading safe harbor, it would not be considered to be engaged in a trade or business. Accordingly, a foreign corporation holding a partnership interest in such a partnership would not be required to treat income from the partnership as ECI as a result of the partnership's activities. See Treasury Regulation § 1.864-2(c)(ii). For application of the dealer exception at the partnership level, see footnote 40, above.

3. *Special Topics*

a. *Derivatives*

b. *Loan Origination*

C.C.A. 201501013 (September 5, 2014) concludes that an offshore investment partnership with foreign partners was engaged in a U.S. trade or business as a result of lending and stock distribution activities carried on in the U.S. by a manager acting as the fund's express agent. The manager directly negotiated with borrowers on a regular basis the terms of straight and convertible debt acquired by the fund. The manager converted some of the debt and sold the acquired stock. The fund also entered into agreements with issuers to buy and distribute their stock. The C.C.A. concludes that (1) the nature and extent of the fund's lending and underwriting activities, carried on by the manager as agent, caused the fund to be engaged in a U.S. trade or business, (2) the fund's lending and underwriting did not constitute "trading in stocks or securities" for purposes of the securities trading safe harbor, and (3) even if such activities did qualify as such trading, the fund would not have qualified for the safe harbor because it was a securities dealer. The C.C.A. ends with some sabre rattling encouraging the field to send in for review other cases involving offshore investment vehicles that engage in a lending or underwriting business or other activities outside of the scope of the safe harbor. The dispute appears to have landed in the Tax Court. See *YA Global Investments LP et al. v. Comm'r*, Tax Court Docket No. 15831-15. The petition is at 2015 *Tax Notes Today* 130-17 (June 18, 2015). The deficiency notice includes a claim for partnership withholding tax under section 1446, so partnerships with foreign partners beware. For commentary about the C.C.A. and the fact pattern, see Lee A. Sheppard and William R. Davis, "News Analysis: Securities Trading Safe Harbor Going Before Tax Court," 2015 *Tax Notes Today* 130-1 (July 8, 2015).

Pending legislation on covered bonds would treat acquisitions of covered bonds as an acquisition of an investment security and not a loan in determining the character of any related trade or business activity or asset of the acquirer under the Code. This rule is not limited to the treatment of foreign investors and it is not clear whether it is aimed at them. See Chapter 2, Part I.3, in this Supplement.

Comment on footnote 69: In the hope springs eternal department, the Real Estate Roundtable has asked the IRS in a letter dated May 31, 2011 to revive the project on offshore lending and include it in the 2011-2012 business plan The group made a similar plea in 2009. See 2011 *Tax Notes Today* 111-50 (May 31, 2011).

A recent article about warehousing loans for inclusion in CLOs says some interesting things about developments in the secondary loan market. See Carol Clouse, "No CLO Warehouse? No Problem," *Asset Securitization Report,* May 2012, p. 8. It discusses the post-crash revival of the CLO market and says that warehousing of loans (obtaining temporary financing to allow loans to be accumulated before issuing CLOs) is less critical now than it once was. The reason is that managers used to have an incentive to participate in loan purchases at the time of origination because loans often were bid up to more than par in the secondary market after issuance and they did not want to buy loans at a premium. Because issuances are episodic, managers had to accumulate loans over time. Now loans are more available in the secondary market at prices not exceeding par, so portfolios can be accumulated more quickly, reducing the need for temporary financing.

The *Sun Capital* case, discussed in Chapter 13, Part D.1, in this Supplement, considers another area that straddles the line between investing and business. It holds that the active management of a company held by private equity funds constitutes a trade or business (for purposes of a law imposing pension liabilities) where the company pays management fees (perhaps analogous to fees paid for structuring or originating loans).

C.C.A. 201423019 (January 22, 2014), described in Chapter 11, Part F.2 (in this Supplement), provides some support for the view that modifying loans in connection with a default is not equivalent to a loan origination business.

In P.L.R. 201504004 (October 3, 2014), the IRS applied special rules for pass-through certificates to commercial mortgages held by a trust. The ruling is discussed in Chapter 12, Part B.2 (in this Supplement). The taxpayer represented that (1) the trust was a disregarded entity rather than a trust, because the mortgages were "scratch & dent" loans that "often require modifications in order for the loans to continue payments or become re-performing," and (2) it was not engaged in a U.S. trade or business. It is interesting that the IRS accepted the trade or business representation given the stated need for default-related modifications.

c. Loan Waivers

Add to the end of footnote 72: In F.A.A. 20151704F (November 21, 2014), the IRS determined that a payment made to note holders for consenting to amendments to the indenture for the notes was a payment on the notes, and under Treasury Regulation § 1.1275-2(a), first a payment of previously accrued OID and second a payment of principal. See also P.L.R. 201105016 (October 19, 2010), which holds that fees paid to holders of notes to consent to a business reorganization were considered payments under the terms of the notes, and therefore first payments of interest to the extent of accrued and unpaid interest and then a payment of principal, where the fee payment and other changes did not amount to a significant modification under section 1001. The principal repayment reduced the adjusted issue price of the notes, with the result generally that the fees would ultimately be treated as additional income (possibly OID) on retirement of the notes. See Treasury Regulation § 1.1272-1(b)(4)(ii) (OID allocable to final accrual period is the excess of the amount payable at maturity over the adjusted issue price). Under this analysis, the consent fees generally would not be subject to withholding tax because they would be treated as either a return of capital or as interest eligible for the portfolio interest exemption.

For the potential significance of fee offsets, see the discussion of the *Sun Capital* case in Chapter 13, Part D.1, in this Supplement.

d. Foreclosure Property

4. Effective-Connection Test

5. Deemed Business Investments (Partnerships With ECI and Real Property Interests)

E. Withholding Tax

In the second bullet point on page 1049 change "(the statement is generally made on Form W-8BEN)" to "(the statement is generally made on Form W-8BEN-E, in the case of an offshore issuer that is a corporation, or on Form W-8IMY, in the case of an offshore issuer that is a partnership)".

F. Taxation of Debt and Equity Interests in Offshore Issuers—Overview

G. Taxation of Equity Interests in an Offshore Issuer Held by U.S. Persons

1. Introduction

Add to footnote 162: On January 18, 2017, the IRS adopted temporary regulations under section 721(c) that generally require a partner transferring appreciated property to a domestic or foreign partnership that has related foreign partners to recognize gain unless the partnership adopts the remedial method for accounting for such gain under section 704(c). See Treasury Regulation §§ 1.721(c)-1T through 1.721(c)-7T, adopted by T.D. 9814.

2. Anti-Deferral Regimes—Overview

In footnote 148, the current B.N.A. Tax Management Portfolios are: Kimberly S. Blanchard, Tax Management Portfolio No. 6300, *PFICs*; Philip Fried and Kevin J. Liss, Tax Management Portfolio No. 6260, *CFCs—Investment of Earnings in United States Property*; Dirk J.J. Suringa, Tax Management Portfolio No. 922, *Foreign Personal Holding Companies*; Lowell D. Yoder, Damon M. Lyon, and David G. Noren, Tax Management Portfolio No. 926, *CFCs—General Overview*.

3. Passive Foreign Investment Companies (PFICs)

Synthetic long positions in PFIC stock may be subject to the gain conversion and interest charge rules of section 1260. Section 1260(a) treats gain from a constructive ownership transaction with respect to an underlying financial asset that otherwise would be long-term capital gain as ordinary income (and imposes an interest charge to compensate for deferral) to the extent such gain exceeds the net capital gain the taxpayer would have had if it had owned the underlying asset directly. Also, if a constructive ownership transaction is closed by taking delivery, the section is applied as if the transaction had been sold (section 1260(f)). Under section 1260(c), a "financial asset" includes an "equity interest in any pass-thru entity," and a PFIC (defined without regard to the CFC overlap rule in section 1297(d)) is one type of pass-thru entity. A constructive ownership transaction is generally a synthetic long position created under a swap, forward or futures contract, put/call option pair on matching terms, or other contract identified in regulations as having substantially the same effect (section 1260(d)).

In Notice 2014-28, the Treasury and the IRS announced that they will amend the definition of shareholder in the section 1291 regulations to provide that a U.S. person that owns stock of a PFIC through a tax-exempt organization or account such as an individual retirement account is not treated as a shareholder of the PFIC.

4. Controlled Foreign Corporations (CFCs)

Pages 1076-1077 list some differences between CFCs and PFICs. One difference not noted is that the time for paying tax on undistributed earnings of a PFIC (but not a CFC) can be deferred under section 1294 with an interest charge.

Add to the end of footnote 162: A.M. 2015-001 (February 9, 2015) holds that in the case of a CFC, a United States shareholder's earnings and profits are increased by the amount included in income under section 951(a). Section 951(a) is described in footnote 187. Presumably, the IRS would take the same position in the case of QEF inclusions.

Add to the end of footnote 187: A.M. 2015-001 (February 9, 2015) holds that a taxpayer's earnings and profits are increased by the amount included in income under section 951(a).

Add to the end of footnote 188: The American Taxpayer Relief Act of 2012 extended until December 31, 2013 the sunset date of the exclusion from subpart F income of income arising in the active conduct of a banking, financing or similar business.

5. Overlap

Section 1260(c)(2) has a definition of pass-thru entity that includes a PFIC as defined in section 1297 without regard to subsection (d). Accordingly, the constructive ownership transaction rules in that section apply to an entity that would be a PFIC absent the CFC overlap rule. The section 1260 definition is also used is applying a qualifying basis exception to the rule treating certain loss transactions as reportable transactions. The qualifying basis exception does not apply (so that reporting of losses may be required) to an interest in a pass-thru entity as defined in section 1260(c)(2). For an explanation of the exception, see Chapter 17, text at footnote 33.

H. Special Considerations Applicable to Tax-Exempt Organizations

P.L.R. 201430017 (May 2, 2014) holds that a private foundation that is tax exempt under section 501(c)(3) will not be subject to tax on UBTI with respect to income from a wholly-owned foreign corporation it will form to facilitate and manage its foreign investments, including debt-financed investments in distressed debt (but not including insurance activities). The foundation's investment in the corporation's stock will not itself be financed with debt. The ruling also holds that the ownership of the foreign corporation will not result in excess business holdings under section 4943(c), because of the passive nature of the corporation's activities. It also concludes that the investment will not be a jeopardizing investment under section 4944 because the foundation managers exercised ordinary business care and prudence in deciding, with the assistance of investment advisors, to make foreign investments through the foreign corporation. Interestingly enough, one of the factors cited in support of this conclusion is that the managers determined that investing through a foreign corporation resulted in a more tax-efficient structure. Tax efficiency is indeed the handmaiden of prudence.

I. Offshore Issuers of Catastrophe Bonds

On September 16, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would change the definition of NPC in several ways, effective for contracts entered into after the adoption of final regulations. Among other things, the amendments would expand the permitted indices on which payments may be based to include a non-financial index (any objectively determinable non-financial information that is not within the control of or unique to any party and is not reasonably expected to front-load or back-load payments accruing under the contract). An example of a non-financial index would be one based on weather.

Add to footnote 214: In Revenue Ruling 2014-15, 2014-24 I.R.B. 1095, a domestic corporation voluntarily provided health benefits to retired employees and their families through a VEBA, the VEBA shifted the risk to an unrelated commercial insurance company, and that company reinsured the risks through a contract with the domestic corporation's wholly-owned subsidiary. The subsidiary was regulated as an insurance company and treated the contract as insurance. The subsidiary's only business was the reinsurance contract. The ruling concluded that the subsidiary qualifies as an insurance company under the tax law definition. Specifically, the risk distribution requirement was met because the parties benefitting from the insurance were the covered individuals, and not the domestic corporation or the VEBA (which had no obligation to maintain the insurance). In *Rent-A-Center, Inc. and Affiliated Subs. v. Comm'r*, 142 T.C. No. 1 (2014), the Tax Court upheld as insurance contracts between operating subsidiaries of a parent and a captive insurance subsidiary. The court reversed its earlier position that there is no risk shifting through brother-sister insurance contracts. *Securitas Holdings Inc. et al. v. Comm'r*, T.C. Memo. 214-225 (2014), upheld brother-sister insurance contracts as insurance despite the existence of a parent guarantee where the guaranteed insurance company was not undercapitalized. For a well-informed and comprehensive three part series on captive insurance companies and related developments in the tax law definition of insurance, see F. Hale Stewart and Beckett G. Cantley, "The Captive Insurance Case Law Timeline: The IRS Victories," 2014 *Tax Notes Today* 214-11 (November 5, 2014); "The Captive Insurance Timeline: The Tide Turns for Taxpayers," 2015 *Tax Notes Today* 53-12 (March 19, 2015); and "The Captive Insurance Timeline: The Rise of Risk Distribution," 2015 *Tax Notes Today* 204-12 (October 22, 2015). T.A.M. 201149021 (December 9, 2011) holds that a contract protecting against the residual value of property at the end of a lease term being lower than a specified amount was not insurance under the tax law definition. To the contrary is *R.V.I. Guaranty Co., Ltd. & Subsidiaries v. Comm'r*, 145 T.C. No. 9 (2015), which held that policies protecting against the residual value of leased property being lower than expected was insurance and not an investment product. C.C.A. 201533011 (May 6, 2015) holds that 10-year excess loss policies written by a captive insurance company to affiliates to cover excess healthcare costs were not insurance. It was highly likely when the policies were entered into that payments would be made by the insurance company at the policy limits, so that the practical effect of the policies was to exchange two fixed payment streams. Accordingly, the policies did not shift risks and were more investment products than insurance as commonly understood. Unhappily for the taxpayer, the C.C.A. does not tax the policies as loans but rather requires that the premiums be included in income by the insurance company as they accrue or are paid and that deductions for losses be deferred until claims are paid.

Add to footnote 217: Validus Reinsurance, Ltd. v. United States, 786 F.3d 1039 (D.C. Cir. 2015), held that a contract by which a foreign reinsurance company reinsured its own risk with a second foreign reinsurance company was not subject to the 1 percent excise tax. The court read an ambiguity in the statute against the government in light of the presumption against extraterritoriality. The court loss led the IRS to throw in the towel. In Revenue Ruling 2016-3, 2016-3 I.R.B. 282, it announced that it would follow *Validus* and revoked Revenue Ruling 2008-15.

Add the following Part J:

J. Partnership Issuers

This Chapter has focused so far on offshore issuers that are corporations as distinguished from an entity that is tax transparent such as a partnership. The use of a corporate issuer is feasible only if the issuer can avoid material U.S. taxes despite being a corporation. As the discussion above shows, that result can be achieved for a foreign corporation that (1) has no ECI and (2) whose income is comprised solely of capital gains, foreign source income (on debt of non-U.S. obligors), and FDAP income from U.S.

sources consisting mostly of interest from unrelated borrowers that qualifies for the portfolio interest exemption.

Use of a corporate issuer has advantages that can be significant depending on the circumstances. They include free transferability of stock and of debt classes that might be considered equity for U.S. tax purposes,[147] receiving distributions from the issuer with limited U.S. information reporting for shareholders that are foreign,[148] and preventing income earned by pension funds or other tax exempt investors from being taxable under the debt-financed property rules.[149] Another practical advantage is that the issuer can provide its own tax certifications of beneficial ownership to domestic borrowers and other income payors without receiving certifications from shareholders.[150] In addition, if a U.S. holder of PFIC stock makes a QEF election, the limitation on deemed distributions to current earnings of the PFIC means that interest income can effectively be offset with capital losses from the sale of assets (provided that such losses do not exceed ordinary income).[151]

That said, the typical Cayman Islands issuer that is not a taxable mortgage pool or insurance company and has equity interests that are not publicly traded could choose to be classified as a partnership (assuming two or more owners),[152] and in certain circumstances, partnership status may be the better choice. Some of the reasons are listed below. In general, the reasons favoring a partnership are more likely to be present where the equity owners are themselves domestic taxpayers, or foreign partnerships with owners who are domestic taxpayers.

Reasons for choosing a partnership over a corporation may include the following:

First, and most critically, if the issuer expects to originate loans or otherwise to be engaged in a U.S. trade or business (or there is doubt on that score that prevents tax counsel from rendering a market standard opinion that there will be no trade or business), then having the issuer be a partnership avoids the corporate tax and branch profits taxes that would be imposed on a foreign corporation. However, the direct owners of a partnership issuer must be limited to U.S. persons, both initially and over the life of the transaction, to avoid issuer-level withholding tax under section 1446.[153]

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[147] The transfer restrictions that may apply to partnership equity are described in footnote 159, below.

[148] Dividends paid by a foreign corporation are foreign source income and not generally subject to U.S. information reporting if paid by a non-U.S. payor or intermediary outside of the United States. See section 6042(b)(2)(A) and Treasury Regulation § 1.6042-3T(b)(1)(iv). FATCA reporting may require information about owners. By contrast, partners must be identified on Schedule K-1 to a partnership tax return. Also, foreign partners may be required to file their own U.S. tax returns if the partnership has ECI or U.S. source income.

[149] See Part H, above.

[150] Interest paid by a domestic borrower is eligible for the portfolio interest exemption only if the withholding agent receives a statement identifying the beneficial owner. For a corporation, the beneficial owner is the corporation. For a partnership, the beneficial owners are the partners (and the partnership must provide a Form W-8IMY that bundles together ownership certificates provided by its partners).

[151] See Chapter 13, footnote 162.

[152] The list of *per se* corporations in different foreign countries does not have an entry for the Cayman Islands. See Chapter 4, text at footnote 19.

[153] Section 1446 is described in Chapter 5, footnote 131. The tax is calculated by applying the highest U.S. net income tax rate to ECI allocated to foreign partners and can exceed distributions that otherwise would be made to those partners. Accordingly, payments of the tax can reduce cash flows available to creditors. Limiting the partners to United States persons can be achieved through investor representations (backed up by receiving IRS Form W-9s) and contractual transfer restrictions. The limitation must apply to all instruments that are treated as equity for tax purposes, which can require some judgment if there are deeply subordinated debt classes. Chapter 3, Part E, discusses the possible tax characterization of debt as equity.

Second, if the issuer pays fees to a professional manager that is taxable in the United States, the manager may prefer to receive compensation in the form of a partnership profits interest that is treated as a share of the partnership's investment income.[154]

Third, domestic taxable investors may prefer the full flow-through treatment of a partnership to holding stock in a foreign corporation. Among other differences, a partnership structure potentially allows an investor to deduct its share of current issuer losses, and all capital gains preserve their character (as do capital losses).[155]

Fourth, for an issuer that acquires from its equity owners a portfolio of assets with significant built-in gain, a partnership structure can avoid current recognition of the gain.[156]

Finally, for equity owners that are RICs or REITs or otherwise subject to tax related asset tests, it may be possible to look through a partnership to underlying assets in a way that would not be possible with corporate stock.[157]

Practical issues to consider with a partnership issuer include:

- for partnerships holding mortgages, ensuring the issuer is not a TMP[158]
- imposing transfer restrictions on equity holders, to prevent the partnership from being publicly traded[159] and to avoid section 1446 liability if the partnership has ECI[160]

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154 The treatment of manager compensation is beyond the scope of this book. However, in brief, the IRS has guidance that recognizes partnership profits interests given for services to be partnership interests. See Revenue Procedure 93-27, 1993-2 C.B. 343, clarified by Revenue Procedure 2001-45, 2001-2 C.B. 191. Partnership interests may avoid limitations on deferred compensation under sections 409A and 457A. Some drawbacks of a profits interest are that the manager is allocated income even if not paid, and the manager's right to fees is effectively capped at the partnership's profits as determined for U.S. tax purposes.

155 If a U.S. holder of PFIC stock makes a QEF election, the holder is taxed currently on the PFIC's annual income and net capital gains (the excess of long-term capital gains over short-term losses). Current year net losses do not flow through to the investor, and current year income is not reduced by prior years' losses. See section 1293 and the discussion at footnotes 179 and 180 above. There is a similar result for CFCs (see Part G.4, above).

156 Transfers of property to a partnership generally are not taxable under section 721(a). See Chapter 15, Part C.2. Gain is generally recognized upon a transfer by a U.S. person to a foreign corporation (even if section 351 otherwise would apply) through the operation of section 367(a). See footnote 135, above.

157 For RICs, see Chapter 4, footnote 400 (in this Supplement). For REITs, see Chapter 11, footnote 15.

158 Chapter 4, Part E, discusses the definition of a TMP. In brief, an issuer is a TMP if more than half of the debt obligations it holds are real property mortgages, and the debt obligations the issuer holds support two or more classes of debt liabilities with pay-through features and different maturities.

159 The publicly traded partnership rules of section 7704 are discussed in Chapter 4, Part F. Most partnership issuers limit transfers of partnership interests (including any debt classes that might be considered equity) rather than relying on the qualifying income exception. While the qualifying income exception generally should be available in theory for many partnership CDO issuers, it is often not relied upon in practice because it is hard to police. Further, it would be risky for a partnership that originated loans to rely on qualifying income exception since under section 7704(d)(2)(A) qualifying income does not include interest "derived in a financial business." Normally, the number of partners is limited to a number less than 100 (with a look through in counting partners to indirect owners of pass-through entities in some cases) to take advantage of the private placement safe harbor rule in Treasury Regulation § 1.7704-1(h)(3). That rule is discussed in Chapter 4, at footnote 386. One way to limit the number of holders is to establish minimum denominations. For partnerships with ECI, partners also must represent that they are United States persons. See footnote 153, above.

160 See footnote 153, above.

- ensuring that direct or indirect partners provide beneficial ownership certificates to the partnership so that it can provide a Form W-8IMY to withholding agents making payments to it, establishing (at a minimum) a right to receive interest income free of withholding tax under the portfolio interest exemption[161]
- including contractual provisions to address the risk of entity level liability for audit adjustments under the BBA partnership audit rules,[162] and
- ensuring proper tax reporting (both ongoing reporting and reporting on transfers of property to partnerships) which is different for foreign partnerships and corporations. A partnership return may be required when a corporate return would not be.[163]

Because (1) a U.S. holder of PFIC stock that makes a QEF election can effectively offset interest income with capital losses up to the amount of ordinary income, but net losses are not passed through, and (2) a partnership passes through capital losses, many U.S investors that invest in the equity of multiple CDO issuers invest in a PFIC that in turn invests in partnership issuers of CDOs. That way, capital losses from one CDO issuer can effectively offset not only ordinary income not only from that CDO issuer but also from other CDO issuers in which the investor invests through the PFIC.

Any entity that is classified as a partnership becomes a disregarded entity once it has a single owner. While having a disregarded entity as an issuer may have advantages (as discussed below), because the tax analysis of a disregarded entity is different from that of a partnership, and the conversion of a partnership to a disregarded entity and vice versa can have undesirable tax consequences, if a partnership structure is chosen, transfer restrictions may be imposed on the partners to prevent the transfer of all ownership interests to a single owner.[164]

It is generally better from a creditor's perspective for an issuer of pay-through bonds to be a disregarded entity rather than a partnership because a disregarded entity is not subject to BBA liability for potential audit adjustments or withholding tax liabilities. For that reason, where those liabilities are a

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[161] Certifications by foreign partnerships to reduce withholding taxes are described in Chapter 12, Part C.4 (in this Supplement). It is common to require partners contractually to provide appropriate certifications to a partnership so that it can properly complete Form W-8IMY. The partnership may also be given the right to force a sale of a partnership interest held by a partner who fails to provide the appropriate documentation.

[162] The BBA rules are discussed in Chapter 5, Part C.1 (in this Supplement). A detailed discussion of contractual provisions responding to the BBA rules is beyond the scope of this book. However, they would generally include the appointment of a partnership representative, requiring the partnership to make elections or take other steps to reduce partnership level liabilities, requiring the partners to cooperate in doing so, and indemnity provisions that allocate tax adjustments attributable to a partner's interest in the partnership in a given year to that partner. Some protection for creditors against BBA liabilities can be gained by having the debt issuer be a disregarded entity owned by a partnership. This two-tier structure is discussed below in the text.

[163] Chapter 14, Parts H.2 and H.3, discuss tax reporting by foreign corporations and foreign partnerships. Note that a foreign partnership will generally be required to file a Form 1065 if it has U.S. source income and any U.S. partners. A foreign corporation generally does not need to file unless it has some ECI.

[164] The conversion of a partnership issuer to a disregarded entity causes the deemed retirement of pay-through bonds of the issuer held by the sole equity owner. If those bonds are subsequently sold by the owner to another investor, they are considered to be reissued and generally would have tax attributes different from other identical bonds that were never held by the owner. While it is very likely that the conversion of a debt issuer from a partnership to a disregarded entity does not cause a significant modification of bonds held by investors other than the owner (see the discussion in Chapter 6, Part D.2, in the book and in this Supplement), there is no issue if the issuer remains a partnership. Also, it can be administratively burdensome to comply with tax reporting requirements if the tax status of an issuer changes. In addition, the source of income on the bonds of an entity that is not engaged in a U.S. trade or business would change from foreign-source to U.S. source when it was converted from a partnership to a disregarded entity wholly owned by a U.S. person.

concern, one way to address them is to use a two-tier structure in which a partnership owns all of the equity in a disregarded entity.[165]

[165] For further discussion of this structure, see Chapter 2, Part A.2 (in this Supplement).

Chapter 14

Legending and Information Reporting

A. Introduction

Comment on penalties: Congress has in recent years significantly increased penalties for lapses in information reporting to the point where unintentional failures (without reasonable cause) to comply can result in meaningful monetary costs. The most recent changes were in the Trade Preferences Extension Act of 2015, P.L. 114-27, which became law on June 29, 2015. Among other things, it increased the basic penalty in section 6721(a) for unintentional failures to file a complete information return with the IRS, and (under section 6722(a)) to provide a complete payee statement to the payee, to $250 from $100 (so $500 for both), and increased the overall cap for any person for any year from $1.5 million to $3 million (or double that for failures under sections 6721 and 6722). The penalties are subject to exceptions based on reasonable cause and, under sections 6721(e) and 6722(e), are increased materially to a penalty based on a percentage of reported amounts without a cap for intentional failures. Lower penalties apply to persons with gross receipts under $5 million. The information returns to which these particular penalties apply are listed in section 6724(d)(1). For a description of recent changes, see Michael M. Lloyd and S. Michael Chittenden, "Congress Hikes Reporting Penalties While Filers Remain Stymied," 2015 *Tax Notes Today* 161-6 (August 20, 2015).

B. REMIC Regular Interests and Pay-Through Bonds

1. Overview

2. Reporting at Time of Issuance (Form 8811)

3. Ongoing Reporting

Add to the end of footnote 16: In reporting OID to payees, a broker is required to make adjustments for acquisition premium assuming acquisition premium accrues ratably. This is true even if the customer has made an election to amortize acquisition premium under a constant yield method or has elected to treat all income on the debt instrument as OID. However, in reporting market discount, while a broker generally is required to assume that each customer has elected to amortize accrued market discount using a constant yield method, a broker treats market discount as accruing ratable if the customer notifies the broker to do so. Similarly, a broker is required to treat each customer as if it has elected to amortize bond premium unless, in the case of a taxable bond, the broker has been notified that the payee does not want the broker to take into account the election or has revoked the election. These presumptions apply only for information reporting purposes; thus, a taxpayer is still permitted (1) to elect to treat all income on a debt instrument as OID and (2) not to elect to amortize bond premium on a taxable bond. See Treasury Regulation §§ 1.6045-1T(n)(11)(i)(A), 1.6045-1T(n)(11)(i)(B), 1.6049-9(b), 1.6049-9(c), 1.6049-10T. These rules have varying effective dates, grandfathering rules, and, in the case of the temporary regulations, sunset dates.

C. Pass-Through Certificates Issued by Grantor Trusts

1. Overview

2. Reporting by WHFITs

a. Terminology and Overview

b. Who Reports to Whom

c. Timing and Method of Reporting—General

d. What is Reported—General

(i) ***Form 1099***

(ii) ***Statement to TIH***

e. What is Reported—Special Rules

(i) ***General de minimis exception***

(ii) ***Qualified NMWHFIT exception***

(iii) ***Special de minimis exception for WHMTs***

(iv) ***NMWHFIT final tax year exception***

f. Simplified Reporting

(i) ***Safe harbor for certain NMWHFITs***

(ii) ***Safe harbor for certain WHMTs***

g. Directory of WHMT Trustees

3. Grantor Trusts That Are Not WHFITs

D. Equity Interests in Partnerships

1. General

Comment to footnote 120: Effective for returns for taxable years beginning after December 31, 2015, section 6072(b) has been amended (by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015) to require that returns of partnerships under section 6031 be filed on or before March 15 for a calendar year taxpayer (the 15th day of the third month after year end for a fiscal year taxpayer).

2. Synthetic Variable Rate Tax-Exempt Bonds

E. REMIC Tax Returns

Effective for returns for taxable years beginning after December 31, 2015, section 6072(b) has been amended to require that returns of partnerships under section 6031 be filed on or before March 15 for a calendar year taxpayer (the 15th day of the third month after year end for a fiscal year taxpayer). This one-month acceleration of filing dates for partnerships should carry over to REMICs.

Add to the text after footnote 126. However, if a REMIC ceases to exist on a date during a calendar year, the instructions to Form 1066 indicate that the return is due by the 15th day of the fourth month following such date, apparently on the basis that the taxable year of the REMIC ends when the REMIC ends.[126a]

The first paragraph on page 1128 describes reporting by a REMIC on Schedule Q of the portion of the REMIC's assets that are mortgages on real property for a REIT. If the average percentage of qualifying assets for the relevant period is at least 95 percent, then a REMIC may report that fact without specifying a number; otherwise it must report the actual average.

In October 2011, the Federal Housing Finance Agency (FHFA) with Fannie Mae and Freddie Mac announced an expansion of the Home Affordable Refinancing Program (HARP) that would facilitate refinancings of home mortgages. The program is available to borrowers who owe more on their mortgages than the value of their homes. Notice 2012-5, 2012-3 I.R.B. 291, adopts a safe harbor rule for an "eligible REMIC" that effectively lowers the 95 percent figure to 80 percent, effective for calendar quarters ending after December 31, 2011. An eligible REMIC is one that has a guarantee from Freddie Mac or Fannie Mae of payments of principal and interest, as applicable, on both regular and residual interests, and has as qualified mortgages only single family (one-to-four unit) dwellings. The notice describes the fact that the REMIC definition of qualified mortgage requires that real property collateral have a value of only 80 percent of the adjusted issue price of a mortgage, and implies, without stating explicitly, that qualified mortgages should therefore have at least 80 percent real property collateral for REIT purposes. Treasury Regulation § 1.856-5(c)(2) (loan value for purposes of determining qualifying interest) allows a REIT to rely on real property collateral values as of the date the REIT acquires a loan.

The REMIC safe harbor is accompanied by Revenue Procedure 2012-14, 2012-3 I.R.B. 296, which allows a REIT holding a residual interest in an eligible REMIC that reports holding at least 80 percent real property mortgages to treat 80 percent (or the higher reported number) of the residual interest as a real estate asset. The same principle applies to a regular interest except that it can use the 80 percent number as a floor whether or not the REMIC reports on Schedule Qs that it meets the 80 percent threshold.

F. Broker Reporting of Sales and Backup Withholding

Add to footnote 144: Final regulations under sections 6045(g), 6045A and 6045B adopted by T.D. 9616, 2013-20 I.R.B. 1061, generally require basis reporting for debt instruments starting for debt acquired on or after January 1, 2014 (2016 for more complex instruments). The regulations do not apply to (and basis reporting is not required for) debt instruments described in section 1272(a)(6) (or stated differently, subject to the PAC method for accruing OID). For an article indicating that these regulations may require reporting by issuers of modifications of a debt instrument (if it is a "specified security" of the type generally subject to the rules), see Lee G. Zimet, "Surprise! New Rules Require Reporting of Debt Modifications," 2015 *Tax Notes Today* 110-12 (June 9, 2015). T.D. 9713 (March 13, 2015) adopts a new Treasury Regulation § 1.6049-9 that requires brokers that are required to report basis information with respect to debt instruments to also adjust interest and OID reporting for amortized premium.

[126a] Cf. Treasury Regulation § 1.6031(a)-1(e)(2), which describes the required filing date for a partnership as the 15th day of the fourth month following the close of the partnership's taxable year. As indicated above, the filing date has been accelerated one month beginning with the 2016 taxable year.

G. Nominee Reporting to Issuers

H. Offshore Issuers

1. Overview

2. Foreign Corporations

Add at the end of Part H.2: On December 27, 2016, final regulations were issued implementing the expanded reporting requirements for shareholders of PFICs under section 1298(f). See Treasury Regulation § 1.1298-1, adopted by T.D. 9806. The regulations generally require a PFIC shareholder that is a United States person to attach Form 8621 to its income tax or information return to report PFIC holdings during the year (one form for each PFIC). The regulations are generally effective for taxable years of shareholders ending on or after December 31, 2013 (see Treasury Regulation § 1.1298-1(h)), and do not require retroactive filing of Form 8621 by taxpayers who would not have been required to file the form before the enactment of section 1298(f). In the case of shares owned indirectly through entities, the regulations generally require expanded filing by the first domestic entity in a chain of ownership, meaning the U.S. shareholder closest to the PFIC. For grantor trusts owning PFIC stock, the reporting requirement is generally imposed on the grantor rather than the trust, with an exception for a WHFIT (WHFITs are described in Chapter 14, Part C.2, above) and certain liquidating trusts created by court order. There are exceptions for shareholders that are tax-exempt entities, for certain small holdings ($25,000 aggregate PFIC holdings or $5,000 indirect holding in one PFIC), for stock marked to market under a section outside of the PFIC rules, and for stock held through certain foreign pension funds if, under an income tax treaty, income from the funds is taxable to the shareholder only when received, and for stock held for 30 days or less. For an article describing a temporary version of the regulations more comprehensively, see Kimberly S. Blanchard, "New PFIC Reporting Rules under §1298(f)", *BNA Tax Management International Journal*, March 14, 2014.

3. Foreign Partnerships

Clarification of footnote 176: To avoid filing Form 1065, a foreign partnership with ECI or U.S. source income and some U.S. partners must have both *de minimis* U.S. source income ($20,000 or less) and no ECI and *de minimis* U.S. partners (aggregate allocations of tax items to United States persons under 1 percent).

Add to footnote 183: Somewhat surprisingly, there is an LB&I Practice Unit dated February 14, 2017 giving IRS examiners guidance on the monetary penalties for failing to file Form 8865. The unit is available at www.irs.gov/businesses/corporations/international-practice-units.

4. Foreign Trusts

5. Foreign or Foreign Owned Disregarded Entities

Add at the end of Part H.5:

There is no separate reporting form for a domestic disregarded entity. However, under regulations issued December 13, 2016 and effective for taxable years beginning after December 31, 2016, a domestic disregarded entity is treated as a corporation for purposes of reporting, record maintenance and associated compliance requirements that apply to 25 percent foreign-owned domestic corporations under section 6038A.[166] These regulations could affect offshore issuers that have domestic co-issuers that are

[166] See Treasury Regulation § 1.6038A-1(c)(1), adopted by T.D. 9796.

disregarded entities.[167] The regulations were aimed at gathering information regarding U.S. entities to allow the Treasury to carry out reporting obligations under tax treaties and information exchange agreements with foreign countries.

Section 6038A authorizes annual reporting under regulations by a domestic corporation that is 25 percent foreign owned. A corporation meets this test for a taxable year if at any time during the year at least 25 percent of the corporation is owned, by vote or value, by one foreign person, applying ownership attribution rules. If this test is met, then reporting is required regarding 25 percent foreign shareholders, and domestic or foreign persons related to such shareholders, who enter into reportable transactions with the domestic corporation during the year.[168] The corporation must also retain records to determine the correct reporting of transactions.

6. FATCA Reporting and Withholding Tax

Chapter 12, Part E (FATCA Reporting and Withholding Tax) has been replaced with an up-to-date discussion in this Supplement. For simplicity, that discussion covers FATCA as it applies to both investors and offshore issuers. Certain aspects of FATCA relevant to the reporting burdens of issuers are also summarized below. Defined terms are defined in Chapter 12.

FATCA effective dates have been pushed back. Thus, no withholding will be required on obligations issued before July 1, 2014, and reporting obligations generally become effective only in 2014 (with staggered dates for different types of information gathering and reporting). Withholding with respect to foreign passthru payments (including payments on debt issued by a foreign corporation) has been pushed off and will not apply to debt issued before six months after regulations are adopted defining foreign passthru payments (the definition is reserved in current regulations).

In response to the fact that equity is never grandfathered, the FATCA regulations have a grandfather rule for certain debt securitization vehicle that were in existence (and issued interests) on or before January 17, 2013 and meet the definition of a limited life debt investment entity or LLDIE. However, the LLDIE definition is so narrow that the rule has limited usefulness. Aside from this, the FATCA regulations do not have any exemptions tailored to securitization vehicles.

The U.S. has signed intergovernmental agreements or IGAs with a number of countries, including the Cayman Islands. The Cayman Islands IGA is a Model 1 IGA, which means that a Cayman Islands FFI will end up collecting information as required by Cayman Islands law and reporting it to the Cayman Islands rather than entering into an FFI Agreement with the IRS. The information gathering and reporting burdens may also be somewhat lessened, although without changing the basic scope of required information.

7. Other Measures to Enforce Reporting Obligations

Section 6038D reporting is generally done by attaching Form 8938 to annual tax returns. Extensive regulations were adopted in 2014 and 2016 under section 6038D, which are Treasury Regulation §§ 1.6038D-1 through 1.6038D-8. A complete description is beyond the scope of this book, but a few points relating to reporting by domestic entities are worth mentioning. Section 6038D(f) authorizes regulations requiring reporting by any domestic entity which is formed or availed of to hold assets that would be reportable if held by a domestic individual. Under this authority, the regulations require reporting by a

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[167] A domestic disregarded entity would not be subject to reporting for a taxable year if it does not transfer property to or receive property from a related person or otherwise engage in a reportable transaction for the year. On that basis, a truly passive disregarded entity may not be subject to reporting.

[168] The list of reportable transactions is in Treasury Regulation § 1.6038A-2(b). The list is expanded soley for domestic disregarded entities to include any transfer of property between the entity and related parties, including contributions to and distributions from the entity.

"specified domestic entity" in addition to an individual. The test is applied annually. A specified domestic entity is defined narrowly in Treasury Regulation § 1.6038D-6 as a domestic corporation or partnership that is both passive (meets a 50 percent or more passive income or assets test, applied in some cases by aggregating related persons) and closely held (80 percent owned) directly, indirectly, or constructively by an individual subject to reporting. A domestic trust that is a taxpayer (is not a grantor trust) may be a specified domestic entity if it has a current income beneficiary that would itself be subject to section 6038D reporting, with some exceptions, including for certain trusts that file returns and have institutional trustees. The owner of a grantor trust would generally be required to look through the trust to its assets for purposes of reporting, but there is an exception in Treasury Regulation § 1.6038D-7(b)(1) for a widely held fixed investment trust as defined in Treasury Regulation § 1.671-5 (namely a domestic trust having any interest held through an intermediary that is subject to information reporting under the WHFIT rules). For the definition of WHFIT, see Part 14.C.2.a, above.

I. Borrower and Miscellaneous Income Reporting

The 2010 expansion of information reporting under section 6041 to cover purchases of goods and to eliminate the exceptions for payments to taxable corporations was repealed by the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, which was signed into law on April 14, 2011.

Comment on section 6050H: The section requires reporting of interest received. There has been some uncertainty about when and how to report accrued and unpaid interest on loans that have been modified to allow some amounts of interest to be capitalized and added to principal. In a letter reproduced at 2015 *Tax Notes Today* 202-14 (October 15, 2015), the American Bankers Association asked the IRS for prospective guidance on the topic under the industry issue resolution program. Apparently, practices have not been consistent. The letter refers to apparently unsuccessful litigation by homeowners challenging bank reporting of such interest.

Add to footnote 226: T.D. 9642 (November 27, 2014) adopted final regulations under section 6050H that require information reporting by persons who receive mortgage insurance premiums, including prepaid premiums, aggregating $600 or more during any calendar year. The regulations implement reporting requirements that result from the extension of the treatment of mortgage insurance premiums made by the American Taxpayer Relief Act of 2012.

Add to footnote 229: At the end of 2016, the IRS issued regulations that eliminate the 36 month presumption for all reporting entities. See T.D. 9793, effective for returns or reports otherwise due after December 31, 2016.

Revenue Procedure 2013-16, 2013-7 I.R.B. 488, provides detailed guidance on the treatment of loan modifications and subsidy payments under HAMP. HAMP contemplates reductions in the principal amount of underwater mortgages. The revenue procedure describes how principal reductions pursuant to HAMP should be reported under section 6050P.

Add to the end of footnote 233: On May 7 2015, the IRS announced temporary, final and proposed regulations that would eliminate the distinction between nonperiodic payments that are significant and those that are not. See Chapter 8, Part H.5.a (in this Supplement).

J. FBAR Filings

In February 2011, Treasury's Financial Crimes Enforcement Network ("FinCEN") adopted a final rule amending the Bank Secrecy Act regulations relating to FBAR reporting. The regulations are at 31 CFR 1010.350. The amendments are effective March 28, 2011 and apply to reports for 2010 that are due June 30, 2011. For the preamble and text, see 2011 *Tax Notes Today* 37-11 (February 23, 2011). Two noteworthy provisions are (1) the inclusion in the definition of "other financial account" of a "mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions" (thus, securitization vehicles, hedge funds and private equity funds without shares of this type are not covered; but to preserve the threat, a category for "other investment funds" is reserved), and (2) a rule treating a person who is the "trust grantor" and is considered to own trust property under the Code's grantor trust rules (e.g., the holder of a pass-through certificate) as holding a financial interest in any account held of record or legally by the trust (without regard to the size of the person's interest in the trust). However, if the trust, trustee or agent of the trust is a U.S. person and itself files a report disclosing the trust's foreign financial accounts, the grantor need not also report those accounts. This rule could be quite troublesome for U.S. persons holding pass-through certificates issued by a foreign investment trust that is classified under U.S. tax principles as a trust, although investments of that type are relatively rare. The final rule also expands required reporting for persons with signature authority over financial accounts in corporate groups. The foregoing is (obviously) not a comprehensive summary, so readers should look to the text of the regulations and preamble for guidance. Also, for a good summary of the significant changes, see Robert S. Chase II, Carol P. Tello, and Dwaune L. Dupree, "The FBAR Reset: Final Regulations Provide Mixed Guidance," 2011 *Tax Notes Today* 80-7 (March 30, 2011).

Notice 2011-31, 2011-17 I.R.B. 724, explains which FBAR regulations and instructions to refer to in answering questions relating to foreign accounts in 2010 federal income tax and information returns that are filed before, on or after March 28, 2011, the date when the final FBAR regulations were published.

Notice 2011-54, 2011-29 I.R.B. 53, allows certain persons having signature authority over, but no financial interest in, a foreign financial account in 2009 or earlier calendar years to extend FBAR filing dates until November 1, 2011.

The filing deadline for Form TD F 90-22.1 was extended to June 30, 2015 for certain individuals. See FinCen Notices 2013-1, 2012- 2, 2012-1, 2011-2 and 2011-1.

On October 1, 2013, TD F 90-22.1 was replaced with FinCEN Report 114, "Report of Foreign Bank and Financial Accounts," which is only available online through the BSA (Bank Secrecy Act) E-Filing System website.

FinCEN Notice 2016-1 announces an extension until 2018 of the due date of FBAR reporting for certain accounts for which individuals have signature authority but no financial interest. Regulations on this topic were proposed in March 2016. There was previously an extension under FinCEN Notice 2015-1. The March 2016 proposed regulations would also eliminate a favorable rule allowing limited reporting for filers with 25 or more accounts. There is an article describing the proposed regulations in the BNA Daily Tax Report for May 31, 2016 by Edward Tanenbaum, "The 'F' Word Revisited—FBAR and FinCEN's Notice of Proposed Rulemaking."

Legislation passed in 2015 changed the filing date for FinCEN Report 114 to April 15 beginning with reporting for the 2016 taxable year, with a six month extension allowed. The Treasury announced December 16, 2016 that it will grant automatic six month extensions so that the filing date is now October 15 (or the next following business day). See www.fincen.gov/news/news-releases/new-due-date-fbars-0.

Current information regarding FBAR reporting is available on the FinCEN web site.

K. Qualified Tax Credit Bonds and Build America Bonds

Chapter 15

Taxation of Sponsors

A. Introduction

B. Sponsors That Are Loan Servicers, Securities Dealers, or Members of Consolidated Groups

1. Excess Servicing

2. Mark-to-Market Accounting for Securities Dealers

3. Intercompany Transactions

C. Pass-Through Certificates

1. Issuer Classified as Trust

2. Issuer Classified as Business Entity

D. Asset-Backed Securities Taxable as Debt

E. REMICs

Add a new heading "General" and a new section on short-term REMICs.

1. General

Add to the end of footnote 63: Section 860F(b)(1)(D)(ii) and Treasury Regulation § 1.860F-2(b)(4)(iv) effectively allow a holder of mortgages (or REMIC regular interests) with a built-in loss to (1) create a short-term REMIC with a small amount of regular interests and a large residual interest and (2) amortize the portion of the built-in loss allocable to the residual interest as an ordinary deduction over the expected life of the REMIC, taking account of any required qualified liquidation provided for in the REMIC's constituent documents. The regular interests are sold to unrelated investors, triggering an immediate loss equal to the portion of the loss allocable to the regular interests. Such a REMIC was approved in T.A.M. 201517007 (November 21, 2014), which is discussed in Chapter 6, Part B (in this Supplement).

TAMRA, enacted in 1988, amended section 171(e) to eliminate any deduction for amortizable bond premium and, instead, treats it as an offset to interest payments. The legislative history indicates that the purpose of treating amortizable bond premium as an offset to interest earned (rather than as previously treated as interest expense) was to prevent limitations on interest deductions from applying and thus ensure that the taxpayer received the full benefit of the amortization. See H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 71-2 (July 16, 1988). Thus, the amendments to section 171(e) should not be read to limit the ability of a regular interest holder to deduct the excess of its basis in the regular interest over the issue price to "interest payments" and prevent the offsetting of accrued OID (of which, under section 1272(c)(1), there is none in the case of a bond to which section 171 directly apples).

2. Short-term REMICs

A sponsor owning mortgages with a built-in loss can use the REMIC rules to obtain an ordinary deduction (or mostly ordinary deduction) for the loss over a relatively short time period, without disposing of the mortgages or triggering a book loss.

This result is achieved by selling to unrelated investors a relatively small amount of notes or other debt instruments secured by the mortgages, and electing to treat the borrowing arrangement as a REMIC. As part of the election, the taxpayer designates the debt as regular interests and the economic residual interest in the mortgages as the residual interest. The taxpayer keeps the residual interest. The mortgage collateral may be held through a special purpose entity or be a segregated pool of assets of the taxpayer.

The REMIC lasts only until the notes are repaid, which may be a period a little longer than a year. The terms of the REMIC require that the mortgages be sold (and the REMIC be liquidated) no later than a specified date, provided, as is highly likely given the small size of the notes, that the proceeds will be sufficient to repay any notes that remains outstanding at that time. The sponsor can potentially reacquire the mortgages by purchasing them from the REMIC in the liquidation sale.

Mortgages may have a built-in loss because of a deterioration in the borrowers' creditworthiness or an increase in market interest rates since the loans were acquired. Thus, the technique may be particularly popular in a high (or higher) interest rate environment or for a taxpayer that has suffered credit losses that cannot be claimed as bad debts. Obviously, a taxpayer that is a dealer or otherwise marks mortgages to market for tax purposes would not need the REMIC rules to claim a loss.

A 2015 technical advice memorandum analyzes a short-term REMIC and upholds the taxpayer's position claiming losses. The balance of this section will describe in more detail the intended tax results of the structure for the sponsor and the advice memorandum.

The anticipated tax consequences of a short-term REMIC are as follows:

- The contribution of mortgages by the sponsor to the REMIC in exchange for REMIC interests is not a recognition event.[169] Instead, the sponsor allocates its aggregate basis in the mortgages between the residual interest and each class of regular interests in proportion to their respective fair market values. This means that the built-in loss in the mortgages is allocated in proportion to those values.
- When the regular interests are sold, the sponsor recognizes loss under section 165 (subject to any generally applicable limitations on loss recognition) equal to the portion of the built-in loss allocated to the regular interests (so a small portion). The loss generally would be a capital loss for a taxpayer that is neither a bank nor a securities dealer.
- The portion of the built-in loss allocated to the residual interest is allowed as an ordinary deduction over the (short) anticipated weighted average life of the REMIC.[170]
- The REMIC has an initial basis in the mortgages equal to their fair market value. Any excess of the face amount of the mortgages over their initial basis is included in the REMIC's income as it accrues, on a constant yield basis, over the anticipated life of the mortgages (not of the REMIC).[171]

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[169] The rules governing REMIC sponsors generally are described in Part E.1, above.

[170] See footnote 63, above.

[171] See Chapter 9, text at footnotes 33 and 42.

- When the remaining mortgages are sold upon liquidation of the REMIC, the REMIC (and hence the sponsor as owner of the residual interest) recognizes gain or loss equal to the difference between the amount realized and the REMIC's basis in the mortgages (which equals their principal amount less the unamortized discount).[172]

Putting these parts together, and assuming for simplicity that the mortgages have a market value at the time of the REMIC's liquidation equal to their face amount less the unamortized acquisition discount to the REMIC (which is the REMIC's basis), and that the sponsor repurchases the mortgages at that price, the end result is that the sponsor is allowed a deduction equal to the initial built-in loss less the portion of such discount that is amortized over the (short) life of the REMIC. The deduction is ordinary, at least to the extent allocable to the residual interest. The loss is economic as it reflects the excess of the sponsor's initial basis in the mortgages over their fair market value at the time of the REMIC's liquidation.

If the REMIC sells the mortgages upon liquidation at a price higher or lower than the REMIC's basis (because the mortgages are in fact worth more or less than the basis amount), the sponsor's net loss would be correspondingly smaller or greater.

The sponsor changes its economic position in the transaction because it is borrowing money from third parties by selling the notes. On the other hand, the borrowed amounts may be relatively small and possibly the sponsor could have borrowed at a lower cost from other sources. Also, if the notes would have qualified as debt under general tax principles, the REMIC election is not needed to ensure debt treatment or to avoid tax on the REMIC (which absent the REMIC election would be a disregarded entity or ignored as a security device).

The IRS considered the tax treatment of a short-term REMIC in a 2015 technical advice memorandum.[173] In the transaction under review, the taxpayer was the parent of a group that included a life insurance company subsidiary. The subsidiary assigned to a newly formed statutory trust a portfolio of qualified mortgages (residential mortgage backed securities) that had a built-in loss due to post-acquisition credit impairments. In return, the trust issued to the sponsor a single class of notes, and a certificate representing a beneficial interest in the trust. The certificate entitled the holder to all mortgage payments not used to make payments on the notes. The sponsor immediately sold the notes to unrelated capital markets investors but retained the certificate. An election was made to treat the trust as a REMIC. The note indenture designated the notes as the REMIC's regular interests and the certificate as the residual interest.

The notes entitled the holder to semi-annual interest payments, scheduled semi-annual principal payments in fixed amounts, and a balloon payment of principal and accrued interest after fourteen months.[174] Payments of principal and interest on the mortgages were the primary source of payments on the notes prior to maturity, and were expected to exceed significantly the amounts due on the notes other than the balloon payment. At the maturity of the notes, the trust was required to sell its remaining mortgage portfolio at auction (with the sponsor retaining a right to outbid other bidders) and to use the proceeds first to retire the notes.[175]

The notes were guaranteed by the taxpayer and were rated based on the guarantor's credit rating. The memorandum indicates that the rate of interest paid on the notes was greater than the rate the guarantor would pay on a conventional corporate bond.

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[172] See Chapter 9, text at footnotes 43 and 44. The gain or loss would be ordinary. See Chapter 9, footnote 28 and accompanying text.

[173] See T.A.M. 201517007 (November 21, 2014).

[174] The REMIC was formed in "Month 1 Year 3" and the maturity date was "Month 3 Year 4".

[175] Presumably, the sale would be in a qualified liquidation, although the memorandum is silent on this point. See section 860F(a)(4) and Treasury Regulation §1.860G-2(j) and discussion at Part B.1.a.iv.

The mortgage assignment was treated as a secured financing for financial statement purposes (not as a sale), in part because the assignment to the trust was not a legal true sale.

Taxpayer claimed a capital loss on sale of the notes equal to the portion of the built-in loss allocated to the notes, and an ordinary loss from amortizing the portion of the loss allocated to the residual interest over the expected life of the REMIC.

The formal requirements of the REMIC interests test, assets test, and arrangements test were not at issue. Rather, the IRS examination team questioned whether, considering all the facts and circumstances (including the parent guarantee, the accounting treatment, and the ability of subsidiary to reacquire the mortgages upon liquidation of the REMIC), no real transfer of mortgages to the trust occurred and the transactions might be more appropriately taxed as a secured borrowing by the sponsor rather than under the REMIC rules. While not noted in the memorandum, this line of argument is quite odd because there is clearly no requirement that a taxpayer transfer mortgage assets to a separate entity; a REMIC election can be made for a segregated pool of assets.[176]

Citing the REMIC rules' legislative history, the advice concludes that where the formal requirements for REMIC formation are met, the tax consequences are governed exclusively by the REMIC rules.[177] Based on that review, the memorandum concludes that, "[a]pplication of these rules is thus elective and the tax consequences of a REMIC transaction follow from such election." The memorandum also notes that the statute gives a taxpayer the choice whether to keep or sell REMIC interests.

Some of the more interesting aspects of the advice are what it does not say. It indicates in the facts that issuing notes was more expensive than issuing conventional corporate debt, but makes no reference to this fact in the discussion of the REMIC rules. It does not question the fact that there is only one class of regular interests and a large residual interest, that the term of the REMIC is significantly shorter than the remaining term of the mortgages, that the notes would be debt for tax purposes absent the REMIC election, and that they provided for a fixed schedule of payments (not tied to the timing of payments on the mortgages). This is the right approach. While REMICs typically issue multiple classes of regular interests with pay-through features that receive cash flows representing substantially all of the payments received on mortgages held by a REMIC, and regular interests are typically in the form of equity, the REMIC rules do not require multiple interests or interests of any particular size or legal form. Also, they clearly allow a REMIC to sell assets in a qualified liquidation when those assets are still significant, at least as long as the proceeds are sufficient to repay any outstanding regular interests.[178] Thus, even with these features, it is accurate to say that the taxpayer complied with the REMIC rules. That said, it would be tempting fate to shorten the life of a REMIC to much less than the fourteen months in the advice memorandum.

The memorandum makes no mention of the economic substance doctrine, either the common law version or as codified in 2010 in section 7701(o).[179] However, by emphasizing the fact that the REMIC rules are mechanical and intended to be exclusive, the authors plainly were indicating that the taxpayer was using the rules in a way that did not frustrate congressional intent (so that disregarding the transaction was not needed to carry out such intent). It is helpful that the REMIC rules were not achieving distortive results but simply allowing the taxpayer to deduct an economic loss. In this setting at least, technical compliance is enough.

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176 See Chapter 6, footnote 3.

177 See Chapter 6, footnote 4.

178 There are separate rules for a clean-up call that requires that the mortgage balance be small. See Chapter 6 at footnotes 31 and 32 and accompanying text. It is important, however, to require that any liquidating sale produce proceeds sufficient to retire regular interest in full. Otherwise, payments on regular interests could be considered to be subject to a prohibited contingency. See Chapter 7, Part D.

179 For a description of this section, see Chapter 6, Part D.12.

Chapter 16

Tax Law Aggregation or Separation of Property Interests

A. Introduction

A recent report by the United States Government Accountability Office identified aggregation and separation as a significant issue in taxing hybrid instruments. The report observed, “Derivatives can…be coupled with each other and with other types of financial instruments, like more traditional debt or equity instruments, to create hybrid securities. Because hybrid securities often do not clearly fall within a single tax category, it can be challenging for IRS and taxpayers to determine which tax rules are appropriate, and whether the hybrid should be treated as a single instrument or broken up into multiple instruments.” GAO, “Financial Derivatives—Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse,” GAO-11-750 (September 2011).

B. Common Law Aggregation of Claims Against Unrelated Parties

1. General

2. Similarity

3. Stapling

4. Offset

a. Hedging Transactions

b. Tax Straddles

5. Income Rights

6. Guarantees

C. Common Law Aggregation of Claims Against One Person

1. General

2. Similarity

P.L.R. 201444022 (July 21, 2014) is the odd case of a private letter ruling that was issued and is adverse. It involves a REIT that had outstanding a class of common stock. It wished to recapitalize and divide the common into Class A and B Shares that would be identical except that the Class B Shares required larger minimum investments and would bear smaller management fees (and receive correspondingly larger dividends). The ruling holds that the two classes effectively should be aggregated into one class, and that the payment of dividends at different rates on shares within this one class would invoke the rule in section 562(c) that denies deductions for dividends paid by REITs if they are paid preferentially (not pro rata) within a class. For a letter from industry expressing considerable dissatisfaction with the ruling, see Real Estate Roundtable, "Comment Letter Relating to Preferential Dividend Analysis in P.L.R. 201444022," 2015 *Tax Notes Today* 72-14 (January 23, 2015).

3. Stapling

a. Stock Options Combined with Stock or Debt

b. Stock Forward Plus Debt

c. Debt and Stock

4. Offset

The *Anschutz* case discussed in Chapter 3 at footnote 71 takes account of a forward contract with an investment bank in holding that section 1058 does not apply to a stock loan made to the same bank. A New York State Bar Association, Tax Section report argues that the case would have been better decided by simply offsetting the stock loan against the forward. It also points out that this approach should not be followed for securities loans and hedge contracts entered into with unrelated parties. See "Report of the Tax Section of the New York State Bar Association on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058," 2011 *Tax Notes Today* 112-22 (June 9, 2011).

C.C.A. 201501012 (July 25, 2014) involved a tax shelter investment consisting of a loan and a prepaid forward contract between the same parties. A special purpose entity (SPE Seller) owned by a brokerage firm acquired interest rate swaptions and entered into two contracts with a second special purpose entity (SPE Buyer). The contracts were a loan of money from SPE Seller to SPE Buyer and a prepaid forward sale contract under which SPE Seller sold certain floating rate certificates of deposit (with floors on the interest rate) to SPE Buyer periodically for specified prices. The periodic sales could be cash settled. The cash settlement payments were set to equal (1) the amounts due under the loan plus (2) additional amounts if interest rates rose. The swaptions held by SPE Seller hedged its obligation to pay the additional amounts. SPE Buyer paid the premium due by SPE Seller for the swaptions. Several years into the transaction, SPE Buyer sold its interest in the loan and forward to tax law partnerships organized by promoters, which sold interests in the partnerships or contracts to individual taxpayers. The intended tax result for the individuals was deductions for interest paid under the loan combined with capital gains from cash settlement of the forward purchases. Only a small percentage of the cost of participating went to purchase the interest in the transaction (as distinguished from fees). The C.C.A. concludes that the loan did not represent genuine indebtedness and that the loan and forward could be netted under substance over form and related principles into an investment in the swaption contracts. The C.C.A. cited *Blue Flame* cited in footnote 61 and the LILO authorities referred to in footnote 62. The C.C.A. also concluded that deductions may be limited under the at-risk rules of section 465 and gain may be considered ordinary under the conversion transaction rules in section 1260. C.C.A. 201515020 (December 4, 2014) addresses the same transaction and concludes that taxpayers' participation in the transaction may also be disregarded under the economic substance doctrine.

5. Related Party Ownership

D. Rules-Based Aggregation

1. General

2. *Debt and Hedges*

a. *Integration*

Another example of regulations-based integration is Treasury Regulation § 1.148-4(h) under which payments made or received by an issuer of tax-exempt bonds pursuant to a "qualified hedge" are taken into account in determining the yield of the bonds. (In very general terms, section 148 prohibits the issuer of tax-exempt bonds from investing the proceeds of an issue of bonds in investments that earn a higher yield than the yield on the bonds.) To be a "qualified hedge" a contract, such as a swap, option, or forward contract must, among other requirements, be entered into primarily to modify the bond issuer's risk of interest rate changes with respect to the bonds and be identified by the bond issuer as a qualified hedge. Similar to Treasury Regulation §§ 1.1275-2(g) and 1.988-2(b)(18) (discussed in footnotes 73 and 74), Treasury Regulation § 1.148-10(e) permits, in general terms, the IRS to depart from the regulations under section 148 of the Code "as necessary to clearly reflect the economic substance of the transaction…[including treating] a hedge as either a qualified hedge or not a qualified hedge…." In P.L.R. 201502008 (May 21, 2014), the IRS ruled that on the facts presented, it would not use its authority under Treasury Regulation § 1.148-10(e) to integrate a tax-exempt bond and a total return swap entered into between the issuer and the holder of the bond.

In addition, Treasury Regulation § 1.446-3T(g)(4)(ii)(2) provides that in determining the term of a contract for purposes of an exemption for certain short-term notional principal contracts from the rule treating nonperiodic payments on an NPC as a separate loan, the IRS "may treat two or more contracts as a single contract if a principal purpose of entering into separate contracts is to qualify for [the exception]."

b. *Timing and Character Matching*

c. *Source Matching*

d. *Tax Straddles*

Comment to footnote 87: Proposed Regulation § 1.1092(d)-1(d) was adopted as a final regulation on August 27, 2014 by T.D. 9691. In F.A.A. 20151201F (December 23, 2014), the IRS cited Treasury Regulation § 1.1092(d)-1(d) in finding that a straddle was created by a taxpayer issuing equity-linked debt and holding the reference shares. The IRS went on to hold that interest paid on the debt was interest to carry a position in a straddle and subject to capitalization. This second holding was not based on the regulation itself, one fair reading of which would be that the entire debt obligation (as opposed to just the equity-linked component) was a position and thus the obligation to pay interest was payment *on a position,* rather than a payment of interest *to carry* a position. The advice cited no authority for bifurcating the contingent debt into non-contingent debt and a separate position. The advice also did not mention proposed regulations under section 263(g), which would specifically treat the interest on contingent debt that is hedged with a swap as interest allocable to a straddle. See Proposed Regulation § 1.263(g)-4(c), Example (3). These regulations are proposed to be effective only when adopted as final regulations.

e. *Constructive Sales*

f. *Special Foreign Currency Rules*

g. *Subpart F (FPHCI Income)*

3. *Debt Aggregation Under OID Regulations*

4. *Debt Pools*

5. Partnership Equity

Separate interests in a partnership held by a single partner are not recognized for tax purposes but instead are aggregated. It almost goes without saying that separate interests in a disregarded entity are not recognized at all for tax purposes. A.M. 2012-001 (February 9, 2012) holds that a taxpayer may not allocate basis and other tax items among different classes of interests in a disregarded entity because those interests have no separate existence for tax purposes. For a further discussion of disregarded entities, see Chapter 4, Part B.6.

6. Section 167(e)

For purposes of computing depreciation deductions, all mortgage servicing rights (excluding the portion treated as stripped coupons) acquired in the same transaction, or in a series of related transactions, are treated as a single asset. See Treasury Regulation § 1.167(a)-14(d)(2)(i).

7. Stock Redemptions

E. Common Law Separation of Single Instruments

1. General

Treatment of rep and warranty claims in mortgage sales agreement as separate financial instrument: C.C.A. 201529006 (April 8, 2015) holds that book reserve losses of a mortgage originator and seller from breaches of conventional representations and warranties in mortgage sales contracts ("W&R Obligations") could not be treated as section 475 losses on securities. The C.C.A. is discussed more generally in Chapter 11, Part F.3 (in this Supplement). The taxpayer argued that the W&R Obligations could be separated from the rest of the sales contract and treated as put rights on debt instruments (to which the mark-to-market rules for securities dealers in section 475 would apply). The C.C.A. advances a number of arguments against the taxpayer's position, one of which was that the IRS and courts have generally refused to treat embedded rights in contracts or financial instruments as options, citing as support the *Chock Full O'Nuts* and *Hunt Foods* cases on convertible debt discussed in footnote 119, below. The C.C.A. also notes that the W&R Obligations were an integral part of the sales agreements (not separately assignable and served to enforce the contracts' terms).

On a similar note, C.C.A. 201132021 (April 26, 2011), involves an owner of an electric generating plant that is an electing dealer in commodities under section 475(f)(2) and a party to a power supply contract. The advice holds that certain provisions in the supply contract that provide for the supply of electricity and payments therefor cannot be separated from the rest of the contract (which is a services contract) so as to be marked to market by the dealer, even though electricity is a commodity.

Like-kind exchange property. Section 1031 allows a taxpayer to defer gain by exchanging property held for productive use in a trade or business or for investment for other property of a like kind which is to be so held. C.C.A. 201605017 (October 19, 2015) rejected a taxpayer argument that aircraft held partly for business or investment purposes and partly for personal use could be bifurcated in applying section 1031. The advice relied in part on the fact that a revenue procedure treats rental property as eligible for like-kind exchange treatment if there is occasional personal use (rather than bifurcating). Presumably the taxpayer was concerned that personal travel was high enough to prevent the aircraft from qualifying as a whole.

2. Debt

a. Conventional Debt

b. Convertible Bonds and Exchangeable Bonds

c. Contingent Payment Debt

d. Debt Plus Ownership Interests in Tangible Property

e. Service Fees Plus Interest Strips

3. Stock

Add to footnote 136: Chapter 8, Part H.3, in this Supplement discusses cases declining to follow *Fisher* in determining gain on sales of stock received in insurance company demutualizations.

a. Carving Up Conventional Stock

(i) *Americus Trust*

(ii) *Dividend stripping*

(iii) *Unbundled stock units*

b. Unconventional Rights Against Issuer

Hewlett-Packard Co. v. Comm'r, T.C. Memo 2012-135 (2012), held that fixed term preferred stock issued by a foreign corporation to a domestic investor was properly treated as debt, not stock, despite the form of the instrument as stock. The issuer was a structured vehicle that was required under investment guidelines to hold high quality financial assets. The dividend rate was to be reset on a future date to a market rate (achieving a fixed value) and the holder had a right to put the stock at a fair market value (essentially a fixed amount). The court held that the issuer effectively had an obligation to redeem the stock after a fixed term based on a contractual obligation to take actions "necessary or appropriate" to facilitate sales of the stock by the U.S. investor under the put right. The court seemed to lump together the low risk of the assets, the rights against the issuer, and the rights against the third party put writer in concluding that the preferred was debt. For a critical analysis of the case, see Jasper L. Cummings, Jr., "Preferred Stock and the Special Purpose Issuer," 2012 *Tax Notes Today* 122-9 (June 25, 2012).

In a legal advice memorandum from associate area counsel, C.C.A. 20121201F (November 10, 2011), counsel concluded that a corporate taxpayer holding preferred stock was not entitled to the dividends received deduction because it failed the holding period requirement of section 246(c). The issuer of the preferred stock was a structured vehicle that was limited to owning (indirectly through a partnership) high quality financial assets. The dividend rates were initially fixed and then were reset to a market rate through an auction. There were various contractual guarantees and indemnities ensuring that the issuer would do what it was required to do. The stock was redeemable by the issuer and it likely would have an incentive to redeem in various circumstances (including a failure of the auction). The advice lumps together the various rights and concludes that the taxpayer had in substance a put right or guarantee that tolled the holding period under section 246(c)(4).

c. Stock With Guaranteed Payments

d. Mutual Companies

Add to footnote 136: Chapter 8, Part H.3, in this Supplement discusses cases declining to follow *Fisher* in determining gain on sales of stock received in insurance company demutualizations.

e. Rights Against Third Parties

See the discussion of *Hewlett Packard* and C.C.A. 20121201F under Part E.3.b, above (in this Supplement).

4. *Forward Contracts*

C.C.A. 201104031 (September 17, 2010) involves a taxpayer that owned shares of a traded stock and entered into, as seller, a prepaid forward contract to sell shares of that class. The contract provided an initial payment based on a floor value for the stock and a right to receive an additional amount based on the market value of the stock on settlement. The contract was settled by the taxpayer in a way that was intended to defer gain. Specifically, the taxpayer borrower shares used to settle the contract and took the view that gain could be calculated on settlement by comparing the forward price with the basis in the new shares (the conventional treatment for a short sale). The C.C.A. holds that the forward contract was a separate contract from the short sale and that settlement of it through delivery of shares against cash resulted in realization of gain from the forward equal to the additional proceeds of the contract. T.A.M. 201214021 (January 10, 2012) reaches a similar conclusion with respect to settlement of in-the-money puts that were part of a collar transaction with borrowed shares.

Samueli (described in footnote 174) was affirmed, 661 F.3d 399 (9th Cir. 2011). The appellate court disagreed with the Tax Court finding that there was no borrowing but concluded that it was harmless error because the interest cost for which the Tax Court denied a deduction had been taken into account by the Tax Court in any event as a capital cost in calculating the tax deficiency.

5. *Option Pairs*

T.A.M. 201214021 (January 10, 2012) analyzes a collar transaction in which the taxpayer bought a put and wrote a call at a higher strike price on third-party stock. The put was in the money when it matured and the taxpayer settled by delivering borrowed shares. The T.A.M. holds that the put was a separate transaction from the borrowing and the taxpayer was required to recognized gain equal to the value of the put as a separate contract. The gain was considered long-term capital gain based on the holding period for the put, which is odd given that the put was settled by delivering newly borrowed shares. It is not clear why the distinction between long and short term gain mattered because the taxpayer was a corporation. The T.A.M. states (footnote 6) that it does not address whether the puts and calls should be viewed as separate contracts, although the analysis appears to assume that they are.

6. *Life Insurance Policies*

Comment to footnote 183: Proposed Regulation § 1.1092(d)-1(d) was adopted as a final regulation on August 27, 2014 by T.D. 9691.

7. *Ferrer Case—Contract Terminations*

F. Rules-Based Separation

1. *General*

2. *Premium on Convertible Debt*

3. *CPDIs*

The House Ways and Means Committee released in January 2013 proposals for reforming the tax treatment of financial products. One the proposals was to require ordinary/mark-to-market treatment for most derivative contracts not held as part of a hedging transaction (as defined in section 1221(e)). The proposal would bifurcate a debt instrument with an embedded derivative into the derivative component and the remaining “straight” debt and apply the new derivative rules to the derivative component. See proposed new Code section 486(d) in the Ways and Means Discussion Draft Provisions to Reform the Taxation of Financial Instruments, dated January 23, 2013. Information about the proposal (and comments on it) may be found on the House Ways and Means Committee web site at http://waysandmeans.house.gov/taxreform/.

4. *Testing Offsets*

Comment to footnote 203: Proposed Regulation § 1.1092(d)-1(d) was adopted as a final regulation on August 27, 2014 by T.D. 9691.

5. *AHYDO Rules*

6. *Section 385*

Proposed regulations issued under section 385 on April 4, 2016 included a bifurcation rule that would have authorized the Service to treat expanded group indebtedness or EGI (which is generally debt within a corporate group with 80 percent or greater ownership links) as part debt and part stock. See Proposed Regulation § 1.385-1(d)(1) (April 4, 2016). However, the rule was not included in the final and temporary regulations issued on October 13, 2016 (see T.D. 9790). The preamble to the October regulations states that while a bifurcation rule is not included in the final regulations, the IRS and Treasury will continue to study bifurcation.

The bifurcation rule in the proposed regulations provided that the IRS may treat an EGI as part stock and part debt "to the extent that an analysis, as of the issuance of the EGI … under general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part." The proposed regulations then gave as an example a case in which there was a reasonable expectation that only a portion of an EGI would be repaid. As many commentators pointed out, there are no general federal tax principles that would treat an instrument as part debt and part equity (aside from unusual cases where the instrument has distinct payment terms some of which might be regarded as severable equity rights), so the proposed rule rested on a shaky foundation. It may have been intended to give the IRS greater leverage to negotiate settlements in which a taxpayer concedes that an instrument is partly stock.

7. *Section 988*

8. *Gain Partially Characterized as Ordinary Income*

G. Notional Principal Contracts

Add at the end of footnotes 211 and 219: With limited exceptions, a nonperiodic payment on a notional principal contract will be treated as a separate debt instrument. See Chapter 8, Part H.5.a (in this Supplement).

Footnote 220: Schering-Plough Corp. v. United States was affirmed, sub nom. *Merck & Co., Inc. v. United States*, 652 F.3d 475 (3d Cir. 2011).

H. Aggregation and Separation of Entities

1. *Stapled Stock*

Add at the end of Part H.1:

A rule implementing section 941 of the Dodd-Frank Act (the "Risk Retention Rule") requires sponsors of asset-backed securitizations to retain a portion of the risk of the assets they securitize.[180] The

[180] The Risk Retention Rule is codified at 15 U.S.C. § 78o-11.

Risk Retention Rule as applied to CLOs has led to creative structures involving the stapling of equity interests.

The Risk Retention Rule generally requires that the person organizing and initiating a securitization transaction (the "sponsor" of the transaction) retain 5 percent of the credit risk of the assets being securitized. As applied to a CLO issuer, the CLO manager is a sponsor for this purpose, as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[181] The retention requirement may be satisfied by retaining a "horizontal interest"—an interest that is subordinated to all other asset-backed interests of the issuer—or a "vertical interest"—an interest that receives a portion of the payments made to each class issued by the securitization, or a combination of both (such interests, the "risk retention interests").

Where it is necessary for non-tax purposes to have a single entity that has non-U.S. investors both (1) act as collateral manager and earn management fees that arise in connection with a trade or business in the United States, and (2) hold the risk retention interests, there may be a concern that income from the risk retention interests will be treated as effectively connected with the trade or business of providing collateral management services in the United States. To address this concern, a collateral manager may be structured as a single domestic entity (such as a limited liability company) with segregated series or segregated pools of assets ("series"), the ownership interests in which are represented by a single indivisible class of equity.[182] One series acts as the collateral manager, earns the management fees, and chooses to be classified as a domestic corporation. A different series holds the risk retention interests and chooses to be characterized as a partnership. While the corporate series is subject to taxation in the United States on the management fees (less applicable deductions), the income from the risk retention interests held by a tax law partnership is not subject to taxation in the United States (except to the extent the income is allocated to partners who are U.S. taxpayers). Because the two series are treated as separate entities for tax purposes but interests in them cannot be separately transferred—because they are represented by one equity interest under local law—the two series are effectively stapled entities.

As discussed above (in the book), section 269B provides for, among other things, rules addressing the stapling of the equity of two corporations. With a limited exception for a corporation that is a RIC or a REIT, section 269B does not affect the characterization of a partnership or corporation where the equity of the partnership and corporation are stapled.

2. REMICs

3. Subsidiary Tracking Stock

4. Tribune Case

5. Segregated Portfolio Companies

6. Separating Assets From Entities

I. Acquired Business Intangibles

Add at the end of page 1275: In what is likely one of the last cases of the era, a court found that a taxpayer thrift institution had not met its burden of showing to a reasonable degree of certainty its cost

[181] In the typical CLO, the CLO manager is considered to transfer assets to the CLO issuer because it selects and manages the issuer's assets.

[182] Segregated portfolio companies (another term for series funds) are discussed in Chapter 4, Part C.2.

basis in two types of intangible rights acquired in government-assisted purchases of assets of failing thrift institutions that occurred in the 1980s. *Washington Mutual, Inc. v. United States*, 130 Fed. Cl. 653 (Cl. Ct. 2017). The court based its decision in part on an earlier case involving the same taxpayer which reached a similar conclusion, *Washington Mutual, Inc. v. United States*, 636 F.3d 1207 (9th Cir. 2011), remanding to the District Court, which held against the taxpayer, *Washington Mutual, Inc. v. United States*, 996 F. Supp. 2d 1095 (W.D. Wa. 2014), on appeal a second time to the Ninth Circuit. The two intangible rights were "branching rights" or the right to establish deposit taking branches in designated locations and "RAP rights" which were the contractual approval to treat goodwill created by the transactions as an asset for regulatory accounting purposes. The taxpayer claimed an abandonment loss for the cost of branching rights it did not use and amortization deductions for RAP rights.

Chapter 17

Special Topics

A. Introduction

B. Aggressive Tax Planning, Reportable Transactions, and Covered Opinions

1. Aggressive Tax Planning

Add to the end of section:

A report of the United States Government Accountability Office explains how financial derivatives can offer opportunities for taxpayer abuse:

> Unique characteristics of financial derivatives make them particularly difficult for the tax code and IRS to address. The tax code's current approach to the taxation of financial derivatives is characterized by many experts as the "cubbyhole" approach. Under this approach, the tax code establishes broad categories for financial instruments, such as debt, equity, forwards, and options, each with its own rules governing how and when gains and losses are taxed. As new instruments are developed, IRS and taxpayers attempt to fit them into existing tax categories by comparing the new instrument to the most closely analogous instruments for which tax rules exist. However, a new financial instrument could be similar to multiple tax categories, and therefore IRS and taxpayers must choose between alternatives. This could result in inconsistent tax consequences for a transaction that produces the same economic results.
>
> Derivative contracts, particularly those traded over-the-counter, are highly flexible, allowing taxpayers to structure transactions to take advantage of the different tax rules for each tax category. Derivatives can also be coupled with each other and with other types of financial instruments, like more traditional debt or equity instruments, to create hybrid securities. Because hybrid securities often do not clearly fall within a single tax category, it can be challenging for IRS and taxpayers to determine which tax rules are appropriate, and whether the hybrid should be treated as a single instrument or broken up into multiple instruments. While the tax rules for each tax category represent Congress's and Treasury's explicit policy decisions, some of these decisions were made long before today's complex financial derivative products were created. The cumulative effect of these decisions combined with the fact that many financial derivatives do not fit neatly in any one tax category can result in mistakes or opportunities for abuse by taxpayers.

GAO, "Financial Derivatives—Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse," GAO-11-750 (September 2011).

2. Reportable Transactions

The temporary regulations under section 6707A cited in footnote 18 have been replaced with final regulations, which are effective September 7, 2011.

Comment on footnote 21: Replace the citation with section 6501(c)(10). Final regulations under this section were adopted by T.D. 9718, 2015-15 I.R.B. 866.

Comment on footnote 32: Revenue Procedure 2004-66 has been modified and superseded by Revenue Procedure 2013-11, 2013-2 I.R.B. 269.

Comment on footnotes 34 and 35: Although a regular interest in a REMIC can potentially fall within the qualifying basis exception, a regular interest acquired by a sponsor in exchange for mortgages transferred to the REMIC would have a substitute basis, which would not be a qualifying basis. Accordingly, loss on sale of the regular interests would not fall within the exception. The tax treatment of REMIC sponsors is discussed in Chapter 15, Part E.

Add to footnote 33: Revenue Procedure 2004-66 was modified and superseded by Revenue Procedure 2013-11, 2013-2 I.R.B. 269.

In footnote 35, change the language referring to currency losses in the second and third lines to read as follows: if the loss is a foreign currency loss that is treated as ordinary under section 988 (with an exception for section 988 losses recognized on or after December 6, 2012 by a bank described in section 581 or 582(c)(2)(A)(i) (concerning foreign banks as limited by section 582(c)(2)(C)).

3. Covered Opinions

T.D. 9778, effective June 12, 2014, eliminated the special rules for covered opinions in section 10.35 and instead adopted one set of standards for written tax advice in a revised section 10.37 (which now addresses written advice not subject to other special rules). The change mercifully ends the need for circular 230 legends and the requirement for a full description in the advice itself of relevant facts and assumptions and application of the law to the facts.

Amended section 10.37 basically requires that a practitioner act reasonably and use common sense. More particularly, it requires a practitioner to meet the following requirements in giving written advice (including by means of electronic communication, but not including government submissions on matters of general policy or CLE presentations):

- base the advice on reasonable factual and legal assumptions (including assumptions as to future events)
- reasonably consider all relevant facts that the practitioner knows or should know (and use reasonable efforts to determine the facts)
- not unreasonably rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person
- relate applicable law and authorities to facts
- not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit, and
- rely on the advice of another practitioner only if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances (including the competence of the other practitioner and possible conflicts of interest).

In evaluating whether a practitioner meets these requirements, the IRS will apply a reasonable practitioner standard, considering all facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client. This approach contemplates that advice may be somewhat informal, limited, or preliminary if that is what the client is seeking. The same standards apply to tax shelters, but emphasis will be given to the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances when determining whether a practitioner has met the section 10.37 standards.

Amended section 10.36 requires a practitioner who oversees a firm's tax practice to take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates and employees for purposes of complying with all of circular 230.

C. Tax Strategy Patents

On September 16, 2011, President Obama signed into law the Leahy-Smith America Invents Act, Public Law 112-29 ("Act"), which reforms the patent law in various ways and limits the issuance of new tax strategy patents. Section 14 of the Act provides that "any strategy for reducing, avoiding, or deferring tax liability [defined to cover any federal, state, local or foreign tax], whether known or unknown at the time of the invention or application for patent, shall be deemed insufficient to differentiate a claimed invention from the prior art," which is a requirement for patentability. There are exceptions for tax preparation and financial management inventions.[56a] Section 14 states that nothing therein shall be construed to imply that other business methods are patentable or that other business-method patents are valid. Section 14 is effective on the date of enactment of the Act and applies to any patent application pending on, or filed on or after, and any patent issued on or after, that date (and thus does not affect previously issued patents).

The U.S. Patent and Trademark Office is reviewing the stock option grantor retained annuity trust (SOGRAT) patent that first focused attention on tax strategy patents to see if some prior art was not sufficiently considered in granting the patent. For a discussion, see Jeremiah Coder, "USPTO Reexamining Controversial Tax Strategy Patent," 2011 *Tax Notes Today* 96-3 (May 17, 2011).

A recent case held that a structure for dividing up multiple real estate properties into shares that could be sold to investors and would be eligible for like-kind exchange treatment under section 1031 was an abstract idea that was not eligible for a patent under the machine-or-transformation test. *Fort Properties Inc. v. American Master Lease LLC*, No. 2009-1242 (Fed. Cir. 2012). For a discussion of the implications of the case, see Jeremiah Coder, "Tax Patents Face Higher Bar After Federal Circuit Case," 2012 *Tax Notes Today* 41-3 (March 1, 2012).

D. Securitization Reforms

1. Overview

2. Summary of Recommendations

a. Changes Relating to Revolving Pool Securitizations

b. Other Changes in REMIC Regulations

c. Changes Relating to TMPs

d. Foreign Trust Reporting

[56a] Specifically, section 14 does not apply "to that part of an invention that (1) is a method, apparatus, technology, computer program product, or system, that is used solely for preparing a tax or information return or other tax filing, including one that records, transmits, transfers, or organizes data relating to such filing; or (2) is a method, apparatus, technology, computer program product, or system used solely for financial management, to the extent that it is severable from any tax strategy or does not limit the use of any tax strategy by any taxpayer or tax advisor."

Glossary

BBA: Bipartisan Budget Act of 2015.

Best Efforts Underwriting: A general term used to refer to a placement of loans or securities by a bank without a commitment by the bank to buy if the placement is unsuccessful. In the context of securitizations, there has been some debate about the circumstances under which offshore CDO issuers should be allowed to commit to buy a loan from a loan originator before the loan is funded where the loan is being sold on a best efforts basis. Appendix D (in this Supplement) has guidelines agreed to by a group of law firms that allow CDO issuers to enter into such a commitment, but only in the case of a broadly syndicated loan.

Chapter 3 Withholding: The rules for withholding of taxes on nonresident aliens and foreign corporations under sections 1441-1446, which are codified in chapter 3 of subtitle A of the Code and, accordingly, are sometimes referred to as *chapter 3 withholding* to distinguish them from the withholding tax rules arising under FATCA, which are in chapter 4.

Chapter 4 Withholding: The rules for withholding of taxes pursuant to FATCA, which are codified in chapter 4 of subtitle A of the Code and, accordingly, are sometimes referred to as *chapter 4 withholding* to distinguish them from chapter 3 withholding.

Common Reporting Standards: Standards published by the OECD in 2014 that call on jurisdictions to obtain account information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. The common reporting standards set out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, and common due diligence procedures to be followed by financial institutions.

Componentization Notice: A notice that may be given by the lender to the borrower under the terms of certain large commercial mortgage loans that directs that the loan be divided into components having the terms specified in the notice. After the notice is given, the loan components may be transferred to a trust that issues classes of pass-through certificates corresponding to the components. The structure is described in Chapter 2, Part B.6, in this Supplement.

Components: Components of a commercial mortgage loan that are created through delivery of a componentization notice, sometimes also referred to as loan components or note components. See also *Componentization Notice*.

Connecticut Avenue Securities (CAS): See *CRTS*.

Credit Risk Transfer Securities: See *CRTS*.

CRS: See *Common Reporting Standards*.

CRTS: As used in this book, Credit Risk Transfer Securities, which are a type of note with a pay through feature used to shift to the holder default risk with respect to a reference pool of mortgages. CRTS have been issued by Fannie Mae (under the name Connecticut Avenue Securities or CAS) and by Freddie Mac (Structured Agency Credit Risk (STACR) Notes). To date, CRTS have taken the form of uncollateralized credit linked notes. The two Agencies, however, have proposed to issue CRTS in the form of REMIC regular interests beginning in 2018. See *REMIC CRTS*.

CRTS REMIC: As used in this book, a REMIC used to issue regular interests that are REMIC CRTS and to hold subordinated classes of regular interests issued by I-REMICs.

Deemed-compliant FFI: An FFI other than a *participating FFI* that is FATCA compliant, for example, by complying with its home country law in the case of a Model 1 FFI.

FATCA Registration System Portal: An online portal run by the Service where an FFI can register and receive a GIIN.

FBAR (add to existing definition): On October 1, 2013, TD F 90-22.1 was replaced with FinCEN Report 114, "Report of Foreign Bank and Financial Accounts," which is only available online through the BSA (Bank Secrecy Act) E-Filing System website.

FFI Agreement: An agreement that an FFI enters into with the IRS by registering with the IRS through the Portal, obtaining a GIIN, and agreeing to follow terms set out in section 1471(b) and Treasury Regulation § 1.1471-4. Among other things, those terms require the FFI to collect, verify, and report to the IRS specified information regarding United States accounts and to provide additional information regarding those accounts on request, and to withhold tax on pass-thru payments made to a recalcitrant account holder (one who refuses to provide requested information) or a nonparticipating FFI. See also *GIIN*, *Nonparticipating FFI*, *Passthru Payments*, and *Portal*.

GIIN: An identification number that an FFI receives from the Service when it registers on the Service's FATCA Registration System Portal. An FFI generally can avoid FATCA withholding by providing its GIIN to a withholding agent.

Global Intermediary Identification Number: See *GIIN*.

IGA: Intergovernmental Agreement implementing FATCA. See *Model 1 IGA* and *Model 2 IGA*.

I-REMIC: An internal REMIC that is used to wrap mortgages held by a trust issuing guaranteed pass-through certificates sponsored by Freddie Mac or Fannie Mae as part of a structure to issue CRTS in the form of REMIC regular interests. The I-REMIC holds the mortgages and issues to the trust senior regular interest classes matching the mortgages (one regular interest for each mortgage). The I-REMIC also issues subordinated regular interests, which are backed by a reserve fund inside of the I-REMIC. The reserve fund absorbs credit losses from the mortgages. The subordinated regular interests issued by the I-REMIC are pooled in CRTS REMICs, which issue REMIC CRTS to investors. See also *CRTS*, *CRTS REMICs* and *REMIC CRTS*.

Lead FI: A financial institution that undertakes FATCA registration for any affiliated member FI that chooses to have the lead FI undertake the registration for it.

Limited Life Debt Investment Entity (LLDIE): A type of debt securitization vehicle that is entitled to limited FATCA grandfather protection if the vehicle was in existence as of January 17, 2013.

Member FI: A financial institution that has a lead FI undertake the member FI's FATCA registration.

Model 1 FFI: As used in this book, an FFI resident in a country that enters into a bilateral agreement based on the Model 1 IGA.

Model 2 FFI: As used in this book, an FFI resident in a country that enters into a bilateral agreement based on the Model 2 IGA.

Model 1 IGA: As used in this book, a model agreement between the United States and another country published by the United States and identified as the Model 1 IGA, modifying the application of FATCA to an FFI in the other country. Such an FFI will not be required to enter into an FFI Agreement with the IRS, but instead must comply with the reporting, withholding, and other obligations delineated in the bilateral agreement, as implemented by laws in the other country. The information collected by such an FFI will be provided by it to the other country, which will transfer it to the IRS. There are two versions of the Model 1 IGA, one providing for a reciprocal exchange of information between the United States and the other country and the other providing for reporting only by the other country to the United States.

Model 2 IGA: As used in this book, a model agreement between the United States and another country published by the United States and identified as the Model 2 IGA, providing for the application of FATCA rules to an FFI in the other country. Such an FFI must still register with the IRS and comply with the requirements of an FFI agreement, but such agreement and compliance will be permitted and required by the other country's domestic law.

Model 1 Partner Country: As used in this book, a foreign country that enters into a bilateral agreement with the United States based on the Model 1 IGA.

Model 2 Partner Country: As used in this book, a foreign country that enters into a bilateral agreement based on the Model 2 IGA.

MSR: A common way of referring to mortgage-servicing rights. For an article by an esteemed tax commentator discussing an array of tax issues raised by MSRs, see Jasper L. Cummings, "Mortgage Servicing Rights", 2014 *Tax Notes Today* 23-5 (February 4, 2014). See also *Excess Servicing* in the Glossary and Index.

Nonparticipating FFI: For FATCA purposes, An FFI that is neither a participating FFI nor a deemed-compliant FFI.

Nonperiodic payments: With limited exceptions, a nonperiodic payment on a notional principal contract will be treated as a separate debt instrument. See Chapter 8, Part H.5.a (in this Supplement).

NPFFI: See *Nonparticipating FFI*.

Participating FFI: For FATCA purposes, an FFI that enters into an FFI Agreement with the IRS.

PATH Act of 2015: The Protecting Americans from Tax Hikes Act of 2015.

PFFI: See *Participating FFI*.

Portal: See *FATCA Registration System Portal*.

Pseudopool: A term used by Fannie Mae to refer to a designated pool of whole loan collateral for a structured transaction that is not a mortgage-backed security.

Qualified Mortgage: As used in this book, the type of mortgage loan (or interest in a mortgage loan) that may be held by a REMIC. Qualified mortgages include qualified replacement mortgages and REMIC regular interests that are transferred to a REMIC on formation or within certain time periods. The term qualified mortgage as used in this book should not be confused with the same term used to refer to a type of mortgage that meets specific underwriting tests and has certain commercial terms so that it complies, or allows underwriters and owners to comply, with a number of non-tax regulatory requirements, including borrower ability-to-pay tests required under the Dodd-Frank Act. See also *REMIC Assets Test*.

REMIC CRTS: As used in this book, a form of CRTS that are regular interests issued by a CRTS REMIC. See also *CRTS REMIC*.

Short-term REMIC: Refers to a REMIC that has regular interests all of which are expected to be repaid over a relatively short term compared with the remaining economic life of the qualified mortgages held by the REMIC. Such a REMIC is typically liquidated, with all remaining mortgage assets being sold, on or before a scheduled date. A short-term REMIC may be used by a sponsor holding mortgages with unrealized losses. For a discussion, see Chapter 6, Part B (in this Supplement).

Sponsored Entity: An entity that has a sponsoring entity perform its FATCA due diligence, withholding, and reporting obligations.

Sponsoring Entity: An entity that will perform the FATCA due diligence, withholding, and reporting obligations of one or more sponsored entities.

Structured Agency Credit Risk (STACR) Notes: The Freddie Mac version of CRTS. See *CRTS*.

U.K. FATCA: A series of agreements that all crown dependencies and overseas territories of the U.K. have entered into that provide for the automatic exchange of tax information with the U.K. Because these agreements are modeled after the information exchange portions of FATCA (without providing for withholding), they are sometimes referred to colloquially as U.K. FATCA. U.K. FATCA is being phased out as CRS becomes effective.

Unitranche Loan: A loan made typically to a middle-market borrower that has a single tranche and interest rate and may be carved up among different groups of “first out” and “last out” lenders having non-pro rata rights to principal and interest under an Agreement Among Lenders or AAL (to which the borrower is not a party). From a tax perspective, the transaction generally involves stripping a single class of debt.

Appendix A

State Tax Exemptions for REMICs

Appendix B

Internal Revenue Code and Regulations

Appendix C

CDO Trade or Business Guidelines

A. Introduction

B. General Guidelines

1. General Restrictions on the Activities of Issuer

2. Special Restrictions Relating to the Ownership of Certain Assets

3. Definitions and Rules of Application

C. Guidelines on Purchasing Loans

1. Guidelines Applicable to All Loans

2. Additional Guidelines Applicable to Deferred Obligations

D. Additional Guidelines Applicable to Synthetic Obligations

In footnote 9, replace "Section IV" with "Part D."

Add the following comment and guidelines to Appendix C:

E. Additional Guidelines for Broadly Syndicated Loans

1. Background

Offshore CDO issuers may be asked to commit to purchase loans from originating banks or other lenders before the loans have been funded. The Guidelines in Part C.1.b allows such a commitment to be given, but only after the original lender has itself committed to make the loan.

In current practice, oftentimes, a syndicate bank or other lender may not be willing to make such a commitment, and rather agrees only to underwrite loans on a "best-efforts" basis. The fact that the lender commits before the CDO issuer is helpful is demonstrating that the terms of the loan are fixed at the time of purchase, and the issuer is thus acting in substance like a secondary market purchaser in acquiring the loan. It also supports the argument that the lender is not acting as an agent of the CDO issuer in originating the loan. The key tax issue, however, is not the precise sequence of events but whether overall there is a sufficient factual record to show that the loan terms have in fact been negotiated before the CDO issuer commits, without its involvement, by a party who is not acting as an agent of the issuer. In light of the wider use of best-efforts underwritings, a group of law firms with active practices in the area have agreed informally to a set of guidelines for broadly syndicated loans that do allow a CLO issuer (that is the term used) to commit to buy such a loan before a commitment to lend is made by the selling syndicate bank. It is still the case that the issuer will purchase the loan through assignment after funding. The agreed guidelines are reproduced below. The thought is that a CLO issuer buying a loan in such a syndication is acting in a manner similar to the buyer of a bond in a widely offering bond issuance, which has not been thought to raise trade or business concerns for the buyer. The additional guidelines are shown as agreed, and have not been edited to conform to the style of the Guidelines in this book.

2. Additional Guidelines

The Collateral Manager shall not, on behalf of the CLO, and shall not cause the CLO to:

* * *

Enter into any commitment or understanding to acquire or purchase a loan that would be legally binding on the CLO (or the Collateral Manager), or that would not be so legally binding, but as to which the Collateral Manager (or the CLO) would be economically compelled to acquire such loan (in either case, a "Commitment") earlier than forty-eight (48) hours after the later of (i) the execution, closing and issuance of the loan, (ii) the funding of the loan, and (iii) the most recent date on which any of the principal terms were modified in a material fashion <u>unless</u> the facts surrounding such Commitment are described in either subsection (1) or subsection (2) below:[1]

1. <u>Broadly Syndicated Loans (whether underwritten on a "Firm Commitment" or on a "Best Efforts" basis)</u>. In order for a Commitment to be described in this subsection, the loan must (a) be marketed and sold pursuant to a "customary underwriting," (b) be acquired in a permissible manner by the CLO and (c) constitute a "broadly syndicated loan," each as described herein.

   a. <u>Customary Underwriting</u>. In order to constitute a "customary underwriting," the Collateral Manager must reasonably believe that the underwriting of the loan includes the following features:

      i. A bank or a syndicate of banks (the "syndicate bank") negotiates the terms of the loan.

      ii. The syndicate bank helps the borrower compile a "confidential information memorandum," "bank book" or similar written document to be used in soliciting loan sales that describes the material terms of the loan and of the borrower (a "Bank Book"). For the avoidance of doubt, the Bank Book, once originally provided and disseminated, may be updated to reflect changes to material terms through supplements or through data postings on Bloomberg, Intralinks or Fintrac.

      iii. The syndicate bank markets or seeks buyers for the loan from a wide (although potentially targeted) group.

      iv. The syndicate bank effectuates its underwriting process through soliciting indications of interest or orders, making loan allocations or similar procedures.

      v. The syndicate bank is paid or compensated in respect of its underwriting services by the borrower.

[1] This preamble language is suggested to facilitate discussion. We assume firms will use their own mechanics for defining "Commitments" and prohibiting Commitments by affiliates.

vi. The syndicate bank is free to sell or allocate such loan to the highest bidder (or to allocate the loan based on other criteria determined in its sole discretion), even after (x) a "soft circling" process has occurred, (y) indications of interest have been provided and (z) preliminary allocations have been communicated to investors. For the avoidance of doubt, the syndicate bank is free to make any such sale or allocation in its own discretion notwithstanding the existence of a Commitment that would obligate the CLO (or the Collateral Manager) to acquire or purchase such loan.

b. Permissible CLO Acquisition. In order for a loan that has been marketed and sold pursuant to a customary underwriting to be acquired in a permissible manner by the CLO, the following criteria must be satisfied:

i. The loan is acquired by the CLO in a manner that otherwise complies with the [Investment Guidelines]. [For the avoidance of doubt, none of the CLO, the Collateral Manager (whether acting on the CLO's behalf or otherwise) or any related or commonly managed or advised parties or other investment management vehicles that are also managed by the Collateral Manager shall participate in the negotiation of the terms of the loan.][2]

ii. The Collateral Manager is not an affiliate of and does not control the borrower, and does not advise it on other matters. No person related to the Collateral Manager or commonly managed or advised by the Collateral Manager is an affiliate of or controls the borrower, or advises it on other matters.[3]

iii. The Commitment is entered into (x) after receipt of the Bank Book (including any supplements thereto, other than supplements that do not affect the material terms of the loan) and (y) at a time when the material terms of such loan (other than interest rate and pricing) have been fully negotiated, it being understood that the interest rate and pricing of the loan may not be finalized until just prior to execution and closing.

iv. The Collateral Manager has no reason to believe that the loan would not be executed on the same terms regardless of whether the Commitment was made.

v. The Commitment is provided pursuant to typical allocation procedures.[4]

vi. The Commitment relates to a purchase of less than 5% of the face amount of the respective tranche of which the loan forms a part.

2 For reference only- we assume firms will institute their own "negotiation" prohibitions.

3 [This condition can be modified based on a tax advisor's conclusion that the relationship with the borrower does not impair its ability to reach a favorable conclusion.]

4 Our understanding is that many Bank Books contain forms to be used by purchasers in making commitments. If this is the case, it would be helpful if can we request that all Commitments be provided on such forms (and that all bank books include such forms). Following on this point, it would also be helpful to add a statement to such commitment forms acknowledging that the syndicate bank is not acting as the agent of the CLO/Collateral Manager for this purpose (if such a statement is not already included).

vii. The CLO, together with any related or commonly managed or advised parties, purchases less than 15% of the face amount of the respective tranche of which the loan forms a part.

viii. Each Commitment is independent (and there is no ongoing understanding or arrangement by which the CLO has agreed to provide funds to the syndicate bank or borrowers) although the CLO may purchase different tranches of loans offered contemporaneously.

c. <u>Broadly Syndicated Loan</u>. For purposes of this subsection, a "broadly syndicated loan" means a loan that satisfies the following criteria:

i. The aggregate size of the loan facility (including undrawn commitments) is at least $100 million.

ii. The CLO and the Collateral Manager reasonably believe that the syndicate bank is acting in the ordinary course of its trade or business of originating and syndicating loans.

iii. The loan is considered by the market to be a broadly syndicated loan offered to typical institutional non-bank investors.

2. <u>Loans Not Described in Subsection (1) (including Non-Broadly Syndicated Loans that are underwritten on a "Firm Commitment" basis)</u>. In order for a Commitment to be described in this subsection, the following criteria must be satisfied.

a. [The Commitment is entered into at a time when the material terms of such loan (other than interest rate and pricing) have been fully negotiated (it being understood that the interest rate and pricing of the loan may not be finalized until just prior to execution of and closing).

b. The Commitment is entered into at a time when the counterparty is fully obligated (subject to a "MAC out" provision) to acquire (or already owns) such loan.

c. To the extent the loan is not already owned by the counterparty, the Commitment is entered into at a time when the counterparty's obligation to acquire the loan is not conditioned upon any commitment by the CLO (or any other assignee).

d. The loan is acquired by the CLO in a manner that otherwise complies with the [Investment Guidelines]. For the avoidance of doubt, none of the CLO, the Collateral Manager (whether acting on the CLO's behalf or otherwise) or any related or commonly managed or advised parties or other investment management vehicles that are also managed by the Collateral Manager shall participate in the negotiation of the terms of the loan.][5]

[5] We assume each firm will employ its own guidelines to address non-broadly syndicated loan Commitments.

Table of Citations

Internal Revenue Code

Treasury Regulations

IRS and Treasury Releases

IRS Forms and Publications

Cases

Circular 230