Chapter 1
Tax Issues in Securitization Transactions

A. Introduction

The main subject of this book is the U.S. federal income taxation of securitization transactions. The book also covers a number of related topics with applications outside of the securitization field. Securitizations are highly significant in the U.S. capital markets, with volumes of new issuances and outstanding securities that typically exceed, for example, corporate debt.[1] The discussion is current through February 2, 2018.[2] Thus, it takes account of the legislation known colloquially as the Tax Cuts and Jobs Act, or *TCJA*.[3]

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1 Statistics are maintained by SIFMA and are available at www.sifma.org. To take one example, for 2016, the amount of outstanding securities in the U.S. bond market was 39.4 (all numbers in this sentence are in trillions of dollars and rounded), consisting of 3.8 of municipal bonds, 13.9 of Treasuries, 8.9 and 1.4 of mortgage-related and asset-backed securities (securitized instruments) for a total of 10.3, 8.5 of corporate debt, 2.0 of Federal agency securities, and .9 of money markets. Thus, securitizations accounted for 26 percent of the total, or 40 percent excluding Treasuries, and more than the amount of corporate debt.

2 The discussion is, of course, subject to change through subsequent legislation, administrative actions, or judicial decisions. Except where otherwise noted, section citations in this book are to the Internal Revenue Code of 1986 (*Code*). There are citations throughout the book to private letter rulings, technical advice memoranda, general counsel memoranda, field service advices, chief counsel advice memoranda, and other informal Internal Revenue Service (*IRS* or *Service*) guidance. While these sources are not binding on the Service and may not be used or cited as precedent (see section 6110(k)(3)), they are nonetheless helpful in determining the views of the Service. The book describes financial accounting rules under GAAP in a number of contexts where they provide a useful contrast with tax rules or have influenced the development of securitization structures. The discussion, however, does not provide a complete or authoritative description of accounting rules and should not be relied upon as guidance on GAAP principles.

3 Public Law 115-97, which was enacted on December 22, 2017. Its less memorable formal name, which was adopted in the Senate at the last moment to comply with the Byrd Rule, is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year

This chapter describes a typical securitization transaction. It also outlines, in Part B, the topics covered in succeeding chapters and in that way identifies the most important tax issues that arise in securitizations. A number of chapters address the limited but still potentially significant effects on securitizations of TCJA. Those effects are summarized in Part C, below, which, as applicable, also has references to more detailed discussions later in the book.

A securitization provides a means of financing through the securities markets a pool of real estate mortgages or other consumer or commercial payment obligations (*receivables*). In a typical transaction, an owner of a pool of receivables (*sponsor*) conveys them, directly or through an intermediary, to a trust or other legal entity (*issuer*), which issues securities backed by those assets. The securities are then sold to investors, with the sponsor receiving the proceeds. The securities supported by the receivables (whether they be mortgages or other obligations) will be referred to as *asset-backed securities*.[4]

Typically, pools of mortgages and other long-dated receivables held by an issuer are fixed or substantially fixed. For obvious practical reasons, that model works less well for short-term receivables, such as credit card balances. Issuers receiving payments on short-term receivables may prefer to reinvest them in new receivables over some period, producing a revolving asset pool. In a fixed-pool securitization, the issuer acts largely as a cash funnel, collecting and combining payments on the pooled assets and directing them to different investor groups. An issuer holding a revolving pool takes on the added role of reinvesting payments before they are distributed to investors.

While the issuer's role as an intermediary between receivables debtors and securities holders is economically useful, a securitization transaction almost certainly would not be viable if passing cash through the issuer resulted in significant additional tax burdens. One of the main goals of tax planning in this area—indeed the *sine qua non*—is to ensure that no material incremental issuer tax costs are incurred.

This book discusses in depth the tax treatment of the issuer, investors, and sponsors in a securitization. As noted above, it also covers a number of related topics not directly related to securitizations. A chapter-by-chapter summary follows.

2018." The official legislative history consists of the report of the House Ways and Means Committee, H. Rep. No. 115-409, 115th Cong. 1st Sess. ("TCJA House Report"), and the report of the Conference Committee, H. Rep. No. 115-466, 115th Cong. 1st Sess. ("TCJA Conference Report"). The TCJA Conference Report has a description of the Senate version of the bill.

4 This term is sometimes used to refer only to securities backed by non-mortgage assets. Mortgages are, however, indisputably assets, and the term as used in this book encompasses *mortgage-backed securities* (*MBS*).

B. Chapter Summary

Chapter 2 (types of securities). Chapter 2 describes the principal types of asset-backed securities and the ways in which the issuer-level tax problem has been addressed for each. In brief, such a tax may be avoided by using an issuer that is considered transparent for tax purposes and allocating its income to holders of ownership interests in the entity, by paying out income in the form of deductible interest on debt, or by moving the issuer offshore.

An important goal in many securitization transactions—in addition to avoiding tax burdens—is to divorce the securitized assets from the sponsor for financial accounting and non-tax legal purposes. As Chapter 2 shows, the development of securitization structures has often reflected compromises between potentially conflicting tax and non-tax goals.

Some of the categories of securities discussed in Chapter 2 (such as pass-through debt certificates and FASIT interests) are now mostly of historical interest. Nonetheless, they are worth discussing to paint a full picture of tax issues in securitizations.

As detailed in Chapter 2, the major categories of securities are:

- *pass-through certificates* issued by trusts, including stripped certificates representing non-pro rata rights to principal and interest, senior/subordinated certificates, callable certificates, and *LEGO certificates* (our term for pass-through certificates that can be separated or combined)
- *pay-through bonds* (debt instruments that receive cash based on principal and interest collections on underlying assets) issued by domestic issuers
- equity interests in issuers of pay-through bonds
- interests in a real estate mortgage investment conduit (*REMIC interests*)
- single loan commercial mortgage-backed securities (*CMBS*)[5]
- *pass-through debt certificates* (our term for instruments taking the form of trust equity that are intended to be classified as debt under general tax principles)
- interests in a financial asset securitization investment trust (*FASIT interests*)

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5 CMBS are mortgage-backed securities having as underlying receivables mortgages on office or apartment buildings, stores, hospitals, or other commercial or industrial properties. The other major category of MBS are *residential mortgage-backed securities* (*RMBS*), which are supported by single family or 2-4 family residences. CMBS and RMBS may be REMIC or non-REMIC securities.

- interests in foreign corporations (which may be debt or stock, and in the debt category include *collateralized debt obligations* (*CDOs*) and *catastrophe bonds*)
- asset-backed debt other than pay-through bonds (such as *net interest margin securities* (*NIMS*), *asset-backed commercial paper* (*ABCP*), *covered bonds*, and debt issued in stranded cost securitizations)
- *synthetic variable rate tax-exempt bonds* (also known as *tender option bonds*), and
- *credit risk transfer securities* (*CRTS*).

Pass-through certificates issued by grantor trusts are the most traditional and in some ways simplest type of asset-backed security. The certificates are beneficial interests in a fixed pool of receivables. The receivables are often mortgages but need not be. The certificates generally cannot (for a tax reason) have sequential-pay features.

Pay-through bonds have traditionally been backed by fixed pools of receivables but may also be used to securitize revolving pools. They were the first type of sequential-pay asset-backed security.

A REMIC is a pool of mortgage receivables and related assets that elects to be subject to a set of tax rules specially tailored for a multiple-class securitization of a fixed pool of real property mortgages. The REMIC legislation was added to the Code by the Tax Reform Act of 1986 (*TRA 1986*) to address tax-law uncertainties and constraints that existed in pass-through certificate and pay-through bond structures. Congress intended that REMICs be the exclusive way to issue multiple-class mortgage-backed securities without an entity-level tax. Although the REMIC regime is elective (subject to the "stick" of adverse consequences under the TMP rules, discussed below, if an election is not made), and has certain anti-avoidance features, REMICs have become the tax vehicle of choice for issuing multiple-class, sequential-pay mortgage-backed securities.

Pass-through debt certificates generally are suitable only for revolving pools. At one time, they were widely used to finance credit card receivables. The securities were cast in the form of trust certificates (equity) to produce financial accounting advantages, which are no longer available.

FASITs were created by legislation enacted in 1996. FASITs were loosely modeled after REMICs in that they were an elective securitization regime that was intended to provide tax certainty, particularly in treating pass-through debt certificates as debt under an explicit statutory rule. FASITs applied broadly to fixed and revolving pool securitizations of all types of receivables. Despite their promise as the universal securitization regime, FASITs flopped for a number of technical reasons and the rules were repealed in 2004. Few FASIT interests were ever issued in securitizations.

Offshore issuers may be used to securitize fixed or revolving pools. The assets may be corporate bonds, loans, or other asset-backed securities, held in physical or synthetic form. The issuers are typically corporations (which broadly speaking are not subject to U.S. corporate tax because they are foreign and not engaged in a U.S. business), although in recent years, a significant number of offshore issuers have been partnerships or disregarded entities as well.

Asset-backed debt other than pay-through bonds resembles conventional corporate debt. It is distinguished mostly by the fact that the debt is secured by pools of receivables and may be issued by special purpose entities.

Synthetic variable rate tax-exempt bonds are floating rate equity interest in state-law trusts that hold a fixed pool of tax-exempt municipal bonds. The trusts are nominally taxed as partnerships, but under a special concessionary regime adopted administratively by the Service that lifts some of the burdens of subchapter K. Interest on the bonds flows through as tax-exempt income to investors.

CRTS are a type of credit-linked note that is backed by the general credit of the issuer or non-mortgage assets and has a principal amount that may be written down to absorb credit losses on reference pools of mortgages. To date, they have been issued by Freddie Mac and Fannie Mae to privatize default risk. Going forward, they are expected to take the form of REMIC regular interests even though they are not paid out of the cash flows on mortgages.

Two additional types of securities are worth mentioning because of the special tax issues they raise. They are securities issued by tax law partnerships, and securities backed by distressed receivables (receivables that are in default or likely to default). Chapter 2 concludes with a brief description of the issues in the two areas and a roadmap showing where in later chapters the topics are discussed.

Chapter 3 (sale/financing and debt/equity). In order to analyze a securitization transaction properly, it is necessary to know whether the conveyance of receivables to the issuer by the sponsor should be treated for tax purposes as a sale or instead as a financing (that is, a pledge of assets to secure indebtedness). Chapter 3 discusses the standards used in distinguishing a tax-law sale from a financing. The distinction exists not only in the tax law but also under financial accounting rules and in testing creditors' rights in a bankruptcy of the transferor. In the jargon of the commercial law, there is a *true sale* when there is transfer of property that is effective as against creditors of the transferor. Chapter 3 compares tax standards with the comparable tests under United States *generally accepted accounting principles* (*GAAP*) and under creditors' rights law.

The tax law authorities addressing the sale/financing distinction are quite extensive. There are many threads that have not been woven into a single cloth. Chapter 3 summarizes the tax authorities in fifteen different settings. They are: repos, sales of installment obligations, options, guarantees, equipment trusts and similar arrangements, pass-through certificates, leased property, conduit arrangements, short sales, forward contracts, the timing of sales under sale contracts, total return swaps, transfers of operating revenues (as illustrated by stranded cost securitizations), variable life insurance and annuity contracts, and an agency between an entity and its owners (the fact pattern addressed in the Supreme Court's *Bollinger* decision).

The sale/financing distinction asks whether a transferee of an interest in an asset acquires an ownership interest therein, or instead a debt claim backed by the asset. Viewed from the perspective of an issuer of asset-backed securities, a similar question arises in determining if securities it issues are properly classified as debt or equity for tax purposes. Chapter 3 also addresses the distinction between debt and equity. It does so, however, selectively, focusing on aspects of the problem that are of particular interest in receivables financings. The topics considered include: the need for minimum equity where purported debt classes are adequately supported without it, high-coupon debt, and the ability of taxpayers and the Service to classify instruments that are in form equity as debt for tax purposes (using as one example pass-through certificates issued by a trust holding a revolving pool of credit card receivables).

The proper classification of an instrument affects not only whether the issuer is allowed to deduct income it pays to investors (interest is deductible, equity distributions are not), but also, potentially, how the issuer is classified for tax purposes (as a corporation or something else) and how investors are taxed.

Chapter 4 (entity classification). Chapter 4 describes the tax law classification of issuers other than REMICs. Entities may be classified for tax purposes as trusts or business entities. Business entities in turn may be corporations, partnerships, or disregarded entities. With limited exceptions, entity-level federal income taxes are imposed only on corporations.[6] Accordingly, the best way to ensure that an issuer is not itself taxed is to avoid classification as a corporation.

Particularly in a world with limited liability companies and statutory trusts, it is easy enough to avoid using a local-law corporation as the issuer of asset-backed securities. However, federal tax law also treats unincorporated business entities as corporations in some circumstances. The relevant classification tests are found largely in Treasury regulations. These regulations were overhauled, effective at the beginning of 1997, to introduce an elective (*check-the-box*) classification system. Two important exceptions to the elective fea-

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6 A number of those exceptions arise only in the securitization field, where taxes may be imposed on pass-through entities in lieu of taxes that otherwise would be imposed on non-taxable equity owners. See, e.g., Chapter 9, Part E.4.d.(ii) (surrogate tax on REMIC excess inclusions). As summarized in Chapter 2, Part M, a tax law partnership may also be liable for taxes imposed as a result of IRS audit adjustments for taxable years beginning on or after January 1, 2018, or may be liable for withholding taxes if the partnership has a foreign partner and either the partnership or the foreign partner is engaged in a U.S. trade or business.

ture of the regulations are Code rules that automatically treat as corporations *publicly traded partnerships* (*PTPs*) that engage in some active business (including a financial business) and *taxable mortgage pools* (*TMPs*). (The TMP rules are described further below in this chapter.)

Entities that are classified for tax purposes as trusts are not considered business entities that may be classified as corporations under the Treasury regulations. Unfortunately, the tax status of an entity as a trust is not determined solely by whether it is organized as a trust under local law. Largely in response to developments in the securitization area, a set of complex rules have been devised to make the determination. With some important exceptions, regulations on fixed investment trusts widely known as the *Sears regulations* treat those trusts as business entities if they have multiple ownership classes.

Chapter 4 discusses the check-the-box rules (including the consequences of changes in classification), when a person is considered a tax owner of an entity, when an entity exists, the classification of trusts (including the Sears regulations), and the TMP and PTP rules. The discussion of the Sears regulations considers an exception that allows a fixed investment trust to be used to strip rights to interest from rights to principal on debt instruments, and the possible extension of that exception to the stripping of stocks. The check-the-box rules begat the disregarded entity. Chapter 4 discusses when disregarded entities are in fact recognized for certain tax purposes. Chapter 4 also analyzes segregated portfolio (or series) companies (specifically whether each portfolio or series is a separate entity). As noted above, a PTP may be classified as a corporation if it is engaged in a *financial business.* The meaning of this term is discussed in some detail. REMICs are considered in later chapters.

Chapter 5 (grantor trusts versus partnerships). The check-the-box rules have accomplished a good deal by making it easy to avoid the unintended classification as a corporation of an entity organized as a domestic local-law trust (assuming the PTP and TMP rules do not apply). They do nothing, however, to clarify the standards for testing whether a local-law trust with multiple owners should be classified as a trust or partnership. While neither type of entity would suffer the burden of corporate taxation, reaching the right answer is important because the substantive tax rules for the two are quite different, as Chapter 5 shows.

An investment trust classified as a trust is taxed as a *grantor trust* and is generally ignored. By contrast, a trust classified as a partnership is recognized to be a separate entity for many tax purposes and is subject to a complex set of substantive tax rules found in subchapter K of the Code. Chapter 5 describes the substantive tax rules governing grantor trusts and partnerships and compares the two. There are, of course, treatises devoted to the taxation of partnerships, so Chapter 5 has only a summary of the subchapter K rules most significant to structured finance. In almost all cases, market participants prefer the grantor trust regime. The chapter also discusses a limited right of investment partnerships to elect out of subchapter K. Issuers of synthetic variable rate tax-exempt bonds had an extended tussle with the Service over the scope of that election.

Information reporting rules also differ significantly for trusts and partnerships. Information reporting is discussed in Chapter 14.

Chapter 6 (REMIC qualification and taxation). Apart from the TMP discussion, Chapters 2 through 5 address topics that are relevant to securitizations of all types of receivables. Chapters 6 and 7, by contrast, are devoted to the REMIC rules, which apply only to securitizations of real property mortgages. A REMIC can issue multiple-class pass-through securities without an entity-level tax.

For an entity to be a REMIC, it must make an election and meet a variety of tests, including tests relating to its assets and the interests issued by the REMIC. A REMIC can issue only two types of interests: a single residual class, and one or more classes of regular interests that resemble debt or rights to payments on debt instruments. Chapter 6 discusses the REMIC qualification tests apart from the definition of a regular interest. It also discusses the tax treatment of, and procedural rules affecting, a REMIC.

One of the topics addressed in Chapter 6 is modifications and assumptions of mortgages held by a REMIC. In that connection, the chapter summarizes and discusses the regulations under section 1001 governing debt modifications. Another special topic is the treatment by REMICs of settlements of contractual claims, which has become an issue for a number of REMICs that acquired shaky mortgages in the lead up to the financial crisis.

Chapter 7 (REMIC regular interest definition). Chapter 7 discusses the definition of REMIC regular interest. REMIC residual interests are not attractive investments and cannot be held by certain categories of investors, so in practice the regular interest definition determines the kinds of interests in a pool of mortgages that can be created under the REMIC regime. The definition is quite precise but also flexible, particularly when more than one tier of REMICs is employed. Securities can be created that have economic characteristics quite different from whole loans. In practice, the regular interest definition has proven to be one of the more daunting aspects of the REMIC regime, which is the reason for having a separate chapter devoted to the topic.

Chapter 8 (tax rules for debt holders). Chapter 8 addresses the tax treatment of holders of asset-backed securities that are taxed as debt. These instruments include pay-through bonds, REMIC regular interests, and pass-through certificates issued by a grantor trust holding debt instruments.

Chapter 8 describes the general tax rules governing debt instruments, including those relating to *original issue discount* (*OID*), market discount, and premium. The chapter discusses when OID arises in residential mortgages and other consumer loans, including credit card receivables. The handling of prepayment contingencies is a particularly sensitive issue in securitizations, particularly for high-coupon premium debt classes, or low-coupon discount classes, backed by prepayable receivables. Those classes have yields that depend significantly on prepayment speeds. TRA 1986 added section 1272(a)(6) to the Code to deal with prepayment contingencies. The scope of section 1272(a)(6) was broadened in 1997 to apply to any pool of debt instruments, whether or not part of a securitization, whose yield is affected by prepayments. Chapter 8 considers the section at length. The chapter also discusses the bond stripping rules of section 1286, which subject to the OID rules any discount at which stripped bonds or coupons are acquired, and special considerations in applying the tax rules for discount and premium to pass-through certificates and debt instruments held in pools.

Chapter 8 addresses a number of special topics: prepayment losses on interest-only asset-backed securities (which lose significant value if underlying debt is prepaid), distressed debt, the use of basis-recovery first methods of accounting, artificial gain recognized when debt instruments purchased at a discount are modified, combinations of debt instruments with other financial contracts (including integration rules), the treatment of payment lags in REMIC regular interests, application of the investment in United States property rules in section 956 to regular interests held by a controlled foreign corporation, and the re-pricing of debt instruments.

Chapter 8 concludes with a discussion of the book income acceleration rule added by TCJA. The new rule was targeted at fees charged by credit card issuers that were spread over time under the OID rules, but could affect more generally the timing of income from discount on debt instruments.

Chapter 9 (equity interests in debt issuers and REMIC residual interests). Not all asset-backed securities are taxed as debt instruments. One exception is equity interests in trusts (that are not classified as corporations) issuing debt; another is residual interests in a REMIC. Where a trust or REMIC issues sequential-pay securities with increasing yields (lower yields for short-term classes and higher yields for long-term classes), the result may be a mismatch in the timing of income and deductions that produces *phantom income* for the holders of the equity or residual interest. Phantom income, as the term is used in this setting, is taxable income that necessarily will be reversed through later losses and never will be realized in cash.[7]

The REMIC rules incorporate a host of special measures to ensure that holders of residual interests are always subject to tax on phantom income, even if they are otherwise generally exempt from income tax. These rules were adopted in recognition of the fact that a residual interest need have no economic value, so that it could potentially be "parked" with a tax-exempt holder at no economic cost.

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[7] Outside of the securitization field, the same term is often used somewhat differently to refer to economic income that is taxed currently to an equity holder but is not currently available for distribution because it is applied to make debt principal payments or for other purposes.

Chapter 9 discusses equity interests in trusts issuing debt (including limitations on deductions for business interest added by TCJA), REMIC residual interests, the sources of phantom income, the special rules to prevent the avoidance of tax on phantom income realized by holders of REMIC residual interests, and income tax issues raised by the fact that residual interests may have negative value (be economic liabilities).

Chapter 10 (taxation of TMPs). The REMIC regime is elective. When it was adopted in 1986, it was not clear that REMICs would be used in light of their anti-tax avoidance and other restrictive features. In order to ensure that phantom income would not escape tax through the use of non-REMIC vehicles, the TMP rules were adopted by TRA 1986 (effective, however, only in 1992 in order to give time to correct any perceived defects in the REMIC rules). They generally define as a TMP any entity or portion of an entity (other than a REMIC or a thrift institution meeting certain tests) that holds debt obligations consisting predominantly of real estate mortgages and issues multiple-maturity classes of debt payable out of the cash flows on those obligations. An entity meeting the TMP definition is treated as a corporation (regardless of which boxes the taxpayer checks) and denied the ability to join in a consolidated return with another corporation. Congress intended that any phantom income arising in the arrangement would be realized by the TMP and subjected to the corporate income tax (at least in the case of domestic issuers).

While the general purpose of the TMP rules is to force issuers of mortgage-backed securities to make REMIC elections, the TMP definition covers considerable ground where a REMIC may not tread. Thus, issuers may be, and often are, faced with the prospect of meeting the TMP definition without being able to avoid the effect of the TMP rules through a REMIC election. Where the election is available, it is the preferred route.

The definition of a TMP is discussed in Chapter 4. The tax treatment of TMPs is the subject of Chapter 10. Chapter 10 addresses, among other things, special rules that treat *real estate investment trusts* (*REITs*) meeting the TMP definition as *quasi REMICs.* (Never doubt the imagination of the congressional tax staff!)

Chapter 11 (special categories of investors, and securities dealers). Chapter 11 discusses special tax rules applicable to certain categories of institutional investors and to securities dealers. The investors are: REITs, thrift institutions, banks, tax-exempt organizations, and life insurance companies (foreign investors are dealt with in a later chapter). At one point, the special tax rules for thrifts were quite significant. Since 1996, thrifts have largely lost their preferred taxpayer status and the mortgage-related qualification tests for thrifts are now largely of historical interest (albeit only to those with an interest in the tax history of savings and loans).

The tax rules for dealers include most significantly section 475, which, with some exceptions, requires dealers in securities to mark to market securities they hold. Chapter 11 has an extensive discussion of section 475, including special rules for securitized assets. A number of dealers faced acute challenges in valuing illiquid asset-backed securities for financial accounting and tax purposes during and in the aftermath of the financial crisis of 2007-2008, although problems in valuing securities without a readily available market price are not, of course, limited to those periods. Chapter 11 describes the GAAP valuation standards under FASB Statement No. 157 and a book-tax conformity safe-harbor rule.

Chapter 12 (foreign investors). Chapter 12 addresses foreign investors. In the absence of a treaty or Code exemption, interest paid by U.S. borrowers to foreign lenders is subject to a 30 percent withholding tax. The portfolio interest exemption is the principal non-treaty exemption from the tax. There are some rules unique to securitizations that affect the portfolio interest exemption (including rules for turning residential mortgages or other consumer loans that are not themselves in registered form into debt in registered form in secondary market transactions, to allow them to qualify for the portfolio interest exemption), and they are discussed in this chapter. The chapter also considers briefly the treatment of swap income, rents, income from options, and debt-related fees (such as late fees or consent fees). The FATCA rules, enacted in 2010 and now almost fully effective after a long transition period, are also discussed, particularly as they relate to securitizations.

Chapter 13 (offshore issuers). In circumstances in which it is desirable or unavoidable for a securitization vehicle to be classified as a corporation for tax purposes, it may be possible to avoid an entity-level tax by locating the vehicle outside of the United States. Chapter 13 addresses the tax treatment of offshore issuers of asset-backed securities and of holders of equity in such issuers. CDOs are the type of asset-backed security most often issued by offshore issuers. The chapter discusses the tax definition of foreign corporation and possible applications of the inversion rules in section 7874 to securitizations.

An offshore issuer is subject to U.S. corporate income tax and branch profits tax on any income effectively connected with a U.S. trade or business. Most offshore issuers conduct their activities so as to fall within a statutory safe harbor rule that deems trading in securities not to be a U.S. business activity. The safe harbor rule is described in detail in Chapter 13.

Many offshore entities have been formed to invest in loans to U.S. borrowers. The securities they issue are a subset of CDOs sometimes called *collateralized loan obligations* (*CLOs*). Loan origination activity is generally considered a business. Also, it may not fall within the scope of the securities trading safe-harbor rule. Offshore issuers often want the flexibility to buy loans at or close to origination, and one issue faced by their tax advisors has been how to draw the line between origination and secondary market trading. Chapter 13 discusses this topic. Offshore issuers that acquire loans typically operate under guidelines drafted by tax advisors that are designed to prevent them from engaging in origination activities (and more broadly, any U.S. trade or business). Appendix C to the book has an illustrative set of CDO trade or business guidelines. Those guidelines also address synthetic investments in corporate debt through credit default swaps and similar instruments.

For foreign corporations engaged in a U.S. financing business, special rules apply in determining the income that is considered effectively connected with that business (and is therefore taxed). Chapter 13 describes those rules. They require that income be earned through a U.S. office. The Service has taken a controversial stand in applying the office test.

The discussion of equity investors in offshore issuers describes the anti-deferral regimes that apply to U.S. shareholders of *controlled foreign corporations* (*CFCs*) and *passive foreign investment companies* (*PFICs*). It describes the somewhat limited changes affecting CFCs and PFICs included in TCJA, and the broader TCJA changes relating to foreign corporations with U.S. shareholders (the new territorial system, the tax on undistributed GILTI, and one-time deemed distribution of past earnings).

Chapter 13 briefly describes investments by tax-exempt entities in equity of offshore issuers and offshore issuers of catastrophe bonds. The effect of the FATCA regime on offshore issuers is covered in Chapters 12 and 14.

Although offshore issuers have typically been classified as corporations, in recent years, issuers that are tax law partnerships have also been used to achieve better tax results for the issuer or its equity owners. The last section in Chapter 13 discusses partnership issuers.

Chapter 14 (legending and information reporting). Chapter 14 describes the information reporting and filing regimes affecting asset-backed securities. These include required reporting by issuers to the Service of tax information relating to REMIC regular interests and pay-through bonds shortly after they are issued, periodic reporting by issuers and payors to the Service and to holders of amounts to be included in income by holders, and reporting by investors of information relating to asset-backed securities issued by offshore entities. Reporting can be a sensitive and important topic for those who are marketing securities and administering securitization programs.

Chapter 14 describes in detail the special reporting regime for *widely-held fixed investment trusts* (*WHFITs*). A WHFIT is generally a domestic trust that issues pass-through certificates held through at least one nominee. Owners of pass-through certificates issued by a grantor trust are taxed as if they owned the underlying assets. The WHFIT regime was adopted to provide ultimate investors with information needed to calculate tax liability on a full flow-through basis. The rules are extremely complex.

U.S. persons holding interests in foreign trusts are subject to extensive reporting requirements that are not well tailored to investment trusts with transferable interests. The penalties for failing to comply are severe even though in some cases compliance is not practically possible. These rules have a broader reach than might be expected because the definition of foreign trust is surprisingly broad (and can include trusts that are organized under the laws of a state).

Chapter 14 discusses reporting with respect to foreign entities (including some of the practical implications of the FATCA reporting rules for offshore issuers), borrower and miscellaneous income reporting, and reporting of foreign financial assets and accounts.

Chapter 15 (sponsors). In addition to issuers and investors, the third principal category of participants in securitization transactions is sponsors. The treatment of sponsors is the topic of Chapter 15. The discussion of REMIC sponsors covers short-term REMICs. A short-term REMIC can be used to accelerate built-in losses in mortgages transferred by the sponsor to the REMIC without the need for an economic disposition of the mortgages that triggers a book loss.[8]

Chapter 16 (aggregation and separation of property interests). As noted above, Chapter 3 addresses two of the main building blocks on which the tax analysis of a securitization transaction rests: whether a transfer of receivables is a sale or financing, and whether interests in the issuer are equity or debt. Chapter 16 considers another foundational topic, which is when units of property as defined for local law purposes are aggregated into a larger item of property, or separated into smaller property interests, for tax purposes. The topic comes up often (as the discussion in Chapter 16 shows), but is quite difficult to research. Chapter 16 surveys the law—both common law and special rules—in a wide range of settings. It may be helpful to look at the detailed table of contents of Chapter 16 to get a sense of the ground it covers.

Chapter 17 (special topics). Finally, Chapter 17 addresses three topics: tax abuses in the securitization area and the application to securitizations of a range of anti-tax shelter measures (including the rules for reportable transactions); tax strategy patents affecting securitizations; and potential securitization reform measures.

Glossary. A number of technical tax and business terms are used throughout the book. While terms are defined when they are first discussed, a glossary of terms is also included for the reader's convenience. Definitions can also be found using the index.

Appendices. There are three appendices. The topics are: state and local taxes, primary sources (Code, regulations, forms) worth knowing about, and CDO trade or business guidelines.

This book addresses only federal income tax issues. Readers are cautioned that while the state or local income or franchise tax consequences of

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[8] In a typical structure, the REMIC acquires the mortgages, issues to third parties a relatively small amount of notes or other debt secured by the mortgages, and then on or before a date that is a fairly short time after the REMIC was formed, sells the mortgages (typically back to the sponsor) and liquidates.

issuing, investing in, or sponsoring asset-backed securities often mirror the federal consequences, there can be material differences. Many states have adopted whole or partial tax exemptions for entities that qualify as REMICs under federal law. A list of these exemptions may be found in Appendix A.

Appendix B has citations, grouped by topic, to some of the more important sections of the Code and Treasury regulations discussed in the book. It also lists significant IRS forms. Websites with the cited materials are indicated in the footnote to Appendix B. Appendix B is intended to serve both as a guide for someone new to the area of financial products and financial institutions who wants to get acquainted with the core primary source materials, and as a checklist for others who want one. The Table of Citations has a comprehensive list of citations in the book.

Appendix C has illustrative U.S. trade or business guidelines for CDO issuers (see the discussion of Chapter 13, above). It includes a set of guidelines for broadly syndicated loans agreed to informally by a group of law firms in 2017.

C. Effects of TCJA

TCJA changed the Code is important ways that are reflected throughout the book. This section describes briefly the changes that either are most significant for securitizations, or might be thought to be, even if it turns out on a closer look that they are not. It also points to where in the book the more consequential changes are reviewed.

Corporate rate drop. Economically, perhaps the biggest accomplishment of the new law is the 40 percent drop in the corporate rate from 35 percent to 21 percent. While nothing to sneeze at, it remains the case that even the reduced rate of 21 percent is far too high a burden for a securitization to bear, particularly since the legislation did not integrate corporate and shareholder taxes.[9] Thus, avoiding a corporate tax on income passing through to investors remains one of the most fundamental goals of tax planning for securitizations (see Chapter 2, Part A.2).

Individual deductions and lower rate for business income. A change that will be important for individual investors holding pass-through certificates, or other equity interests in an investment vehicle with expenses that pass through, is the elimination of a deduction for investment expenses for 2018 through 2025. Before TCJA, those expenses, together with other miscellaneous itemized deductions, were deductible for regular tax purposes to the extent they exceeded 2 percent of adjusted gross income.

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9 In one sense, the law made the double taxation of corporate earnings worse. It cut back on the dividends received deduction allowed to domestic corporations receiving dividends from other domestic corporations, in order to preserve the effective rates of corporate tax paid by the receiving corporation. See Chapter 10, footnote 13 and accompanying text.

Another noteworthy feature of TCJA for individuals that probably is not important for securitizations is the reduced rate of tax for income from a business conducted through a pass-through entity. TCJA adds section 199A, which generally allows individuals a deduction of 20 percent of qualified business income from a qualified business (the deduction is simply a means of lowering the effective rate of tax). Income from an equity interest in a securitization issuer is unlikely to qualify for the lower rate. The short explanation is that such an issuer typically engages in investing rather than a business and does not have employees or tangible property.[10]

Dividends paid by a REIT (other than dividends taxable as net capital gains or qualified dividend income) and income from a publicly traded partnership may also qualify for the deduction. Curiously, the REIT benefit does not require a trade or business connection, and thus would apply, for example, to a REIT that invests in residential mortgages or securities backed by such mortgages. It would seem to make sense in the future for individuals acquiring mortgage-backed securities to hold them through a REIT, even if the REIT is simply a passive intermediary.

Foreign corporations. TCJA overhauls the tax treatment of U.S. persons owning stock in foreign corporations, and thus potentially alters the treatment of U.S. owners of stock in offshore issuers that are corporations. Specifically, TCJA replaces the old income deferral model with a territorial tax (a dividends received deduction allowed to a corporate shareholder that effectively exempts from tax foreign source dividends received from foreign corporations), while at the same time imposing a shareholder minimum tax on certain foreign corporate earnings (called global intangible low-tax income, or GILTI). There is also a one-time deemed distribution (taxed at a reduced rate) of untaxed accumulated earnings to provide transition to the new system. While the explanation is involved, these changes affect mostly earnings of a foreign corporation from an *active* business. Offshore issuers are largely untouched because they are passive. The details are in Chapter 13, Part G.3.

Also, as discussed in Chapter 13, shareholders of a foreign corporation that are considered to be "United States shareholders" (within the meaning of

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[10] Putting to one side the REIT dividend exception described below in the text, qualified business income must (not surprisingly) arise from a trade or business. Capital gains are expressly excluded, as is interest income not properly allocable to a trade or business and income from notional principal contracts that are not part of a hedging transaction. The income derived from a business that qualifies is also generally capped (with an exception for individuals with incomes below a threshold) at the lesser of (1) 50 percent of the wages paid to employees in the business, or (2) 25 percent of those wages plus 2.5 percent of the cost of depreciable tangible property used in the business. Securitization vehicles do not typically pay wages to employees or own tangible property.

section 951(b)) of a controlled foreign corporation (a foreign corporation more than 50 percent owned by United States shareholders) are subject to tax currently on their shares of the passive income of the foreign corporation. TCJA changes the definition of United States shareholder so that it now includes a U.S. person owning 10 percent of the stock by value (not just by vote as under prior law). This change is important because investors often own equity interests in offshore issuers in the form of subordinated notes, and it has been challenging to measure the voting power of such securities.

Partnerships. TCJA makes a number of changes relating to partnerships. One important one clarifies that a foreign person selling an interest in a partnership engaged in a U.S. trade or business must treat gain from the sale as income effectively connected with the partnership's U.S. business. As a result, such gain is subject to tax on a net income basis. Starting in 2018, all transferees of partnership interests are required to withhold a tax equal to 10 percent of the amount realized by the transferor, unless the transferor certifies that it is a domestic person (or the partnership in fact is not engaged in a U.S. trade or business). If the transferee fails to withhold, then the partnership must withhold the same amount from distributions to the transferee. Issuers that are partnerships, and are or could be engaged in a U.S. trade or business, will need to contend with the new withholding requirement. The IRS has suspended withholding for publicly traded partnerships pending further guidance, but most securitization issuers are not publicly traded. The new withholding tax is discussed in Chapter 5, Part C.7.a.

Business interest limitation/NOL carrybacks. A TCJA change that undoubtedly will be important for some securitizations is the amendment to section 163(j) limiting deductions for net business interest expense (business interest expense in excess of business interest income). The new limitation is discussed in detail in Chapter 9, Part C.2. By contrast with old section 163(j), it applies to all types of taxpayers, and even separately to partnerships (at least if they are engaged in a trade or business). Section 163(j) has the potential to affect any securitization involving the issuance of pay-through bonds or other debt that is relying on deductions for interest expense to reduce taxable income allocated to a U.S. taxpayer. The two biggest mitigants are: (1) the ability to deduct interest expense in full against interest income (but not against other types of investment income), and (2) the fact that for noncorporate borrowers, the limitation applies only to interest arising in a trade or business. REMICs escape because they are noncorporate investors.

Although the ability to deduct interest expense against interest income is very helpful, as discussed in Chapter 9, Part E, securitizations sometimes exhibit a pattern in which so-called phantom (noneconomic) income in one or more years is followed in later years by phantom losses attributable to interest expense. Section 163(j) allows net business interest expense in a taxable year to be carried over to later years, but not back. Thus, where this pattern is present, some interest deductions could be lost even if there is net business interest income for all years combined.

The distaste for carrybacks is not limited to section 163(j). TCJA also changes section 172 to end carrybacks of net operating losses (effective for losses arising in 2018 and later years). It also caps the portion of taxable income that can be offset with NOLs at 80 percent.

Book income acceleration rule. Another consequential TCJA rule does not limit deductions but instead accelerates income. With some exceptions, new section 451(b), which is discussed in detail in Chapter 8, Part I, requires an accrual method taxpayer with an audited financial statement to accelerate an item of gross income as needed to conform to when the item is reported as revenue for book purposes. The book income acceleration rule was aimed squarely at certain credit card fees earned by card issuers that have been treated as OID. The fees, as OID, are spread over the life of related card receivables, even though for accounting purposes the fees are booked currently as they are earned (viewed as fees). The acceleration rule may also affect the timing of recognition of conventional discount on debt instruments, although there is reason to hope it will not extend to market discount or *de minimis* OID.

BEAT. TCJA gets rid of the old corporate alternative minimum tax, but starting in 2018, imposes a new one under section 59A called the base erosion and anti-abuse tax. The BEAT, as described briefly in Chapter 16, Part F.9, is imposed on a taxable domestic corporation (with gross revenues exceeding a threshold) with respect to an expanded tax base that adds back deductions for certain amounts (including interest) paid by the domestic corporation to a related foreign person. While this tax is a major concern for many corporate groups in the financial sector (among others), it is unlikely to be a significant issue in securitizations because it would be rare in those transactions to see deductible payments made to a related foreign person (as least in the securitizations themselves as distinguished from ancillary funding arrangements). That said, the fact pattern will arise somewhere, so at the least the tax should be kept in mind.