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Chapter 16

FASITs

A. Introduction

As indicated in Chapters 1 and 2, SBJPA 1996 created a set of elective tax rules governing pools of assets and interests therein that qualify as *financial asset securitization investment trusts* or *FASITs*.[1] In short, the FASIT rules extend some of the benefits of the REMIC regime (specifically, the unambiguous treatment of FASIT regular interests as debt for tax purposes) to revolving pool securitizations that may include both mortgage and non-mortgage receivables. This chapter addresses the qualification and taxation of FASITs and the tax treatment of FASIT sponsors and holders of FASIT interests. Because FASIT regular interests are generally taxed as debt, the rules governing debt instruments discussed in Chapter 8 are also relevant to them.

Chapter 2, Part G, describes the background of the FASIT legislation and gives an overview of FASITs and the various types of FASIT interests. To recapitulate, FASITs can hold virtually any type of receivable (provided only that it is issued by a consumer or other unrelated third party, is taxed as debt and has no contingent interest features). Further, a FASIT may acquire new assets over time, which allows it to have changing asset pools. A FASIT must have one *ownership interest*. It also may have one or more classes of *regular interests* which can be issued at any time. The ownership interest and a subclass of regular interests referred to as *high-yield interests* must be held by taxable domestic corporations (referred to as *eligible corporations*).[2] Interest-only classes are considered to be high-yield interests.

1 The rules became effective on September 1, 1997. Certain transition rules are discussed in Part G.2.e, below.

2 The term is defined in the text accompanying footnote 93, below. High-yield interests (but not ownership interests) may also be held by another FASIT.

There can be only one holder at any time of the ownership interest. That person will be referred to in this chapter as the *Owner*. The regular interests are treated as debt (generally of the Owner). Income from FASIT assets, net of deductions for interest on the regular interests, is taxable to the Owner. Gain is recognized with respect to appreciated assets contributed to a FASIT at the time of contribution. For receivables that are not traded on an established securities market, the gain is calculated using a formula discount rate, which may result in artificially inflated gains. Assets held outside of a FASIT that support FASIT interests are deemed to be contributed to the FASIT for purposes of the gain recognition rule. A FASIT is not a trading vehicle; gains on dispositions of assets (with certain exceptions) are subject to a 100 percent prohibited transactions tax. The tax also applies to interest on loans originated by a FASIT (i.e., FASITs may not originate loans). There is some tension between this rule and the freedom generally afforded FASITs to hold revolving asset pools.

To date, the FASIT vehicle has been used only sparingly. Perhaps the most important reason is the rule requiring gain recognition for receivables contributed to or supporting a FASIT. Another inhibiting factor has been uncertainty over various technical aspects of the FASIT rules. The effective date of the FASIT legislation was delayed for one year following enactment (until September 1997) to permit the government to fill in the gaps with regulations or other guidance. The IRS and Treasury did not seize the moment.[3] The first (and to date only) response has been a set of proposed regulations issued in February, 2000.[4] These regulations (which will be

3 The Service did issue Announcement 96-121, 1996-47 I.R.B. 12, asking for comments on rules to permit FASIT ownership interests to be held by two or more members of a consolidated group, transitional rules for pre-effective date entities making FASIT elections and anything else that should be addressed before the September 1, 1997 effective date. The announcement resulted in a number of comment letters, including an extensive report from the New York State Bar Association Tax Section. See "Report on Suggested FASIT Regulations," 97 *Tax Notes Today* 28-27 (February 7, 1997).

4 The regulations, issued on February 4, are at 2000-1 C.B. 682. Except for the anti-abuse rule in Proposed Regulation § 1.860L-2(e), and certain rules for entities in existence when the FASIT rules became effective, the FASIT regulations would generally be effective on the date (hopefully in 2001, see footnote 5) on which final regulations are filed in the Federal Register. See Proposed Regulation § 1.860L-4. The FASIT regulations provide no grand-

referred to in this chapter as the *FASIT regulations*) are not comprehensive, addressing only selected issues. They do not go as far as many had hoped in resolving problems with the statute. Further, they would erect new obstacles to the use of FASITs that were not foreseeable based on the statute and legislative history. Perhaps the best that can be said of the FASIT regulations is that they are only proposed; surely the final ones (expected not earlier than 2001)[5] will be better.[6] Anticipating that the FASIT regulations will be changed significantly before adoption as final regulations, this chapter generally first addresses a topic based on the text of the Code and legislative history, and then considers separately issues raised by the regulations.

As the discussion above suggests, a threshold question for most securitization sponsors considering the FASIT regime is whether the benefits outweigh the costs. Part B outlines the major advantages and disadvantages of a FASIT election for both mortgage and non-mortgage assets and illustrates some types of securitizations for which FASITs are (or could be) particularly well suited. Part C discusses the applicability to FASITs of REMIC precedents. This issue is important because the REMIC regime and practices are far more developed. Part D describes the tests that must be satisfied in order for an entity to qualify as a FASIT. The 100 percent prohibited transactions tax is discussed in Part E. Parts F and G consider the taxation of holders of FASIT regular interests and the ownership interest. Part H explores a number of special topics: support property, an anti-abuse rule, proposed anti-conduit rules relating to foreign holders of regular interests, two-tiered FASITs, issues that arise in making a FASIT election

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father rule for FASITs already in existence at that time, although one could of course be added in the final regulations.

5 The Service publishes an annual "business plan" identifying the projects it expects to complete during the year. The plan for 2000 lists the FASIT regulations as a project on which substantial work will be done during 2000, with a view to completion in 2001. See 2000 *Tax Notes Today* 56-18 (March 21, 2000).

6 Many comments on the FASIT regulations have been submitted to the Service. See, e.g., letter from James M. Peaslee to the Service dated February 9, 2000, reprinted in 86 *Tax Notes* 1011 (2000); New York State Bar Association Tax Section, "Report on Proposed Regulations Relating to Financial Asset Securitization Income Trusts," 2000 *Tax Notes Today* 93-17 (May 5, 2000), letter to the Service from the Bond Market Association, 2000 *Tax Notes Today* 116-44 (May 19, 2000).

for a pre-existing entity and allocations of FASIT interest expense against FASIT income for purposes of calculating the foreign tax credit limitation. Finally, FASIT elections and other procedural matters are covered in Part I.

B. Potential Uses of FASITs

1. Advantages and Disadvantages—Overview

a. Advantages. The one and only reason to make a FASIT election is to obtain certainty regarding the tax status of classes of regular interests as debt. Accordingly, the election makes sense only if:

- there are classes of interests that would or might be considered equity in the absence of the election, and
- treatment of those classes as equity would result in significant adverse consequences for the issuer and/or investors.

In the context of a mortgage securitization, any evaluation of a FASIT necessarily invites comparison with a REMIC. The two are compared in Part B.3, below. It is assumed in the discussion leading up to that section that the securitization structures that are alternatives to FASITs are governed by general tax principles.

A FASIT election may be made in order to achieve debt treatment for classes of securities that would clearly or possibly be equity in the absence of the election. As discussed in Chapter 3, in broad terms, uncertainty as to the debt status of securities generally will be most significant if they:

- are not in the form of debt (even if they have the economic characteristics of debt)
- are in the form of debt but the issuer is thinly capitalized, even by comparison with the standards for financial institutions, or the securities otherwise closely match the underlying receivables
- are in the form of debt but are subject to a significant risk of nonpayment of amounts due, or
- are in the form of debt but are issued at a high premium over their principal amount.

The potential costs of treating securities as equity are most significant where the issuer is classified as a domestic corporation or would be so classified if the securities in question were considered to be equity. Payments

on corporate equity are not deductible in computing taxable income subject to the corporate income tax.

The deliberate use of a taxable domestic corporation as an issuer is rare, so the debt/equity question usually arises where the issuer is a local-law trust, LLC or partnership. As discussed in Chapter 4, such an issuer risks being classified as a corporation if it either

- holds primarily mortgages and issues multiple classes of securities with staggered maturities and is therefore a taxable mortgage pool, or
- holds revolving pools of assets, originates loans or otherwise engages in activities that might be regarded as a financial business and has at least one class of equity interests that are publicly traded, so that the PTP (publicly traded partnership) rules apply.

The risk of an issuer's being characterized as a financial business, and hence the risk that a corporation will be created under the PTP rules, is virtually nil for issuers holding a substantially fixed asset pool.

For issuers not classified as corporations, a second category of tax costs arising from the treatment of securities as equity is that foreign investors or tax-exempt organizations may be subject to tax on income from equity interests in partnerships despite being able to receive income on most other types of asset-backed securities free of tax.[7]

To the extent the costs of treating securities as equity stem from public trading or the holding of securities by foreign investors or tax-exempt organizations, those direct costs can be avoided by limiting free assignment of interests or preventing foreigners or tax-exempt organizations from becoming investors. In that setting, the benefit of a FASIT election is potentially to allow more active trading or a wider distribution of one or more classes of securities. This advantage would, of course, be less if the securities would be treated as high-yield interests under the FASIT regime, be-

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7 This issue arises as to foreigner investors (1) if the issuer is active enough to be engaged in a trade or business, (2) if the portfolio interest exemption would not apply to interest on receivables because they are not in registered form so that interest is potentially subject to the 30 percent withholding tax, or (3) possibly if the investor is receiving guaranteed payments. Investors that are generally tax-exempt organizations would be subject to tax if the issuer either is engaged in a trade or business or has outstanding other classes of securities that are classified as debt. For a discussion, see Chapter 5, Part C.7.

cause those interests can be owned only by eligible corporations (or other FASITs).

b. Disadvantages. The primary disadvantages of a FASIT compared with other structures are the following:

- recognition of gain (but not loss) on contribution of assets to a FASIT (including assets that support a FASIT)

This factor is particularly significant when the alternative structure is a borrowing in which no gain would be recognized, but less significant compared to a sale of pass-through certificates or REMIC interests, where gain is recognized based on the portion of the interests that are sold. The FASIT regulations would prevent any gain on contributed assets from being offset with non-FASIT losses.[8]

- measurement of gain for contributed receivables not traded on an established securities market is based on an artificial value (120 percent-of-AFR discount rate)

The importance of this factor depends on whether receivables are market-traded (consumer receivables would not be except possibly for mortgages), whether the market yield is significantly higher than 120 percent of the AFR (so that gain is inflated), and whether the term of the receivables is short or long (because the amount of gain and period over which gain is accelerated depends on the term).

- the requirement that ownership interests and high-yield interests (including interest-only classes) be held by eligible corporations (or, in the case of high-yield interests, other FASITs) and that income thereon not be offset with non-FASIT losses

The significance of this factor depends, of course, on whether the plan for distributing securities contemplates the sale of interest-only classes or lower-grade classes having a "high-yield" to investors who are not eligible corporations.

- limits on trading and origination activities

FASITs are allowed to acquire most types of debt instruments and can hedge them, but cannot trade debt instruments (sell them to capture a profit) or originate loans. Whether the scope of permitted activities is considered

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8 See footnote 307, below.

wide or narrow depends on the point of reference. FASITs can do more than a REMIC or grantor trust, and less than a non-REMIC issuer that is classified as a business entity.[9] FASITs and REMICs are compared further in Part B.3, below.

2. Uses in Credit Card or Other Non-mortgage Transactions

The primary boosters of the FASIT legislation were bank sponsors of credit card trusts. It might be expected, then, that they would be among the principal users of the FASIT regime. In fact, however, they are not, and likely never will be unless the rule requiring gain recognition is eliminated and a number of technical issues are resolved.

A typical credit card trust is described in Chapter 3, Part E.4 (see discussion of Example 5). In brief, such a trust holds a revolving pool of credit card receivables and issues over time pass-through debt certificates (interests in the form of beneficial interests in a trust that are expected to be taxed as debt). A credit card trust is a natural candidate for the FASIT rules for two reasons. First, such a trust issues securities in the form of equity, so there is some doubt regarding their status as debt.[10] Second, because the trust holds revolving pools of debt, and routinely extends credit to card holders, there is a risk that the trust is engaged in a financial business. If so, the trust would be classified as a corporation if it had outstanding publicly traded ownership interests (i.e., interests that are not debt). Further, the trust is potentially engaged in a trade or business, so that equity classes cannot safely be sold to foreign investors or tax-exempt organizations.

Applying general tax principles, tax advisors have been willing to give strong debt opinions for highly rated classes (A or better), but not for lower-grade classes. The upshot (absent the FASIT rules) has been that the transfer of lower-grade classes has routinely been curbed to prevent public trading and ownership by foreign investors or tax-exempt investors. A

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9 Issuers classified as business entities that have publicly traded interests may limit their activities to reduce the risk that they will be considered to be in a financial business and hence corporations under the PTP rules. Although the definition of a financial business is not very clear (see Chapter 4, Part F.3.b), an entity that intends to avoid engaging in such a business may avoid loan origination activities, and in that regard could be subject to some limitations similar to those imposed by the FASIT rules.

10 The tax status of pass-through debt certificates is discussed in Chapter 3, Part E.4.

FASIT election could permit greater freedom to transfer lower-grade classes. Further, even the best lawyers are sometimes wrong. If all certificate classes (senior and junior) were successfully recharacterized as equity, the financial consequences would potentially be disastrous. Credit card sponsors of the FASIT legislation therefore sought tax certainty regarding the treatment of all classes, including those with favorable tax opinions.

Credit card sponsors have not embraced the FASIT rules for several reasons. First, the gain recognition requirement is particularly onerous in this setting because no gain would be recognized in a non-FASIT structure (which is regarded as a pledge of receivables to support debt). The fact that gain must be recognized on all receivables transferred to the FASIT without regard to the amount of regular interests that are sold does not help. The amount of potential gain has been reduced, however, by the 1997 statutory change that requires use of a prepayment assumption in calculating income from a pool of credit card receivables.[11] Second, the potential benefit of tax certainty has yet to be realized because of vagueness in the statute and the lack of user-friendly regulations. As a result, a FASIT election would simply substitute one set of tax interpretation risks for another. Further, the practical risk of a serious IRS challenge to traditional structures has been reduced by the passage of time as billions of dollars of credit card trust securities continue to be issued each year outside of the FASIT rules.[12] Third, most credit card sponsors that would be potential users of FASITs have already established master trust programs that cannot readily be changed midstream. The transition rule included in SBJPA 1996 is simply not workable in the absence of further guidance. Finally, issuers have developed structures to achieve the regulatory capital benefit of issuing equity while reducing the tax recharacterization risk for lower-grade classes by transferring the trust cash flows supporting those classes to a second trust that issues instruments in the form of debt to investors.[13] The availability of

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11 See Chapter 8, Parts C.2 and G.3. Other potentially mitigating factors are that servicing costs and anticipated defaults are taken into account in measuring gain (see Part G.2.b.(ii), below), and credit card receivables generally have a short term.

12 This is a tax version of the "too big to fail" argument sometimes advanced for financially frail banks. Much time has passed since 1993 when the first FASIT bill was introduced. See Chapter 2, Part G.

13 See Chapter 3, footnote 188.

this technique reduces the need for making a FASIT election. In short, the FASIT rules would have been far more useful for credit card issuers had they been available (with a set of user-friendly regulations) in the late 1980s as credit card structures were just getting off the ground.

Outside of the credit card arena, where practices are not as well established, a FASIT election would potentially make sense in any case where the status of securities as debt is in doubt. Those doubts exist for credit card trusts principally because of the need, for non-tax reasons, to issue securities in the form of equity. The aversion to instruments cast in the form of debt has been tempered somewhat (at least for non-bank sponsors) due to changes in GAAP standards that permit debt of a QSPE not to be consolidated with its equity owner.[14] Even where securities are cast in the form of debt, however, their tax status may be uncertain because of the factors outlined above. The benefit of the election will be greater for issuers holding revolving pools of loans, because those issuers may be classified as corporations if they have publicly traded equity. On the other hand, the revolving feature will likely weaken the argument for reclassifying purported debt as equity. As noted above, the significance of the gain recognition rule will vary depending on the nature of the receivables and other factors.

3. Use in Mortgage Transactions

Issuers of multiple-class mortgage-backed securities face two special considerations in evaluating a possible FASIT election: the threat of the taxable mortgage pool rules and the opportunity to make a REMIC election. Because the TMP rules force such an issuer to be classified as a corporation absent a REMIC or FASIT election, they place a premium on accurately determining whether securities are equity (paying nondeductible dividends) or debt. The debt classification problem can be avoided by making either a FASIT or REMIC election.

The potential advantage of a FASIT over a REMIC is that it is a more flexible vehicle. In particular,

- assets can be acquired and regular interests can be issued at any time after the FASIT startup day—hence a FASIT can be open-ended and not simply a liquidation vehicle for a fixed asset pool

14 See Chapter 2, Part D.3.

- substitutions of debt obligations held by a FASIT are allowed at any time, compared to the REMIC rule allowing free substitutions for three months after the startup day and substitutions of defective loans for two years after that day
- FASIT assets can be disposed of to reduce overcollateralization and to retire an individual class of regular interests (even if significant amounts of the class are outstanding)
- a FASIT can enter into currency, interest rate and certain other types of hedges (whereas the same practical result can sometimes be achieved for a REMIC through a hedge outside of the REMIC), and
- there is no requirement that debt instruments be supported by any minimum amount of real property collateral.

As described below, FASITs also have a number of disadvantages compared to REMICs. Accordingly, as a general matter, an issuer would never choose a FASIT over a REMIC unless there was a genuine need for greater flexibility in managing assets and liabilities. Whether such a need exists will depend on the business reasons for a securitization. Mortgage securitizations that are intended to pass through to investors the economic features (including prepayment risk) of an identified pool of mortgages can be carried out perfectly well within the rigid constraints of the REMIC rules. FASITs will make most sense where there is a desire (1) to use one vehicle to provide follow-on loans to mortgagors, (2) to finance mortgages on a shorter term basis (more like a conventional warehouse financing) or (3) to give a servicer more latitude in renegotiating mortgage terms (assuming that option is in fact available under the FASIT rules).[15] Some examples of structures that can be accommodated by the FASIT rules are given in Part B.4, below.

The ways in which FASITs are less advantageous than REMICs may be summarized as follows:

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15 Loan modifications raise various issues under the FASIT prohibited transaction tax rules. See Parts E.3 (dispositions, including modifications) and E.4 (loan originations).

- the measurement of up-front gain for receivables not traded on an established securities market is based on an artificial value (120 percent-of-AFR discount rate)

Many mortgages can readily be valued, but are not traded on an established securities market. Unless and until regulations remove the threat of the 120 percent-of-AFR valuation rule for non-traded assets that can be readily valued, the amount of gain recognized upon formation of a FASIT will in many cases be significantly overstated compared with a sale at fair market value. There is no comparable artificial valuation rule for REMICs. The basic FASIT rule requiring full gain recognition would not in itself be a significant obstacle for any securitization in which the sponsor intends to sell all or substantially all of the securities created, because the sponsor of a REMIC similarly recognizes gain based on the portion of securities sold.[16]

- no losses on formation of FASIT unless the Owner is unrelated to the sponsor

When a REMIC is formed to securitize mortgages that have an unrealized loss, a portion of the loss is recognized equal to the portion of the REMIC securities that are sold. Thus, for example, if regular interests are sold to investors representing 80 percent of the aggregate value of REMIC interests, 80 percent of the loss is recognized. By contrast, with a FASIT, no loss is recognized upon a transfer of receivables to a FASIT unless the holder of the ownership interest is unrelated to the former owner of the receivables.[17]

- the requirement that a FASIT ownership interest be held by a single domestic taxable corporation which cannot offset income from such interest with other losses

There are three distinct disadvantages stemming from this requirement. First, income from a FASIT ownership interest is subject to a corporate income tax. The same income generally is taxed again when distributed out of corporate solution. REMIC residual interests can be held

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16 The FASIT regulations would extend the rule that prevents income from a FASIT ownership interest from being offset with non-FASIT losses to gain recognized upon the transfer of receivables to a FASIT. See footnote 307, below. If that approach is preserved in the final regulations, it would represent an additional disadvantage of FASITs over REMICs relating to up-front sponsor gain.

17 See footnote 303, below, and accompanying text.

by noncorporate taxpayers (so that the tax imposed on income on such interests is the final tax).[18] Second, all income from a FASIT ownership interest is subject to the rule prohibiting the income from being offset with non-FASIT losses. The corresponding rule for REMIC residual interests is limited to the part of the income that is excess inclusion income. This difference is significant only for residual interests providing substantial cash flows held by taxpayers with losses. Third, a FASIT ownership interest is less liquid than a REMIC residual interest. At any time, it must be held in its entirety by a single corporation. That corporation will need to file a tax return that reflects all of the individual items of FASIT income and expense and, for the first year, makes the FASIT election. Further, the Owner is personally liable for any prohibited transaction taxes imposed on the FASIT whether or not it participates in the prohibited transaction. In contrast, a REMIC residual interest can be held by multiple parties, and a holder's tax return includes only a single item of income or loss, as reported to it by the REMIC. Also, prohibited transaction taxes are imposed on the REMIC itself and not on the residual interest holder.

- FASIT high-yield interests (including interest-only classes) can be held only by domestic taxable corporations (or other FASITs), and the income thereon may not be offset with non-FASIT losses

The FASIT requirement was intended to ensure that regular interests having equity characteristics be held by corporations so that the corporate tax deduction allowed to the FASIT would be offset by a corporate income inclusion. Unfortunately, Congress extended the rule to high-coupon interests (including interest-only classes), even though they resemble stripped coupons that are taxed under the bond stripping rules rather than equity interests. This rule is a significant drawback because mortgage securitizations frequently include interest-only classes and, at least under current market conditions, a significant number of potential buyers are not eligible corporations. In contrast, there are no special REMIC rules for high-yield interests.

- greater obstacles to acquiring defaulted loans

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18 In practice, however, REMIC residual interests are rarely held by individuals because of limitations on the deductibility of servicing fees and other non-interest expenses. See Chapter 9, text following footnote 47.

The FASIT statute requires that a FASIT hold debt instruments, as defined for tax purposes. Accordingly, a loan that has been worked out prior to acquisition by a FASIT (and is considered an equity interest for tax purposes) would not be a qualifying asset. By contrast, a REMIC can acquire an instrument in the form of debt that is classified as equity, although it may not be allowed to acquire the related real property collateral. The FASIT regulations include a draconian rule that would prohibit the acquisition of any debt instrument with a defaulted payment unless the loan is expected to be brought fully current within 90 days.[19]

- prohibition against debt instruments with contingent interest

A REMIC can hold debt instruments with contingent interest (e.g., equity kickers), although the contingent payments cannot be passed on as contingent interest on regular interest classes. FASITs cannot hold contingent interest debt. The FASIT regulations would not allow the problem to be cured by stripping off the contingent interest before a debt instrument is conveyed to a FASIT, although the final regulations may be more lenient.

- prepayment penalties

A REMIC can pass through prepayment penalties received on mortgages as payments on regular interests. It is not clear if the same is true for FASITs.

- greater overall interpretation risk

The extensive legislative history of the REMIC legislation in combination with user-friendly, comprehensive regulations provide substantial clarity as to how the rules are to be applied. The FASIT legislative history is sparse and the FASIT regulations create as many problems as they solve. Hopefully, the final regulations will be more constructive.

4. Examples of FASIT Transactions

The following examples explore potential uses of the FASIT vehicle in a variety of situations. They involve the financing of multiple, changing pools of loans using common credit support, non-default related modifications of loans, prepayment guarantees, the restructuring of borrowings, the stripping of debt with default risk, and commercial paper issuers.

> ***Example 1.*** A loan originator wishes to finance loans which it originates over time. It creates a trust which periodically issues trust cer-

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19 See footnote 127, below.

tificates to investors. The trust uses the proceeds to purchase loans under a contract with the originator. Certain classes of certificates are payable only out of certain groups of loans, but there is a common subordinated class sold to investors that bears credit risk with respect to all of the loans.

All of the issued classes, including the subordinated class, could potentially be regular interests. One issue would be whether the subordinated class would be a high-yield class that could only be held by eligible corporations (or other FASITs). There is a question whether the contract between the FASIT and the sponsor would cause the FASIT to be considered a loan originator, but the answer should be no.[20]

Example 2. A trust holds a fixed pool of loans. The servicer wants to have the ability to renegotiate the terms of the loans for commercial reasons in a non-default setting.

Assuming that the change in terms results in a significant modification, so that the change is considered an exchange of a new mortgage for an old one, gain from the deemed exchange generally would not be subject to the prohibited transaction tax.[21] (The same result would obtain for a REMIC only during the three months after its startup day.) There is a question whether actions taken by the servicer to renegotiate the loan would be considered the "origination" of a new loan, and whether those actions would be attributed to the FASIT.[22] Also, the Owner could recognize gain under the artificial valuation rule if it is not changed.[23]

Example 3. A trust holds a fixed pool of loans that are subject to prepayment. To insulate investors from prepayments, the trust enters into a guaranteed investment contract that requires it to reinvest prepaid principal in the contract at a rate of interest matching that on the prepaid loan over the remaining scheduled term of the loan.

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20 See Part E.4, below.

21 The text assumes that the original loan was not acquired for a principal purpose of generating gain. See text at footnote 238, below.

22 See Part E4, below. Hopefully, the final FASIT regulations will clarify the point.

23 See Part G.2.d, below

A FASIT could potentially be used in this structure. The assets which a FASIT is allowed to hold do not explicitly include prepayment guarantees, but the guaranteed investment contract is simply an agreement to invest in debt instruments, which are qualifying assets.

> ***Example 4.*** The owner of a pool of mortgages wants to issue trust certificates backed by the mortgages. The certificates will be typical mortgage-backed securities, including a planned amortization class that is slated to receive prepayments on the underlying assets according to a schedule. The sponsor would like to ensure that the prepayment schedule is met, even in periods of slower principal payments.

A FASIT could potentially be used in this situation. The planned amortization class could be structured as a series of FASIT regular interest subclasses, each of which matures on a consecutive payment date. Each subclass would have a principal amount equal to the scheduled principal payment for the date of its maturity. If prepayments and principal payments received in the ordinary course are not sufficient to make the principal payments due on any payment date, the FASIT could dispose of sufficient assets to retire that class.

> ***Example 5.*** A securitization vehicle has outstanding classes of interests that resemble debt economically. The sponsor intends aggressively to monitor changes in the market in order to "re-optimize" the debt structure by eliminating, refunding, combining or subdividing debt classes.

A FASIT would potentially permit such re-optimization. FASITs can issue new debt classes at any time. A FASIT can use proceeds of new issuances to call in a class of regular interests without retiring other classes or it may sell assets to retire a particular class of regular interests. One potential obstacle is that it is not clear if a FASIT can pay prepayment penalties.[24]

> ***Example 6.*** A trust is formed to hold unsecured corporate bonds. The trust issues interest-only and principal-only classes of certificates which entitle the holders to interest and principal payments, respectively, on the underlying bonds. In the event of a prepayment of the bonds, all classes share pro rata in trust assets, in proportion to the

24 See footnote 63, below, and accompanying text.

present values of the payments each class would have received in the absence of the prepayment.

As discussed in Chapter 4, Parts D.5 and D.6.b, the reallocation of cash flows upon a prepayment or acceleration may cause the trust to fail to qualify as a grantor trust. A FASIT election could potentially be made. On the other hand, there would be a substantial argument that the trust is a grantor trust (particularly if the bonds could be prepaid only following a default), and if it were not (and no FASIT election were made), there would not be significant adverse consequences. Specifically, the trust would be classified as a partnership and not an association, even if the certificate classes are actively traded. The trust would not be engaged in a trade or business so that buyers who are foreign investors or tax-exempt organizations should not be adversely affected by a partnership characterization.

Example 7. A limited liability company is formed to issue commercial paper as part of an ongoing program. The company issues such paper from time to time and uses it to buy receivables (or debt secured by receivables) from third parties. The equity of the issuer (which is nominal) is held by a special purpose corporation for the benefit of a charitable trust. A third party is responsible for managing the program and provides credit support through a letter of credit. The net income of the issuer (except for certain designated amounts) is paid to the manager as a fee.

A FASIT could potentially be used in this example to ensure that the commercial paper would be treated as debt. If the manager of the program were treated as owning equity in the issuer for tax purposes, however, the arrangement would violate the FASIT requirement that the ownership interest be held by a single taxable corporation. In any event, the commercial paper is highly likely to be treated as debt under general tax principles (notwithstanding the thin capitalization of the issuer) because it is in the form of debt, is highly rated, and has a very short term. If the non-FASIT transaction were recharacterized for tax purposes, it likely would be treated as the issuance of commercial paper by the manager, secured by the nominal issuer's assets. This recharacterization generally would not produce significant adverse tax consequences that would necessitate use of the FASIT vehicle.

C. Use of REMIC Rules as Aid in Interpretation

As indicated above, there is a substantial body of law interpreting the REMIC rules and a much less developed one for FASITs. Before turning to a more detailed discussion of the FASIT rules, it is worth considering the relevance to them of the REMIC statute, regulations and practices.[25] In those instances where the FASIT provisions explicitly refer to REMIC sections, those sections and interpretations thereof apply directly (although sometimes with adjustments). In other instances, the FASIT statute uses terms that are the same as, or similar to, those used in the REMIC context, but without an explicit cross-reference. The REMIC rules can still usefully be relied upon by analogy, although more judgment is required to take account of the differences between REMICs and FASITs (e.g., the ability of a FASIT to hold non-mortgage assets and to acquire new assets). The sections that follow draw frequently on REMIC analogies, but the reader should bear in mind the distinction between authoritative and persuasive applications of the REMIC rules.

D. FASIT Qualification

Any type of legal entity, or segregated pool of assets within an entity, may qualify as a FASIT.[26] There is no statutory requirement that a FASIT be organized in the United States or under U.S. law, although the FASIT regulations would limit the election to domestic entities that are not subject

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25 It is unfortunate that there is no statement in the FASIT legislative history acknowledging the relevance of the REMIC rules, although the genealogy is unmistakable.

26 Sen. Rep. No. 104-281, 104th Cong. 2d Sess. (the “1996 Senate Report”), 127; Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96) (December 18, 1996) (*1996 Blue Book*), 260; Proposed Regulation §1.860H-1(a)(2). Proposed Regulation § 1.860H-1(a) refers to an entity or segregated pool of assets that can qualify as a FASIT as a “qualified arrangement.” For convenience, references herein to an “entity” include a segregated pool of assets unless the context requires otherwise. As a practical matter, it would seem that to qualify as a FASIT, a segregated pool of assets would have to be owned by an eligible corporation given the requirement that the ownership interest be held by such a corporation.

to foreign net taxes.[27] As a substantive tax matter, the requirement of a domestic entity is largely beside the point because all of the income of a FASIT is attributed to the Owner which must be an eligible (domestic) corporation.

To qualify as a FASIT, an entity must elect to be a FASIT and (1) satisfy a test relating to interests in the FASIT (*interests test*), (2) satisfy a test relating to the assets of the FASIT (*assets test*), and (3) at no time qualify as a RIC.[28] Parts D.1 and D.2, below, discuss the interests and assets tests, respectively.[29] Procedures for making a FASIT election are discussed in Part I.1.

1. Interests Test

The interests test requires that the interests in a FASIT be either regular interests or a single ownership interest.[30] There must be an ownership inter-

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27 Proposed Regulation § 1.860H-1(a)(3) would prevent an entity from qualifying as a FASIT if it is created or organized under the law of a foreign country or a possession of the United States, or any of its income is or has ever been subject to net tax by a foreign country or a possession of the United States. Presumably a "net tax" is intended to be a tax on net income. The preamble to the FASIT regulations states that an entity may be "subject to" such a tax without an actual tax being imposed, and may lose its status as a FASIT prospectively if it becomes subject to tax as a result of newly conducted foreign activities (or it would seem, a change in foreign law). 2000-1 C.B. 691. The purpose of the "subject to" rule appears to be to limit the use of FASITs in transactions generating foreign tax credits, although it is odd in that case to fret over taxes that are in fact not imposed. The reason for a separate exclusion for entities organized under foreign laws is not clear. REMICs have been formed outside of the United States in connection with securitizations of non-U.S. mortgages. Also, non-mortgage assets are routinely financed using offshore issuers, as described in Chapter 13. See also the discussion of foreign FASITs in the NYSBA report on the FASIT regulations cited in footnote 6, above.

28 Section 860L(a)(1)(E) disqualifies as a FASIT any entity that "is described in section 851(a)," which defines a RIC. For a description of section 851(a), see Chapter 4, footnote 271.

29 A related rule that treats assets supporting FASIT interests as if they were part of the FASIT is discussed separately in Part H.1, below.

30 Section 860L(a)(1)(B).

est, but there is no requirement that any regular interest be issued or outstanding. The ownership interest must at any one time be held by a single eligible corporation, although transfers from one eligible corporation to another are allowed.

a. Definition of Interest. The term "interest" is not defined in the Code, and neither SBJPA 1996 nor the legislative history sheds any light on its intended meaning. The term has been developed reasonably in the REMIC regulations, and they should apply by analogy to FASITs.

In the REMIC context, an interest is generally understood to encompass any economic right relating to an investment in a REMIC or arising under a financial instrument to which a REMIC is a party, or any contractual right designated as a REMIC interest.[31] The REMIC regulations provide safe-harbor rules[32] that exclude the following items from the definition:

- certain *de minimis* interests
- reasonable compensation for services
- stripped bonds or coupons not held by a REMIC representing interests in obligations held by a REMIC (including excess servicing and rights to contingent interest on mortgages retained upon a transfer of the mortgages to a REMIC)
- reimbursement rights under credit enhancement contracts, and
- rights and/or obligations to acquire mortgages in connection with exercise of a clean-up call (the retirement of a class of regular interests for administrative reasons when its balance drops to a low amount) or a qualified liquidation of a REMIC.[33]

A REMIC must issue all of its interests on (or within a 10-day period containing) the startup day. The purpose of the *de minimis* rule is to allow a trust to be formed with nominal assets prior to the startup day without vio-

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31 See Chapter 6, Part B.1.

32 Treasury Regulation § 1.860D-1(b), which is discussed in Chapter 6, Part B.1.a.

33 For the definition of a clean-up call, see Chapter 6, Part B.1.a.(iv). The REMIC regulations also exclude from the interest definition rights and obligations to acquire convertible mortgages (those whose rates are reset at the option of the mortgagors to current market rates).

lating the REMIC interests test. While the FASIT rules also require that FASIT interests be issued on or after (i.e., not before) the startup day, the existence of a special transition rule for pre-effective date FASITs and other FASIT rules make it clear that a FASIT election can be made for a pre-existing entity.[34] Accordingly, a *de minimis* exception based on the REMIC model appears to be unnecessary.

A right to reasonable compensation for services provided to a FASIT should not be a FASIT interest.

As in the REMIC context, it generally would be reasonable to treat stripped coupons or bonds representing interests in loans held by a FASIT as interests in the loans and not in the FASIT, but subject to three qualifications. First, the FASIT regulations would not seem to allow a FASIT to hold a partial interest in a debt obligation that has a contingent payment right even if that right is allocated to someone else.[35] Second, subordinated interests in a pool of receivables held outside of a FASIT may be brought into the FASIT under the support rule. That rule, and its effect on the FASIT interests test, are considered in Part H.1, below. Finally, as regards excess servicing, servicing compensation for a REMIC or other fixed-pool securitization usually takes the form of a fixed number of basis points of interest on a portfolio of identified loans. It is straightforward to treat the excess portion of such a fee (the part exceeding reasonable servicing compensation) as stripped coupons that are regarded as ownership interests in the mortgages.[36] The same conclusion may not be easily reached for servicing provided to a revolving pool FASIT, either because the formula for calculating the fee is not expressed as a fixed number of basis points of interest or because the underlying receivables change. Another factor that may make the excess servicing issue more of a practical issue for FASITs than for REMICs is that market standards for testing whether servicing compensation is "at market" may be less well developed for non-mortgage receivables than for mortgages. In cases where servicing may be considered above market, consideration should be given to qualifying the excess portion as a regular interest or part of the ownership interest. This approach requires advance planning, however, given the requirement, discussed be-

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34 See Part H.5, below.

35 See Proposed Regulation § 1.860H-2(b)(1)(vii) discussed in Part D.2.c.(v), below.

36 See Chapter 4, Part D.7.

low, that FASIT regular interests and the ownership interest be designated as such.

Rights of a non-FASIT counterparty under any guarantee or hedge contract that is permitted to be held as a FASIT asset should not be considered a FASIT interest even though, in the case of a hedge contract, the contract may at times represent a significant economic liability of the FASIT, at least provided the contract is priced at market when issued.[37]

The special rule for rights or obligations to acquire mortgages from a REMIC applies in the two principal cases in which a REMIC is allowed to sell non-defaulted mortgages, namely in a qualified liquidation or upon the retirement for administrative reasons of a class of regular interests.[38] In effect, the drafters reasonably concluded that if a REMIC can sell, someone should be allowed to buy, including by means of a predetermined right or obligation to buy. FASITs have a similar right to dispose of assets in a qualified liquidation.[39] Their power to sell in order to retire regular interests is broader, however, because they can retire a class for any reason whatsoever, not simply to "clean up" a class that has been reduced to an administratively inconvenient size.[40] Following the logic of the REMIC regulations, a right to buy assets to effect the retirement of a particular regular interest class should not be considered to create a prohibited FASIT interest, even if the reason for retiring the class is an economic one (not just administrative). Similarly, a right to substitute receivables should be allowed (at least where the substitution would not be a prohibited transac-

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37 Section 860L(a)(6) (except as provided in regulations, any asset which is a permitted asset at the time acquired by the FASIT shall not be treated at any time as an interest in the FASIT). The FASIT regulations would treat a hedge or guarantee contract as not a permitted asset if at the time it is entered into, it "in substance creates an investment." Proposed Regulation § 1.860H-2(d)(4). Presumably the rule would apply when the contract represents a liability (or maybe a significant liability) of the FASIT at the time when it is entered into. Changes in value thereafter would not matter.

38 A REMIC can substitute mortgages without restriction during the first three months following the startup day, and the REMIC regulations do not address the effect of substitution rights in such a case. It is very rare, however, for a sponsor to have a free substitution right (rather than a right to substitute new loans for defective ones as an alternative to a required cash purchase).

39 See Part E.3, below.

40 See Part E.3, below.

tion). While the REMIC regulations do not limit the price at which a REMIC asset may be sold, it would be unusual to have a right to purchase at a price that is expected to be significantly less than fair market value, and in the absence of more specific guidance, it would be prudent not to cross that line in the FASIT area.[41]

b. Ordinary Regular Interests. The FASIT rules define a subcategory of regular interests referred to as *high-yield interests*, which are discussed in the next section. For convenience, this chapter will refer to regular interests that are not high-yield interests as *ordinary regular interests*.

A regular interest (whatever kind) can take the form of an equity interest under local law. For example, it may be a beneficial interest in a trust, a partnership interest or preferred stock.[42]

To qualify as an ordinary regular interest, section 860L(b)(1)(A) requires that an interest:

- be issued by a FASIT[43] on or after the startup day (the *issuance requirement*)[44]

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41 Options to buy mortgages from REMICs are often set at a price equal to the face amount (including accrued and unpaid interest) of the mortgages. Before adoption of the REMIC regulations, some counsel required that the purchase price be the greater of face or fair market value at the time of purchase. Given the REMIC analogy, it should be possible to have a purchase option for a FASIT receivable at a price of face if there is no reason to believe that such a price will be significantly below fair market value. In all events, the price in non-default cases should be sufficient to allow regular interest classes to be retired in full with the proceeds of the sale and other FASIT assets so as to avoid creating a contingency that runs afoul of the regular interest definition. See Part D.1.b.(ii), below.

42 The FASIT legislative history states that any entity (including a corporation, partnership, or trust) or a pool of segregated assets may qualify as a FASIT. See footnote 26, above. It also states that regular interests are treated as debt regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity. See 1996 Senate Report at 128; 1996 Blue Book at 261-262. These statements strongly indicate that any type of instrument (including, for example, partnership interests and preferred stock) may qualify as a regular interest. Further, the REMIC rules clearly allow instruments of this type to be regular interests (see Chapter 6, footnote 2 and accompanying text) and there is no reason not to follow the REMIC analogy.

- have fixed terms (the *fixed terms requirement*)
- be designated as a regular interest (the *designation requirement*)
- unconditionally entitle the holder to receive a specified principal amount (or other similar amount) (the *unconditional principal requirement*)
- provide for interest payments (or other similar amounts), if any, that are determined based on a fixed rate or, except as otherwise provided in regulations, a variable rate (other than a specified portion rate) permitted under the REMIC rules (the *permissible rate requirement*)
- have a stated maturity (including options to renew) of 30 years or less (unless regulations permit a longer term) (the *maturity requirement*)
- have an issue price that does not exceed 125 percent of its stated principal amount (the *limited premium requirement*), and
- have a yield to maturity based on its issue price less than 500 basis points over the AFR for the calendar month in which the obligation is issued (the *permissible yield requirement*).

There are no requirements restricting the number or types of holders of ordinary regular interests. High-yield interests must be held by eligible corporations (or other FASITs).

A high-yield interest is a regular interest that meets the same tests except that it may fail one or more of the unconditional principal requirement, the permissible rate requirement, the limited premium requirement or the permissible yield requirement. However, if the permissible rate requirement is not met, a high-yield interest must provide for interest payments that consist of a specified portion of the interest payments on permitted assets (which portion does not vary during the period the interest is out-

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43 Where the issuer is a segregated pool of assets within an entity, the REMIC regulations require that the interest in the REMIC be based solely on assets of the REMIC. Treasury Regulation §1.860D-1(c)(1). The same principle should apply to a FASIT.

44 There is a typo in section 860L(b)(1)(A), which refers to "startup date" (not day).

standing). We consider first the requirements for ordinary regular interests and then special rules for high-yield interests.

(i) Requirements for ordinary regular interests—overview. As discussed in Part F.1, below, a FASIT regular interest is treated as a debt instrument for tax purposes. The requirements for regular interests are therefore intended to ensure that the interests functionally resemble debt.

The first five requirements listed in the preceding section (the issuance, fixed terms, designation, unconditional principal and permissible rate requirements) mirror requirements in the definition of a REMIC regular interest.[45] These FASIT requirements should generally be interpreted in accordance with the corresponding REMIC provisions, taking into account the particular features of the FASIT vehicle. The most important difference is that FASIT regular interests can be issued at any time on or after the startup day (and the fixed terms of an interest need be set only when it is issued); REMIC regular interests cannot be issued after the startup day. The maturity and permissible yield requirements are unique to FASITs.

The next four sections consider the unconditional principal, permissible rate, maturity and permissible yield requirements. The limited premium requirement is discussed further below in the section on high-yield interests.

(ii) Unconditional principal requirement—the effect of contingencies. A FASIT regular interest must have an "unconditional entitlement to a specified principal amount." Also, the stated rates of interest must be based on certain fixed or qualifying variable rates. Suppose that a FASIT regular interest has a stated principal amount and bears interest at a permitted rate, but there are circumstances in which principal and interest will not in fact be paid in the stated amounts. Does the existence of payment contingencies jeopardize the status of an interest as a regular interest? The FASIT statute addresses the issue only by stating that a regular interest will not fail to qualify merely because the timing of principal payments may be contingent on prepayments on debt obligations or on the amount of income from permitted assets.[46]

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45 See section 860G(a)(1) (the REMIC definition of regular interest).

46 Section 860L(b)(1)(A), flush language. There is similar language in the REMIC statute. See section 860G(a)(1), flush language.

The same issue exists for REMICs. The REMIC regulations supply a list of permitted contingencies, which is exclusive as regard principal.[47] The REMIC list should be the starting point for testing contingent features of FASIT interests, although some adjustments are clearly needed. Under the REMIC regulations, an interest will not fail to qualify as a regular interest solely because:

- the timing of (but not the right to or amount of) principal payments is affected by prepayments or the amount of income from permitted investments
- the timing of interest and principal payments is affected by the payment of REMIC expenses
- the amount or timing of principal or interest is affected by defaults on qualified mortgages and permitted investments, unanticipated REMIC expenses, or lower than expected returns on permitted investments
- the interest bears losses stemming from defaults or delinquencies on qualified mortgages or permitted investments, unanticipated expenses incurred by the REMIC, prepayment interest shortfalls, or lower than expected returns on permitted investments before other interests
- the interest permits deferral of interest payments
- the amount of interest payments is affected by prepayments on underlying mortgages, or
- the amount or timing of principal or interest is subject to a remote or incidental contingency.[48]

In the FASIT context, references to defaults on qualified mortgages and permitted investments should be interpreted to mean defaults on any permitted assets (including swaps and other permitted hedges).[49]

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47 Treasury Regulation § 1.860G-1(b)(3), which is discussed further in Chapter 7, Part D. See also Treasury Regulation § 1.860G-1(a)(5) (stating that contingencies affecting principal other than those set forth under subsection (b)(3) of the same regulation are not permitted).

48 Treasury Regulation § 1.860G-1(b)(3).

49 Section 860L(e)(3)(A) offers some guidance on how to make the transition from REMICs to FASITs in applying default-related rules. It extends to

A more difficult issue is whether additional contingencies should be allowed to reflect the greater flexibility of FASITs in managing assets and liabilities.[50] Consider a FASIT that issues short-term regular interests backed by a revolving pool of longer-term debt. The regular interests account for 80 percent of the face value of the debt assets. The Owner expects to refinance the regular interests. The Owner and investors believe that the 20 percent equity cushion is sufficient to ensure that payments on the regular interests will be made when due. If there is a significant rise in interest rates, however, the FASIT may not be able to refinance the regular interests or to sell assets at a price sufficient to make the required principal payments. This type of basis risk would not be permissible for REMIC regular interests. Should it be allowed for FASITs because of the provisions for substitution, additions of collateral, and later issuances of regular interests? The answer is plainly "yes" if the risk can be characterized as remote. Otherwise there is some doubt, but a strong argument can be made that contingencies of this type should be allowed.

FASITs resemble conventional debt issuers more than REMICs, and creditors routinely accept risks attributable to mismatches between the terms of debt and the underlying assets. They lend because the fair market value of the assets is sufficient to support the debt whether or not the cash flows match. Stated differently, a mismatch in cash flows is not necessarily an equity characteristic. Lenders, of course, do not lend blindly, and require a level of overcollateralization that they believe to be adequate to back the borrower's repayment obligation. Some accept greater risks than others, and at some point, the level of risk may be so high that the character of a regular interest as debt is called into question. For FASITs, unlike REMICs, the level of risk is effectively policed by the permissible yield requirement. As the credit risk of a regular interest goes up, so does the yield demanded by investors. Once that yield reaches 500 basis points over

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FASITs the REMIC rule that carves out of the definition of prohibited transaction dispositions of defaulted qualified mortgages, but in doing so treats "permitted assets (other than cash and cash equivalents)" as if they were "qualified mortgages." It probably does not much matter whether cash equivalents are included because any default contingency relating to them is likely to be remote.

50 Special considerations may apply to high-yield interests. See Part D.1.c.(iv), below.

the AFR, the interest falls into the high-yield category and, because a high-yield interest must be held by a taxable corporation or another FASIT with a corporate owner, interest payments thereon can no longer be used to reduce the corporate income tax base.

The ability of a FASIT to issue regular interests after the startup day would allow it to participate in revolving credit lines that provide for additional borrowings and repayments of principal (maybe more than once). The designation requirement and fixed terms requirement may require that each additional advance be viewed as a separate class of regular interests. In any event, changes in principal balances attributable to additional advances and repayments is a common feature of debt and would not be a prohibited contingency affecting principal.

(iii) Permissible rate requirement. An interest will be an ordinary regular interest only if "interest payments (or other similar amounts), if any, with respect to such interest are determined based on a fixed rate, or, except as otherwise provided by the Secretary, at a variable rate permitted under section 860G(a)(1)(B)(i)." The cross-reference is to the part of the definition of a REMIC regular interest that allows interest to be paid, to the extent provided in regulations, based on a variable rate. There are extensive regulations allowing different types of variable rate REMIC regular interests.[51] Because no regulations have been adopted or proposed that cut back on the definition of the analogous FASIT term, the REMIC regulations should apply in full.[52] Accordingly, the following rates would satisfy the permissible rate test:

- a rate based on current interest rates (generally a qualified floating rate under the OID regulations or a rate equal to the highest, lowest or average of two or more such rates)
- a weighted average rate

51 Treasury Regulation § 1.860G-1(a)(3). For a detailed description, see Chapter 7, Part C.3.

52 The FASIT definition of permitted asset generally requires that debt instruments bear interest at a fixed rate or a variable rate as defined under the same REMIC section. The FASIT regulations would cut back on the definition of variable rate in that setting. See Part D.2.c.(ii), below.

- a rate derived from one of the preceding rates by addition of, subtraction of, or multiplication by, a fixed number (or a combination of multiplication and addition or subtraction)
- one of the preceding rates subject to a cap or floor or maximum basis point increase or decrease per period
- one of the preceding rates subject to a funds-available cap, and
- a combination of one or more fixed rates and one or more of the foregoing variable rates.

Weighted average rates, rates subject to funds-available caps, and combination rates may have special features in the FASIT context which are explored in the next three sections.

Weighted average rates. The REMIC weighted average rate definition permits a rate based on an average of interest rates on some or all of the "qualified mortgages" held by the REMIC.[53] A REMIC may hold other permitted investments that are debt instruments (cash flow investments and qualified reserve assets), but the yields on those assets may not be taken into account in a weighted average rate calculation. The FASIT rules treat any noncontingent debt instrument not issued by a related person as a permitted asset, and the only sensible way to apply the REMIC regulation to FASITs is to allow the rate to be based on the interest payable on any or all of the debt instruments held by a FASIT.[54]

Since REMICs are not permitted to hold notional principal contracts or other hedge contracts, a question arises whether a FASIT should be permitted to take those contracts into account in defining a weighted average rate. Although there is no clear answer, doing so would be adventuresome

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53 Treasury Regulation § 1.860G-1(a)(3)(ii)(A) requires that the qualified mortgages bear interest at a fixed or variable rate. Debt instruments held by a FASIT would meet this test automatically. See Part D.2.c.(ii), below.

54 The definition of permitted assets in section 860L(c)(1) lists separately debt instrument and cash or cash equivalents. While there does not seem to be any policy reason why interest on cash or cash equivalents could not be factored into a weighted average rate calculation, it might be prudent not to count such items (at least if they would not otherwise be permitted assets under the debt instrument part of the test) in the absence of clarification. It could be argued that they should not be counted by analogy to the exclusion under the REMIC rules regarding cash flow investments.

in the absence of guidance on the point. On the other hand, if a hedge and debt instrument were integrated into a synthetic debt obligation under the OID integration rules, it should be possible to treat the synthetic debt like any other FASIT debt obligation for this purpose.[55]

In the REMIC context, a weighted average rate is useful as a way of ensuring that all cash flows from qualified mortgages bearing interest at a range of rates are paid out on regular interests rather than being allocated to the residual interest. For a FASIT, an alternative mechanism for making up the gap between earnings on assets and interest paid on regular interests would be to use a notional principal contract that exchanges interest received for interest paid.[56]

Funds-available caps. A REMIC funds-available cap is a limit on the amount of interest to be paid that is based on the total amount available for distribution (including principal and interest receipts).[57] Such a cap is useful in cases where mortgages bear interest at a rate that is in some respects mismatched with rates on regular interests (e.g., they may be based on different rate indices) so that there cannot be certainty that interest on the assets will be sufficient to pay interest on regular interests calculated at an uncapped rate. The REMIC regulations do not permit funds available caps that are used as a device to pay interest on regular interests at a rate that is not a permitted variable rate. For example, if a REMIC held a contingent payment debt instrument and issued regular interests bearing interest at a very high floating rate, subject to a funds available cap, the practical effect of the cap may be to create a contingent rate regular interest.[58] To determine whether a funds-available cap is a device, the REMIC regulations apply a "facts and circumstances" test that looks to current and historical relationships between the interest rate on REMIC assets and on regular interests.[59] The goal of the test is to distinguish between a cap that is expected to be reached regularly and one that should come into play only in unusual circumstances.

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55 See the discussion of synthetic debt instruments at footnote 174, below, and Chapter 8, Part H.4.

56 For a description of permitted hedge assets, see Part D.2.d, below.

57 Treasury Regulation § 1.860G-1(a)(3)(v)(A).

58 Treasury Regulation § 1.860G-1(a)(3)(v)(C), Example (2)(iii) illustrates this case.

59 Treasury Regulation § 1.860G-1(a)(3)(v)(B).

The use of a funds-available cap to create regular interests with contingent payment features is a form of abuse that is not even an option for a FASIT because a FASIT cannot hold contingent interest debt obligations. Nonetheless, the device test would still be relevant if the rate that would result if the funds-available cap were binding would, for whatever reason, not be a qualifying rate.

In the FASIT setting, the facts and circumstances that would need to be taken into account in evaluating a funds-available cap would include changes in the composition of assets (and any resulting changes in rates). As a commercial matter, the issuer may be sufficiently constrained for commercial reasons in what it can do so that the test can still meaningfully be applied. Where that is not the case, funds-available caps should be approached with caution.

Combination rates. Combination rates are a type of variable rate consisting of successive fixed or variable rates in effect in different periods. In the REMIC context, it is common practice to use an objective formula to determine the rate that applies in a particular accrual period rather than setting the rate in advance.[60] The formula is typically linked to a factor having a connection with the underlying mortgages or interest rates. For example, a rate could be set to change from fixed to floating on the first date on which LIBOR reaches 8 percent, or on which the principal amount of the underlying mortgages drops below some amount. Formulas based on factors unrelated to a mortgage securitization (e.g., the price of General Motors stock) probably are not allowed.

Similar principles should apply to FASITs. One issue faced by FASITs but not REMICs is whether objective formulae for switching rates that are tied to FASIT assets may be too open-ended to pass muster in cases where the FASIT sponsor retains discretion to replace or otherwise alter FASIT assets in a way that would affect the rate of interest on a class of FASIT assets.[61] The technical question is whether a rate that can be changed based on discretion of any party meets the requirement that a

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60 See Chapter 7, Part C.3.e.

61 To give an example of a case raising the issue, suppose that a class of FASIT interests pays interest of 8 percent, except that interest of LIBOR plus 200 basis points is paid in any period in which the FASIT assets exceed some amount. The initial asset pool is under that amount, but can be increased at any time by the contribution of additional assets by the sponsor.

FASIT interest have "fixed terms" when issued. The REMIC regulations construe the test to require that REMIC documents irrevocably specify the interest rate or rates to be used to compute interest payments. Although not clear, it might be argued that the rate is not so specified if it can be altered through the exercise of Owner discretion.

Effect of prepayment penalties. A prepayment penalty is a payment made by the obligor on a debt instrument to compensate the holder in the event the instrument is prepaid, generally through exercise of an optional prepayment right. A FASIT can hold debt instruments that provide for prepayment penalties,[62] so an issue arises whether those payments can be passed through as additional interest on classes of regular interests. A further question is whether a FASIT can pay prepayment premiums on regular interests that are not linked to premiums received on FASIT assets. The technical issue is whether a prepayment premium could be regarded as additional interest that is not part of a fixed or permitted variable rate or as principal that the holder is not unconditionally entitled to receive.[63]

The same issue arises in the REMIC context, and regulations there provide a clear answer. They state that a REMIC can pay out on regular interest classes prepayment premiums it receives, and can allocate them among classes any way it wants.[64] Premiums are frequently allocated to interest-only regular interests to compensate for potential losses due to faster than expected prepayments. Other types of premiums not traceable to those received on qualified mortgages are not allowed.

There is no guidance on the treatment of prepayment premiums in the FASIT context. At the least, the REMIC rule allowing prepayment premiums received on underlying assets to be passed through should apply by analogy, although the absence of a comparable regulation is somewhat troublesome. There is also a strong policy argument to allow a FASIT to pay conventional prepayment premiums on regular interests that are not derived from FASIT assets. A FASIT has more freedom than a REMIC to

62 See footnote 144, below.

63 For the different characterizations of prepayment premiums under general tax principles, see Chapter 8, footnote 69. Prepayment premiums received by a FASIT or REMIC that are passed through on a class of regular interests differ from conventional prepayment premiums in that they may not be tied to the payment of the corresponding principal on that class. In those circumstances, the argument for viewing the premiums as additional interest is stronger.

64 Treasury Regulation § 1.860G-1(b)(2).

issue regular interest classes that differ from the underlying assets in terms of the timing of principal payments. FASITs can refinance regular interests by issuing new interests, enter into contracts that hedge prepayment risks and acquire new assets without issuing new interests. Because there is no general principle requiring a direct link between assets and FASIT interests, it would be odd to limit prepayment premiums to those derived from assets. Conventional prepayment premiums would not cast doubt on the status of regular interests as debt because they are commonly found in debt instruments.

(iv) Maturity requirement. A FASIT regular interest may not have a "stated maturity (including options to renew) greater than 30 years," unless permitted in regulations (there currently are none). Presumably, the maturity requirement means that a regular interest must provide for principal and accrued interest that is "due" subject to the permitted contingencies described in the last section on or before the date which is 30 years after the issue date.[65]

The statement that the maturity includes options to renew would clearly cover a case in which either the holder or the issuer has a right to renew without the consent of the other. Suppose, however, that renewal requires the consent of both parties. In that case, there is no real "option." A borrower and a lender can always agree when debt matures to extend it. That being said, the option language has no modifiers and it would be risky to allow any extension right extending beyond the 30-year term.[66]

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65 Section 1271(a)(4)(B) defines a short-term nongovernmental obligation as an obligation that has a fixed maturity date not more than one year from the date of the issue. Treasury Regulation § 1.1272-1(f)(1) states that the term of a debt instrument would include either the issue date or the maturity date but not both dates. Thus, a debt instrument issued on September 1, 2000 and maturing on September 1, 2001 would not have a term of more than one year.

66 As an intermediate ground, there might be an argument that an extension right ought not to count if exercising it would constitute a "significant modification" within the meaning of Treasury Regulation § 1.1001-3 that would result in the creation of a new debt instrument under general tax principles. Putting that proposition to the test would require courage. The debt modification regulations are discussed in Chapter 6, Part D.2. The OID rules apply differently to certain short-term obligations (having a fixed maturity date not more than one year after the issue date). In applying that definition, the maturity

The FASIT maturity requirement has no parallel in the REMIC provisions. The reason for the difference is presumably that FASITs can acquire new assets, so that there is no natural maturity date based on the term of the underlying assets.

One practical concern with the FASIT requirement is that it would effectively preclude the inclusion in a FASIT of newly originated 30-year residential mortgages. Maturity dates of regular interests need to lag behind maturity dates of the underlying assets for some period to allow for collections. Thus, it would be necessary to warehouse such loans for at least a short period outside of a FASIT.

(v) Permissible yield. To qualify as an ordinary regular interest, a FASIT interest must have a yield to maturity that is "less than the sum determined under section 163(i)(l)(B) with respect to such interest." This sum is the AFR in effect for the calendar month in which the obligation is issued plus 500 basis points. Unfortunately, there are no regulations under the section, so details of the computation are unclear.

The AFR for any month is published monthly by the Service before the beginning of the month. There is not one rate, but three: a short-term rate for debt instruments having a term of not over three years, a mid-term rate for a term of over three years but not over nine years, and a long-term rate where the term is over nine years. The definition of AFR in section 1274 arises in a setting in which taxpayers want the lowest possible number (the opposite is true for FASITs). Where a debt instrument provides for principal payments that are uncertain in time, regulations under section 1274 require a taxpayer to use the latest possible date on which a principal payment can be made (and if the debt instrument is an installment obligation, the longest possible weighted average maturity under any possible payment schedule).[67] The cross-reference to section 1274 for the definition of AFR would seem to mean that this rule can be used in applying the permissible yield test to a FASIT interest. A more conservative approach for

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date is the last possible date that the instrument could be outstanding under the terms of the instrument (giving effect not only to likely contingencies but also to those that are remote). See Treasury Regulation § 1.1272-1(f)(2).

67 Treasury Regulation § 1.1274-4(c)(2). The short-term rate is used for most floating rate debt instruments that provide for rate resets at least every three years. Id.

any regular interest class that is subject to section 1272(a)(6) would be to give effect to the prepayment assumption determined under that section.[68]

Regular interests are priced before they are issued, and it is essential to know on the pricing date whether a class of interests will meet the permissible yield test. Section 163(i)(l)(B) clearly applies a test based on the AFR for the month that includes the issue date.[69] Because the AFR for any calendar month is announced before the beginning of the month, the relevant AFR will be known on the pricing date as long as the pricing date is in the same calendar month as the issue date. The yield to maturity of a class should be known as of the pricing date.[70]

Where an investor is committed to make additional advances to a FASIT, the permissible yield test would seem to be applied to each advance as of the date the advance is made (assuming the advance is sufficiently separated in time from the original loan so that it is not part of the same "issue").[71] Accordingly, if the rate on the advance is fixed, it would not seem to be possible in many cases to determine with certainty at the time that the funding commitment is made whether new advances would meet the permissible yield test. Further, if a FASIT regular interest is modified

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68 The regulations under section 1274 that determine the AFR do not have an explicit carve out for debt instruments described in section 1272(a)(6). However, the basic rule for accruing OID in Treasury Regulation § 1.1272-1(b)(2)(i) does have such an exception. It is probably fair to say that the latest maturity date rule in the section 1274 regulations was not crafted with any thought being given to section 1272(a)(6), particularly given that section 1274 applies to debt instruments issued in exchange for property (not cash), and it is very rare to sell property in exchange for a debt instrument subject to section 1272(a)(6).

69 The 1996 Senate Report at 129 and 1996 Blue Book at 262 confirm that the relevant AFR is the one for the month in which the regular interest is issued. The issue date is defined in the OID regulations in the case of debt instruments issued for money as the first settlement or closing date on which a substantial amount of debt instruments in the issue is sold for money. Treasury Regulation § 1.1273-2(a)(2).

70 The yield to maturity is described in Chapter 8, Part C.3. The yield to maturity of a debt instrument that pays interest at a qualified floating rate should be calculated based on the value as of the issue date of the qualified floating rate. See Treasury Regulation § 1.1275-5(e)(2)(ii).

71 For the definition of "issue," see Chapter 8, footnote 28.

and the modification is a "significant modification" that gives rise to a deemed exchange of the old interest for a new one, it would appear to be necessary to apply the permitted yield test again.

In the event that an Owner transfers assets to a FASIT in exchange for an ownership interest and regular interests, and sells some regular interests after the issue date, a question would arise as to whether the instruments sold at the later date must be retested as of the date of sale. The answer would clearly be "no" if the interests sold in the later sales are, under the OID regulations, considered part of the same "issue" with those previously sold.[72] If not, then the answer would depend on whether the regular interests are considered to be issued when they are actually issued or only when they are held by a person other than the Owner.[73]

The reason why a FASIT regular interest would fail the permissible yield test ordinarily would be the risk of nonpayment. Accordingly, it should be possible to bring down the yield by providing credit enhancements for the regular interest class. Specifically, a conventional guarantee would not be broken out and treated as a separate property right.[74]

The permitted yield test is intended to be a surrogate for risk. A high-yield indicates that the investor is accepting some degree of equity risk. The absolute level of risk that the test will tolerate will likely vary considerably from time to time depending on overall spread levels for high-yield debt. During periods of market disruption, bonds of a given credit quality (as evidenced for example by a rating) may trade at significantly higher yields over a benchmark interest rate than in more normal times. While this result will prove frustrating, a yield test is probably as good a way as any of drawing the line.

c. High-Yield Interests.

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72 See footnote 71, above.

73 A similar question could arise when regular interests are held by a corporation that files a consolidated return with the Owner (see footnote 372, below). For a general discussion of transactions between a FASIT and the Owner, see Part G.7, below.

74 See Chapter 3, Part D.1.d, for a discussion of guarantees. For limitations under the FASIT regulations on guarantees by the Owner or related persons, see footnote 199, below.

(i) Overview. A FASIT interest that fails certain of the qualifying tests for ordinary regular interests may still be, under section 860L(b)(1)(B), a second type of regular interest referred to as a "high-yield interest." A high-yield interest is a FASIT interest that would be an ordinary regular interest but for:

- failing to meet one or more of the unconditional principal, limited premium or permissible yield requirements, or
- failing to meet the permissible rate requirement, but only if interest payments (or other similar amounts), if any, with respect to such interest consist of a specified portion of the interest payments on permitted assets and such portion does not vary during the period such interest is outstanding.[75]

The Code definition of high-yield interest does not include an express requirement that it be held by any particular type of holder. However, as discussed in Part F.2.b, below, the statute effectively limits holders to eligible corporations[76] or FASITs by providing that if the holder of a high-yield interest is not such a qualifying person, then all income from the interest will be taxable not to the actual holder but rather to the last holder who was a qualifying person. This rule does not work well where a high-yield interest is first issued to the wrong type of holder. The legislative history states that in such an event, the interest will be considered not to have been issued.[77] Thus, a high-yield interest cannot come into existence unless it is issued to an eligible corporation or another FASIT.

(ii) Scope of specified portion rule. When applied to an interest-only class (one failing the limited premium requirement), the definition of a high-yield interest raises one key question, which is whether such a class can qualify as a regular interest only if it bears interest at a specified portion rate.

To illustrate a fact pattern in which the issue would arise, suppose that a FASIT holds a revolving pool of receivables. It issues Class A Certificates that provide for principal payments at uncertain times and bear inter-

75 Sections 860L(b)(1)(B)(ii)(I) and (II).

76 An eligible corporation is generally a taxable domestic C corporation. For a more complete description, see Part D.1.d.(ii), below.

77 See footnote 282, below.

est at a rate of 7 percent. The FASIT also issues Class X Certificates that have a notional principal amount equal to the outstanding principal amount of Class A and bear interest at a rate of 1 percent of such principal amount (i.e., a fixed rate).[78] Class X fails the limited premium requirement and, thus, can qualify as a regular interest only if it is a high-yield interest. Because the assets of the FASIT are revolving, the interest on Class X very likely cannot be expressed as a specified portion of the interest on permitted assets of the FASIT. Accordingly, it is critical to determine if the specified portion test must be satisfied. For the reasons given below, an interest-only class should also be able to qualify as a high-yield interest if it provides for interest applied to a notional principal amount at a fixed or variable rate.

The treatment of high-premium regular interest classes under the REMIC rules offers some guidance in addressing the point.[79] The original 1986 version of the REMIC legislation allowed only fixed or variable rate regular interests. The legislative history stated that regular interests with "disproportionately high interest" could not qualify as regular interests. The REMIC regulations treat a regular interest as having disproportionately high interest if its issue price exceeds 125 percent of the principal amount.[80] The REMIC disproportionately high interest limitation was apparently not a gloss on the definition of fixed or variable rate, but rather an independent test for a regular interest.[81] In 1988, the statute was amended to allow a new category of regular interests providing interest payments that are a specified portion of the interest on qualified mortgages held by the REMIC. Specified portion regular interests were not subject to the disproportion-

78 It can be questioned whether a class that bears a fixed or variable rate calculated by reference to a notional principal amount meets the permitted rate test. For an argument that it does in the REMIC setting (specifically in applying a part of the definition of a specified portion rate which applies only to qualified mortgages bearing interest at a fixed or qualified variable rate), see Chapter 7, Part C.4.a.(i). The fact that a high-yield interest need not meet the unconditional principal requirement also supports the argument. At any rate, nervous tax advisors could address the point by requiring some small actual principal amount.

79 For a discussion of these rules, see Chapter 7, Part C.1.

80 See Treasury Regulation § 1.860G-1(b)(5).

81 The regulation cited in footnote 80, above, takes this approach (it is not part of the definition of a fixed or variable rate).

ately high interest rule.[82] In short, all REMIC interest-only classes must bear interest at a specified portion rate.

The limited premium requirement for FASITs is clearly based on the REMIC disproportionately high interest regulation. The limited premium requirement is separate, however, from the permitted rate requirement. Accordingly, a high-yield interest must have specified portion interest only if it fails the permitted rate requirement. It would be odd to list the permitted rate requirement separately (as is done in the statute)[83] if it was understood that a high premium class would *always* fail the permitted rate test. The legislative history states that an interest-only class can qualify as a high-yield interest under the specified portion rule.[84] While that statement is clearly true, given the statutory language, it should not be read to preclude an interest from qualifying on a different theory.

If all interest-only classes were required to satisfy the specified portion test, then high-yield classes that economically are strips off other regular interest classes could still be created, as in the REMIC area, by using two tiers of FASITs. See Part H.4, below. The extra step entails some added complexity and reading the statute to require it serves no obvious purpose.[85]

(iii) Definition of specified portion. In cases where a FASIT interest fails the permitted rate test, it can qualify as a high-yield interest if "interest payments (or other similar amounts), if any, with respect to such interest consist of a specified portion of the interest payments on permitted assets and such portion does not vary during the period such interest is outstanding." Because the specified portion rule is borrowed from the REMIC regular interest definition, the learning in that area (see Chapter 7, Part C.4) should be directly relevant. One difference is that the specified portion can

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82 See Treasury Regulation § 1.860G-1(b)(5)(ii).

83 Section 860C(b)(1)(B)(ii)(II).

84 See Conf. Rep. No. 104-737, 104th Cong., 2d Sess ("1996 Conference Report") at 328; 1996 Blue Book at 262 (providing that "interest-only instruments ('IOs') may be issued by a FASIT as high-yield instruments if the instrument makes payments which consist of a specified portion of the interest payments in [sic] permitted assets and that portion does not vary throughout the life of that instrument").

85 For a discussion of the creation of interest-only classes through stripping outside of a FASIT, see footnote 294, below.

be taken from any permitted asset (the REMIC rule refers to qualified mortgages). Permitted assets include, in addition to debt instruments, foreclosure property and hedge instruments. The difference is less than meets the eye, however, because a specified portion must be derived from "interest payments" on permitted assets, and such payments would exist only in respect of assets that are taxed as debt. Specifically, payments on a swap or other non-guarantee hedge contract would not be interest payments, unless the swap was integrated with a debt instrument to produce a synthetic debt obligation.[86] Payments under guarantees or other credit enhancement contracts (as that term is understood in the REMIC area) that make up for defaulted or delinquent interest payments on permitted assets should be treated as interest, by analogy with the treatment of such payments as incidental to mortgages under the REMIC rules.[87] FASIT or REMIC regular interests held by a FASIT are permitted assets, and would produce interest payments that could be passed through under the specified portion rule.

(iv) Principal entitlement. The scope of the rule that permits a high-yield interest to fail the principal entitlement requirement is unclear. It may be simply that no actual principal is required.[88] Alternatively, it could mean that a stated principal amount can be subject to nonpayment contingencies that relate to the FASIT assets or income but go beyond those ordinarily allowed. For example, perhaps a FASIT used in a credit card securitization could be given the right not to pay a designated amount of principal if account holders terminate their accounts during the term of the FASIT. The broadest reading would allow principal to vary based on any index or measure that catches the sponsor's fancy.[89] Unfortunately, the drafters did not provide any explanation of the provision.

d. Ownership Interest.

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86 See discussion of integrated debt instruments at footnote 174, below.

87 See Chapter 6, Part D.1.b.(ii). There is a similar rule in the TMP regulations. See Chapter 4, footnote 183 and accompanying text.

88 See footnote 78, above.

89 In that case, if interest is calculated by applying a fixed or variable rate to a noncontingent principal amount (rather than the actual principal amount), the interest would fail the permitted rate test and would need to be a specified portion rate.

(i) Overview. A FASIT is required at all times to have one ownership interest which is:

- held directly by an eligible corporation
- designated as the ownership interest, and
- not a regular interest.[90]

The statute requires that the ownership interest be issued "after" the startup day of the FASIT. This is clearly a drafting error and should be interpreted to mean "on."[91] A FASIT cannot exist without an ownership interest. Where a pre-existing entity elects to be a FASIT, an existing interest in the entity or its assets would become the ownership interest on the startup day.[92]

(ii) Ownership by an eligible corporation. An ownership interest must be held directly by an eligible corporation as defined in section 860L(a)(2). A corporation is an eligible corporation if it is:

- domestic[93]
- a C corporation (meaning not an S corporation)[94]
- subject to corporate income tax (and not exempt from the tax)
- not a RIC, REIT or REMIC, and
- not taxed as a cooperative.

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90 Sections 860L(a)(1)(C) and 860L(b)(2).

91 The same problem existed for regular interests in section 860L(b)(1)(A) as originally enacted in 1996, but was corrected by substituting "on or after" for "after" in the Taxpayer Relief Act of 1997. One of the many mysteries regarding the FASIT statute is why the error was not also corrected in the definition of ownership interest.

92 Elections by existing entities are discussed in Part H.5, below.

93 This means that it must be created or organized in the United States or under the laws of the United States or any State. See section 7701(a)(4) and Chapter 13, Part B.

94 Section 1361(a)(2). An S corporation, as defined in section 1361(a)(1), is one that (1) is owned by 75 or fewer shareholder who are (generally) U.S. citizens or residents individuals, and meets other requirements, and (2) elects to be taxed on a pass-through basis under subchapter S of the Code.

The requirement that the corporation be subject to tax would carve out corporations that are considered to be part of a government and eligible for governmental immunity from tax. The eligible corporation test, combined with the rule preventing the offsetting of income from a FASIT ownership interest with non-FASIT losses, ensures that such income will always be subject to the corporate income tax.

The requirement that an ownership interest be owned by "an eligible corporation" means that there must be at any time one owner that is an eligible corporation. There is, however, no prohibition against transfers from one eligible corporation to another over time.[95] The SBJPA 1996 legislative history directs the Service to issue regulations allowing an ownership interest to be held by multiple members of a group of corporations filing consolidated returns. The FASIT regulations do not, however, include such a rule.[96]

The affiliated group definition in section 1504(a)(1)(B), includes a requirement that stock be held "directly." Interpretations of the term in that setting may be instructive in applying the corresponding FASIT rule. The requirement of direct ownership should not preclude an ownership interest from being held by a nominee, or even through a wholly owned grantor trust or disregarded entity,[97] although in the absence of direct authority, it would be imprudent to insert an intermediary into the picture without good

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95 As discussed in Part G.6, below, the Code clearly contemplates transfers of FASIT ownership interests.

96 The preamble to the regulations states that allowing multiple Owners raised concerns relating to the shifting of stock basis, income or loss. Different models that would address these concerns would add administrative complexity, and the potential for attribute shifting was too much to be ignored or addressed through a general anti-abuse rule. The preamble invites the submission of additional comments addressing these concerns. 2000-1 C.B. 690. For comments discussing different models for allocating attributes among group members and recommending that each Owner be treated as owning a pro rata interest in FASIT assets, see the NYSBA report referred to in footnote 3, above. The NYSBA report on the FASIT regulations cited in footnote 6, above, reaffirms support for a pro rata approach.

97 See Revenue Ruling 84-79 (revocable voting trust does not preclude finding that parent directly owns a subsidiary for purposes of affiliated group definition under section 1504); Revenue Ruling 70-469, 1970-2 C.B. 179 (revocable nominee relationship permissible under section 1504); G.C.M. 39166 (revocable voting trust).

reason. Any type of intermediary that would be recognized as an entity for substantive tax purposes (such as a partnership) would pose a problem.[98]

Under the statute, the ownership interest in one FASIT (call it the lower-tier FASIT) cannot be owned by a second FASIT (the upper-tier FASIT).[99] The definition of permitted assets includes FASIT regular interests but not ownership interests. The policy argument in favor of allowing ownership interests is that, under the look-through rule governing a FASIT, the upper-tier FASIT would be considered to own the assets of the lower-tier FASIT, which by definition would be permitted assets. Also, the requirement that the Owner of the lower-tier FASIT be an eligible corporation could be met by treating the Owner of the upper-tier FASIT as the Owner of the lower-tier FASIT ownership interest (again based on the same look-through principle).

(iii) Form. The statute is silent regarding the legal form of an ownership interest, but any interest in a FASIT that is designated as an ownership interest (and meets the other tests outlined above) should qualify. For example, if the FASIT election were made in respect of a corporation, the ownership interest could be issued in the form of corporate stock. If the FASIT is a segregated pool of assets within a legal entity consisting of collateral pledged to secure bonds, the ownership interest could take the form of a contractual right to receive assets released from the pledge or could be evidenced by a bond entitled to residual cash flows.

The REMIC rules require that a REMIC residual interest be in registered form to satisfy the requirement that there be reasonable arrangements to ensure that a residual interest not be transferred to a disqualified organization.[100] Given the even tighter limitations on the ownership of a FASIT ownership interest, it would be expedient to have an ownership interest be nonassignable or in registered form.

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98 In addition to violating the rule against direct ownership, a partnership would presumably split up rights to an ownership interest between multiple owners in violation of the one-Owner rule.

99 Compare section 860L(a)(1)(C) (only eligible corporations may own ownership interests) with section 860K(c) (eligible corporations and FASITs may own high-yield interests).

100 See section 860D(a)(6) and Treasury Regulation § 1.860D-1(b)(5)(A).

(iv) Status as economic residual interest. An ownership interest would ordinarily represent an economic residual interest in a FASIT, but it need not. In a case where a FASIT holds a fixed pool of debt instruments, it may be possible to account for all of the cash flows thereon through one or more classes that resemble debt and could qualify as regular interests. There is no reason why one such class (even a senior class) could not be designated as the ownership interest. Conversely, all such classes could be designated as regular interests, in which case the ownership interest would be a class that is entitled to no cash distributions and has no positive value.[101]

In a case where the ownership interest does represent an economic residual interest in a FASIT, its characteristics could change over time. For example, there is no limitation on contributions of assets to a FASIT after the startup day, so an ownership interest may grow as additional assets are contributed. The designation requirement should not pose a problem in such a case. It requires only that an interest in a FASIT be identified as an ownership interest; the particular economic characteristics of the interest should not be part of the designation.

FASIT assets and liabilities are generally attributed to the Owner. Part G.7, below, discusses whether FASIT interests otherwise qualifying as regular interests would cease to so qualify when they are acquired by the Owner. In that event, an obvious alternative would be to fold them into the ownership interest. One issue would be whether they could be included in the ownership interest in light of their prior designation as regular interests. Guidance in this area from the Service would be most welcome.

Another related issue concerns assets held outside of a FASIT that support a FASIT. Under the support property rule described in Part H.1, below, those assets are considered part of the FASIT. However, the owner of the supporting assets would ordinarily be entitled to the cash flows from the assets subject to the support obligation. It would make sense to deem that economic interest to be part of the ownership interest. Otherwise, it

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101 This conclusion should follow readily from the analogous rule for REMIC residual interests, although it is not addressed in the legislative history or FASIT regulations. For a discussion of the REMIC rule, see Chapter 6, Part B.1.c.

would seem that many applications of the support rule would lead to disqualification of the FASIT on the ground of violating the interests test.[102]

2. *Assets Test*

a. Overview. Qualification as a FASIT also requires satisfaction of an assets test. The test is satisfied if, as of the close of the third month beginning after the day of a FASIT's formation[103] and at all times thereafter, substantially all of the FASIT's assets consist of permitted assets.[104] Even though a FASIT can receive new contributions of assets over its life, there is no new grace period for assets acquired after the startup day. As in the REMIC context, the assets test need not be met during the liquidation period relating to a qualified liquidation.[105]

The substantially all requirement should be interpreted consistently with the correspondingly REMIC rule, which permits only a *de minimis*

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102 If the assets are held by a person related to the Owner, rather than the Owner itself, treating rights to the assets as part of the ownership interest would require the construction, for tax purposes only, of a separate transaction between the Owner and related party to account for the actual cash flows.

103 There is unfortunately some ambiguity in determining the length of this initial start-up period. The statutory language "as of the close of the third month beginning after the day of its formation" appears to refer to a period ending at the close of the third calendar month following the date of formation. The legislative history states that the substantially all requirement must be satisfied "at the 90th day after [a FASIT's] formation." 1996 Senate Report at 128; 1996 Blue Book at 261. In the REMIC context, the "3rd month" language is used in section 860D(a)(4) for the similar startup grace period, while "three-month period" is used in section 860G(d)(2)(C) to describe the period for cash contributions. These provisions have been interpreted differently, with the latter encompassing only the 90-day period beginning at startup. See Chapter 6, text following footnote 59, and footnote 190 and accompanying text. Further uncertainty arises from the use of the phrase "day of its formation" rather than "startup day." See section 860L(a)(D). It appears likely that the language reflects only careless drafting and that the startup day was intended.

104 Section 860L(a)(1)(D). For this purpose, FASIT assets include assets that have not actually been transferred to the FASIT but are deemed to be held by the FASIT because they support regular interests. See Part H.1, below.

105 Section 860L(a)(1) flush language (referencing section 860D(a)).

amount of non-qualifying assets.[106] The REMIC regulations have a safe-harbor rule that treats non-qualifying REMIC assets as *de minimis* if the aggregate adjusted bases of the non-qualifying assets is less than 1 percent of the aggregate adjusted bases of all of the REMIC's assets.[107] The FASIT regulations would turn the safe harbor into a rocky shoal by creating a limit on non-qualifying assets.[108] This change is difficult to defend, and hopefully will be abandoned in the final regulations.

If a FASIT holds a *de minimis* amount of non-permitted assets, any net income from those assets will be subject to the 100 percent prohibited transactions tax discussed in Part E. For that reason, it is generally important for a FASIT to avoid holding any amount of such nonqualifying assets.

The definition of a permitted asset may be affected by numerous factors, some of which can change over the period in which a FASIT owns an asset. For example, a debt instrument may cease to be a permitted asset because the obligor becomes related to the Owner or because it is modified in a default context so that it is no longer debt or provides for contingent interest. A hedge contract may cease to function as such because of retirements of regular interests. Some of these factors may not be within the practical control of the FASIT or the Owner. There is a strong need for a rule that would allow a FASIT to continue to treat an asset as a permitted asset even if it ceases to be one as a result of factors outside of its control (or that at the least gives the FASIT a period in which to dispose of the asset following discovery of the problem).[109]

Permitted assets are defined in section 860L(c)(1) as follows:

- cash or cash equivalents

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106 See Chapter 6, Part B.2.

107 Treasury Regulation § 1.860D-1(b)(3).

108 Proposed Regulation § 1.860H-2(a) (defines "substantially all" as more than 99 percent). The preamble justifies the different approach on the extraordinary ground that a FASIT can simply acquire new assets if it is in danger of failing the test. 2000-1 C.B. 684. For a critique, see the NYSBA report on the FASIT regulations cited at footnote 6, above.

109 The same problem exists for REMICs only when a loan is modified in a default setting, and the REMIC regulations provide that in such a case, the modification does not alter the status of a loan as a qualified mortgage. Treasury Regulation § 1.860G-2(b)(3). A broader rule is needed for FASIT assets. For a letter requesting such a rule, see letter to the Service from the Bond Market Association, 2000 *Tax Notes Today* 3-35 (December 13, 2000).

- any debt instrument issued by an unrelated party that bears interest at a fixed or qualifying variable rate (contingent interest instruments are not allowed)
- foreclosure property
- any interest rate or currency swap, guarantee against payment defaults, or other similar instrument permitted by the Service, which is reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor on interests issued by the FASIT
- contract rights to acquire assets described in the second or fourth bullet points above (debt instruments or hedges and guarantees)
- any regular interest in another FASIT, and
- any regular interest in a REMIC.

This definition is much broader than its REMIC counterpart. REMICs can hold only real estate mortgages and ancillary assets (not including hedges). The mortgages must be acquired during the startup period for the REMIC (or, if not during the initial three-month period, during the two-year period following the startup day in replacement of defective loans). By contrast, FASITs may hold any type of fixed or variable rate debt instrument (secured or unsecured) and related hedges, and they may be acquired at any time. One respect in which the FASIT rules are narrower is the general requirement that receivables be classified as debt for tax purposes. Qualified mortgages held by REMICs must be "obligations," but not necessarily debt.[110] The ability to hold regular interests in other FASITs allows the creation of multiple tiers of FASITs. A FASIT can hold high-yield interests as well as ordinary regular interests. A FASIT cannot hold a REMIC residual interest or a FASIT ownership interest.[111]

The following sections describe in more detail certain categories of permitted assets: cash and cash equivalents, qualifying debt instruments

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110 See text accompanying footnote 124, below, for a case in which this distinction is important.

111 A REMIC residual interest is not considered a debt instrument for tax purposes and does not otherwise fit into any category of permitted asset. For the treatment of FASIT ownership interests, see footnote 99, above, and accompanying text.

(other than FASIT or REMIC regular interests), hedges and guarantees, contracts to acquire hedges and guarantees, and foreclosure property.

b. Cash and Cash Equivalents. In practical terms, a FASIT would never hold actual cash, but rather would maintain deposit accounts. Because such accounts would be considered debt instruments under general tax principles (and would therefore be permitted assets under that part of the definition), the separate category for cash and cash items does not appear to be very significant. In fact, it has relevance principally in two circumstances: when a cash item would not qualify as debt or when it is debt but the issuer is the Owner or a related person (obligations of the Owner or related person are generally excluded from the definition of permitted asset unless they are cash equivalents or regulations otherwise provide).

Neither the statute nor legislative history offers any guidance on the definition of cash equivalents. In other settings, the term "cash items" or "cash equivalents" has been construed narrowly to include bank deposits and certificates of deposit, but not commercial paper or repos.[112] The

112 See Chapter 11, footnotes 1 and 9 (discussion of cash items and cash). A useful analogy is the interpretation of the phrase "cash and cash items (including receivables)" in the rules for RICs and REITs. See sections 851(b)(3)(A) (RICs) and 856(c)(4)(A) (REITs). "Cash items" is not defined under these sections, and hence has the same meaning as when used in the Investment Company Act of 1940. See sections 851(c)(5) and 856(c)(5)(F). In that context, it includes bank deposits and similar items such as short-term certificates of deposit. Revenue Ruling 77-199, 1977-1 C.B. 195. For certain items not included, see Revenue Ruling 72-171, 1972-1 C.B. 208 (bankers' acceptances not cash items); Revenue Ruling 77-59, 1977-1 C.B. 196 (repos not cash items). The definition of cash and its equivalent in other areas is similar. See Revenue Ruling 66-290, 1966-2 C.B. 112 ("The phrase 'cash and its equivalent' used in Treasury Regulation §§ 1.334-1(c)(4)(v)(b)(1) and 1.334-1(c)(4)(viii) of the regulations includes cash, currency, bank deposits (including time deposits) whether or not interest bearing, share accounts in savings and loan associations, checks (whether or not certified), drafts, money orders, and any other item of similar nature. It does not include accounts receivable (as the term is commonly used), inventories, marketable securities, and other similar current assets."). See also Revenue Procedure 81-42, 1981-2 C.B. 611 (defining cash to include "negotiable instruments and other cash equivalents within the meaning of Rev. Rul. 66-290"); *Boise Cascade Corp. v. United States*, 288 F.Supp. 770 (D.C. Ida. 1968) (marketable securities, inventories, accounts receivable, and prepaid supplies are not cash or its equivalent).

FASIT regulations define cash and cash equivalents somewhat more generously to mean:

- U.S. dollars
- another currency if received as a payment on a permitted asset or needed to make a payment on a regular interest
- a fixed, variable rate or inflation-indexed debt instrument otherwise qualifying as a permitted asset if it has a remaining maturity of 270 days or less and is rated investment grade by a nationally recognized rating agency that is not related to the issuer, and
- shares in a U.S. dollar-denominated money market fund.[113]

This language is permissive in including investment-grade commercial paper and other debt with a short remaining term and money market funds. While the statute indicates that any cash equivalent may be a permitted asset even if it is issued by the Owner or a related person, the regulations include a separate, somewhat narrower rule.[114] Until regulations are finalized, it would seem to be prudent to comply with the narrower rule when dealing with related party paper.

c. Qualifying Debt Instrument. A debt instrument other than a FASIT or REMIC regular interest or cash or its equivalent will be a permitted asset if it is:

- characterized as debt under general tax principles (more technically, is a debt instrument as defined in section 1275(a)(1))
- pays interest, if any, at a fixed or qualifying variable rate as determined under the REMIC rules
- not issued by the Owner or a related person, and
- under the FASIT regulations, is not a traded instrument that is subject to a withholding tax.[115]

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113 Proposed Regulation § 1.860H-2(c).

114 See footnote 158, below.

115 Section 860L(c)(1) and (2); Proposed Regulation § 1.860H-2(b)(3)(vii).

The next four sections discuss these requirements in greater detail. The fifth section considers application of the definition to partial ownership interests in debt instruments, such as stripped coupons or stripped bonds. The sixth section addresses changes in the status of a debt instrument arising from a default-related modification of terms.

(i) Treatment as debt. The cross-reference to section 1275(a)(1) mentioned in the first bullet point above means that an asset must be a "bond, debenture, note or certificate or other evidence of indebtedness." This language is vague on its face, but has been construed to require that an instrument be indebtedness for federal income tax purposes.[116] The categories of instruments that qualify as debt are not limited to notes or bonds. For example, trade receivables,[117] bank CDs, credit card balances,[118] installment sales contracts, repo agreements,[119] synthetic leases[120] and other asset-backed securities are potentially eligible for inclusion in a FASIT, provided again that their particular terms are such that they are taxed as debt. Partial ownership interests in debt instruments are addressed separately below. True leases (in which the lessor is regarded as the owner of the leased prop-

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116 Treasury Regulation § 1.1275-1(d) (except as provided in section 1275(a)(1)(B) relating to annuity contracts, debt instrument means any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax law, including for example, a certificate of deposit or a loan). The legislative history confirms that a debt instrument must be considered indebtedness for federal income tax purposes. 1996 Senate Report at 128; 1996 Blue Book at 261. See Chapter 3, Part E, for a general discussion of the circumstances in which a purported debt instrument may be recast as equity for tax purposes.

117 The FASIT legislative history mentions trade receivables as one type of instrument that may qualify as indebtedness for tax purposes. 1996 Senate Report at 128; 1996 Blue Book at 261.

118 Proposed Regulation § 1.860H-2(b)(1)(vi) lists as a permitted debt instrument "[a]ny receivable generated through an extension of credit under a revolving credit agreement (such as a credit card account)." Such a receivable generally would be debt. It is not clear why this category of instrument is separately listed, although the reason may have to do with the interest rate requirement discussed below.

119 For a discussion of the treatment of repos as debt for tax purposes, see Chapter 3, Part D.1.b.

120 See Chapter 3, footnote 53.

erty and not a lender)[121] and annuities with significant life contingencies or issued by certain insurance companies are not eligible.[122] The same may also be true of tax liens.[123]

One problem area involves loans to a borrower in shaky financial condition. If the risks undertaken by the lender are too high, such a loan may be considered to be equity under general tax principles.[124] In a case where (1) a borrower was in adequate financial shape when a loan was made, (2) such borrower subsequently suffers reverses and defaults (or threatens a default), and (3) the loan is modified significantly (in a manner that is considered a deemed exchange of the old instrument for a new one)[125] to reflect the changed circumstances of the borrower, the continued status of the loan as debt or equity may be retested when the modification occurs. Particularly in a case where the modified loan has significant contingent payment features (e.g., for a mortgage, a right to share in profits of the underlying property), the status of the modified instrument as debt may be called into question. The REMIC regulations include a very helpful rule for addressing the point that is significant primarily for loans with a checkered pre-REMIC past, including workouts. It treats as an "obligation" any instru-

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121 The treatment of the right to receive rental payments under a true lease, divorced from ownership of the leased property, is a closer case, since the holder has only a right to receive payments in cash.

122 For the exclusion of annuities from the definition of debt instrument, see section 1275(a)(1)(B) and Treasury Regulation § 1.1275-1(j).

123 It would be easier to fit a tax lien secured by real property into the REMIC definition of qualified mortgage because that term requires only an "obligation" secured by a mortgage on real property, not a tax law debt instrument.

124 See Chapter 3, Part E.

125 Treasury Regulation § 1.1001-3 sets out the standards for determining whether there is a significant modification of a debt instrument. The tests in the regulations are described in Chapter 6, Part D.2.c. An agreement by a lender to stay collection or temporarily waive an acceleration clause is not considered a modification until the forbearance remains in effect for a period that exceeds two years following the issuer's failure to perform plus any additional period in which the parties conduct good faith negotiations or the borrower is in bankruptcy. Treasury Regulation §1.1001-3(c)(4). A mere deterioration in the financial condition of a borrower (without other changes) does not give rise to a deemed modification. Treasury Regulation § 1.1001-3(e)(5).

ment that provides for non-contingent principal payments at least equal to its issue price even if it also provides for contingent payments.[126] There is no counterpart to this rule for FASITs, and one is unlikely to be adopted for two reasons. First, the FASIT definition requires that a debt instrument be classified as debt for tax purposes (not just an "obligation"). Second, the contingent payment feature would itself disqualify a loan as a FASIT asset.

The FASIT regulations go one step further and propose a very restrictive rule that would disqualify a debt instrument as a permitted asset of a FASIT if it was in default when acquired by the FASIT due to the debtor's failure to have timely made one or more payments owed on the instrument, unless the Owner reasonably expects the default to be fully cured on or before the date that is 90 days after the instrument is first held by the FASIT.[127]

The preamble to the regulations indicates that the rule is needed to prevent a FASIT from holding instruments with equity characteristics.[128] This reasoning is at odds with the statute, which requires only that an instrument be taxed as debt. As indicated above, in the absence of other changes agreed to between a borrower and lender, the tax status of a debt instrument is not re-tested because of a deterioration of the financial condition of the borrower. The fear of disguised equity is particularly difficult to understand for consumer loans. In these post-Civil War times, a loan to an individual cannot be recast as an ownership interest. Further, the proposed rule would frustrate the policy goals of the FASIT statute. The most fundamental purpose of the legislation was to allow sponsors to transfer pools

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126 Treasury Regulation § 1.860G-2(a)(7), which is discussed further in Chapter 6, Part D.6.b.

127 Proposed Regulation § 1860H-2(b)(3)(ii). The cure must include the payment of "all delinquent payments on the instrument, including any interest and penalties thereon[.]" Presumably this rule would not prevent a servicer from waiving interest and penalties on delinquent amounts, but the language is not clear.

128 2000-1 C.B. 685. The preamble goes on to state that a distressed debt instrument may take on the characteristics of equity because the FASIT (and in turn the regular interest holders): (1) may have to look to the obligor's general assets for payment of the instrument, (2) may not receive full payment of the instrument, and (3) may not receive any payment until the satisfaction of claims held by the obligor's other creditors. These factors, however, are general characteristics of debt.

of receivables off their books with a view to spreading credit risk.[129] The proposed rule would allow sponsors to securitize only high-quality loans, while forcing them to keep riskier loans on their books. There might be a concern that a FASIT acquiring a defaulted secured loan was doing so in contemplation of acquiring the underlying property rather than the debt itself, but that case is addressed directly by a statutory anti-abuse rule.[130]

The apparent assumption of the proposed defaulted loan rule that a loan with an uncured payment default is nonperforming is simply not true for consumer loans. Consumers who miss a monthly payment on a car loan or mortgage often fail to make up the missed payment, but continue to make monthly payments thereafter on schedule. Lenders often assume that it is easier and less expensive just to add a payment to the end of the schedule of payments than attempt to collect the single missed payment. Loans of this type could not be included in a FASIT under the proposed rule.

The defaulted loan rule would have significant practical consequences. It would require sponsors to cull through pools of receivables and transfer to a FASIT only those that have no uncured defaults (even if they are currently paying and are considered performing). It would be impossible for many sponsors to accomplish this task based on available accounting systems. Further, information on collections is reported only with a lag, so that a 90-day default rule would require that loans be excluded based on some shorter period of delinquency. Sponsors would need to be conservative in identifying defaulted loans because a failure to properly identify a defaulted loan could have very severe consequences (a 100 percent tax on interest and, if the loans represent more than one percent of assets, loss of FASIT status). The proposed defaulted loan rule makes no sense on technical or policy grounds and would be a serious impediment to use of the FASIT statute. Hopefully, it will be eliminated in the final regulations.

Suppose that a debt instrument was not in default and was clearly debt when acquired by a FASIT but later is modified on account of a default or threatened default by the borrower. If the modified loan itself qualifies as

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129 1996 Senate Report at 126; 1986 Blue Book at 258-259. It is ironic that the FASIT anti-abuse rule in Proposed Regulation § 1.860L-2, discussed in Part H.2, below, describes the basic purpose of the FASIT as "the spreading of credit risk on debt instruments by facilitating the securitization of those debt instruments."

130 See section 860L(c)(3)(A), discussed in Part D.2.f, below.

debt for tax purposes, there is no issue. Suppose, however, that it is not debt (or not clearly debt). The REMIC regulations state that a default-related modification of a mortgage will not change its status as a qualified mortgage.[131] There is no similar rule for FASITs. In the absence of other guidance, it would seem that if the modification changes the status of a loan to an equity interest, then the FASIT could hold it only as foreclosure property. Unfortunately, the modified loan would also fail to satisfy the definition of foreclosure property, which refers to property that was security for a defaulted loan.[132] It cannot have been intended that a FASIT would be worse off in these circumstances than a REMIC, and hopefully the final FASIT regulations will extend the REMIC rule to FASITs.[133]

Under general tax principles, a bond that is convertible at the holder's option into an equity interest in the issuer is treated as noncontingent debt unless and until the conversion right is exercised.[134] Accordingly, under the statute it would be possible to include such a bond in a FASIT prior to conversion, although the FASIT would be unable to convert the bond since it could not hold the equity acquired on conversion or generally realize its value through a sale.[135] The FASIT regulations preclude FASITs from

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131 Treasury Regulation § 1.860G-2(b), discussed in Chapter 6, Part D.2.d.

132 Foreclosure property is discussed in Part D.2.f, below. In short, it refers to property that would be foreclosure property under section 856(e) if the property were real property acquired by a REIT. The cited section describes foreclosure property as property acquired by a REIT after there was a default on debt which such property secured.

133 In a different setting, the FASIT regulations adopt a favorable rule for default-related modifications of loans (specifically, they clarify that the modified loan is not considered to have been originated by the FASIT). See footnote 260, below. The rule acknowledges the obvious reality that any lender may need to participate in a workout of a loan, but addresses only one narrow issue. For a letter asking that the REMIC rule be extended to FASITs, see letter to the Service from the Bond Market Association referred to in footnote 109, above.

134 See Treasury Regulation §§ 1.1272-1(e) (in applying OID accrual rules in section 1272, conversion option is ignored), 1.1273-2(j) (issue price of convertible debt includes amount paid for conversion features) and 1.1275-4(a)(4) (convertible bond not a contingent debt instrument).

135 The stock would not be a permitted asset and any gain on disposition of the bond or stock generally would be subject to the 100 percent prohibited transactions tax. Relief rules for defaulted debt instruments would not help be-

holding such debt by carving out of the definition of permitted asset any equity-linked debt instrument even if it would otherwise qualify as debt.[136]

(ii) Fixed or variable interest. To be a permitted asset, debt instruments must have interest payments meeting the requirements "applicable under clause (i) or (ii) of section 860G(a)(1)(B)."[137] The cited section describes the permitted rates of interest on REMIC regular interests. Clause (i) refers to REMIC regular interests paying interest at a fixed or qualifying variable rate. Clause (ii) addresses interest consisting of a specified portion of interest payments on qualified mortgages. There are extensive regulations defining permitted variable rates for REMIC regular interests. They include rates based on a qualified floating rate, rates based on a weighted average of rates on other mortgages, combinations of fixed and floating rates, and rates calculated by adding to or subtracting from such rates a fixed amount or multiplying them by a fixed factor.[138] Without any explanation, the FASIT regulations would cut back on the statute and allow a variable rate debt instrument only if it was a *variable rate debt instrument* (*VRDI*) under the OID regulations and provided for interest at a qualified floating rate (under a literal reading, apparently a single qualified rate over its life).[139] The two most significant ways in which the FASIT regulations

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cause the conversion right would not be exercised unless the borrower was doing well.

136 Proposed Regulation § 1.860H-2(b)(3). The regulation would exclude from the permitted asset definition (1) a debt instrument containing a provision that permits it to be converted into, or exchanged for, any legal or beneficial ownership interest in any asset other than a permitted debt instrument (such as a debt instrument exchangeable for a partnership interest), and (2) a debt instrument providing for payments determined by reference to, or that are contingent upon, the value of any such asset (such as a debt instrument that pays interest based on the value of stock).

137 Section 860L(c)(1)(B).

138 The rates are set out in Treasury Regulation § 1.860G-1(a)(3). For a description, see Part D.2.c.(ii), above.

139 Proposed Regulation § 1.860H-2(b)(1)(ii). The definition of a VRDI is found in Treasury Regulation § 1.1275-5 and summarized in Chapter 8, footnote 51 and accompanying text. The regulations drop altogether the specified portion part of the test. This may not be very significant because specified portion interest rates are unlikely to be encountered except in REMIC or FASIT

would limit the REMIC definition relate to the ability to combine different qualified floating rates and/or fixed rates over the life of a loan,[140] the treatment of caps and floors,[141] and the treatment of multiples of floating rates less than or equal to 0.65 or greater than 1.35.[142] It is not clear if these differences were intended. Hopefully, the final regulations will track the statute more closely.[143]

A FASIT is clearly not supposed to hold debt instruments with contingent payments, but even conventional fixed or floating rate loans may in

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regular interests, and they qualify independently as permitted assets. It is troublesome, however, that the regulations seek to narrow the statute without any explanation. Note that section 860L(c)(1)(B) does not grant any express authority to the Service to limit the types of permitted rates for debt instruments held by a FASIT. For criticism of the limitations, see the NYSBA report on the FASIT regulations cited at footnote 6, above.

140 A REMIC variable rate can be a combination rate that mixes various fixed and floating rates over the life of a debt instrument. See Treasury Regulation § 1.860G-1(a)(3). The VRDI definition itself allows one fixed rate plus one or more qualified floating rates, or multiple qualified floating rates. Treasury Regulation §1.1275-5(a)(3)(i). The FASIT regulations, as now written, would not allow even this flexibility because they would require "a" qualified floating rate. But see Chapter 7, footnote 16.

141 The REMIC rules allow caps and floors without restrictions. Treasury Regulation § 1.860G-1(a)(3)(iv). By contrast, a cap or floor on a debt instrument taxable as a VRDI must either be the same over the instrument's life, or reasonably expected as of the issue date not to change the yield of the instrument. Treasury Regulation § 1.1275-5(b)(3). The FASIT regulations would also cut back on the REMIC variable rate definition by not allowing weighted average coupon rates. In practical terms, such rates are unlikely to be encountered except in REMIC regular interests, which qualify independently as permitted assets.

142 The definition of a VRDI does not allow a multiplier less than or equal to 0.65 or greater than 1.35. Treasury Regulation § 1.1275-5(b)(2). It is becoming increasingly common to originate commercial mortgage loans that have both fixed rate and floating rate components (e.g., half of the principal might bear interest at a fixed rate and half at a spread over LIBOR). For tax purposes, such a loan would be a single debt instrument and would bear interest at a fixed margin over a fraction of LIBOR. If the floating rate component represents 65 percent or less of the loan, the loan would not be a VRDI.

143 For a comment letter asking for this result, see the letter to the Service from the Bond Market Association referred to by footnote 109, above.

fact have some contingent features. These may include prepayment penalties; additional interest payable upon a default; for bank loans, payments to compensate for additional costs attributable to regulatory changes; or, in the international context, withholding tax gross-ups. These features ought not to affect the status of a debt instrument as a permitted asset.[144]

The FASIT regulations would allow a FASIT to hold an inflation-indexed debt instrument (as defined in certain regulations).[145] While one should not look a gift horse in the mouth, such an instrument would not qualify as a variable rate debt instrument under the REMIC definition.[146]

(iii) Debt of the Owner or a related party. A debt instrument (which is not a cash equivalent) is not a permitted asset if it was issued by the

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144 The preamble to the FASIT regulations states that a commentator had asked for clarification that the existence of prepayment penalties would not cause a debt instrument to pay interest at an impermissible rate. Unfortunately, the Service clarified the point by stating that a fixed rate debt instrument includes an instrument under which a single yield can be determined under Treasury Regulation § 1.1272-1(c) or (d) (dealing with alternative payment schedules and options). See Proposed Regulation § 1.860H-2(b)(1)(i); 2000-1 C.B. 684-685. Following this tack is unfortunate for several reasons. First, prepayment penalties are often computed under formulas, and the cited sections apply only to alternative payment schedules with fixed payments. Second, prepayment penalties are sometimes found on variable rate loans, and no comparable fix has been provided for them. It would have been far preferable to simply acknowledge that incidental payments under terms commonly found in conventional fixed or floating rate loans will not prevent a loan from being a permitted asset. The definition of a REMIC regular interest requires only that interest be "based on" a fixed or variable rate. This phrase has been relied upon in the REMIC area to justify some looseness in the definition, particularly in periods before the REMIC regulations were issued. See Chapter 6, footnote 11 and accompanying text. The FASIT regulations do not use the phrase.

145 Proposed Regulation § 1.860H-2(b)(1)(v) (refers to Treasury Regulation § 1.1275-7).

146 An inflation index is considered an objective rate but not a qualified floating rate within the meaning of the VRDI rules and as a result is not a permitted variable rate for purposes of the REMIC regular interest definition. See Chapter 8, footnote 51 and accompanying text (definition of objective rate and qualified floating rate) and Chapter 7, footnote 24 and accompanying text.

Owner or a person related to the Owner or is a direct or indirect interest in such an instrument.[147] The purpose of this related-debtor rule appears to be to prevent a FASIT from being used as a group finance company rather than as a means of securitizing third-party receivables. In general, a person is related to the Owner if one owns the other, directly or indirectly, or they are commonly owned, where the required ownership percentage is more than 20 percent (not the usual 50 percent).[148] The relationship test is not limited to corporate groups, but also applies to partnership and trust arrangements.

The rule has no exception for small amounts or for trade receivables. Thus, for example, if a bank were the Owner of a FASIT that held credit card receivables, and those receivables included amounts charged by employees of the bank or its affiliates on corporate credit cards, then technically the amounts due by the bank on those cards would seem to be tainted. It would make sense to have some kind of exception for business receivables that are not issued to raise funds.[149] The exception for short-term debt

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147 Section 860L(c)(2).

148 Section 860L(g) provides that one person is related to another if (1) they bear a relationship specified in sections 267(b) or 707(b)(1) (replacing 20 percent with 50 percent) or (2) they are engaged in trades or businesses under common control within the meaning of section 52(a) and (b). The reference to section 267(b) covers corporations that are members of controlled groups under section 1563(a) (with more than 20 percent common ownership) and also corporations and partnerships with more than 20 percent common ownership (see paragraphs (b)(3) and (10)). Section 52(a) also picks up controlled groups under section 1563(a) by substituting more than 50 percent for at least 80 percent and making certain other modifications, but as just noted those groups are already covered through the reference to section 267(b)(3)). Section 52(b) applies to trades or businesses (whether or not incorporated) under common control as provided in regulations, which require not less than a 50 percent ownership link. See Treasury Regulation §§ 1.52-1(c) through (g). Presumably the reference in section 860L(g)(2) to subsections (a) *and* (b) of section 52 really means *or*, because the test does not make sense otherwise. The reference to section 707(b) would treat as related persons, among others, a corporation and a partnership in which the corporation owns more than a 20 percent capital or profits interest. These sections apply various constructive ownership rules, which in some cases effectively treat options as if they were exercised and look through intermediaries.

149 Compare the dealer exception in Treasury Regulation § 1.108-2(e) to the rule in section 108(e)(4) that treats acquisitions of debt by persons related to the

instruments described below would cover some of these cases for borrowers with an investment-grade rating.

The issuer of a debt instrument could be related to the Owner at some times and not at others. Given that the asset test is continuous, it would seem that the related person rule may be continuously applied and would depend on the relationships existing from time to time. If that is true, then a FASIT would be exposed to a risk of disqualification due to events over which it has no control. For example, suppose that a FASIT sponsored by a publicly owned insurance company owns as part of a portfolio a loan that was made to finance an office building owned by a securities firm. During the life of the FASIT, the securities firm acquires from public shareholders more than 20 percent of the stock of the insurance company. Potentially, the loan would become tainted and the FASIT would be disqualified. While this result could be reached under the statute, it makes no sense, at least when the parties do not become related as part of a plan to avoid the purposes of the FASIT rules. Again, one can only hope that the Service will adopt in the final FASIT regulations a rule that generally tests related party status only when a loan is acquired.[150]

The related party rule affects a debt instrument only if its "issuer" is the Owner or a related person. Under normal tax principles, the issuer is the person that is primarily liable to repay the debt (required to pay without a right of reimbursement), even if others are also liable because of a joint obligation or guarantee.[151] On the other hand, a purported guarantor may be considered the true debtor if the nominal debtor is not expected to be able to repay the debt.[152] The FASIT regulations affirm both of these principles. Thus, a guarantee by an Owner or related person of a debt instrument

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borrower as acquisitions by the borrower for purposes of recognizing cancellation of debt income.

150 For a comment asking for such relief, see the letter to the Service from the Bond Market Association referred to in footnote 109, above.

151 See, e.g., Treasury Regulation §§ 1.163-7(a) (person allowed deduction for OID is one primarily liable on the instrument), and 1.1275-1(g) (if entity is primary obligor on debt instrument, it is the issuer even if a natural person is a co-maker and is jointly liable).

152 See Chapter 3, Part D.1.d (discussion of guarantees).

owned by a FASIT will not disqualify the instrument as a permitted asset unless the guarantor is in substance the primary obligor.[153]

The related party debt rule applies to any "direct or indirect" interest in debt of an Owner or related party.[154] The FASIT regulations read this rule broadly to bar any debt instrument that is issued by a person other than the Owner or a related person if the timing or amount of payments on the instrument are determined by reference to, or are contingent on, the timing or amount of payments made on a debt instrument issued by the Owner or a related person.[155]

Section 860L(c)(2) carves out of the related-debtor rule cash or cash equivalents. Although the FASIT regulations include a definition of this term, they would not seem to allow such instruments to be permitted assets if they are issued by the Owner or a related party.[156] Separately, the FASIT regulations would except from the related-debtor rule fixed or variable rate debt that (1) has an original stated maturity of 270 days or less, (2) is rated at least investment grade by an unrelated rating agency,[157] and (3) is acquired to invest cash temporarily awaiting investment in other permitted assets (not issued by the Owner or a related person) or distribution on FASIT interests.[158] An exception also would apply to FASIT regular interests, which would allow the creation of tiered FASITs having the same Owner.[159]

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153 Proposed Regulation §1.860H-2(b)(3)(iv). For additional restrictions on Owner or related person guarantees, see text accompanying footnote 199, below.

154 Section 860L(c)(2).

155 Proposed Regulation § 1.860H-2(b)(3)(v).

156 See Proposed Regulation § 1.860H-2(b)(3)(iii) (treats related-debtor debt instrument as a permitted asset only if issued under the exception described immediately below in the text).

157 The carve out for related rating agencies seems to reflect an unwarranted lack of faith in the integrity of such agencies, particularly given that the FASIT investors will be relying on the rating.

158 Proposed Regulation §1.860H-2(b)(2). Although the language could be clearer, a succession of investments in related-debtor paper should be allowed if the purpose of all investments together is to make a temporary investment described in the regulation (i.e., of less than or equal to 270 days).

159 See Proposed Regulation § 1.860H-2(b)(3)(iii) (reference to paragraph (b)(1)(iv)). Two-tier FASITs are discussed in Part H.4, below.

Although the ban on related-person debt covers certain debt that is not directly issued by the Owner or a related person but is connected to them indirectly, the exception for short-term paper in the regulations applies only to "issued" debt. It would make sense to read the exception to apply to any category of debt that is considered to fall within the scope of the basic rule. This construction would be important for commercial paper that is issued by "orphaned" off–balance sheet special purpose entities that are supported by some form of credit support from the Owner or a related person.

(iv) Traded debt instruments subject to withholding tax. The FASIT regulations evidence great concern that FASITs will be used to capture foreign tax credits.[160] One rule prevents a FASIT from holding a debt instrument that is traded on an established securities market if interest thereon is subject to any tax determined on a gross basis (such as a withholding tax) other than a tax which is in the nature of a prepayment of a tax imposed on a net basis. This rule is something of a blunderbuss. It does not distinguish cases where the taxes are imposed in respect of periods in which the FASIT owns the instrument from those in which the FASIT acquires the instrument with significant amounts of accrued interest. Also, it does not matter whether the taxes are credited. For example, an Owner could not cure the problem by agreeing to deduct foreign taxes rather than crediting them. Another issue is whether the rule would apply to an instrument that is exempt from withholding tax at the time it is acquired but becomes subject to tax on account of a change in law.

(v) Partial ownership interests in debt instruments. A FASIT may acquire a partial ownership interest in a debt instrument (or pool of debt instruments) in the form of a participation or interest in a trust holding such instruments. The partial interest may be a pro rata interest (a right to the same fixed fraction of each payment on the debt instrument) or a non–pro rata interest.

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160 The rule described in Part H.6, below, that would allocate FASIT interest expense against FASIT income also appears intended to limit credits for taxes imposed on income of a FASIT. Another sign of Treasury's concern is the proposed rule disqualifying a FASIT that is subject to a foreign net tax (see footnote 27, above). These restrictions augment those applicable under Notice 98-5, 1998-1 C.B. 334, which imposes a post-tax economic profit test as a condition to claiming credits for withholding taxes.

While the REMIC statute defines qualified mortgages to include "any participation or certificate of beneficial interest therein,"[161] there is no comparable rule for FASITs. Under general tax principles, however, a participation interest, or a certificate of beneficial interest in a trust that is taxed as a grantor trust, is considered an ownership interest in the underlying property, and the same principles should apply in determining if such an interest is a permitted asset.[162] A somewhat harder case arises when the partial interest is a non–pro rata interest. The FASIT regulations would treat a partial interest that is a stripped bond or stripped coupon within the meaning of section 1286 as a permitted asset if (and only if) the underlying debt instrument itself qualifies.[163] As discussed above, a debt instrument qualifies as a permitted asset only if it bears interest at a fixed or qualifying variable rate. To the extent the purpose of this rule is to prevent a FASIT from receiving contingent interest payments, it would seem to make sense to apply this test to the partial interest held by the FASIT and not the whole bond.

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161 Section 860G(a)(3)(A).

162 As described in Chapter 5, Part B, holders of beneficial interests in a grantor trust are considered the owners of the underlying trust property. For a discussion of participation interests, see Chapter 3, Part D.1.h. Proposed Regulation § 1.860H-2(b)(1)(viii) states that a "certificate of trust representing a beneficial ownership interest in" an otherwise qualifying debt instrument is a permitted asset. The language does not clearly require that the trust be classified as a grantor trust, although it might be read that way. The explicit rule for trusts should not be read to preclude other arrangements that would convey an ownership interest to the FASIT under general tax principles. The FASIT regulations would not allow a FASIT to hold a debt instrument if the timing or amount of payments thereon are contingent on the timing or amounts of payments on a debt instrument issued by the Owner or a related person. See footnote 155, above. This rule should not prevent a FASIT from entering into a conventional participation agreement with an Owner or related person creating an interest in a third-party debt instrument. Although the Owner or related person would have contractual obligations to the FASIT, those obligations would not be considered debt.

163 Proposed Regulation § 1.860H-2(b)(1)(vii). The opposite is also true, that a partial ownership interest, including a stripped bond or coupon, in a debt instrument that is carved out of the definition of permitted asset in the regulations (because it is equity linked, defaulted, issued or guaranteed by an Owner or related person or linked to a debt instrument of such a person) is not a permitted asset. Proposed Regulation § 1.860H-2(b)(3)(vi).

Under that approach, for example, a FASIT could hold a partial interest in a debt instrument that has contingent payment features if those features are stripped off of the interest held by the FASIT. The FASIT regulations do not follow this approach, but the issue has been raised in a number of comment letters and perhaps the final regulations will be more forgiving.[164]

(vi) Default-related modifications. Some loans acquired by a FASIT will inevitably turn bad. When that happens, the FASIT may simply sell that loan at a loss or, if it is collateralized, acquire and dispose of the collateral. These alternatives are addressed in the FASIT statute.[165] There is, however, a significant middle ground, when the FASIT might wish to agree with the borrower to a modification of loan terms. Very often, the modification would be a "significant modification" that results in a deemed exchange of the modified loan for the original one. In that event, in the absence of a rule to the contrary, it would seem to be necessary to test whether the new loan satisfies the definition of a permitted asset. At least with respect to certain categories of loans (such as commercial real estate mortgages), the modified loan could well have features that would prevent it from being a permitted asset. Specifically, if the loan has an equity kicker, it would generally fail the test requiring that interest be payable at a fixed or qualifying variable rate and could conceivably be an equity interest that would fail to be a debt instrument. In that event, income on the modified loan would be subject to the 100 percent prohibited transactions tax and, if the amount of nonqualifying loans were sufficiently large, the FASIT election would be terminated.

In the REMIC area, default-related loan modifications are an even greater potential concern, because REMICs generally cannot acquire new loans on any terms more than two years after the startup day. The problem is addressed by a rule in the REMIC regulations that prevents a qualified mortgage from losing its status as such because of a default-related modifi-

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164 See, e.g., the NYSBA report on the FASIT regulations cited in footnote 6, above.

165 See Part E.3, below (discussing carve out from prohibited transactions definition for sales of permitted assets in connection with a default or imminent default) and Part D.2.f, below (foreclosure property).

cation.[166] There is a critical need for a similar rule in the final FASIT regulations.[167]

d. Hedges and Credit Enhancements. A FASIT is a type of securitization vehicle. As such, it channels cash flows on debt instruments to different classes of interests. It may also enhance FASIT interests by providing contractual credit support. This could take the form of a guarantee of assets or of the interests themselves (or an equivalent contract with a different name, such as a letter of credit or surety contract). Also, it is very common for loan servicers to advance funds to cover delinquent payments, which may provide only liquidity or real credit support. Further, a FASIT, like other borrowers, may reduce the risk of a mismatch between assets and liabilities by hedging against interest rate, currency or other risks.

REMIC sponsors face similar issues. In order to provide a backdrop for considering FASIT guarantees and hedges, it is worthwhile considering how they are dealt with in the REMIC context. Guarantees (and similar credit support contracts) and hedges are not addressed in the statute.[168] Securitized mortgages often benefit from guarantees, however, and it was inconceivable that they would not be allowed. The straightforward way to reach that result was to apply the basic tax rule that treats guarantees as incidental to and part of the guaranteed asset.[169] This practice received official sanction in the REMIC regulations issued in 1991. They treat a "credit enhancement contract" as part of the mortgages to which it relates (so that

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166 See Treasury Regulation §§ 1.860G-2(b)(3)(i) (change in terms occasioned by default or a reasonably foreseeable default is not a significant modification) and -2(b)(4) (if modification of a loan is not a significant modification, old loan is continued). This regulation is discussed in Chapter 6, Part D.2.d.

167 For a comment letter requesting such a rule, see the letter to the Service from the Bond Market Association, referred to in footnote 109, above. Two related topics are the possible recognition by the Owner of artificial gain from a modification, discussed in Part G.2.d, and the treatment of a modified loan as a loan originated by the FASIT, discussed in footnote 260, below, and the accompanying text.

168 The REMIC statute does allow REMICs to hold assets in a qualified reserve fund which protects against defaults on regular interests in the event of defaults on mortgages or lower than expected returns on cash flow investments. The legislative history discusses subordinated regular interests and qualified reserve funds, but otherwise is silent on credit enhancements.

169 For a discussion, see Chapter 6, footnote 222 and accompanying text.

it becomes a qualifying asset).[170] A credit enhancement contract is defined as follows:

> any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or full or partial payment on one or more classes of regular interests or on the class of residual interests, in the event of defaults or delinquencies on qualified mortgages, unanticipated losses or expenses incurred by the REMIC, or lower than expected returns on cash flow investments.

The regulation goes on to identify various types of contracts that satisfy the definition, including contracts to make mandatory or optional advances for delinquencies or property protection expenses.

A credit enhancement contract may not be used to cover basis risk (mismatches in interest rates) or currency risk. Fluctuations in interest rates or exchange rates are not default-related contingencies and are not "unanticipated." Also, it is not generally possible to treat interest rate or currency contracts as part of the related assets or liabilities.[171]

Returning to FASITs, in terms of permitted assets, they are supposed to be "REMIC plus." Thus, it would make sense to allow a FASIT to benefit from any contract that would qualify as a credit enhancement contract under the REMIC rules (substituting for qualified mortgage any debt instrument that is a permitted asset). In addition, the fact that FASITs can hold revolving pools and issue debt over time suggests that they should be allowed to use the same debt management tools as other active borrowers. In broad terms, the statute contemplates these results. Section 860L(c)(1)(D) includes in the definition of permitted assets any asset which:

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170 Treasury Regulation § 1.860G-2(c), which is discussed in Chapter 6, Part D.1.b.(ii). The regulations also state that a reimbursement obligation under a credit enhancement contract is not an interest in a REMIC. Treasury Regulation § 1.860D-1(b)(2)(iii). The TMP rules similarly treat credit enhancement contracts (defined largely using the REMIC definition) as part of the assets to which they relate. Treasury Regulation § 301.7701(i)-1(c)(4).

171 For a discussion of regulations allowing the integration of debt instruments and swaps, see Chapter 8, Part H.4.

- is an interest rate or foreign currency notional principal contract (or *NPC*), letter of credit, insurance, guarantee against payment defaults, or other similar instrument permitted by the Secretary, and
- is reasonably required to guarantee or hedge against the FASIT's risks associated with being an obligor on interests issued by the FASIT (the *guarantee or hedge requirement*).[172]

As discussed in the next section, a FASIT may also hold a contract to acquire debt instruments, hedges and credit enhancements that satisfy the permitted asset definition.[173]

In broad terms, the statute can be paraphrased to say that a FASIT can enter into contracts that relate to credit, interest rate or currency contingencies and reduce risks associated with FASIT interests, rather than being, for example, merely speculative. As discussed below, the FASIT regulations generally follow this functional approach.

(i) Issues under the statute. The FASIT regulations are not yet final and may be changed significantly before going into effect. Accordingly, before turning to the regulations, it is worth considering a number of technical questions that arise under the statute.

Exclusivity. One threshold question is whether the statutory definition is exclusive. Specifically, the REMIC statute does not address contractual credit support at all, and yet the universal assumption followed in practice before the REMIC regulations were issued was that conventional guarantees of assets or regular interests (or equivalent contracts with a different name) were allowed. The same assumption should hold true for FASITs. If not, then a FASIT potentially could not hold a guaranteed debt instrument on the ground that the guarantee would benefit the ownership interest as well as the regular interest (see the discussion of interests below). While the FASIT regulations do not address this point explicitly, hopefully the final regulations will do so to avoid any adverse inferences that otherwise might be drawn.[174]

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172 Section 860L(c)(1)(D).

173 Section 860L(c)(1)(E).

174 See the letter to the Service from the Bond Market Association referred to in footnote 109, above. The FASIT regulations would impose special limitations on guarantee contracts provided to a FASIT by the Owner or a related person.

Types of contracts. Following the statute, let us consider separately three types of contracts: (1) an interest rate or foreign currency NPC, (2) a letter of credit, insurance, or a guarantee against payment defaults, and (3) other similar instruments permitted by the Service.[175]

"Notional principal contract" is the tax term for a swap and is defined in some detail in Treasury regulations.[176] It generally means a contract to make periodic payments calculated by reference to a specified index on a notional principal amount, in exchange for similar payments or other consideration. A specified index may be a fixed rate or amount, an interest rate

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See footnote 199, below. Those limitations presumably are intended to apply to all such contracts. A related issue is whether a hedge of a debt instrument that is integrated with the instrument under one of the two existing sets of regulations allowing integration would be analyzed under the separate hedge rules or would simply be folded into the related debt instrument. The two sets of regulations (§ 1.988-5 for foreign currency hedges and § 1.1275-6 for other hedges) are described in Chapter 8, Part H.4. As a general rule, the purpose of the integration regimes is to allow the component parts to be ignored, and there would seem to be no reason not to follow the same approach in applying the FASIT assets test. There are other issues raised by application of the integration rules. First, the Treasury Regulation § 1.1275-6 rules do not apply to a debt instrument to which section 1272(a)(6) applies. As discussed below, at footnote 347, the Owner of a FASIT may in some circumstances be required to compute its income from FASIT assets under the tax accounting rules of section 1272(a)(6). It would seem that the ban on integration should apply only if a debt instrument is described in section 1272(a)(6) based on its own terms. A second issue is whether the hedge contract should be viewed as a prohibited interest in the FASIT. The answer should be "no" if the contract is not a liability when the FASIT acquires the integrated position. See discussion at footnote 37, above. Even if it is a liability at that time, it should not be considered a FASIT interest on the ground that the contract is taken into account fully as part of the related debt instrument. Some clarification of these points by the Service would be helpful.

175 The comma before "other similar instrument permitted by the Service" in section 860L(c)(1)(D)(i) makes it clear that the "permitted by the Service" language modifies "other similar instrument" only and not the earlier parts of the definition.

176 Treasury Regulation § 1.446-3(c)(1).

index or any index based on objective financial information.[177] An NPC does not include instruments treated for tax purposes as forwards or options (including contracts to enter into NPCs in the future) or debt. An "interest rate" NPC should include any NPC that exchanges one interest rate index for another. Although somewhat less clear, it also should include interest rate caps and floors.[178] A total return swap on a debt instrument (one that takes account of interest earned on a debt instrument, plus or minus changes in its market value) pushes the definition further, because it would take account of factors influencing value other than those related only to interest rates. A foreign currency NPC would be one that provides for payments in or based on a nonfunctional currency.[179] An NPC that combines features of an interest rate and currency swap (e.g., floating rate dollars for fixed rate sterling) should also be an interest rate or foreign currency NPC.

The phrase "letter of credit, insurance, guarantee against payment defaults" is ambiguous in one respect. Read literally, the "against payment defaults" language modifies "guarantee" but not letter of credit or insurance. Presumably what was intended, however, was to describe different types of contracts providing credit support. At any rate, any letter of credit or insurance must meet the second part of the definition (guarantee or

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177 Objective financial information is any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock). An NPC can be based on assets held by one of the swap counterparties (e.g., the principal balance or return on an identifiable pool of receivables held by one of the parties). See Treasury Regulation § 1.446-3(c)(4)(ii).

178 Treasury Regulation § 1.446-3(c)(1)(i) refers to an interest rate swap as one type of NPC but does not define the term. It also lists separately interest rate caps and floors. At least in the FASIT context, it would seem that any NPC that relates to an interest rate risk should be regarded as an interest rate NPC.

179 Presumably any NPC that is a section 988 transaction (subject to rules for nonfunctional currency transactions in section 988) would be a currency swap. See Treasury Regulation § 1.988-1(a)(2)(iii)(B)(2). Treasury Regulation § 1.988-2(e)(2) defines one subcategory of such contracts referred to as a "currency swap contract." A currency swap contract provides for an exchange of two streams of payments corresponding to interest and principal on two debt instruments maturing at the same time and denominated in different currencies (an initial exchange of principal is not required).

hedge of FASIT interests). One further question is whether the mentioned "payment defaults" are those on the assets held by the FASIT or rather defaults on FASIT interests. Following the REMIC model, it should include both.[180]

Asset. The rules for hedges and guarantees are part of the definition of permitted asset. It is not surprising, then, that they refer to "any asset" which is a permitted guarantee or hedge. Hedge contracts in particular may be assets or liabilities at different times depending on market conditions. Surely the drafters intended only to describe the types of contracts a FASIT could enter into, and there is no requirement that a contract have any positive value when entered into or at any time thereafter. To the extent a contract has negative value to a FASIT (is a liability), there is a potential issue as to whether it is a prohibited FASIT interest.[181]

An NPC that provides for significant nonperiodic payments may be recharacterized in part as a loan between the FASIT and the swap counterparty (either from the FASIT to the swap counterparty or vise versa).[182] With respect to a loan by the FASIT, if a separate loan by the FASIT would be a permitted debt instrument, it is difficult to see why an embedded loan should prevent the swap from being a permitted asset.[183] In the case of a loan to the FASIT, two issues would be whether the loan has the economic terms required to qualify as a regular interest and whether it is properly designated as a regular interest.

Guarantee or Hedge Requirement. The FASIT definition of permitted guarantee or hedge requires that an asset be reasonably required to "guarantee or hedge against the FASIT's risks associated with being the obligor on interests issued by the FASIT." This language is ambiguous. Specifically, it is not clear whether the permitted guarantees are "guarantees against the FASIT's risks associated with being an obligor on interests is-

180 Presumably payment defaults could arise on NPCs or other contracts to which a FASIT is a party, and a guarantee of them would be allowed.

181 See footnote 37, above.

182 See Treasury Regulation § 1.446-3(g)(4).

183 A loan to the Owner or a related person would not be a permitted asset. See Part D.2.c.(iii), above. A swap contract should not be considered a loan "originated by" a FASIT because the swap counterparty would not have a customer relationship with the FASIT. The prohibited transactions tax on loans originated by a FASIT is discussed in Part E.4, below.

sued by the FASIT" or instead "guarantees of interests issued by the FASIT." The first reading would seem to allow only guarantees of FASIT assets, as contrasted with FASIT interests. The second view might have the opposite effect of allowing guarantees of interests but not of assets. Maybe the logic was that the Code need cover only a guarantee of a FASIT asset because a guarantee of a FASIT interest would run directly in favor of an interest holder and not produce any kind of asset from the FASIT's perspective. Probably the best reading is that any contract providing default protection to the FASIT directly or to investors is allowed (subject to the discussion of protected interests below).

The legislative history states that an instrument is a hedge if it results in risk reduction in accordance with Treasury Regulation § 1.1221-2.[184] The statement does not require that the transaction *be* a hedging transaction described in this regulation, but only that it result in risk reduction as described in the regulation. The regulation applies to transactions entered into by a taxpayer in the ordinary course of business primarily (as regards hedges of liabilities) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings or other obligations made or to be made, or incurred or to be incurred, by the taxpayer. The regulation then has special rules explaining what risk reduction means. The risk reduction standard was adopted in 1994 to parallel the hedging exception in section 1256(e). In 1999, the Code definition of capital asset was expanded to exclude any position entered into to "manage risks" with respect to ordinary assets rather than just to reduce them.[185] The FASIT statute does not refer to either the reduction or management of risks and, thus, could accommodate the broader term. It is not clear whether the reference in the FASIT legislative history to the pre-1999 risk reduction test was intended to be exclusive.

In the context of section 1221, there has been some controversy regarding so-called "gap hedges," which fill in a gap between assets and liabilities. Such a hedge would be a hedge under Treasury Regulation § 1.1221-2 if it hedges an ordinary liability but not if it hedges a capital asset. The preamble to the final version of these regulations acknowledges the issue and says that the outcome depends on the factual question whether the hedge is more closely associated with assets or liabilities.[186] It would be

184 1996 Senate Report at 128; 1996 Blue Book at 261.

185 Sections 1221(a)(7) and (b)(2).

186 T.D. 8555, 1994-2 C.B. 180,182.

unfortunate to have the qualification of a FASIT hedge contract turn on this distinction (specifically on whether the hedge reduces risks as an obligor more than as a holder of assets). Presumably what the drafters had in mind was allowing derivative contracts that (loosely speaking) played a role in the securitization of assets held by the FASIT and were not entered into for purposes of speculation. A related issue, discussed below, arises in determining what type of FASIT interests can be hedged.

In theory, an NPC could be entered into by a FASIT that reduced the FASIT's risk of its obligation under regular interests (viewing the regular interests on a stand-alone basis) but enlarged the gap between assets and liabilities. For example, suppose that a FASIT issues floating rate regular interests and owns short-term assets that are expected to bear interest at current market rates. If the FASIT effectively converted a class of regular interests into fixed rate liabilities by entering into an NPC under which it paid fixed payments and received floating, it could be said to reduce the risk that it will owe greater amounts if interest rates go up. On the other hand, the NPC would increase the gap between FASIT assets and liabilities. It is doubtful whether an NPC that increases risk in this way would be a permitted asset.

Reasonably required. The term "reasonably required" is also used in an analogous setting in the REMIC rules and interpretations there may be a useful starting point.[187]

Types of protected interests. A significant question is whether the reference in the guarantee and hedge requirement to FASIT "interests" encompasses both ownership interests and regular interests. The term interests would naturally be read to include both, although the reference to being an "obligor on" an interest suggests fixed payment obligations more usually associated with regular interests. At any rate, the legislative history paraphrases the statute but replaces the word "interests" with "regular interests."[188] As described below, the FASIT regulations would provide a similarly restrictive reading. Assuming that only regular interests count, following the approach in the section 1221 hedge regulations referred to

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187 Section 860G(a)(7)(B) (definition of qualified reserve fund); Treasury Regulation § 1.860G-2(g)(3) (same). For a description of the REMIC rule, see Chapter 6, Part B.2.b.(ii).

188 1996 Senate Report at 128; 1996 Blue Book at 261.

above, account should be taken of anticipated as well as outstanding regular interests.

A rule that allows guarantees or hedges to protect only regular interests (including future ones) could significantly limit the use of the FASIT vehicle, at least if the statutory hedge/guarantee rule were considered to be exclusive (it is argued above that it should not be read that way). Specifically, any plain-vanilla third-party guarantee of an asset would benefit the Owner.

Change in status of contract. The status of a hedge or guarantee contract depends on how it is used. Accordingly, an instrument that is a permitted asset could potentially lose its status as such because of changes in other FASIT assets or liabilities. For example, a hedge of a regular interest could cease to be a qualifying hedge if the regular interest is retired (and not expected to be replaced). Under these circumstances, the FASIT should be allowed to dispose of the hedge during some reasonable period of time without adverse consequences. The FASIT statute takes a bow in the right direction by exempting gains from dispositions of formerly qualifying hedge or guarantee contracts from the 100 percent prohibited transactions tax, but as discussed below, the solution is not complete.[189]

Transactions with Owner or related parties. There is nothing in the statute or legislative history indicating that special rules would apply to hedge or guarantee contracts between a FASIT and a related party. Issues could arise, however, under the rule that attributes FASIT assets and liabilities to the Owner (Part G.7) and the rule treating support property as a FASIT asset (described below in Part H.1). As to the first point, FASIT assets are treated for most tax purposes as if they were owned by the Owner. Accordingly, if a FASIT entered into, say, an NPC with the Owner, for substantive tax purposes the contract would simply disappear, because a taxpayer cannot contract with itself. The FASIT regulations include special rules for hedges and guarantees with the Owner and related parties that assume that such contracts will be given effect for at least some tax purposes, although there is no explicit discussion of the point.[190] If the NPC or other hedge contract involves a deemed loan to the Owner or a related person, it may not to that extent be a permitted asset.[191]

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189 See the text accompanying footnote 221, below.

190 See footnote 199, below.

191 See footnote 183, above.

(ii) FASIT regulations. The FASIT regulations describe hedges and guarantee contracts that are permitted assets (*permitted hedges*).[192] In general, they adopt a functional approach that looks to what a contract does rather than what it is called. The regulations are troublesome in that they would limit permitted hedges to contracts hedging or guaranteeing regular interests, and would place stringent restrictions on contracts with the Owner or persons related to the Owner.

The FASIT regulations would limit a permitted hedge to one that is reasonably required to offset any differences that any risk factor may cause between the amount or timing of the receipts on assets the FASIT holds (or expects to hold) and the amount or timing of the payments on the regular interests the FASIT has issued (or expects to issue). The risk factors are:

- fluctuations in market interest rates
- fluctuations in currency exchange rates
- the credit quality of, or default on, the FASIT's assets or debt instruments underlying the FASIT's assets, and
- the receipt of payments on the FASIT's assets earlier or later than originally anticipated.

A hedge or guarantee contract meeting these tests need not be associated with any of the FASIT's assets or regular interests, or any group thereof. Thus, hedges of aggregate risk would be allowed.

A hedge or guarantee contract is not a permitted hedge if it references any asset other than a permitted asset,[193] or references an index, economic

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192 Proposed Regulation § 1.860H-2(d). This regulation sets out requirements that must be met for a hedge or guarantee contract to be described in section 860L(c)(1)(D). Hopefully, a guarantee or other credit enhancement contract might also qualify as a permitted asset on other grounds. See the text at footnote 174, above.

193 One ambiguity in this rule is whether the reference to permitted asset means an asset actually held by the FASIT or merely one that could be held by it. For example, if a FASIT owns only corporate bonds, would a contract based on changes in the value of certain Treasuries be allowed? The preamble (at 2000-1 C.B. 686) states that the purpose of the rule is to prevent the use of a hedge to effect the economic equivalent of a transfer of non-permitted assets to the FASIT. This concern would be addressed by reading "permitted asset" to mean any asset that would be permitted if held by the FASIT.

indicator, or financial average, that is not both widely disseminated and designed to correlate closely with changes in one or more of the risk factors listed above. The FASIT regulations would disqualify a hedge or guarantee contract if at the time it is entered into it "in substance creates an investment in the FASIT." This rule is discussed further in connection with the FASIT interests test.[194]

The FASIT regulations would not allow a permitted hedge to protect the ownership interest as well as regular interests. This is unfortunate because it would be quite natural to obtain guarantees or hedges of assets that would protect the ownership interest as well as regular interests. There is no obvious policy reason for the limitation. The preamble to the FASIT regulations states that the regulations accommodate incidental hedges of the ownership interest by allowing hedges to relate to future regular interests,[195] but that is simply not the case. The need for incidental hedging of the ownership interest would exist whenever there is an ownership interest outstanding, whether or not additional regular interest classes are to be issued.

The regulations would allow a hedge contract that protects against fluctuations in market interest rates. Thus, if a FASIT holds fixed rate loans and issues floating rate regular interests, it could enter into a contract to protect against changes in floating rate interest expense. A FASIT may hold a debt instrument that allows the borrower to convert from one interest rate mode to another (e.g., from floating to fixed). In that case, the FASIT should be allowed to enter into a hedge contract that protects against the risk of interest rate fluctuations only during the period in which the protection is needed. Stated differently, the hedge should not be disqualified on the ground that it protects against not only the risk of interest fluctuations but also the risk that the borrower will convert from one rate mode to another. In the end, the risk that is protected against while the contract is in effect is fluctuating rates.

The list of risk factors refers to the credit quality or default risks relating to FASIT assets, but not the credit quality or default risks relating to regular interests. Defaults could potentially occur on regular interests because of lower than expected reinvestment rates or unexpected expenses.

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194 See footnote 37, above.

195 2000-1 C.B. 686.

Guarantees of regular interests may simply not give rise to any FASIT asset and be allowed on that ground.[196]

The FASIT regulations would prevent a FASIT from entering into a swap or other hedge contract (other than a guarantee) with the Owner or a related person unless, apparently, that person is a regular dealer in such contracts and the terms of the contract are "consistent with" the terms that would apply in the case of an arm's-length transaction between unrelated parties.[197] For a host of commercial reasons, it may be desirable for a FASIT to enter into a hedge contract with the sponsor or a related person, which could then decide whether to transfer its risks to third parties.[198] Unless the regulations are changed, these arrangements would be either clearly prohibited or quite risky.

Guarantee contracts with an Owner or related person are also subject to further requirements.[199] Such a contract must be a credit enhancement contract within the meaning of the REMIC rules and when the contract is acquired by the FASIT or substantially modified, the value of all of the FASIT's guarantee contracts issued by the Owner (and related persons) must be less than 3 percent of the value of all the FASIT's assets. "Value"

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196 For a discussion of the same issue for REMIC regular interests before the issuance of REMIC regulations, see Chapter 6, Part D.1.b.(i).

197 Proposed Regulation § 1.860H-2(e). Records must also be maintained showing that the consistency requirement is met and how consideration for the contract was determined. The regulation does not refer to a dealer, but would require that the Owner or related person regularly provide, offer, or sell substantially similar contracts in the ordinary course of its trade or business. The "consistent terms" requirement would be applied when the contract is acquired or on any later date on which it is substantially modified.

198 Those reasons may include the desire of swap counterparties to deal with an entity with an established credit rating, the lack of market swaps or other contracts that track exactly the terms of the assets in the vehicle, a desire to be able to replace third-party swaps (for example, in the event of a counterparty default) without involving the vehicle, or the desire to have termination provisions that track the terms of the securitization vehicle but that are not common in market contracts (e.g., the ability to close out a contract without marking it to market if the transaction is wound up early). These reasons would often involve contract terms that depart from, and therefore may not be "consistent with," market terms.

199 Proposed Regulation § 1.860H-2(e)(2).

for this purpose is the subsection (d) value used in computing gain on the transfer of assets to a FASIT.[200] As is true of the Owner/related person rules relating to other hedge contracts, this requirement, if it stays in the final regulations, could well have the practical effect of prohibiting the guarantees it covers.[201]

e. Contracts to Acquire Debt Instruments or Hedges. Contract rights to acquire debt instruments, hedges or guarantees are themselves permitted assets.[202] This rule would potentially allow a FASIT to enter into an arrangement with a loan originator to acquire debt instruments over time as they are originated. It would also allow it to contract in advance to acquire NPCs to meet the changing hedging requirements of a FASIT.[203] The

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200 The rules for determining "value" in calculating gain (Proposed Regulation § 1.860I-2, discussed in Part G.2.b, below) do not require separate valuation of guarantees related to debt instruments not traded on an established securities market (recognizing perhaps the difficulty in assigning a separate value to the contract), and yet separate valuations of guarantees seem to be required for purposes of administering the 3 percent limit. At any rate, the two rules are not coordinated.

201 Specifically, valuing guarantees would not be easy unless the guarantees are issued under a program that offers them to third parties at a fixed price. The problem is exacerbated by the apparent need to revalue all guarantees whenever a new guaranteed asset is acquired. Thus, if a FASIT holds a revolving pool of assets (as FASITs are supposed to be able to do), on each date on which it acquires a new asset, the test would have to be met. It is not clear whether the value of guarantees on existing assets would be based on their value when the guaranteed asset was acquired or on the new testing date. If the latter, the value of the guarantee would be huge in respect of any debt instrument that is in default or close to it. If the former, adjustments would have to be made for changes in the outstanding balance of assets. It also is not clear whether in valuing guarantees any guarantee fees payable by the FASIT would be taken into account. If not, guarantees that have relatively modest values when expressed in terms of basis points of yield could exceed the 3 percent limit even if the guarantee contract has no positive market value because the FASIT is required to pay an arm's-length fee. For example, using a discount rate of 8 percent, an annual fee of 45 basis points payable over 10 years would have a present value of 3 percent.

202 Section 860L(c)(1)(E).

203 A contract or option to enter into an NPC in the future is not itself an NPC. Treasury Regulation § 1.446-3(c)(1)(ii).

statutory term "contract rights to acquire" would seem to be broad enough to cover options as well as bilateral agreements. It should also extend to cash settled contracts, although this point is less clear.

The FASIT regulations would impose additional restrictions on contract rights acquired from the Owner or a related person. Specifically, such rights would not be permitted assets if the agreement permitted the FASIT to acquire assets for less than fair market value, in the case of hedges or debt instruments traded on an established securities market, or less than 90 percent of their "value" (as determined under the gain recognition rules) for debt instruments not traded on an established securities market.[204] The practical effect of these rules is that the risk of changes in value cannot be shifted from the FASIT to the Owner or related person (except up to 10 percent in the case of non-traded debt instruments), which would seem to undermine one of the principal reasons for having such contracts in the first place.

To the extent a FASIT enters into a contract to acquire a loan upon origination, it will be necessary to consider if the loan is considered to be "originated" by the FASIT. If it were, then interest thereon would be subject to the prohibited transactions tax. See Part E.4, below.

A contract to acquire FASIT assets could have a positive market value. To the extent it does, and the FASIT acquires the contract for less than such value, the Owner may recognize gain. The gain recognition rules are discussed in Part G.2, below.

There are no special rules allowing a FASIT to enter into a contract to dispose of an asset. The REMIC regulations allow a REMIC to enter into contracts to sell loans that convert to a market interest rate.[205] They also contemplate that a REMIC may have a contract to dispose of assets in connection with a qualified liquidation.[206] If such a contract had an initial

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204 Proposed Regulation § 1.860H-2(h). There is no special rule for contracts to acquire hedges not traded on an established securities market. The reason may be that any hedge contracts entered into with the Owner or a related person must effectively be a traded instrument.

205 See Chapter 6, Part D.3.

206 See Chapter 6, Part B.1.a.(iv) (discussing rule that treats contracts to acquire assets as not being REMIC interests) and footnote 38, above (possible extension of same rule to FASITs).

value (and basis to the FASIT) of zero, then it could generally be held by the FASIT without running afoul of the assets test.[207]

f. Foreclosure Property. Debt instruments held by a FASIT may go into default. To the extent a defaulted obligation is secured, a FASIT should be allowed to acquire possession of the collateral and to liquidate it without adverse tax consequences. The FASIT rules accommodate this need by allowing a FASIT to hold foreclosure property.[208] The definition is taken, with modifications, from the REIT rules.[209] Thus, foreclosure property is generally any property that secures a debt instrument and is acquired by a FASIT (through a foreclosure proceeding or otherwise) after there was a default (or default was imminent) on the instrument. Property acquired on default or imminent default will not qualify as foreclosure property, however, if the principal reason for creating a security interest in the property was to permit the FASIT to invest in such property.[210] The grace period

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207 See footnote 107, above, and accompanying text discussing substantially all of the assets test calculated by reference to tax basis. In determining the basis of a contract, account should be taken of possible gain recognized upon the transfer of the contract to the FASIT. See Part G.2.c, below. A sale of property under the contract ought not to produce a separate item of income subject to the prohibited transactions tax. Any gain on sale would be considered to arise from the property sold rather than the contract. Another question to consider is whether the rights of the counterparty against the FASIT would be regarded as an interest in the FASIT that would violate the interests test. See footnote 37, above.

208 Section 860L(c)(1)(C).

209 See section 860L(c)(3)(A)(i), which defines foreclosure property by reference to the REIT definition in section 856(e) (but without the need for the property to be real property). The REIT definition is also used to define foreclosure property in the REMIC setting, and is discussed in more detail in Chapter 6, Part B.2.b.(iii). As is also true for REMICs, (1) section 856(e)(5) requiring a REIT to elect to treat property as foreclosure property does not apply to FASITs, and (2) section 856(e)(4), which causes property to cease being foreclosure property in certain circumstances, does not apply for purposes of the FASIT assets test but does apply for purposes of imposing the 100 percent prohibited transactions tax on income from non-permitted assets. Property securing a hedge or guarantee contract cannot qualify as foreclosure property.

210 Section 860L(c)(3)(ii). Note that the purpose test looks to the reason for creating the security interest (a test that would apply at the time of origination of a loan) rather than the reason why the FASIT acquired the loan. The REIT

over which a FASIT may hold foreclosure property is generally the same as for REMICs.[211] The Service may by regulation shorten the grace period for property that is not real property or personal property incident to real property, but no regulations having this effect have been issued or proposed.

Whenever a FASIT acquires property from a person other than the Owner or a related person, the Owner is deemed under section 860I(a)(2) to acquire the property at the property's cost to the FASIT and then to resell it to the FASIT at the value calculated under section 860I(d). Property acquired in foreclosure takes an initial basis in the hands of the foreclosing creditor equal to its fair market value,[212] so that except in the case of debt instruments not traded on an established securities market, the section 860I(d) value would equal such cost and there would be no gain. Acquisitions of non-traded debt instruments could potentially trigger a tax on any difference between the section 860I(d) value and fair market value.

The FASIT regulations address only one narrow aspect of the foreclosure property definition.[213] They state that if foreclosure property consists of property that is a permitted asset under another part of the permitted asset definition (e.g., a third-party debt instrument), then the property may qualify as both foreclosure property and the other type of permitted asset. A disposition of the property while it is foreclosure property is not subject to the prohibited transactions tax. If the property is held beyond the end of

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regulations (§ 1.856-6(b)(3), discussed in Chapter 6, footnote 305 and accompanying text) include a rule that prevents property securing a debt instrument from being foreclosure property if at the time the instrument was acquired by the REIT, the REIT intended to foreclose or knew or had reason to know that a default would occur. Presumably the principal purpose test in the FASIT statute was intended to supplant the REIT regulation.

211 For a discussion, see Chapter 6, Part B.2.b.(iii). The period generally ends at the close of the third "taxable year" following the year in which the property was acquired. A FASIT, unlike a REIT or REMIC, does not have its own taxable year apart from the taxable year of the Owner. See Part G.1, below. Because foreclosure property is generally defined as property that would be foreclosure property if acquired by a REIT, and a REIT is required to have a taxable year which is the calendar year (see section 859), it would make sense to apply the FASIT foreclosure property definition as if the FASIT had a taxable year which is the calendar year.

212 Treasury Regulation § 1.166-6(c).

213 Proposed Regulation § 1.860H-2(f).

the grace period, so that it is no longer foreclosure property, then the Owner recognizes gain as if the property were deemed contributed at that time. The regulation implies that there is no deemed contribution at the time when the property is acquired in foreclosure.

E. Prohibited Transactions

1. Overview

The permitted activities of a FASIT are limited by the prohibited transactions rules. They impose on the Owner a tax equal to 100 percent of the net income derived from "prohibited transactions" engaged in by the FASIT.[214] For this purpose, "net income" has the same meaning as the corresponding REMIC term.[215] A prohibited transaction is defined as:

- the receipt of income derived from an asset other than a permitted asset[216]
- the disposition of a permitted asset other than foreclosure property, with exceptions relating to defaults, over-collateralization, substitutions, and liquidations of a FASIT or a regular interest class[217]
- the receipt of income from any loan "originated" by the FASIT,[218] and
- the receipt of any income representing a fee or other compensation for services.[219]

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214 Section 860L(e)(1). The fact that the tax is imposed directly on the Owner means that an Owner is at risk if either (1) the FASIT documents do not properly limit FASIT activities (and in some areas, such as the origination of loans, the prohibited activities are not clearly defined) or (2) a loan servicer or other person acting on behalf of the FASIT engages in a prohibited transaction in violation of those documents.

215 See section 860L(e)(4) (cross-reference to section 860F(a)(3)). For a description of the REMIC term, see Chapter 6, Part C.1.

216 Section 860L(e)(2)(A).

217 Sections 860L(e)(2)(B) and (e)(3).

218 Section 860L(e)(2)(C).

219 Sections 860L(e)(2)(D). The receipt of a fee as compensation for a waiver, amendment or consent under permitted assets (other than foreclosure prop-

The following sections discuss in more detail income from assets that are not permitted assets, permitted dispositions of assets and loan originations.

2. *Income From Assets That Are Not Permitted Assets*

The tax on income from assets that are not permitted assets prevents a FASIT from holding *de minimis* amounts of non-permitted assets (amounts that are too small to terminate the FASIT election). While it is reasonable to ask that a FASIT not acquire assets unless they are permitted assets when acquired, assets that are initially permitted assets could lose their status as such because of factors beyond the control of the FASIT. There is no generally applicable relief rule to cover such a case.[220]

The Code excepts from the definition of prohibited transaction income derived from the disposition of a financial instrument that qualified as a permitted hedge when initially acquired by a FASIT but no longer does so.[221] While this rule was intended to be taxpayer friendly, it obviously assumes that a contract right that was a permitted asset can cease to be one, and fails to deal with all of the consequences of such a transformation. Specifically, unless the contract is disposed of at the precise moment in which it changes into a non-permitted asset, it will potentially generate some income other than gain from its disposition. That income would itself be subject to the prohibited transactions tax. Further, the existence of the contract during the period between the date of its conversion and the date of disposition could raise a question regarding the qualification of the FASIT under the assets test.[222] The only sensible way to address these concerns is

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erty) is not a prohibited transaction. There is no comparable exception for REMICs, but it is likely that income from the waiver of a term of a debt instrument would not be considered income from services even without this clarification. For a discussion of the treatment of consent fees under general tax principles, see Chapter 13, Part D.3.c.

220 For a comment letter asking for help through regulations, see footnote 109, above.

221 Section 860L(e)(3)(D). The rule also applies to guarantees and other credit enhancement contracts and to contract rights to acquire qualifying hedge or guarantee contracts.

222 In many cases, the answer to this point will be that the FASIT does not have a material tax basis in the contract, so that its existence ought not to matter under any assets test rule that looks to tax basis. See footnote 107, above. It

through a regulation that allows a FASIT to continue to treat a hedge instrument that was a permitted asset as a permitted asset if it is disposed of within some commercially reasonable time after the FASIT determines that it is no longer needed for its original purpose.[223] Presumably, that was the intention of the drafters of the FASIT statute even if it was not clearly expressed.

3. Dispositions (Including Modifications)

A FASIT is not supposed to be a trading vehicle. Consequently, sales or other dispositions[224] of assets at a profit generally trigger a 100 percent tax on the gain. Because foreclosure property is acquired involuntarily to collect a debt rather than to produce trading gains, dispositions of foreclosure property are not considered prohibited transactions.[225]

FASITs ought to be allowed at least as much flexibility to manage assets as a REMIC, and indeed the rules that allow REMICs to dispose of qualified mortgages in certain circumstances without a prohibited transac-

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could, however, acquire a tax basis as a result of the accrual of a right to income payments.

223 If the contract were treated as a permitted asset at the time of its disposition, then gain from the disposition would be exempted from the prohibited transactions tax under the proposed rule described in the text accompanying footnote 246, below.

224 The term "disposition" is not defined. By analogy to the REMIC rules, it should not include any payment by the obligor (or other party) of a debt instrument (or other contract right) held by a FASIT. See Chapter 6, footnote 180 and accompanying text. The Code does not state explicitly that a distribution of assets by the FASIT to the Owner in respect of the ownership interest would be a disposition (compare section 860F(c)(1) for REMICs), but that result is implied by the exception for certain distributions to reduce overcollateralization discussed in footnote 231, below. Further, the FASIT regulations would treat the deemed transfer of FASIT assets to the Owner in a liquidation as a disposition that is subject to the prohibited transactions tax. See Part I.3, below, discussing Proposed Regulation § 1.860H-3(c)(2)(ii). A distribution of property by a FASIT to the Owner would not seem to be a taxable event for income tax purposes. See footnote 354, below.

225 The prohibited transactions tax would apply to property acquired on foreclosure that was held beyond the grace period during which such property may be held, even if the property is a debt instrument that otherwise qualifies as a permitted asset. See footnote 213, above.

tions tax apply equally to FASITs (substituting permitted assets other than cash or cash equivalents for qualified mortgages).[226] Accordingly, a FASIT may dispose of debt instruments or permitted hedge contracts

- incident to the foreclosure, default or imminent default of the asset
- pursuant to the bankruptcy or insolvency of the FASIT itself
- pursuant to a qualified liquidation of the FASIT,[227] and
- to avoid a default on a regular interest of a FASIT because of a default on permitted assets (other than cash or cash equivalents) held by the FASIT.[228]

The rules interpreting these provisions in the REMIC context generally should apply as well to FASITs.[229]

There are four additional circumstances in which a FASIT may dispose of an asset without tax. They relate to: distributions of debt instruments back to the Owner to reduce over-collateralization, substitutions of debt instruments, dispositions to liquidate a class of regular interests, and dispositions of permitted hedges. As noted above, there is also a special

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226 See the cross-references in section 860L(e)(3)(A) (the four bullet points which follow are based on clauses (ii), (iii) and (iv) of section 860F(a)(2)(A) and section 860F(a)(5)).

227 There is no separate definition of this term for FASITs, so the REMIC definition described in Chapter 6, text accompanying footnote 31 would apply. The legislative history states that the prohibited transactions tax does not apply to a disposition "arising from complete liquidation of a class of regular interests (i.e., a qualified liquidation) [as defined using the REMIC definition in section 860F(a)(4)]." 1996 Senate Report at 130; 1996 Blue Book at 263. In fact, a qualified liquidation is a liquidation of the REMIC as a whole, and not of a class of regular interests. The statute is clear on the point, so the legislative history is simply a mistake.

228 Section 860F(a)(5) (which is referred to in section 860L(e)(3)(A)(ii)) also has an exception for dispositions to facilitate a "clean-up call," which is the retirement of a class of regular interests that occurs when the class is so small that it is an administrative inconvenience to continue servicing the class. The exception for clean-up calls is effectively supplanted by the FASIT rule discussed in footnote 240, below, and accompanying text allowing dispositions in connection with any retirement in full of a class of regular interests.

229 For a discussion of the REMIC rules, see Chapter 6, Part C.1.

rule allowing dispositions of contracts that used to be permitted hedges but no longer are.[230]

Regarding over-collateralization, a FASIT may distribute a debt instrument contributed by the Owner back to that Owner in order to reduce over-collateralization, so long as the distribution satisfies a purpose test described below.[231] This exception is quite narrow because it applies only to debt instruments distributed back to the contributing Owner. Thus, debt instruments representing reinvestments of contributed assets, debt instruments contributed by a person related to the Owner, debt instruments contributed by a predecessor Owner, or debt instruments sold (but not contributed) to the FASIT, would not seem to qualify. There is no requirement that a FASIT dispose of such excess assets, but it can do so if the Owner so desires.[232] An Owner may wish to withdraw assets from a FASIT not only to be able to use them elsewhere, but also to reduce the income from the FASIT that cannot be offset with non-FASIT losses.

The relief from the prohibited transactions tax applies to a disposition of a debt instrument through a distribution to the Owner "only if a principal purpose of acquiring the debt instrument which is disposed of was not the recognition of gain (or the reduction of a loss) as a result of an increase in the market value of the debt instrument after its acquisition by the FASIT." This language is ambiguous. It is not clear whether the test looks to the reason why the FASIT acquired the asset or rather the reason why the Owner acquired the asset in the distribution. It should be read the first way, for two reasons. First, under that view, the test makes some sense as a policy matter. The key issue should be whether the FASIT acquired the asset for trading purposes or instead to support the FASIT regular interests. If it was acquired to trade, then the motive for the acquisition would be to take advantages of increases in the instrument's market value while it was held by the FASIT. By contrast, the second reading makes little policy sense. Why would an Owner acquire an asset so that it could trigger an unrealized gain (and accelerate income)?[233] A second reason supporting this reading is

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230 See footnote 221, above.

231 Section 860L(e)(3)(B)(ii).

232 By contrast, the REMIC definition of qualified reserve asset requires a reserve fund to be appropriately reduced as payments of qualified mortgages are received. See section 860G(a)(7)(A), discussed in Chapter 6, Part B.2.b.(ii).

233 The reason given in the preamble to the FASIT regulations (see footnote 237, below) is not convincing.

the use of the word "was" rather than "is" in referring to the reason for the acquisition of the debt instrument.[234] It implies that the acquisition was a prior event.

The legislative history paraphrases the principal purpose test in a manner that supports the second interpretation,[235] and the FASIT regulations follow suit. While the legislative history would normally be controlling where a statute is ambiguous, the legislative history of the FASIT rules generally reflects less care and thought than committee reports accompanying other tax legislation.[236] Also, the committee report does not address the point directly but only by the way in which it paraphrases the rule. Further, the FASIT regulations follow a winding path to find a reason why an Owner would want to trigger the recognition of a gain.[237] While it is

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234 Presumably, the drafters knew what "was" meant.

235 1996 Senate Report at 130; 1996 Blue Book at 263: "A permitted disposition is any disposition of any permitted asset…in order to reduce over-collateralization where a principal purpose of the disposition was not to avoid recognition of gain arising from an increase in its market value after its acquisition by the FASIT." Just to give some indication of how loose the drafting of the legislative history is, the legislative history describes the purpose test as applying to the reduction in over-collateralization but not to loan substitutions, even though section 860L(e)(3)(B) clearly applies the test to both.

236 Witness the clear error discussed in footnote 227, above.

237 The preamble expresses a concern that an Owner would want to trigger a gain to take advantage of a character mismatch. 2000-1 C.B. 687. Specifically, the Owner would seek to treat gain from a disposition of debt instruments as capital and at the same time terminate a hedge of those instruments to generate an ordinary loss. There are three problems with this reasoning. First, a termination of a hedge contract would usually produce a capital loss. The only reason why it would be ordinary is a special rule in the FASIT regulations, discussed below at footnote 351, which treats all hedge gains and losses recognized by a FASIT as ordinary. There is no hint of this rule in the FASIT statute or legislative history. Accordingly, it is not persuasive to argue that the principal purpose test in section 860L(e)(3)(B) was included in SBJPA 1996 to prevent taxpayers from taking advantage of it. Second, the principal purpose rule says nothing about the character of recognized gains, and certainly makes no reference to hedges. Third, the principal purpose test applies equally to substitutions and there is no requirement that the Owner participate in substitutions. The FASIT regulations would seek to prevent Owners from taking advantage of the character mismatch that the regulations create by

understandable that the regulation drafters would defer to the legislative history where the statute is ambiguous, this is a case where they should simply acknowledge that the statute means something other than what the legislative history implies.

Another exception to the prohibited transactions tax allows a FASIT to substitute one debt instrument for another, again subject to the limitation that a principal purpose of acquiring the debt instrument given up by the FASIT not be recognizing gain for the period in which it was held by the FASIT.[238] There is no requirement that the substitution be effected by the Owner or a related party. Further the debt instruments need not be similar, although presumably they would have to have equivalent values. Otherwise, the exchange would involve some transaction other than a substitution, such as a sale, purchase or contribution of assets. The FASIT substitution rule is substantially more liberal than its REMIC counterpart.[239]

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automatically treating the principal purpose test as being met (i.e., imposing the prohibited transaction tax) if the Owner realizes a gain on the disposition of the instrument within 180 days after its acquisition (whether or not the gain is recognized). Proposed Regulation § 1.860L-1(c). The underlying assumption here seems to be that the withdrawal of the debt instruments from the FASIT is not a taxable event (a point that is not very clear), so that the gain realized within the 180-day period would be attributable mostly to the gain earned while the debt instrument was held by the FASIT. (The regulations would not distinguish between gain accruing in the FASIT and gain from later appreciation.) Thus, under the regulations, if a FASIT sponsor contributed debt instruments to a FASIT to support regular interests, withdrew them from the FASIT as the regular interests are paid off, and sold them as they were withdrawn, all gain from the disposition would be subject to the 100 percent tax. Hopefully, this result will be reconsidered before the regulations are finalized.

238 The purpose test should look to the reasons why the FASIT acquired the debt instrument rather than the reasons for the substitution, but the legislative history and FASIT regulations cloud the point. See footnote 235, above. Indeed, the thought that the test was aimed at preventing the manipulation of the character of gain on the disposition of a debt instrument is particularly odd given that the substitution of debt instruments need not involve the Owner at all.

239 REMICs are allowed a free right of substitution only during the three months following the startup day. Thereafter and until the second anniversary of the startup day, they can exchange qualified mortgages only if they are "defective." For a discussion of loan substitutions by REMICs, see Chapter 6, Part B.2.a.(iv).

The last exception to the prohibited transaction rules warranting special mention may be the most significant. It allows a FASIT to dispose of assets in order to completely liquidate[240] a class of regular interests.[241] There is no requirement (as there is for REMICs) that the class be reduced in size to the point where the retirement can be described as a "clean-up call."[242] Accordingly, it should apply where the FASIT wishes to retire a class to refinance at a lower rate or to gain some other financial advantage or to accommodate regular interest holders. The ability of a FASIT to retain a right to call classes early will depend significantly on whether final FASIT regulations allow the payment of call premiums.[243] It is curious that the rule allows the complete liquidation of a class but not a partial liquidation. A rule that allowed a FASIT to dispose of assets only to pay down outstanding regular interests would hardly allow active trading. The rule as written could encourage the division of regular interests into smaller, separately tradeable classes to allow greater flexibility in retiring them.[244]

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240 As described in footnote 227, above, the legislative history confuses retirements of individual classes of regular interests with qualified liquidations, which involve a liquidation of the entire FASIT. The statutory language, however, clearly allows the retirement in full of a class of regular interests that is not part of a larger liquidation of the FASIT.

241 Section 860L(e)(3)(C). This provision states that paragraph (2)(B) (which defines a prohibited transaction to include the disposition of permitted assets) "shall not apply to the complete liquidation of any class of regular interests." This language is odd because the retirement of a class of regular interests is not itself a disposition of assets (unless perhaps a class of regular interests is disposed of through an in-kind distribution in retirement of a class, which would be quite rare). Presumably what was intended was to cover dispositions that are made to generate the cash needed to effect the retirement. Compare section 860F(a)(5) (prohibited transaction does not include any disposition "to facilitate a clean-up call"). The legislative history (quoted at footnote 227, above) speaks of dispositions of permitted assets "arising from" complete liquidations.

242 For a discussion of the REMIC prohibited transaction tax exception for clean-up calls, see Chapter 6, Part C.1.

243 See text at footnote 62, above.

244 There would be nothing abusive about this practice. As just noted, it is difficult to see why only complete liquidations are allowed.

The prohibited transactions tax generally applies to all income from assets that are not permitted assets (including gains from dispositions) and (with the exceptions noted above) to gain from dispositions of permitted assets. In a case where a hedge contract that was a permitted asset ceases to be one because it no longer is reasonably required to hedge FASIT interests, a special rule, described in Part E.2, above, permits the asset to be disposed of without triggering the prohibited transactions tax. On the other hand, dispositions of hedge contracts that are permitted assets would potentially be subject to the tax unless the disposition was default related. Following the REMIC analogy for prepayments of mortgages, however, the termination of a hedge agreement through the settlement of the contract with the counterparty should not be considered a "disposition" of the contract for purposes of the prohibited transactions tax.[245]

The FASIT regulations would provide a helpful rule exempting from the prohibited transactions tax any gain from the disposition of any hedge contract or guarantee that is a permitted asset.[246] As a result, gain from the disposition of any such contract that was a permitted asset would not be subject to the prohibited transactions tax, regardless of whether the contract continued to be a permitted asset at the time of disposition.

A FASIT may be authorized under its governing documents to modify a loan (subject to the loan origination issue discussed in the next section) in a non-default setting. If the modification is considered a significant one that causes a deemed exchange of the modified loan for the original one, there are three possible grounds why any resulting gain should not be subject to the prohibited transactions tax. First, the exchange should be eligible for the exemption for loan substitutions. Second, the modification may not be considered a "disposition" of the modified loan, on the ground that the borrower has simply paid off the old loan with a new one (and pay-

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245 The retirement by the obligor of a qualified mortgage held by a REMIC is not considered a disposition of the mortgage. See footnote 224, above. The same rule should apply to any type of settlement of a hedge or guarantee contract in which the contract is cancelled. It might be argued that the rule should not apply to a settlement that occurs through exercise of a termination option by the FASIT, but no similar distinction between holder and issuer options is made for REMICs. Furthermore, the requirement that a hedge contract be held primarily to reduce risks relating to FASIT interests ensures that such a contract cannot be used to earn trading profits.

246 Proposed Regulation § 1.860L-1(d).

ments by obligors are not considered dispositions).[247] Finally, while not clear, there may also not be any gain.[248]

Aside from the prohibited transactions tax on gain from a disposition of the original loan, loan modifications raise questions under the loan origination ban discussed in the next section and, where the stated rate of interest on the modified loan exceeds 120 percent of the AFR, under the rule described in Part G.2, below, that attributes to the Owner gain with respect to debt instruments acquired by a FASIT calculated assuming a 120 percent of AFR discount rate.

4. Loan Originations

a. Overview.

The receipt of income derived from any "loan originated by" a FASIT is considered a prohibited transaction. The reason for this rule is straightforward: a FASIT is not itself supposed to be engaged in an active financial business that competes with banks or finance companies. Both financial businesses and investors may hold loans to earn the income therefrom. As discussed elsewhere in this book, a key distinction between them is that a financial business provides a service to customers by making loans on demand, whereas an investor lends money not to accommodate borrowers but

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247 See footnote 224, above.

248 A debt instrument that is deemed exchanged for a new debt instrument is usually considered to be repaid at its principal amount. See Treasury Regulation § 1.1001-1(g) (amount realized on exchange of property for debt is issue price of debt) and sections 1274 and 1273(b)(4) (issue price of debt issued in exchange for property, where neither the debt nor the property is a debt instrument traded on an established securities exchange, equals the principal amount of the debt instrument, assuming the instrument provides for stated interest at a rate at least equal to the AFR). Accordingly, any gain attributable to the repayment would be attributable to any unaccrued discount on the original loan. To the extent accruals of discount on loans held by a FASIT are computed under section 1272(a)(6), all remaining discount on a prepaid loan would be included in income as additional interest during the accrual period in which the loan is prepaid. Accordingly, there should be no gain on disposition of the original loan that would be subject to the prohibited transactions tax. For a discussion of whether section 1272(a)(6) applies, see footnote 347, below.

to earn the best possible return on its capital.[249] While the drafters of the FASIT statute and legislative history did not explain the intended meaning of "origination," presumably it was intended to refer to the kind of customer-based lending activity that distinguishes a bank or finance company from an investor.

One obvious consequence of the FASIT loan origination rule is that a FASIT cannot seek customers through its own merchandising efforts. That limitation is not very important. FASITs are securitization vehicles. For purely commercial reasons, issuers of asset-backed securities tend to be bankruptcy-remote entities that are not allowed to engage in any active businesses. Specifically, they do not have any direct dealings with customers, either in originating loans or administering them. Thus, the key issue in applying the loan origination test is the degree to which origination activities undertaken by non-FASIT parties with a view to sale of the resulting receivables to a FASIT will be attributed to the FASIT.

Where a securitization involves a fixed pool of receivables, the pool is generally fully funded before the securitization vehicle is formed, and for that reason alone, it would be unreasonable to attribute origination activities to the vehicle. FASITs, however, are tailored for revolving pools of receivables. Revolving pools typically involve ongoing origination activity that will overlap in time with the existence of the FASIT. As a result, there is some tension between the prohibition against loan originations and the basic purpose of the FASIT legislation. The best way to reconcile the two is to conclude that the drafters intended to prevent a FASIT as such from engaging in loan originations, but understood that others would be able to originate loans on the FASIT's behalf.

FASITs are supposed to be useable in the securitization of credit card receivables. Accordingly, some useful information about the scope of the origination rule can be gleaned from an examination of the "origination" activities surrounding a typical credit card securitization trust.[250] Such a

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249 The financial business/investment distinction is critical in applying the passive income test applicable to publicly traded partnerships, and is discussed in that context in Chapter 4, Part F.3.b. It also affects offshore issuers of asset-backed securities. As discussed in Chapter 13, Part D.3.b, the statutory safe-harbor rule that allows foreign corporations to trade in securities in the United States without being considered to engage in a U.S. trade or business does not apply to a loan origination business.

250 Such a trust is described in Chapter 3, Part E.4 (see Example 5).

trust is typically assigned both existing receivables, and future receivables as they come into existence through use of the card, relating to particular card member accounts. The owner and originator of the accounts is generally the sponsor of the trust and services the receivables during the trust's life (directly or through affiliates). Based on the credit card model, then, it can be concluded that a FASIT will not be considered the originator of a loan merely because any or all of the following factors are present:

- the FASIT is the first owner of the loan and the party that advances funds to the borrower
- the FASIT is committed in advance to fund receivables as they are created
- the originator of the receivables (or perhaps more accurately of the account) is the Owner or a related party, and
- the receivables are generated on an ongoing basis as part of an active financial business carried on by their originator.

These conclusions make sense only if a sharp distinction is drawn between activities undertaken by the FASIT directly and the activities of others, including the Owner or its affiliates.[251] As described below, the FASIT regulations include presumptions based on this approach.

b. FASIT Regulations. The FASIT regulations include a number of presumptions that add some content to the meaning of origination.[252] The presumptions turn largely on whether a FASIT acts through a person who we will refer to as an *Active Originator*. An Active Originator is defined, with respect to any loans, as a person (including the Owner or a related person) that regularly originates similar loans (such as through a standardized contract) in the ordinary course of its business.[253]

251 The ban on originations applies technically only to originations of "loans." It could be argued that credit card receivables are not "loans," but such an argument would be difficult to sustain. The card sponsor is certainly advancing money either to or on behalf of card users.

252 Proposed Regulation § 1.860L-1(a).

253 Proposed Regulation § 1.860L-1(a)(2)(iii). One question raised by this definition is whether a person who originates loans solely for sale to a FASIT could meet the ordinary course of business standard. As a policy matter, the answer should be "yes." Otherwise, an originator could not use FASITs to

The substantive rules begin with the statement that whether a FASIT originates a loan depends on all the "facts and circumstances."[254] A FASIT is considered to have originated a loan if it engages in or facilitates certain listed activities that are commonly undertaken in connection with the origination of a loan, unless it engages in those activities through an Active Originator.[255] This regulation would seem to allow a FASIT to have an agreement with the Active Originator to buy loans as they are originated (including being the party providing the funding), as long as the origination activity is undertaken by the Active Originator.[256] A FASIT may also buy loans on an ongoing basis without being involved (directly or through agents) in origination activities. That case is covered by a separate rule under which a FASIT is considered not to have originated a loan if it acquires it from an Active Originator.[257]

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securitize all of the loans that it originates, which would be an odd result. Also, the key issue should be how responsibilities are divided up between the FASIT and the originator, not whether the originator is originating loans for other parties.

254 Proposed Regulation § 1.860L-1(a)(1).

255 Proposed Regulation § 1.860L-1(a)(3). The activities are: soliciting the loan, including advertising to solicit borrowers, accepting the loan application, or generally making any offer to lend funds to any person; evaluating an applicant's financial condition; negotiating or establishing any terms of the loan; preparing or processing any document related to negotiating or entering into the loan; or closing the loan transaction. Presumably the reference to evaluating an applicant's financial condition would not include evaluating a borrower's financial condition after the loan has been closed by the originator (and prior to its sale to the FASIT). At least in the absence of third-party credit support, no one would buy an outstanding loan without looking into the borrower's financial condition.

256 The treatment of contracts to acquire assets as permitted assets is discussed in Part D.2.e, above.

257 Proposed Regulation § 1.860L-1(a)(2)(iii). The regulations are inconsistent in a number of places in describing rules as presumptions or as operative rules. For example, the language of the rule under discussion bespeaks an operative rule (FASIT "is considered not to have originated a loan"), but the heading describes it as a presumption. To the extent the rule is a presumption only, it is not clear what the Service could do to rebut it. Hopefully the language will be cleared up in the final regulations. The regulations do not specifically ad-

A FASIT may wish to be a party to loan agreements or other contracts that commit the FASIT to make a new loan to the same borrower, or further advances under a loan facility. In such a case, the FASIT will be obligated to advance funds directly to the borrower. The FASIT regulations allow this type of revolving loan arrangement so long as the FASIT itself did not play an active role in creating the contract under which the advance is made.[258] Specifically,

- a FASIT is presumed to have originated a debt instrument issued under a contract or agreement in the nature of a line of credit if and only if it originated the contract
- a FASIT is presumed not to have originated such a contract if it acquired it from a person (including the Owner or a related person) that regularly originates similar contracts in the ordinary course of its business (a variation on the definition of Active Originator that focuses on the origination of contracts), and
- if a FASIT assumed the role of a lender under a contract not originated by such a person, then the FASIT is considered to originate the contract if it engaged in any of the listed origination activities referred to above[259] with respect to the contract.

Another case in which a FASIT would be the first holder of a loan is one where a loan held by the FASIT is significantly modified, with the result that the FASIT is deemed to exchange the unmodified loan for a new one. The FASIT regulations confirm that a FASIT is not treated as originating a new loan that it receives from the same obligor in the context of a workout.[260] It is not as clear whether a FASIT would be considered to originate a loan that was deemed to be acquired through a modification that is not default related.[261]

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dress indirect acquisitions of loans through bankruptcy-remote affiliates. The use of such intermediaries may be useful for commercial reasons.

258 See Proposed Regulation § 1.860L-1(b).

259 See footnote 255.

260 Proposed Regulation § 1.860L-1(a)(4).

261 In a case where all activities relating to the modification are carried out by a loan servicer acting in the ordinary course of its business, it would seem that by analogy to the Active Originator exception described above in the text, the servicer's actions should not be attributed to the FASIT. For a comment letter

The FASIT regulations include two other presumptions covering obvious cases. A FASIT is considered not to have originated a loan acquired from an established securities market or at a time that is more than 12 months after its issue date.[262]

F. Taxation of Holders of Regular Interests

1. Overview

A holder of a FASIT regular interest (including a high-yield interest) is treated as holding a debt instrument for all federal income tax purposes.[263] Accordingly, general tax rules applicable to holders of debt instruments apply, except that income must always be accounted for under an accrual method.[264] OID on regular interests in REMICs is always accounted for under the prepayment assumption catch-up, or PAC, method set forth in section 1272(a)(6).[265] There is no comparable rule for FASIT regular interests. Accordingly, the PAC method would seem to apply only if the regular interest can be described as a debt instrument, payments under which "may be accelerated by reason of prepayments of other obligations securing such debt instrument."[266] Many FASIT regular interests (specifically those in the form of trust interests) would not meet this definition simply because they are not secured. At any rate, it makes some sense to apply the PAC method to FASIT regular interests selectively because the ability of a FASIT to hold revolving pools of assets may separate the timing of payments on receivables from the timing of payments on regular interests sufficiently so that a special regime to account for prepayments is not needed. The FASIT regulations muddle the question considerably by treating FASIT regular

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asking that this point be clarified, see letter to the Service from the Bond Market Association referred to in footnote 6, above.

262 Proposed Regulation §§ 1.860L-1(a)(2)(i) (rule for established securities market defines the term by reference to Treasury Regulation § 1.1273-2(f)(2), (3) or (4) dealing with, among other things, exchanges, interdealer quotation systems, and quotation systems that provide actual price quotations or prices of recent sales) and (ii) (12-month rule).

263 Section 860H(c)(1).

264 Section 860H(c)(3).

265 That method is described in Chapter 8, Part C.4.

266 Section 1272(a)(6)(C)(ii).

interests as instruments subject to section 1272(a)(6) for information reporting purposes but not for substantive tax purposes.[267]

The Code has asset tests applicable to REITs and domestic building and loan associations that require a minimum percentage of their assets to be, alone or in combination with other permitted assets, real estate mortgages. For this purpose, a look-through rule applies to FASIT regular interests. Specifically, they are treated as qualifying assets in the same proportion as the assets of the FASIT, except that nonqualifying assets of 5 percent or less are ignored.[268] A similar rule treats a FASIT regular interest as a qualified mortgage that can be held by a REMIC, but only if at all times at least 95 percent by value of the FASIT's assets are attributable to obligations principally secured by an interest in real property.[269] FASIT regular interests (including high-yield interests) are permitted assets in the hands of other FASITs.[270] A FASIT regular interest is treated as a debt in-

267 See Proposed Regulation §§ 1.860H-6(e)(4) (Owner annual statement must set forth prepayment and reinvestment assumptions used under section 1272(a)(6) if any regular interests are issued during the year) and (f)(3) (for purposes of subtitle F (procedure and administration) regular interests are treated as collateralized debt obligations within the meaning of Treasury Regulation § 1.6049-7(d)(2)). This reference has the effect of applying to FASIT regular interests the information reporting rules that apply to debt instruments that are subject to section 1272(a)(6). It seems odd to apply those rules to all such instruments when many will not in fact be subject to section 1272(a)(6).

268 See sections 856(c)(5)(E) (last sentence) (REITs) and 7701(a)(19)(C)(xi). For a discussion of similar rules providing look-through treatment for REMIC regular interests, see Chapter 11, footnote 25 and accompanying text.

269 Section 860G(a)(3)(D). Because the test is measured by value and must be satisfied continuously, it will be difficult to rely on this rule with respect to any FASIT that has any material non-mortgage assets such as hedges. It is not clear whether the "attributable to" language would extend to a case in which a FASIT owns REMIC regular interests rather than direct interests in mortgages. As a policy matter at least, it is difficult to see why a distinction should be drawn between mortgages and REMIC regular interests representing interests in mortgages. The REMIC definition of qualified mortgage is discussed generally in Chapter 6, Part B.2.a.

270 See section 860L(c)(F), discussed in Part D.2, above. For a special rule allowing a FASIT to own a FASIT regular interest in a related FASIT, see footnote 159, above.

strument for purposes of section 582(c), so that a bank or thrift's sale of a regular interest generates ordinary income or loss.[271]

For certain Code purposes it is important in determining the tax treatment of the holder of a debt instrument to be able to identify (or at least determine the tax status) of the issuer. Where relevant, is the issuer the FASIT itself, or the Owner? As a general matter, the issuer should be considered the Owner. In determining the substantive income tax treatment of the Owner, the Code treats assets and liabilities of the FASIT (including regular interest) as assets and liabilities of the Owner.[272] If regular interests are debt of the Owner in determining the tax treatment of the Owner, it is hard to avoid the same conclusion from the perspective of holders. The legislative history confirms this view.[273]

2. High-Yield Interests

Income on high-yield interests is supposed to bear the corporate income tax. To that end, the statute

- prevents holders from offsetting income with non-FASIT losses,

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271 Section 582(c)(1). This provision is discussed in Chapter 11, Part E.

272 See section 860H(b)(1), discussed at footnote 343, below.

273 1996 Conference Report at 324; 1996 Blue Book at 262-263: "A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner." Regarding the substantive tax provisions mentioned in the quotation, although there are a number of related party rules in the Code, many of them are based on the existence of a relationship described in section 267(b). A corporation may be considered related to another person under the definition. FASITs are not separately listed. Section 871(h) is the portfolio interest exemption, which is described in Chapter 12, Part C.2 and Chapter 13, Part E. The exemption does not apply to interest paid by a corporation to a 10-percent or greater shareholder. In the case of a "security" defined in section 165(g)(2)(C) and with an exception for holders that are banks, deductions are allowed for bad debts only when the security becomes wholly worthless, and then only as a capital loss. A security is defined to include a debt instrument issued by a corporation in registered form.

- effectively limits holders to eligible corporations or FASITs by refusing to give effect to transfers to other categories of holders (subject to a dealer exception), and
- imposes on certain pass-thru entities[274] that are used to create high-yield securities a tax in lieu of the tax that otherwise would apply to the holder of a high-yield interest.

These measures are discussed in the next three sections.

a. Limitation on Use of Non-FASIT Losses. The taxable income of the holder of an ownership interest or any high-yield interest in a FASIT for any taxable year may not be less than the sum of (1) such holder's taxable income determined solely with respect to such interests (including gains or losses from sales and exchanges of such interests), and (2) excess inclusions from the holding of REMIC residual interests.[275] A similar rule applies for purposes of the alternative minimum tax.[276] Appropriate adjustments are made to net operating loss carryovers to reflect the fact that losses may not be useable because of the minimum income requirement.[277] For purposes of these rules, members of an affiliated group that files a consolidated return are treated as a single taxpayer.[278] Thus, losses of one group member cannot be offset against income of another member from FASIT ownership interests or high-yield interests. By contrast with the treatment of REMIC residual interests, the prohibition against offsetting losses applies to all income from ownership interests and high-yield interests, not just to a portion of the income that is considered noneconomic income. There are no restrictions on offsetting taxes with credits.

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274 This spelling is used in the Code, perhaps to shorten it.

275 Section 860J(a). Excess inclusions are defined in section 860E(c). See Chapter 9, Part E.4.

276 Section 860J(c). The rule parallels the REMIC rule discussed in Chapter 9. Curiously, the FASIT AMT rule, unlike the rule for the regular tax, takes account only of income from FASIT interests and not REMIC excess inclusions. Presumably, this was a mistake.

277 Section 860J(b). The parallel REMIC rule is described in Chapter 9, Part E.4.a.

278 Section 860J(d).

The floor on taxable income clearly aggregates all income and losses from the ownership interests and high-yield interests issued by a single FASIT. As a result, a loss from one such interest could be offset against income from another.[279] While the statutory language is ambiguous, it should be interpreted to aggregate losses and income from interests in different FASITs.[280]

As described in Part G.2.a, below, the FASIT regulations would extend the minimum income test to gain realized upon a transfer of property to a FASIT by the Owner, and as an ancillary measure, to gain on property transferred by related persons who own no interests in the FASIT.

b. Transfers to Disqualified Holders. The FASIT statute does not directly prohibit any investors from holding a high-yield interest. It effectively does so, however, by providing that if a high-yield interest is held by a "disqualified holder" (person other than an eligible corporation or a FASIT), then gross income of such holder does not include income (other than gain) attributable to the high-yield interest, and the excluded amount is included (at the time when it otherwise would be taxable to the actual holder) in the gross income of the most recent holder of such interest that is not a disqualified holder.[281] This scheme assumes that there is a prior holder other than a disqualified one. The legislative history takes the view

279 Income or losses from regular interests that are not high-yield interests would not count.

280 The statute refers to the ownership interest or any high-yield interest in "a FASIT," and then requires the aggregation of income or losses from "such interests." The better reading of the language is that it refers to ownership interests or high-yield interests in all FASITs held by the taxpayer. Any other reading would produce unreasonable results. Thus, if the section applied separately to individual FASITs, a taxpayer that earned income of 100 from each of two FASITs would need to have taxable income of only 100 rather than 200, which cannot have been intended. Proposed Regulation § 1.860J-1(b) allows a person to aggregate the net income (or loss) from all FASITs in which the person holds the ownership interest. While this rule could be read to mean that aggregation is not allowed when a taxpayer holds a high-yield interest in one FASIT and an ownership interest in another, it is doubtful that was intended.

281 Section 860K(a)(1).

that a high-yield interest that is issued directly to a disqualified holder is not considered to be issued.[282]

A transferor that is an eligible corporation or FASIT can protect itself against an unexpected allocation of income from the transferee of a high-yield interest by obtaining an affidavit from the transferee confirming that it is not a disqualified holder, provided that, at the time of the transfer, the transferor does not have actual knowledge that the affidavit is false.[283]

The deemed income provision raises a number of questions. One obvious one is what happens when the last owner that was a qualified holder ceases to exist or changes its status so that it is no longer taxable? Suppose a corporation holding a high-yield interest liquidates, distributing its assets to its individual shareholders. Could the shareholders take the view that they are not taxable on the income from the high-yield interest because they are disqualified holders, even though (presumably) no tax would be due by

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282 1996 Senate Report at 131, note 85; 1996 Blue Book 264, note 194. The REMIC rules treat all REMIC interests as being issued initially to the sponsor, and then transferred by it to whomever is the actual first owner if not the sponsor. The sponsor is defined for this purpose as the person transferring mortgages to the REMIC. REMICs are not allowed to issue residual interests to disqualified organizations (generally governments), so that a technical issue would arise if such an organization were a sponsor even if it was not the first real holder of the residual interest. The REMIC regulations solve this problem by allowing transitory ownership of residual interests by a disqualified organization. See Treasury Regulation § 1.860E-2(a)(2), discussed in Chapter 6, Part B.3. There appears to be no similar rule that deems FASIT regular interests to be issued initially to a transferor of receivables, so the same question would not arise for FASITs having such a transferor that is not an eligible corporation.

283 See section 860K(b), which applies rules similar to paragraphs (4) and (7) of section 860E(e) to transfers of high-yield interests. Section 860E(e) imposes an excise tax on transfers of REMIC residual interests to disqualified organizations. Paragraph (4) is the affidavit rule described in the text. Paragraph (7) states that the Service may waive the excise tax arising from a transfer if, within a reasonable period of time after the discovery that a transfer was subject to the excise tax, steps are taken so that the interest is no longer held by a disqualified holder and the tax due for the period so held is paid. This second rule does not seem to add much in the context of the FASIT reallocation rule, because all the reallocation rule does is shift income to the prior owner for periods during which it is held by a disqualified holder.

the corporation because it no longer exists? A similar issue would arise if a corporation holding a high-yield interest made an S election, so that it was no longer an eligible corporation. The rule attributing income to the most recent holder that is not a disqualified holder might be read to attribute income to the most recent such holder that still exists. This approach would not be effective if all prior holders had obtained affidavits upon transferring high-yield interests to the next holder.

If the most recent holder that is an eligible corporation is in existence and the rule applies to reattribute income to it, then the income would be taxable at the corporation's marginal rate. Because corporations are taxed at graduated rates beginning at 15 percent, the corporate tax bite may be less than the tax that otherwise would apply to the buyer.[284] Further, there would be no second tax when the earnings are distributed by the corporation to its shareholder, because there is no cash income to distribute. This example has very limited practical application, however, so that it should not be regarded as a meaningful hole in the statutory scheme.[285]

c. Securities Dealers. The FASIT statute allows high-yield interests to be held by a disqualified holder without a reallocation of income to a prior holder if the disqualified holder is a dealer in securities who acquired such interests exclusively for sale to customers in the ordinary course of business

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284 If the corporation is closely held, it would need to have some active business income to avoid the personal holding company tax. Section 541 imposes a 39.6 percent tax on the undistributed personal holding company income of a personal holding company. The PHC regime is described briefly in Chapter 13, Part G.2. It applies to corporations that are closely held by individuals and satisfy a passive income test. Passive income includes interest, and there would seem to be a good argument for treating income from a high-yield interest that is reallocated to a former holder as having the same character (interest) as if it were earned directly. A corporation that is allocated income from a high-yield interest but does not distribute it would have undistributed PHC income equal to the full allocated amount.

285 The example requires a C corporation engaged in some active business and having a small enough amount of income to be taxed in the lowest brackets. Small businesses are more likely to be conducted through S corporations or LLCs than C corporations. The active business requirement, the need to set up corporations and the fact that the low brackets are exhausted when income reaches $100,000 mean that it would not make sense to use the arrangement to facilitate an offering of high-yield interests.

(and not for investment).[286] If such a dealer acquires a high-yield interest with a pure heart but later either ceases to be a securities dealer or changes its mind and holds the interests as an investment, the dealer (or former dealer) becomes subject to an excise tax (which is imposed in addition to all other taxes) on income from the high-yield interest that substitutes for the corporate tax that otherwise would apply.[287]

d. Pass-thru Entities. The FASIT statute contains a provision to prevent the avoidance of the restrictions on high-yield interests through the use of pass-thru vehicles. The best way to describe the operation of the rule is with an example. Suppose that a FASIT holds 100 in receivables (by principal amount and value). It issues class A, B and C regular interests having principal amounts and initial values of 90, 3 and 3. The balance of 4 is financed through the ownership interest. Class A is senior to B, and B is senior to C, in the event of defaults on the receivables, with the result that A has a yield lower than the yield of B and B's yield is lower than that of C. To make the example more concrete, suppose that the AFR is 7 percent, and that the yields of classes A, B and C are 9, 10 and 13 percent. Based on these figures, class C is a high-yield interest (the AFR plus 5 is 12). To avoid the creation of any high-yield interest, as an alternative to the original plan, classes B and C are combined into one class (call it BC). Class BC has a yield of 11.5 (the average of the yields of B and C), so that it is not a high-yield class. Class BC is acquired by a partnership that issues two classes of interests, B* and C*, each having an initial principal amount of

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286 Section 860K(d). It is not clear what the "not held for investment" language adds. In other analogous settings, it has been read to mean "not held in a dealer capacity." See Treasury Regulation § 1.475(b)-1(a), which is discussed in Chapter 11, Part F. In other settings, a dealer is defined as one holding "primarily" for sale to customers, rather than "exclusively." It is unlikely that the change in wording would have much practical significance. Under section 860K(d)(2)(B), a dealer is not treated as holding a high-yield interest for investment before the 32d day after the date the dealer acquired the interest unless such interest is held as part of a plan to avoid the purposes of the dealer rule.

287 Section 860K(d)(2)(A). The excise tax equals the product of the highest corporate rate and the income of the dealer attributable to the high-yield interest for periods after the date the dealer ceases to be a dealer or begins to hold the interest for investment. The payment of the tax is discussed in Part I.4, below.

3. Class C* is subordinate to class B*. Classes B* and C* reproduce the original economic terms of classes B and C, so that class C* should have a yield exceeding the 12 percent cutoff. The end result is much the same as if the FASIT had issued directly a high-yield interest, and so it could be argued that as a policy matter, Class C* should be taxed as if it were a high-yield interest. The pass-thru rules achieve this result by imposing on the pass-thru entity an excise tax on income allocable to Class C*.

The more detailed terms of the pass-thru tax regime are as follows. If a pass-thru entity[288] issues a debt or equity interest that is supported by a FASIT regular interest[289] and meets the yield test described below, then the entity itself is subject to a tax,[290] in addition to other applicable taxes, unless the arrangement did not have as a principal purpose the avoidance of the high-yield interests rules. The tax equals the product of the highest corporate tax rate and the income of the holder of the pass-thru interest which is properly attributable to the FASIT regular interest.

The yield test is met if the original yield to maturity of the interest in the pass-thru entity is greater than each of (1) the sum of the AFR for the month in which the interest in the pass-thru entity is issued and 500 basis

288 A pass-thru entity for these purposes is a RIC, REIT, REMIC, common trust fund, partnership, trust, estate or cooperative defined in section 1381. Section 860K(e)(1) (referencing section 860E(e)(6)); Proposed Regulation § 1.860H-4(b)(2)(ii) (adding REMICs to definition).

289 The "support" term is not defined in this setting. For other areas where it is used, see the TMP definition referred to in footnote 378, below. See also text accompanying footnote 376, below. The requirement that the entity "issue" interests that are supported by a FASIT regular interest should mean that the entity must either own, or be expected to acquire, FASIT interests at the time when the entity issues the interests in question.

290 Curiously, the statute does not refer to the tax as an "excise" tax, although Proposed Regulation § 1.860H-4(b)(2)(i) describes it that way. Compare section 860K(d)(2) discussed in the last section which imposes a closely analogous tax on income from high-yield interests earned by dealers who are disqualified holders. The tax is described there as an excise tax. If these taxes were considered income taxes, a question could arise regarding their deductibility for purposes of the regular income tax. See section 275(a)(1), which denies a deduction for "Federal income taxes." The payment of the tax on pass-thru entities is discussed in Part I.4, below.

points[291] and (2) the yield to maturity of the FASIT regular interest to the pass-thru entity, determined as of the date the entity acquired the regular interest.[292] The two-part test has the result of ensuring that the tax will not apply solely on account of changes in the AFR following the issuance of a FASIT regular interest. Thus, if a regular interest that was issued at a yield of 11.5 percent at a time when the AFR is 7 were acquired by a pass-thru entity at a yield of 11.5 when the AFR has dropped to 6 and used to support interests in the entity having a yield of 11.5, the issuance of those interests would not trigger the tax. The pass-thru entity must contribute to the creation of a high-yield interest at least to the degree of issuing an interest having a yield greater than the yield of the interest to it.

Any partnership that is established to buy FASIT interests (either alone or together with other investments) using borrowed funds runs the risk that the equity interests it issues could fail the yield test simply because of the greater risk and returns associated with common equity interests. It does not seem to matter whether the higher returns are attributable to allocations of credit risk (something that might be relevant to a debt/equity analysis at the FASIT level) or simply to interest rate risk (a bet that rates will rise increasing the value of fixed rate debt). Perhaps that would matter under the principal purpose test.

At any rate, the principal purpose test should protect established partnerships that have an ongoing business of investing, trading or dealing in securities, buy FASIT regular interests as part of that business and do not issue classes of interests that are specifically linked to the FASIT interests.[293] More broadly, it can be argued that any partnership that acquires FASIT regular interests in a secondary market transaction that is not connected with the initial offering by the FASIT should satisfy the principal purpose test.

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291 Section 860K(e)(1)(B)(i) (referencing clauses (i) and (ii) of section 163(i)(1)(B)). Applying section 163(i)(1)(B), the applicable AFR is the rate that is in effect for the calendar month in which the interest in the pass-thru entity is issued.

292 The yield to maturity of any equity interest in a pass-thru entity supported by a FASIT regular interest will be determined in accordance with FASIT regulations. Section 860K(e)(1), flush language. None have been issued.

293 If no new interests in the partnership are issued after the FASIT interests are acquired, there may be an additional reason for avoiding the tax. See footnote 289, below.

The definition of high-yield interest includes not only interests that have a yield exceeding the AFR plus 500 basis point threshold, but also interest-only interests, or more broadly interests that have an issue price greater than 125 percent of the stated principal amount. The pass-thru entity tax regime has no counterpart to this rule. Accordingly, if a trust buys a FASIT regular interest and strips it into principal-only and interest-only components, the trust should not be subject to the tax, provided neither interest meets the yield test for application of the tax.[294]

G. Taxation of Owner

1. Overview

The basic model used by the drafters of the FASIT statute in fashioning rules for taxing income from a FASIT is a borrowing by the Owner secured by FASIT assets. For income tax purposes, the FASIT is not generally considered to be an entity separate from the Owner, and the FASIT's assets and liabilities (including in particular the debt represented by the FASIT's regular interests) are attributed to the Owner. The collateralized borrowing model could accommodate multiple equity owners, but the drafters opted for simplicity by requiring that there be only one.[295]

The urge to simplify has its limits, and the FASIT rules depart from the collateralized borrowing approach in a number of respects. Contributions of assets by the Owner to a FASIT trigger full gain recognition.[296] Further, in the case of debt instruments that are not traded on an established securities exchange (which would encompass the bulk of FASIT assets in most securitizations), gain is measured based on a value calculated under a formula. The formula discounts expected cash flows using a discount rate of 120 percent of the AFR. For certain categories of assets, the discount

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294 For a letter asking the Service to clarify that stripping of FASIT regular interests is permissible, see letter to the Service from Bond Market Association referred to in footnote 6, above).

295 The legislative history indicates that the Service has authority to allow multiple owners if they join in a consolidated return, but so far it has chosen not to do so. The preamble to the FASIT regulations explains (in brief) that figuring out how to allocate tax items among members of a single consolidated group is just too complicated to allow. 2000-1 C.B. 690.

296 With limited exceptions, a pledge of collateral is not considered a taxable disposition of assets. See Chapter 3, footnote 5.

rate is below market, producing an artificially high value. The tax on contributions applies not only to contributions actually made by the Owner, but to any acquisition of assets by a FASIT. The assets are deemed for this purpose to be acquired by the Owner and contributed by it to the FASIT. Similarly, assets held outside of the FASIT that support FASIT regular interests are deemed to be contributed to the FASIT, thereby triggering tax on any gain.

Although a FASIT may be taxed like a collateralized borrowing, the ownership interest may in fact be transferable, so that the FASIT rules need to accommodate transfers from one Owner to another. Also, an Owner may engage in transactions with a FASIT other than contributing property and holding or transferring the ownership interest. For example, it may acquire regular interests, enter into hedge contracts or act as a servicer. There is a question whether those transactions are recognized for tax purposes or instead are ignored as transactions entered into between the Owner and itself.

The balance of this Part G will address the consequences for the Owner of transfers of property to a FASIT, the taxation to the Owner of income or losses from the FASIT (including a rule limiting the offsetting of income with non-FASIT losses and the integration of the FASIT rules with mark-to-market rules applicable to securities dealers), transfers of FASIT interests, and transactions between a FASIT and the Owner. The rule treating support property as contributed to a FASIT is discussed in Part H.1, below.

2. Transfers of Property to a FASIT

a. Overview. If property is transferred or sold (or deemed transferred or sold) to a FASIT by the Owner or a person related to the Owner, the Owner (or that person) is required to recognize gain equal to the excess of the value of the property determined under section 860I(d) (the *subsection (d) value*) over the property's basis.[297] The basis of the property is stepped up

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297 Sections 860I(a) and (b). The FASIT regulations would extend the rule to transfers of property by the Owner or related person to FASIT regular interest holders (a highly unlikely case) and cases in which property that was held by a FASIT as foreclosure property is held beyond the grace period. It seems odd to apply the rule to a transfer of property to a regular interest holder because such a transfer would itself be a taxable disposition that would reverse any recognized gain. See Part D.2.f, above, for a discussion of foreclosure

to reflect the gain.[298] The FASIT statute authorizes regulations deferring the recognition of gain on transfers of property to a FASIT until the date on which such property supports any regular interest in the FASIT or debt of the Owner or a related person, but the FASIT regulations as currently proposed would not include such a rule.[299] The gain recognition requirement overrides other nonrecognition rules in the Code.[300] Related parties for purposes of the gain recognition rule are defined broadly and generally include affiliates with a 20 percent ownership link to the Owner.[301] In a case where property transferred to a FASIT has previously been sold between members of a consolidated group that includes the Owner, it would seem that a transfer of the property to the FASIT should trigger any prior intercompany gains, at least to the extent they would have been recognized if the property had been transferred directly from the first group member owning the property to the FASIT.[302]

The gain recognition rule is a one-way street; there is no corresponding provision for losses, although losses may be allowed under general tax

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property. As already noted, support property (described in Part H.1, below) is deemed contributed to a FASIT. See Proposed Regulation § 1.860I-1(a)(1)

298 Section 860I(e)(2). There are no special rules for taking the higher basis into account, so normal Code rules would apply. For example, in the case of a debt instrument, the higher basis would reduce the Owner's future discount income or to the extent basis exceeds the amount payable on maturity, produce amortizable bond premium.

299 Section 860I(c). The preamble states that any gain deferral system must build on rules for accounting for pooled debt instruments. The Service and Treasury anticipate providing such rules in future guidance, and at that time expect to revisit the FASIT gain deferral rules. 2000-8 I.R.B. 690.

300 Section 860I(e).

301 See footnote 148, above, for a more extensive discussion of the related person definition.

302 The intercompany transaction rules in Treasury Regulation § 1.1502-13 are generally described in Chapter 15, Part B.3. In broad terms, they seek to place members of a group in the same aggregate tax position as if they were a single corporation. The result described in the text is consistent with that approach.

principles on sales of property by a related person (at least where the relationship involves a 50 percent or lower ownership link).[303]

The gain recognition rule also applies to acquisitions of property by a FASIT from someone other than the Owner or a related person. In that case, the property is deemed to be (1) acquired by the Owner for an amount equal to the FASIT's cost and (2) sold by the Owner to the FASIT for its subsection (d) value.[304] The effect of this construction is to require the Owner to report gain equal to the excess of the subsection (d) value over the actual cost of the property.

As discussed below, the subsection (d) value of property will in many cases exceed the fair market value of property. As a result, the gain recognition rule goes beyond a mere requirement to treat a securitization as a taxable asset sale, and effectively imposes a toll charge on the use of FASITs. The magnitude of the charge will depend on the type of asset involved (particularly its credit quality and term). The charge thus bears no particular relationship to the benefit to be derived from the FASIT election.

Use of a formula valuation is particularly difficult to justify where a loan is recently purchased in an arm's-length transaction. The FASIT regulations would take a step in the right direction by eliminating gain where a debt instrument was purchased by the Owner or a related person from an unrelated person in an arm's-length transaction shortly before it

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303 In general, a FASIT should be considered part of the Owner for purposes of analyzing whether a transfer of property to the FASIT triggers a loss under general tax principles. In a case where a related person transfers loss property to a FASIT, losses may be disallowed or deferred under section 267 or section 707(b) or under consolidated return regulations dealing with intercompany transactions (Treasury Regulation § 1.1502-13). Although section 860L(g) defines a related person in part based on a modified version of the section 267(b) or section 707(b)(1) definitions (specifically, reducing 50 percent ownership thresholds to 20 percent), the modifications apply only for purposes of the FASIT rules and should not be relevant in determining if a loss is recognized upon a transfer of property by a related person to a FASIT. The legislative history states that losses on assets contributed to a FASIT that are not recognized upon transfer to the FASIT may be allowed to the Owner upon the disposition of such assets by the FASIT. 1996 Senate Report at 131; 1996 Blue Book at 264.

304 Section 860I(a)(2).

was transferred to the FASIT.[305] As presently drafted, the exception is too narrow to be useful,[306] but it could prove to be very helpful if it is expanded in a reasonable way in final regulations.

In administering the gain recognition rule, the FASIT regulations would depart from the statute in two rather surprising ways. First, gain recognized by the Owner upon the transfer of assets to a FASIT would be treated as if it were income from the ownership interest.[307] Accordingly, that gain could not be offset with losses. Second, although the statute plainly treats any related person who transfers assets to a FASIT as the person who recognizes the resulting gain, the regulations would shift any gain attributable to the use of the subsection (d) value to the Owner so as to subject the gain to the no-offset rule.[308]

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305 Proposed Regulation § 1.860I-2(d)(3). The regulation would treat the debt instrument as having a subsection (d) value equal to the cost of the instrument to the Owner or related person.

306 Some of the problem areas are described in a letter to the Service from the Bond Market Association referred to in footnote 6, above. Three concerns are that the rule does not clearly apply to purchases of pools of loans, to purchases directly by a FASIT or to newly originated loans. Another problem is that the permitted time periods (a maximum of 15 days from the pricing of a debt instrument to the date of purchase and 15 days from purchase to contribution to a FASIT) are much too short. As discussed in footnote 331, below, where property is purchased under a fixed price contract, it would seem to make sense to require that the property be priced within 15 days of the contract date, not the date of purchase.

307 Proposed Regulation § 1.860J-1(a). Under section 860J(a), the no-offset rule applies to income with respect to FASIT interests (including gains and losses from sales or exchanges of such interests). It is quite remarkable to conclude that gain recognized upon the transfer of property to a FASIT is income with respect to a FASIT interest. The legislative history paraphrases the rule as one that applies to "taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT)." 1996 Blue Book at 264. The reading is particularly odd when applied to gain that would normally be recognized by a related person who may hold no interests in a FASIT.

308 Proposed Regulation § 1.860I-1(g) (except for property traded on an established securities market, if a related person transfers property to a FASIT or its regular interest holders, then for purposes of the gain recognition rule, the related person is deemed to transfer the property to the Owner for the property's actual fair market value and the Owner is then treated as transferring the

The next sections will address the subsection (d) value, the treatment of contracts relating to FASIT assets, loan modifications and the application of the value rule to securitization vehicles that were already in existence on August 31, 1997.

b. Subsection (d) Value. Normally gain in a taxable disposition of property is based on the fair market value of the property. The subsection (d) value of property is fair market value, with one important exception. The value of debt instruments that are not traded on an established securities market equals the sum of the present values of "reasonably expected payments" on the debt instruments, determined using a discount rate equal to (1) 120 percent the AFR or (2) such other method as may be specified in regulations (of which there are none).[309]

For purposes of determining the value of a pool of revolving loan accounts, each extension of credit is treated as a new loan (in other words, the repayment of an outstanding balance and a new draw are treated as two separate loans rather than one continuing loan), and principal payments on a pool of revolving loan accounts having substantially the same terms are applied on a first-in, first-out basis. Thus, for example, if the weighted average life of individual extensions of credit in a pool of credit card receivables (giving effect to a reasonable prepayment assumption) is six month,

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property to the Owner for its subsection (d) value). By contrast, section 860I(a)(1) states that if property is sold or contributed to a FASIT by "the holder of the ownership interest in such FASIT (or by a related person) gain (if any) shall be recognized to such holder (or person)…." There is parallel language in the support property rule in section 860I(b)(1). The FASIT bill as passed by the Senate omitted the "(or person)" phrase in section 860I(b)(1), and it was added in conference to make it clear that gain on support property held by a related person would be taxable to that person and not to the Owner. See 1996 Conference Report at 328: "The conference agreement makes a technical modification to the rule which deems gain to be recognized on assets held by the owner of the FASIT or a related person that support any regular interest of the FASIT to clarify that the gain will be deemed realized to the related person when the assets which support a regular interest in the FASIT is held by that related person."

309 Section 860I(d)(1)(A). The discount rate is applied using semiannual compounding.

the 120 percent of AFR discount rate would be applied only to the six-month period, not to the anticipated life of the credit card accounts.

The main problem with the formula valuation method is that the 120 percent of AFR discount rate is significantly below a market rate for many of the categories of receivables that might be securitized through a FASIT. Accordingly, the valuation method effectively accelerates future income from receivables into the year in which they are contributed to a FASIT, increasing the cost of the FASIT election. There is some debate about whether the formula method was adopted as a rule of administrative convenience for cases in which receivables were in fact difficult to value, or rather as a means of deliberately inflating gains so that the proposed FASIT legislation could be scored as a revenue raiser.[310] As a tax policy matter, the formula approach makes sense only as a rule of convenience.

The next three sections discuss when debt instruments are "traded on an established securities market," the determination of "reasonably expected payments" and the calculation of the discount rate.

(i) Traded on an established securities market. In the absence of regulations adopting a more reasonable discount rate, the only way to escape from the valuation formula with respect to debt instruments contributed to a FASIT is to conclude that they are "traded on an established securities market." Neither the statute nor the FASIT legislative history says what the phrase means. The same language is used, however, in the OID sections of the Code. Regulations under those sections treat a debt instrument as traded on an established securities market if it (1) is listed on a traditional exchange or interdealer quotation system (such as NASDAQ) (virtually no debt instruments fall into this group),[311] (2) appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations of one or more identified brokers, dealers or traders or actual prices of recent sales transactions,[312] or (3) is readily quotable (meaning that price quotations are readily available from dealers, brokers or traders, presuma-

310 See the preamble to the FASIT regulations at 2000-1 C.B. 688.

311 Treasury Regulation §§ 1.1273-2(f)(2) and (3).

312 Treasury Regulation § 1.1273-2(f)(4). The key requirement is that the quotation medium provide pricing information, not just a listing of brokers willing to make a bid.

bly on request). There are a number of safe-harbor rules that generally prevent the readily quotable standard from being met unless the debt instrument is part of a substantial issue and resembles other debt of the same issuer that is traded on an established securities market under other parts of the definition.[313] None of the three prongs of the definition in the OID regulations requires that there be any minimum level of trading.

As a general observation, with the exception of some categories of residential mortgages, virtually none of the receivables that would be the natural candidates for inclusion in a FASIT (including most commercial mortgage loans and private placement loans) would be considered traded on an established securities market except under the readily quotable standard, and then only if the test were applied without the safe-harbor exceptions.[314] What this means in practical terms is that the 120 percent of AFR standard would apply unless and until regulations are adopted that either expand the definition of established securities market beyond the OID regulations or allow the use of a market discount rate in lieu of the formula rate.

The FASIT regulations as currently proposed would adopt an even narrower definition of established securities market than is found in the OID regulations. Specifically, they would apply the first two parts of the definition in those regulations but exclude the readily quotable standard (even with the safe-harbor exceptions). The explanation given in the preamble is that a broader definition was not needed because of the rule in the

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313 Treasury Regulation § 1.1273-2(f)(5). The rule does not apply to a debt instrument if any of the following is true: neither the issuer nor the guarantor of the debt instrument has outstanding other debt that is publicly traded under parts of the definition other than the readily quotable standard, the issue of which the debt instrument is a part has an original stated principal amount of $25 million or less, the conditions and covenants in the debt instrument are materially less restrictive than those in the issuer's other traded debt, or the maturity date of the instrument is more than three years after the maturity date of the issuer's other traded debt.

314 Commercial mortgage loans or private placement loans would often be readily quotable in the sense that there is an active dealer market in similar debt instruments and securities firms would stand ready to make a bid for individual loans in a reasonable period of time at a price that reflects secondary market pricing of the loans (with no element of goodwill). A securities firm would not, however, generally be able to make a bid without first gathering and evaluating information about the particular instruments.

regulations that would allow recently purchased loans to be valued at cost.[315] The usefulness of that rule will depend on whether it is expanded significantly in final regulations. At any rate, it is not a substitute for a broader definition of a traded debt instrument because securitizations are often done of loans that have been held in portfolio for some period of time.

Securitizations are used to combine and divide cash flows on debt instruments. Accordingly, it is common to convey to a securitization vehicle partial interests in debt instruments representing stripped coupons or stripped bonds, and interests in grantor trusts holding pools of debt instruments. The FASIT regulations include sensible rules that treat a beneficial ownership interest in one or more debt instruments as a traded debt instrument if either the interest itself is traded or all of the underlying debt instruments are traded (and in the case of an interest (not itself traded) that is a stripped bond or coupon taken from one or more whole debt instruments, the interest is valued using a commercially reasonable method based on the market value of the underlying instrument(s)).[316] These rules reflect the view that the trading exception is based on the ability to accurately determine value and that interests in traded instruments can readily be derived from the value of the underlying property.

(ii) Reasonably expected payments. The legislative history of SBJPA 1996 clarifies that "reasonably expected" cash flows are determined taking into account default losses, prepayments, and reasonable costs of servicing the loans.[317] In the REMIC context, it is commonplace to state in offering materials a prepayment assumption for purposes of applying the OID rules under section 1272(a)(6). The assumption is based on the speed used in pricing regular interests and is not considered a prediction. There is no tax reason why a REMIC would make predictions regarding future losses or servicing costs. With respect to credit card accounts or other unsecured consumer receivables, the ability to take default losses, prepayments and servicing costs into account in determining value is likely to reduce value

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315 See 2000-1 C.B. 689. The recent purchase rule is described in footnote 305, above, and accompanying text.

316 Proposed Regulation §§ 1.860I-2(d)(1) and (2).

317 1996 Senate Report at 132; 1996 Blue Book at 266.

significantly. The same is not true (at least to the same degree) for larger denomination commercial loans.[318]

The FASIT regulations track the legislative history by providing that reasonably expected payments on a debt instrument may take into account reasonable assumptions concerning early repayments, late payments, non-payments, and loan servicing costs. They go on to state that no other assumptions may be considered. They construct a fairly complex set of rules that check the tax assumptions that are made against assumptions made for non-tax purposes. Specifically, reasonably expected payments on an instrument must be determined in a commercially reasonably manner and any assumption used in determining reasonably expected payments must be consistent with (and no less favorable than) the first of the following categories that applies:

- representations made in connection with the offering of a regular interest in the FASIT
- representations made to any nationally recognized statistical rating organization
- representations made in any filings or registrations with any governmental agency with respect to the FASIT, and
- industry customs or standards.[319]

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318 In the case of commercial mortgage loans, for example, there would often be no expectation that any particular loan would default (although some credit risk premium would obviously be built into the pricing of the loan) and the size of individual loans may be such that a pool-wide analysis of default risk would not be meaningful. The costs of servicing such loans is usually not very high in the absence of a default, and the most common prepayment assumption is that there will be no prepayments.

319 Proposed Regulation § 1.860I-2(e)(2). Industry customs and standards are defined in Proposed Regulation § 1.860I-2(c). An industry custom is defined as any long-standing practice in use by entities that engage in asset securitizations as part of their ordinary business activities, and an industry standard is any standard that is both commonly used in evaluating the expected payments on securitized debt instruments (or debt instruments pending securitizations) in similar transactions and is disseminated through written or electronic means by any independent nationally recognized trade association or other authority that is recognized as competent to issue the standard. Presumably what the drafters had in mind is common industry standards for describing prepayment

It is interesting that the list makes no reference to financial accounting. The main problem with the approach in the regulations is that there will very likely be no "representation" in any of these sources as to "expected" prepayments or losses. (Servicing costs may well be fixed under servicing contracts.) Instead, there will be information about historical losses for similar debt instruments and potentially tables showing yields or cash flows based on a range of loss and prepayment assumptions. These tables are not predictions, just modeling exercises. The regulations of course require only that expected values be "consistent with" the first category of representations that applies. Perhaps that means only that a FASIT must (1) identify the first of the listed categories in which relevant information of some kind was provided and (2) show that the expected figures are within the range of possible values that were listed. Curiously, the regulations make no express reference to the prepayment assumption that is used in applying section 1272(a)(6) to the extent it applies, although surely that should be "consistent with" any assumption used under the FASIT rules.[320]

The FASIT regulations provide that if a taxpayer in determining the expected payments on an instrument takes into account an assumption that fails to meet the consistency requirement or is unreasonable, then the Service may determine reasonably expected payments disregarding the factor entirely. Thus, if a taxpayer assumes a rate of expected defaults that is not consistent with one of the categories of representations described above, the Service can disregard losses entirely in calculating expected payments.[321] There is nothing in this rule that requires that the taxpayer have acted willfully. It does not seem a helpful step in making the FASIT vehicle workable to adopt punitive rules of this type, particularly in an area involving

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speeds (such as the PSA model or a constant annual percentage). Unfortunately, these standards are just measuring sticks and say nothing at all about what the actual numbers ought to be.

320 As discussed at footnote 432, below, the FASIT regulations would require the Owner to report annually in a statement attached to its tax return, the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6). Presumably that would then be considered a filing with a governmental agency with respect to the FASIT. The assumption made pursuant to section 1272(a)(6) is based on assumptions made in pricing regular interests and does not necessarily represent the sponsor's expectations. Again, it is not clear how much conformity is required by the need for "consistency."

321 Proposed Regulation § 1.860I-2(c)(4).

inherently subjective and factual questions about the expected performance of assets and imprecise standards such as “reasonableness” and “consistency” with “representations.”

The regulations describe the reasonable expectations standards as applying to individual debt instruments. In fact, however, in the context of securitizations, they would necessarily be applied to a pool of similar receivables based on the aggregate characteristics of the pool.

(iii) 120 percent of AFR discount rate. In the absence of contrary regulations, the discount rate to be used in discounting reasonable expected payments on a debt instrument to determine its value is 120 percent of the “applicable Federal rate (as defined in section 1274(d)).” The AFR as so defined is actually a group of three rates for different ranges of maturities published by the Service shortly before the beginning of each calendar month for use during that month. The three rates are a short-term rate (for debt instruments with a term of not over three years), a mid-term rate (a term of over three years but not over nine years) and a long-term rate (over nine years). To apply these rates to a debt instrument that is transferred to a FASIT, it is necessary to determine as of the date of transfer the remaining term of the instrument. The FASIT regulations provide that the remaining term equals the “weighted average maturity” of the reasonably expected payments on the instrument. In other words, the remaining term takes account of expected prepayments.[322] While this term is not defined in the FASIT regulations, it generally should have the same meaning as in the regulations under section 1274, and, thus, should be an average of the periods to each payment, weighted by the amount of the payment. Generally, only principal payments should be taken into account.[323]

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322 This approach makes sense, but it does differ from section 1274(d) and the regulations thereunder, which assume the longest possible life permitted under the terms of a debt instrument. See section 1274(d)(3) and Treasury Regulation § 1.1274-4(c)(4).

323 See Treasury Regulation § 1.1274-4(c)(1), referring to Treasury Regulation § 1.1273-1(e)(3). The latter regulation takes account of all payments other than payments of qualified stated interest. For a definition of that term, see Chapter 8, Part C.1. The regulation also takes account only of whole years to each payment (thus rounding down for partial years). It is not clear if this feature (which reflects a quirk in the OID *de minimis* rule) should apply in making the FASIT calculation.

The regulations under section 1274 have a number of special rules for determining the relevant AFR. One significant rule is that the term of a floating rate debt instrument generally equals the period until the next date on which the interest rate is reset.[324] Under the FASIT statute, it would seem that this rule would apply, although the FASIT regulations create a doubt.[325]

(iv) Relationship between maturity and discount rate. One type of loan that may be contributed to a FASIT is a commercial mortgage or private placement loan. Such a loan may be callable by the borrower (either at par or with a prepayment premium), and the value of the loan may differ significantly depending on what assumption is made regarding the timing of the call right. Ordinarily, the borrower will call the loan if the cost of refinancing it (including both interest costs and transaction costs) is lower than the cost of leaving it outstanding. Because the likelihood of an early call depends on interest rates, the value of a callable loan could be distorted significantly if (1) the schedule of expected payments were calculated based on the actual market rate and (2) the schedule were then discounted using the 120 percent of AFR rate. Specifically, such an approach could indicate premium values for callable loans that are obviously unrealistic. If a FASIT sponsor is forced to value a loan using the 120 percent of AFR

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324 Treasury Regulation § 1.1274-4(c)(2). Technically, the rule applies to variable rate debt instruments (for a description, see Chapter 8, footnote 51 and accompanying text), with an exception for formula rates that, because of restrictions on rate movements, in substance resemble a fixed rate.

325 Another special rule, in section 1274(d)(2), calculates the AFR in the case of a sale or exchange of property as the lowest AFR for any month in the three-calendar-month period ending with the month in which there is a binding contract in writing for the sale. This rule is normally a pro-taxpayer rule, but in the context of FASITs it would have the opposite effect. The FASIT regulations would apply "the rate prescribed under section 1274(d) for the period that includes the date the instrument is valued.…" While this language is not a model of clarity, it does not seem to contemplate application of the three-month rule. Moreover, it makes no policy sense to value FASIT assets differently depending on whether they are contributed to a FASIT without a sale or exchange or are sold.

rate, then the expected prepayment schedule should be set on the assumption that the formula rate is the market rate.[326]

c. Contributions of Contracts. As noted in Part D.2.e, above, a FASIT may enter into a contract to acquire debt instruments or other permitted FASIT assets. The contract price could equal the fair market value of the acquired property when acquired, or a fixed price.[327] FASITs may also enter into other hedge or guarantee contracts. Could a FASIT sponsor be required to recognize gain under such arrangements either at the time when the contract is transferred to the FASIT or, in the case of contracts to acquire property, when the property is acquired?

The FASIT gain recognition rule applies to sales or contributions of "property" to a FASIT. If a FASIT enters into a contract with a third party, it would stretch the normal meaning of these terms to say that the contract has been contributed or sold. On the other hand, if the Owner or a related person entered into a contract with a FASIT that has value to the FASIT (i.e., costs the FASIT less than its value), it could be said that the Owner or related person has contributed something of value.[328] In that case, it might

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326 To illustrate the point, suppose that a sponsor transfers to a FASIT a commercial mortgage loan having a remaining term to maturity of 10 years. The loan bears interest at a rate of 10 percent, which is one percentage point lower than a current market rate for a similar loan, and is callable at any time by the borrower. Because of the call right, no one would ever purchase the loan for more than its principal amount. Assume that the AFR is 7 percent, so that 120 percent of the AFR is 8.4 percent. The sponsor may expect that the loan will remain outstanding to maturity, given that its interest rate is lower than a comparable market rate. However, if the cash flows on the loan were discounted from the maturity date to the date of transfer using the 8.4 percent rate, the loan would be valued at 110.55 percent of its principal amount. If the sponsor must use a discount rate of 8.4 percent in valuing the loan, it should be allowed to assume that the borrower will repay the loan on the next call date, because that is what the borrower would do if the market interest rate were 8.4 percent.

327 The FASIT regulations would limit the use of fixed price contracts entered into with the Owner or a related person. See text accompanying footnote 204, above.

328 A contract should in all cases be valued taking account of fees or other consideration payable by the FASIT. That approach is consistent with the way in

arguably be necessary to value the contributed contract and force the Owner to recognize gain accordingly. In effect, the Owner would be taxed on the value as if it had contributed cash to the FASIT equal to the value of the contract, which then paid that amount back to the Owner as an up-front fee. If the contract in question were a guarantee of loans, then an alternative approach would be to take the guarantee into account in valuing the loans, not as a separate asset.

The FASIT regulations address these issues only through the back door. They include a rule that allows the guarantee of a non-traded debt instrument to be valued together with the debt instrument if the reasonably expected payments on the guarantee are taken into account in valuing the debt instrument.[329] The unstated premise is that the guarantee must be valued as contributed property in some form. On the other hand, the legislative history, in discussing the rule that deems support property held outside of a FASIT to be a FASIT asset, indicates that a contract to make contributions to a FASIT will not result in the contributed assets being treated as FASIT assets until they are actually contributed or set aside for use by the FASIT.[330] While strictly speaking this statement addresses whether the contributed assets are considered to be contributed now or in the future, its seems quite unlikely that the drafters contemplated that the contract itself would be marked to market when entered into. A contract to contribute assets in the future (e.g., when needed on account of losses) could be the functional equivalent of a guarantee.

Where a FASIT acquires assets under a contract at a price that is less than fair market value (or for non-traded instruments, is less than the subsection (d) formula value), then the Owner would seem to be required to recognize gain. The asset would be sold to the FASIT, and there is no exception to the gain recognition rule for assets acquired under contracts entered into on arm's-length terms.[331] Under general Code principles, assets are not marked to market when acquired under a contract.

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which a contract would be valued when it is assigned in an arm's-length transaction.

329 Proposed Regulation § 1.860I-2(d)(4).

330 See footnote 376, below.

331 The rule at Proposed Regulation § 1.860I-2(d)(3) valuing recently purchased property at cost does not seem to apply to direct purchases by a FASIT. It also would not apply if the purchase price were fixed more than 15 days prior to the date of purchase. It seems odd to draw a sharp distinction between a

d. Modifications of Debt Instruments. Under general tax principles, when a debt instrument is modified and the modification is "significant," the old unmodified instrument is considered to be exchanged for the modified one. A question would then arise whether the exchange would be considered a transfer of the modified loan to the FASIT that could trigger gain. The exchange would be a taxable event, however, so that any gain represented by the excess of the value of the modified loan over the holder's basis in the old loan would already be taxed.[332] Normally, however, the new loan would be valued at its principal amount, so that gain would arise only to the extent of any untaxed discount.[333] Thus, ignoring discount, gain would exist only as a result of application of the subsection (d) valuation formula. It seems odd that the FASIT artificial valuation rule would override other Code sections valuing debt instruments issued in exchange for property, but the risk exists that they do just that. The imposition of tax on an artificial gain seems particularly harsh when a debt instrument is modified in a default setting.[334] Depending on the facts, the problem could be solved by taking into account in determining future payments an expected default loss. Making loan-by-loan factual determinations, however, would be burdensome.

e. Gain Recognition by Pre-Effective Date Entities That Make a FASIT Election.

A FASIT election may be made by a existing entity that holds assets and has outstanding interests. Ordinarily, upon making the election, the assets of the FASIT would be deemed transferred to the FASIT from the

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case where a FASIT acquires an asset that has been recently purchased at an arm's-length price (no gain) and where the purchase is accomplished through two steps, by entering into a contract to buy at a fixed price that is an arm's-length price when the contract is executed and then taking delivery at a later point. It would seem that the relevant pricing date should be the date of the contract, not the date of purchase.

332 One exception to this statement is the nonrecognition rule in section 354 for exchanges of securities of the same corporation in a recapitalization (an "E" reorganization under section 368(a)(1)(E)). This exception would rarely apply to the types of assets held by FASITs.

333 See footnote 248, above.

334 A modification can give rise to a deemed exchange even if it is occasioned by a default. See footnote 125, above.

person who becomes the Owner.[335] The deemed contribution could trigger tax on any gain. SBJPA 1996 includes a gain-related transition rule for entities in existence on the date when the FASIT rules became effective. That rule is described in this section. Other issues that arise in applying the FASIT rules to existing structures are discussed in Part H.5, below. In the absence of guidance from the Service on these other issues, it is highly unlikely that an existing entity would ever make a FASIT election, wholly apart from concerns over gain recognition.

Trusts used to securitize credit card receivables, which were intended at the time of enactment of SBJPA 1996 to be an important class of users of the FASIT legislation, typically take the form of master trusts that issue certificates over time. The certificates may be based on all assets of the trust or may be linked to particular subpools. The 1996 legislation includes a transition rule that permits securitization vehicles that were in existence on August 31, 1997 to make a FASIT election and defer the recognition of gain with respect to assets until those assets cease to be "properly allocable to a pre-FASIT interest."[336] A pre-FASIT interest is defined as any interest in the pre-effective date FASIT that was outstanding prior to the startup day (other than any interest held by the Owner).[337] The FASIT regulations would add two requirements to the definition of pre-FASIT interest that are not found in the statute. They are that the pre-FASIT interests be issued before February 4, 2000 and qualify under general tax principles as debt.

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335 Section 860L(d)(2) states that all property held (or treated as held under the support property rule in section 860I(b)(2)) by an entity as of the startup day (the day as of which a FASIT election is made) shall be treated as contributed to the entity on such day by the Owner.

336 Section 1621(e)(1) of 1996 SBJPA, which reads as follows: "In the case of the holder of the ownership interest in a pre-effective date FASIT—(A) gain shall not be recognized under section 860L(d)(2)…on property deemed contributed to the FASIT, and (B) gain shall not be recognized under section 860I…on property contributed to such FASIT, until such property (or portion thereof) ceases to be properly allocable to a pre-FASIT interest." Section 860L(d)(2) is described in footnote 335, above. Section 860I is the section that requires the Owner to recognize gain on contributions (or deemed contributions) to a FASIT.

337 Section 1621(e)(3)(B) of SBJPA 1996.

These new tests make the prospect that anyone would make an election for an existing entity even more remote.[338]

Property is to be allocated to pre-FASIT interests "in such manner as the Secretary may prescribe," except that all property in an entity will be treated as allocable to pre-FASIT interests if the fair market value of all such property does not exceed 107 percent of the aggregate principal amount of all outstanding pre-FASIT interests.[339]

The FASIT regulations provide that the Owner of a pre-effective date FASIT may elect to defer the recognition of FASIT gain on assets that are held by the FASIT but that are allocable to pre-FASIT interests. *FASIT gain* is gain that the Owner would be required to recognize on the contribution of assets to a pre-effective date FASIT. The Owner must establish a method of accounting for FASIT gain. To clearly reflect income, this method must periodically determine the aggregate amount of FASIT gain on all of the assets in the FASIT and exclude the portion of the FASIT gain attributable to the pre-FASIT interests.[340] The regulations also provide a

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338 See Proposed Regulation § 1.860L-3(a)(2). The rules in the FASIT regulations dealing the pre-effective date FASITs would be effective February 4, 2000 but may be applied by an owner to a pre-effective date FASIT having a startup day before then. The FASIT regulations do not seem to contemplate that the rules might have been applied to pre-February 4, 2000 FASITs based on the statute (which is self-executing). The preamble to the FASIT regulations does not give a reason for adding the two new requirements mentioned in the text. The February 4 cut-off date would virtually assure that no ongoing issuer of securities will ever take advantage of the transition rule. Specifically, a sponsor that has in place a structure that works satisfactorily without a FASIT election is surely not going to make a FASIT election in the absence of final, taxpayer-friendly regulations, and the February 4 cut-off date would mean that securities issued during the period from February 4 until final regulations are eventually issued would not benefit from the rule. The exclusion of instruments not classified as debt is also a significant deterrent given that lower-rated classes may well be issued whose status as debt is at least unclear.

339 Section 1621(e)(2) of SBJPA 1996. The safe harbor was apparently aimed at existing credit card securitizations, where the industry standard for the sponsor piece of a master trust was approximately 7 percent. Note that the safe harbor refers to "all property in a FASIT" and not just debt instruments.

340 Proposed Regulation § 1.860L-3(b).

safe-harbor rule.[341] It generally requires assets to be divided into pools. Each pool must consist of one of: assets with no gain on the day when contributed to the FASIT, assets with gain on that day that are valued under the subsection (d) valuation formula, and assets with gain on that day that are valued at fair market value. Each year, a calculation is made of the total FASIT gain for each pool. The FASIT gain is the excess of the net increase in value of the pool for the year over the amount of income recognized therefrom under general tax principles. An amount of the FASIT gain for each year is then recognized equal to the FASIT gain times one minus a fraction, where the numerator of the fraction is 107 percent of the adjusted issue prices of all pre-FASIT interests outstanding at year-end and the denominator is the total value of all FASIT assets at year-end. One ambiguity is whether the values of receivables are frozen when they are contributed to the FASIT or whether they must be recalculated at the end of each year.[342] The latter approach would mean that gain is calculated on a mark-to-market basis at least where values are determined based on fair market value. The safe harbor would not allow separate calculations for pools that support different classes of FASIT interests, but presumably that could be accomplished under the general rule allowing an Owner to fashion its own accounting method.

3. *Income/Loss From Holding an Ownership Interest*

For purposes of determining the taxable income and credits of the Owner, the assets, liabilities, and items of income, gain, deduction, loss and credit of a FASIT are treated as assets, liabilities, and such items of the Owner.[343]

341 Proposed Regulation § 1.860L-3(c).

342 Proposed Regulation § 1.860L-3(c)(2)(A) refers to "the sum of the value of the pool (as determined under § 1.860I-2) at the end of the taxable year…." It is not clear whether this contemplates a revaluation at the end of the year or rather use of the date of contribution values for those assets in the pool at year-end. The cross-reference is also vague in that the cited regulation deals only with valuation under a formula and not at fair market value, where applicable.

343 Section 860H(b)(1). The statute is a little ambiguous on the treatment of credits. It states that in determining the "taxable income" of the Owner, credits of a FASIT are treated as credits of the Owner. Presumably, the language should have referred to taxable income *or tax*. Also, the reference to taxable income should include alternative minimum taxable income (the no-offset rule

In other words, for this purpose, a FASIT is not a separate entity but is effectively treated as a branch of the Owner. The treatment of a FASIT as a separate entity for other purposes is discussed in Part G.7, below.

One of the few credits of a FASIT that might flow through is a foreign tax credit. The FASIT regulations acknowledge that result but then go to great lengths to limit the possible existence and use of those credits. They include prohibiting a FASIT election for entities that are foreign or are subject to foreign net income tax,[344] prohibiting the holding of publicly traded debt instruments that pay interest subject to foreign withholding taxes,[345] and requiring that interest expense on FASIT regular interests be allocated specially to income from FASIT assets for purposes of applying the foreign tax credit limitation.[346]

There are a number of adjustments that are made in calculating income from a FASIT:

- the constant yield method (including the PAC method of section 1272(a)(6)) must be applied under an accrual method of accounting in determining all interest, acquisition discount, OID, and market discount and all premium deductions or adjustments with respect to each debt instrument held by the FASIT[347]

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in section 860J(c) clearly assumes this result). The FASIT regulations state that FASIT items are attributed to the Owner in determining the Owner's taxable income or credits. Proposed Regulation § 1.860H-6(a).

344 See footnote 27, above.

345 See text at footnote 160, above.

346 See Part H.6, below.

347 Section 860H(b)(2). The reference in the statute to debt instruments "of the FASIT" is clearly intended to mean those held by a FASIT and not those issued by it. The rule is paraphrased this way in the legislative history. 1996 Senate Report at 129-130; 1996 Blue Book at 263. Whether the PAC method applies to regular interests is discussed at footnote 266, above, and accompanying text. The PAC method is described in Chapter 8, Part C.4. The statute is not clear on whether section 1272(a)(6) is to be applied in all cases or only where it applies by its terms. Proposed Regulation § 1.860H-6(b) simply parrots the statute and does not clarify the point. At any rate, section 1272(a)(6) was extended in 1997 to "any pool of debt instruments the yield on which may be affected by prepayments" so as a practical matter, it would cover most receivables that are likely to be held by a FASIT if use of a prepayment assumption would affect the timing of income. The reference to acquisition dis-

- no item of income, gain or deduction from a prohibited transaction is taken into account (although apparently, losses from dispositions of property in a prohibited transaction are allowed)[348]
- tax-exempt interest is treated as taxable ordinary income[349]

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count would seem to mean that discount must be accrued even if it would otherwise be considered *de minimis* for purposes of the rules governing OID and market discount. The *de minimis* rule is described in Chapter 8, Parts C.1 and E.2. The term "acquisition discount" is defined in section 1283(a)(2) for purposes of sections 1281 and 1282, which describe the treatment of acquisition discount on short-term obligations. However, in the case of any debt instrument other than a Government obligation, the rules are applied substituting OID for acquisition discount. This FASIT accrual requirement goes beyond the corresponding REMIC rule in section 860C(b)(1)(B), which simply deems a REMIC to have made an election to accrue market discount (the definition of which includes an exception for *de minimis* amounts). Normally, premium on a debt instrument is amortized at the election of the holder under section 171. The FASIT statute seems to require, in effect, that premium be amortized. An election under section 1278(b) to include market discount in income as it accrues generally applies to all market discount bonds held by the taxpayer. There is nothing in the FASIT statute to indicate that reporting market discount income from FASIT assets represents a deemed election under section 1278(b). The FASIT statute addresses only the tax treatment of debt instruments, and not hedge contracts. Nonetheless, the legislative history states that "[t]he taxable income of a FASIT is calculated under an accrual method of accounting." 1996 Senate Report at 129; 1996 Blue Book at 263. The distinction does not much matter, because virtually all Owners would be accrual method taxpayers.

348 Section 860H(b)(3). Although the statute disallows "deductions," the legislative history states that "the owner of a FASIT may currently deduct its losses incurred in prohibited transactions in computing its taxable income for the year of the loss." 1996 Senate Report at 130; 1996 Blue Book at 263. The reference to deductions in the statute may have been intended to insure that if the income from a prohibited transaction was not taxed, the Owner would not be able to deduct the 100 percent prohibited transactions tax. Such a deduction might be distinguished from a loss arising from the disposition of property. Compare to section 860C(b)(1)(C), which states that the taxable income of a REMIC shall be determined without taking into account "any item of income, gain, *loss,* or deduction" allocable to a prohibited transaction (emphasis added). The FASIT regulations shed no light on the point.

- the Owner is not subject to the rules for applicable high yield discount obligations that might otherwise deny deductions in respect of a FASIT's high-yield interests [350]
- in a misguided attempt to avoid character mismatches, the FASIT regulations would treat income or losses from permitted hedge contracts as ordinary, [351] and

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349 Section 860H(b)(4). The practical effect of this rule is limited because no one would ever place tax-exempt bonds in a securitization vehicle that issues debt. The tax-exempt interest would not pass through to debt holders and interest expense would be disallowed under section 265 (which denies deductions for interest on debt incurred or continued to purchase or carry tax-exempt bonds). At any rate, if a municipal bond did find its way into a FASIT, section 265 should not apply because the bond effectively would become a taxable bond under the FASIT rules.

350 Section 860H(c)(2) (stating that section 163(e)(5) is not applicable to FASIT regular interests).

351 Proposed Regulation § 1.860H-6(c). The rule refers to permitted hedges as defined in Treasury Regulation § 1.860H-2(e), which is limited to hedge contracts with the Owner or a related person. Probably what was intended was a reference to section 1.860H-2(d). The rule is misguided because under general Code principles (including the carve out from the definition of capital asset in section 1221(a)(7) enacted in 1999), a hedge will produce ordinary income or loss if it is primarily a hedge of borrowings and capital gain or loss if it is a hedge of capital assets. The proposed regulation would convert gains and losses from hedge contracts into ordinary items even if they hedged debt instruments held by the FASIT that are capital assets. The drafters have implicitly acknowledged the flaws in the proposed character rule for hedges by adopting an anti-abuse rule to prevent taxpayers from using the proposed character rule to *create* a character mismatch (ordinary loss on a hedge and capital gain on a debt instrument). The anti-abuse measure is described in footnote 237. If the drafters want to avoid potential character mismatches (and disputes about whether a hedge that bridges the gap between assets and liabilities relates more to the assets or liabilities), they might follow the REMIC model and make all items of FASIT gain or loss ordinary. See Treasury Regulation § 1.860C-2(a). Perhaps the reason this was not done is that debt instruments with a built-in loss are not marked to market when contributed to a FASIT (as they are when contributed to a REMIC), so that such a rule would have the potential consequence of converting a pre-contribution capital loss into an ordinary loss. This could be avoided by limiting ordinary

- again under the regulations, the method of accounting used for a permitted hedge must clearly reflect income and otherwise comply with hedge accounting regulations (whether or not they would otherwise apply).[352]

Following the general look-through approach, gains and losses of a FASIT attributable to debt instruments should be ordinary items where the Owner is a bank or other financial institution to which section 582(c) applies.[353]

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losses on a debt instrument that is a capital asset to ordinary income on a hedge contract. Policy to one side, it is not clear what the source of authority is for changing the character of FASIT items. The legislative history states that "The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is taken into the income of the holder as ordinary income." 1996 Senate Report at 131; 1996 Blue Book at 264 (similar). While strictly speaking this statement deals with the flow through of character rather than the substantive rules for determining character at the FASIT level, it does not seem to contemplate any separate character rules. Moreover, it is not clear that changes in the basic Code rules governing character are "necessary or appropriate to carry out the purposes" of the FASIT rules (and, thus, come within the grant of authority to write regulations under section 860L(h)). Given that FASITs are not separate entities and there are no character rules in the Code governing income of the Owner (unlike the rule treating income of the holder of a REMIC residual interests as ordinary), it is not clear why a collateralized borrowing using a FASIT should be treated differently from one falling outside of the FASIT rules.

352 Proposed Regulation § 1.860H-6(c), which refers to the hedge accounting rules in Treasury Regulation § 1.446-4. The hedge accounting rules were adopted as a complement to Treasury Regulation § 1.1221-2(b), which (as a preview to the hedging transaction rule now found in section 1221(a)(7)) treated income or loss from contracts that hedged ordinary assets or liabilities as ordinary items. Because hedge losses would no longer be subject to the rule limiting capital losses to capital gains, it was thought to be necessary to conform the timing of hedge losses and gains to the timing of income and losses from the hedged asset or liability, which is what Treasury Regulation § 1.446-4 does.

353 An earlier version of the bill that became SBJPA 1996 would have applied section 582(c) directly to ownership interests. See H.R. 3448, as reported by the Senate Finance Committee on June 18, 1996, section 1621(b)(4). Presumably, the reference to ownership interests was dropped on the ground that

Apart from the rule requiring gain recognition upon the transfer of assets to a FASIT, it appears that the transfer of property to a FASIT by the Owner, or by a FASIT to the Owner, would be a nonrecognition event for income tax purposes, on the ground that the Owner is transacting with itself. The issue is not squarely addressed, however, either in the Code or the FASIT regulations.[354]

4. Securities Dealers

As discussed in Chapter 11, Part F, under section 475, securities dealers are required to mark-to-market securities they hold at the end of every taxable year or upon an earlier disposition, with certain exceptions, including an exception for securities held for investment.[355] The FASIT statute states that, except as provided in regulations, if the Owner of a FASIT is a dealer in securities (or a trader electing mark-to-market treatment) and sells or contributes to the FASIT any debt instrument or other security that was required to be marked-to-market under section 475 by the Owner, then section 475 continues to apply, except that the value of the security shall not be

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a look-through approach was more appropriate. For a general discussion of section 582(c) (and its application to securitization vehicles), see Chapter 11, Part E. As discussed in Chapter 11, Treasury Regulation § 301.7701-2(c)(2)(ii) provides that if the single owner of a disregarded entity is a bank, special tax rules applicable to banks will continue to apply to the owner as if the wholly owned entity were a separate entity. There is no FASIT counterpart to this regulation.

354 Thus, there is no counterpart to section 860F(c), which treats distributions by REMICs on residual interests as gain recognition events. The FASIT legislative history appears to assume that no loss is recognized upon the transfer of property to a FASIT. See footnote 303, above. Further, the special rule in the FASIT regulations that would impose a prohibited transactions tax on gain with respect to a debt instrument distributed by a FASIT to the Owner if the Owner realizes a gain with respect to the instrument within 180 days after the distribution (see footnote 237, above) assumes that the distribution is not itself a taxable event. Curiously, a distribution of property by a FASIT to the Owner does seem to be a "disposition" that can trigger the prohibited transactions tax. See footnote 224, above.

355 Chapter 11, Part F, discusses whether a taxpayer may be considered to be a dealer solely as a result of origination and securitization activities.

less than its subsection (d) value.[356] The FASIT regulations would turn the statute around and not allow or permit mark-to-market accounting for any permitted asset held by a FASIT.[357] Instead, a security transferred by a dealer to a FASIT would be marked to market one last time upon transfer based on its actual fair market value, and any resulting gain or loss would be recognized and taxed without regard to the FASIT rules. To the extent the subsection (d) value of the security is greater than its fair market value, that excess would be taxed under the FASIT rule that triggers gain upon the contribution of property to a FASIT.

5. Limitation on Use of Non-FASIT Losses

The rule described in Part F.2.a, above, limiting the use of non-FASIT losses to offset income from FASIT high-yield interests is equally applicable to income from FASIT ownership interests (income from both is aggregated in applying the rule). There are no limitations on the use of credits. The no-offset rule for FASIT ownership interests is more stringent than the one for REMICs in that it applies to all income from an ownership interest, without attempting to distinguish between phantom income and economic income.

6. Transfers of Ownership Interests

a. Overview. The FASIT statute, legislative history and regulations provide very little guidance on the tax consequences of a transfer of ownership interests. The only specific rules on point appear to be (1) the special wash sale rule discussed below, (2) a rule treating gain from sales of ownership interests as part of the income from the ownership interest that cannot be offset with non-FASIT losses,[358] and (3) rules in the FASIT regulations requiring the Owner to report information regarding acquisitions and trans-

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356 Section 860L(f)(2).

357 Proposed Regulation § 1.860H-6(d). The preamble to the FASIT regulations does not explain the reason for the change. Perhaps it was the view that securities held in a FASIT are sufficiently removed from a dealer's business so that an end to mark-to-market treatment was warranted. The ban on mark-to-market treatment is not limited to assets contributed by the Owner and hence would apply to FASIT assets that are deemed to be owned by a successor Owner that is a securities dealer.

358 Section 860J(a)(1), discussed in Part F.2.a, above.

fers of the ownership interest.[359] While these measures address peripheral issues, they clearly acknowledge the possibility that an ownership interest will be transferred.

The fact that the Owner is taxed as if it were the direct owner of FASIT assets raises a question about the degree to which a FASIT has an existence independent of the Owner. At a minimum, the FASIT statute cannot fairly be read to contemplate a deemed termination of a FASIT every time the ownership interest is transferred (unless, of course, the new Owner is not an eligible corporation). In that respect, the FASIT is not personal to the Owner.[360] Indeed, if a FASIT terminated upon a transfer, a deemed termination would potentially result in a prohibited transaction tax on any unrealized gain on FASIT assets, which cannot have been intended.[361] Because a FASIT continues in existence despite the transfer of an ownership interest from one Owner to another, the successor Owner should not recognize gain from a deemed contribution of assets to a new FASIT even if its basis in FASIT assets is less than their subsection (d) value.[362] Similarly, holders of regular interests should not be deemed to

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359 See Proposed Regulation §§ 1.860H-6(e)(2) and (3), discussed in Part I.2, below.

360 If the transfer of an ownership interest invariably resulted in a FASIT termination, there would be no need to address transfers of FASIT ownership interests, because the Owner would be, in effect, transferring directly the underlying assets, subject to FASIT liabilities.

361 As discussed in Part E.3, above, the prohibited transactions tax applies to gain on dispositions of FASIT assets unless an exception applies. The only potentially relevant exception is one for a qualified liquidation, which requires that a FASIT adopt a plan of liquidation and, within 90 days, "sell" its non-cash assets and distribute or credit the proceeds and its other cash to holders of FASIT interests. While a sale might include an in-kind liquidation, that result is not clear. In any event, the FASIT regular interests would not be retired.

362 The taxation of gain on contributions of assets to a FASIT is discussed in Part G.2, above. The new Owner's basis in assets could be less than the subsection (d) value either because the Owner acquires the assets with a carryover basis that is less than fair market value, or, for nontraded debt instruments, because the subsection (d) value exceeds fair market value.

exchange regular interests in one FASIT for regular interests in a second FASIT, potentially resulting in taxable gain.[363]

A number of additional questions arise concerning the tax consequences of a transfer of an ownership interest. The discussion below considers the amount and character of gain or loss, wash sale rules, and the voiding of transfers with a tax avoidance purpose.

b. Amount and Character of Gain or Loss. The principle that FASIT assets and liabilities should be attributed to the Owner for purposes of computing taxable income likely would carry over to the calculation of gain or loss from a sale of an ownership interest. Under that view, gain or loss

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363 The most straightforward way to analyze this issue is to treat regular interests as liabilities of the issuing FASIT, and conclude that the issuer has not changed as a result of the transfer of an ownership interest. Hopefully, the Service will follow this approach in future regulations. Given, however, the treatment of regular interests as debt of the Owner in determining at least some of the tax consequences of ownership of those interests (see footnotes 272 and 273, above, and accompanying text), until the issue is clarified it will be worthwhile to consider how the regular interests would be treated if the regular interests were conventional debt of the Owner. The answer depends to some degree on the facts. Under general tax principles, the regular interest holders would be deemed to exchange one debt obligation for another if the substitution of Owners caused a "significant modification" within the meaning of Treasury Regulation § 1.1001-3. Those regulations are described generally in Chapter 6, Part D.2.c. Viewing the Owner as the debtor, under Treasury Regulation § 1.1001-3(c)(2)(i), the change in obligors would automatically be a "modification" whether or not holder consents were required. If the FASIT regular interests were "nonrecourse" obligations payable solely out of FASIT assets and related credit support, then the substitution of obligors would not be a *significant* modification under Treasury Regulation § 1.1001-3(e)(4)(ii). If credit support or collateral were changed at the same time, consideration would need to be given to Treasury Regulation § 1.1001-3(e)(4)(iv)(B), which treats changes affecting substantial amounts of collateral, guarantees or other credit enhancements as significant modifications. A change in obligors under credit enhancement contracts could be a significant modification under this rule (although the substitution of a similar commercially available credit enhancement contract is not a significant modification). In the unusual case in which the debt is a recourse obligation of the Owner, the substitution of obligors ordinarily would cause a significant modification. Treasury Regulation § 1.1001-3(e)(4)(i). Avoiding a deemed exchange in those circumstances may require a determination that the FASIT and not the Owner was the obligor.

would be calculated separately with respect to each FASIT asset, and the amount realized in a sale would include the amount of FASIT liabilities. As a practical matter, unless gain or loss from individual assets would have a different character, gains and losses are likely to be aggregated to produce one net figure. The holding period, for purposes of determining whether any capital gains or losses are long term would be the lesser of the period over which individual FASIT assets were held or the period in which the seller was the Owner (assuming the Owner acquired its ownership interest in a taxable purchase). The calculation would be similar to a sale of pass-through certificates representing interests in a grantor trust that had issued debt.

One argument against breaking an ownership interest up into individual assets is that it is treated as a "security" for purposes of the wash sale rules (see next section). There is no reason, however, why an interest in a pool of receivables could not be considered a security for some purposes and still be taxed on a look-through basis.[364]

c. Wash Sale Rule. Although the ownership interest generally is not treated as a separate security, the FASIT statute provides that rules "similar to" the REMIC wash sale rules apply to the FASIT ownership interest.[365] In brief, subject to a dealer exception, the wash sale rule in section 1091 defers losses on the sale or other disposition of a security if within a period beginning 30 days before the date of the sale and ending 30 days after that date, the seller acquires, or enters into a contract or option to acquire, substantially identical securities. The deferred loss is preserved through an increase in the basis of the acquired security. The REMIC wash sale rule has three components: (1) treating a REMIC residual interest as a "security," (2) expanding the definition of "substantially identical security" to include any REMIC residual interest and any interest in a TMP comparable to a REMIC residual interest, and (3) extending each of the 30-day periods to six months. It is obvious how (1) and (3) should be applied to a FASIT

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364 The same is true for pass-through certificates that are taxed as interests in grantor trusts. See Chapter 5, Part B.2.

365 See section 860L(f)(1) ("[r]ules similar to the rules of section 860F(d) [wash sale rule for REMIC residual interests] shall apply to the ownership interest in a FASIT"). The wash sale rule as applied to REMIC residual interests is described in Chapter 9, Part D.

ownership interest. It is less apparent on the face of the statute what securities should be considered substantially identical to a FASIT ownership interest under the statutory command to apply rules "similar to" the REMIC wash sale rule. The legislative history clarifies that the cross-reference treats as securities substantially identical to FASIT ownership interests (1) other FASIT ownership interests and (2) "residual interests in a pool of debt obligations that are substantially similar to the debt obligations in the FASIT."[366] The reference to "residual interests" can be read to mean that the pool of debt instruments must have outstanding some debt (or other senior securities), which would be consistent with the reference in the REMIC wash sale rule to a TMP. A TMP is not similar to a REMIC simply because both hold mortgages, but rather because both hold mortgages *and* issue multiple classes of sequential-pay securities. One open question in applying the wash sale rule is whether making additional contributions to a FASIT by the Owner will be considered the acquisition of an additional ownership interest by the Owner.

d. Transfers for Tax Avoidance Purpose. The REMIC regulations include an anti-abuse rule that disregards transfers of noneconomic residual interests if the transferor has "improper knowledge" (that is, it either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of taxable income of the REMIC).[367] The REMIC rule applies only to noneconomic residual interests, which are generally defined as those that will not produce sufficient cash distributions to pay taxes on excess inclusions. There is a safe-harbor rule that presumes a transfer not to have been made for an improper purpose if, in summary, the transferor finds that the transferee has historically met its debts and finds no significant evidence that it will not continue to do so and the transferee provides an affidavit acknowledging its obligation to pay taxes on income from the residual interest (even if they exceed cash distributions).[368]

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366 1996 Senate Report at 133; 1996 Blue Book at 265.

367 Treasury Regulation §1.860E-1(c), which is discussed in Chapter 9, Part E.4.e.(i).

368 A proposed regulation (as modified by Revenue Procedure 2001-12, 2001-2 I.R.B. 1) would further require, for transfers on or after February 4, 2000, that either the inducement fee paid to the transferee at least equal a minimum amount determined under a formula, or the transferee have $100 in gross financial statement assets and $10 million in net assets. For a more complete explanation, see Chapter 9, Part E.4.e.(i). Revenue Procedure 2001-12, sec-

The FASIT regulations apply a similar rule (including the safe-harbor exception) to transfers of FASIT ownership interests, but broaden it in one respect. Specifically, the FASIT rule would apply to all ownership interests, and not simply to those that are noneconomic. Presumably the burden of establishing that the transferee will pay would be more easily met if the ownership interest itself produces cash distributions sufficient to pay taxes due.

7. Transactions Between FASIT and Owner

An Owner can engage in various transactions with a FASIT. For example, it can transfer assets to, or receive them from, a FASIT, hold regular interests, be the counterparty with the FASIT to a permitted hedge or guarantee contract, or borrow money from a FASIT, by issuing to it debt. It would seem that under the rule attributing assets and liabilities of a FASIT to the Owner for purposes of calculating taxable income of the Owner, these transactions generally would be ignored in determining most income tax consequences because the Owner would be dealing with itself. It is equally clear, however, that they are recognized for purposes of applying the various FASIT-specific rules, including qualification tests, and the prohibited transactions tax. For example, Owner/FASIT transactions are given effect in the following circumstances discussed in this chapter:

- the rules imposing tax on gain from contributions of assets by the Owner to a FASIT (Part G.2, above)
- the making of a FASIT election is treated as a deemed contribution of assets to the FASIT and a termination is a deemed distribution[369]
- the FASIT regulations impose a number of additional requirements on hedge contracts and guarantees entered into with the Owner or a related person (Part D.2.d.(ii), above), and

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tion 3, states that the same principles also apply to transfers of ownership interests in FASITs "appropriately adjusted with respect to terminology and other technical differences between the REMIC and FASIT provisions.…"

369 See section 860L(d)(2) (contributions). Part I.3, below, discusses terminations.

- under the Code, a FASIT is not allowed to hold debt issued by the Owner or a related person unless the debt is a cash equivalent (Part D.2.c.(iii), above).

There is no clear guidance on the treatment of regular interests held by an Owner. The central question is the degree to which those interests are recognized to be outstanding for purposes of FASIT qualification rules and general income tax principles. Consider the following examples:

> ***Example 1.*** A FASIT has outstanding a class of ordinary regular interests that are owned by persons unrelated to the Owner. The Owner buys a portion of those interests from an investor, holds them for a time and then resells them to someone else. At the time of the resale, the credit quality of the underlying FASIT assets has deteriorated so that the yield at which the regular interests are sold exceeds the AFR plus 500 basis points. What results?

The first question is whether the regular interests continue to qualify as such in the hands of the Owner. The answer should be "yes," at least in the absence of further guidance providing different results. The only two alternatives are to fold them into the ownership interest or to disqualify the FASIT (on the ground that they are interests in the FASIT that are neither regular nor ownership interests). Given that the regular interests would have been designated as regular interests when issued, it may be difficult to consider them to be part of the ownership interest unless they are cancelled. The alternative of disqualifying the FASIT simply makes no sense. There is no abuse involved and all income of the FASIT will be properly accounted for.[370]

The resale poses the question whether the status of the regular interest as a high-yield interest is retested upon its sale by the Owner to the new investor. If it were, then the regular interest would be a high-yield interest. As a practical matter, such a result would likely make a resale impossible. The regular interest that had passed through the hands of the Owner would

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370 One difference between recognizing the regular interest and folding it into the ownership interest relates to the no-offset rule discussed in Part G.5, above. Income from the ownership interest cannot be offset with losses, but income from ordinary regular interests could be. It would seem, however, that if the regular interests when issued had a yield low enough to qualify as ordinary regular interests, then the income on those interests does not have the equity flavor that justifies applying the no-offset rule.

be physically identical to all the others, but would have dramatically different tax characteristics.[371]

> ***Example 2.*** Same facts as Example 1, except that the Owner, forewarned as to the risks of a direct purchase of regular interests, causes them to be purchased by R, a related person. R may be another corporation that is a member of the Owner's consolidated tax group.

It would be natural to consider a related party purchase as an alternative, but will it work? The concern over a deemed satisfaction of regular interests arises from the rule that attributes FASIT liabilities to the Owner. As long as the related person is sufficiently divorced from the Owner so that a loan from the related party to the Owner would be recognized, the regular interest should not, under general tax principles, be cancelled. General tax principles may be overridden where the related party is a corporation that joins in a consolidated return with the Owner. A consolidated return regulation treats debt of one member of a consolidated group that is acquired or sold by another member in transactions with third parties as discharged and replaced with a new debt instrument.[372] It would make sense in this setting to treat a regular interest as debt of the FASIT and not the Owner, but the point is not clear.

Issues of this sort do not arise for REMICs because REMICs are generally recognized to be entities separate from the holders of residual interests. REMIC sponsors can, and routinely do, buy and sell regular interests after the startup day without any fear that doing so will change the character of the regular interests and, where the interests are part of a class, destroy the fungibility of securities within that class.

The preamble to the FASIT regulations states that the Service considered adopting a general rule to characterize the FASIT's relationship with

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371 The same problem may exist in applying the OID rules of the Code (a repurchase of debt by the issuer and its later resale would create a new issue price and cause the debt to no longer be identical for tax purposes to debt that had never been bought in). For traded securities held by U.S. parties, that issue may also inhibit or effectively prohibit resales, although the substantive consequences of nonfungibility in that setting are far less severe.

372 Treasury Regulation § 1.1502-13(g)(4) (debt that is not intercompany debt is deemed reissued when it becomes intercompany debt, with an exception, among others, through a cross-reference to Treasury Regulation § 1.108-2(e), for ordinary course of business acquisitions by securities dealers).

the Owner, and decided that it was better to resolve the issue on an issue-by-issue basis.[373] The discussion above indicates that there was good reason to follow this approach. Unfortunately, until the gaps are filled in, the result will be to add more interpretational risk to a regime that already has its fair share.

H. Special Topics

This Part H addresses: the rule treating support property as contributed to a FASIT, a general anti-abuse rule in the FASIT regulations, special anti-conduit rules in the regulations aimed at foreign holders of regular interests making loans indirectly to related borrowers, two-tiered FASITs, the making of FASIT elections by existing entities, and allocations of interest expense to FASITs for purposes of the foreign tax credit limitation.

1. Support Property

Property held outside of the FASIT by the Owner or a related person that "supports" any FASIT regular interest is considered to be contributed to the FASIT, thereby triggering gain to the Owner or related person to the extent the property's subsection (d) value exceeds its basis.[374] Further, the support property is considered part of the FASIT for purposes of applying other parts of the FASIT statute, presumably including the FASIT assets and interests test.[375] Thus, prohibited transactions taxes apply to support property in the same way as if such property were part of the FASIT.

The statute does not define the term "support." The legislative history offers a definition, but unfortunately it is not well thought out. A footnote reads as follows: "For this purpose, supporting assets includes [sic] any assets that are reasonably expected to directly or indirectly pay regular interests or to otherwise secure or collateralize regular interests. In the case where there is a commitment to make additional contributions to a FASIT, any such assets will not be treated as supporting the FASIT until they are

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373 2001-1 C.B. 684.

374 Sections 860I(b) and (d)(1). As discussed in footnote 308, above, the FASIT regulations would depart from the statute and tax gain from support property held by a related person to the Owner (to the extent the subsection (d) value exceeds fair market value).

375 Section 860I(b)(2).

transferred to the FASIT or set aside for such use."[376] This definition is discussed further below.

The origin of the support test was presumably a concern that a sponsor, faced with the prospect of recognizing gain on FASIT assets, would try to minimize FASIT assets. To the extent, however, that assets were really needed to make payments on FASIT regular interests, the sponsor would then need to enter into a contract to make those assets available to the FASIT, through a guarantee or some kind of commitment to contribute the assets in the future. In a case where there was an artificial division of the FASIT, with assets being held outside the FASIT that would, but for tax shenanigans, be in, the support rule should apply. One plausible way to draw the line is to rely on the definition of support asset in a closely analogous rule found in the TMP regulations.[377] Those regulations treat an asset as supporting a debt obligation when the timing and amount of payments on the obligation are in large part determined by the timing and amount of payments on the asset. Importantly, the rules make it clear that there must be an expectation that payments on the asset will be used to fund debt service payments. Thus, property is not support property if it is unlikely to produce any significant cash flows for the holders of the debt instruments, and the mere fact that those holders have recourse to the asset is not enough. Contracts that are credit enhancement contracts or serve the same function (i.e., contracts that protect against payment defaults) are not regarded as support property. The same is true of property pledged to secure such contracts.[378] A similar definition would make sense for FASITs.

The quotation from the legislative history above treats property as support property when it either is reasonably expected to be used to pay regular interests, or is used to secure or collateralize them. The reasonably expected test is similar to the TMP rule. The problem is with the statement regarding security. Read literally, it could encompass any property that is pledged to secure an obligation owing to a FASIT, even if the asset is not expected to be used to fund a payment to the FASIT, but instead serves to

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376 1996 Conference Report 326, note 67; 1996 Blue Book at 265, note 196.

377 Treasury Regulation § 301.7701(i)-2.

378 Treasury Regulation § 301.7701(i)-2(b). See also Treasury Regulation § 301.7701(i)-1(c)(4)(i) ("Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of an entity solely because it supports the guarantee represented by that contract.").

upgrade the credit quality of the obligor. Thus, imagine a case in which the Owner wishes to guarantee FASIT regular interests. In one case, the Obligor is sufficiently creditworthy so that it can provide an unsecured guarantee. In a second case, the Obligor is creditworthy, but has a rating that is a notch below what is required by a rating agency. It holds a portfolio of debt obligations for investment, and pledges them to support the guarantee. The purpose of the pledge is not to provide a source of payment, but to reduce the risk of an Owner default. It would not make sense in that case to treat the collateral as part of the FASIT. The effect of doing so is simply to discriminates against sponsors that wish to provide credit support but do not have the credit rating to do so on an unsecured basis. If the effect of treating the collateral as support property were simply that it is marked to market, then the Owner could calculate the cost and decide whether the pledge is worth it. However, the effect of treating property as support property is that the Owner cannot sell it at a profit (in the absence of default) at any time during the life of the FASIT, because any gain would be subject to the 100 percent prohibited transactions tax. Furthermore, if the property the Owner has available for use as collateral is not debt instruments but some other type of property (e.g., a building), then it cannot be used in any circumstances, because the deemed holding of the asset by the FASIT would either subject income from the asset to the prohibited transactions tax or result in disqualifying the FASIT.

The TMP support property rule draws a sharp distinction between contracts that protect against credit defaults or unexpected expenses (credit enhancement contacts) and contracts that perform other functions (provide additional cash flows that supplement the original assets even if they perform). That same distinction would make sense for FASITs. Assets pledged to secure credit enhancement contracts should not be regarded as support property.

The FASIT regulations would define support property in a mechanical way that looks to whether the property is directly or indirectly pledged to pay a FASIT regular interest, is otherwise identified as providing security for the payment of a FASIT regular interest, or is set aside for transfer to a FASIT under any agreement or understanding.[379] This test does not take account of the likelihood that the property will be transferred or the purpose of the contract under which it is set aside. Credit enhancement contracts are treated the same as a contract to supplement payments in the absence of

379 Proposed Regulation § 1.860I-1(b).

default. The "otherwise [identified]…as providing security for" phrase is ambiguous. It could be read to refer to "security agreements" other than pledges, although perhaps a more colloquial meaning of "security" was intended.

The "set aside" language would apply to any contract to "transfer" property to a FASIT. The legislative history quoted above uses the set aside language in the context of a contract to "contribute" property, which suggests an arrangement under which the property is transferred for no consideration other than a greater ownership interest in the FASIT. The word "transfer" covers any kind of transfer, including a sale for cash.[380] Accordingly, under the regulation, if the Owner or a related person is a loan originator and has a contract with a FASIT under which it will sell loans to a FASIT, it would be required to determine when the loans are "set aside" for the contract. It is not clear if this result was intended.

The definition of support property in the regulations does not clearly indicate whether collateral securing a hedge contract could be considered support property. For example, suppose a FASIT owns fixed rate debt instruments and swaps them into floating rate assets under an interest rate swap. The swap is needed because interest is paid on the FASIT's regular interests at a floating rate. Collateral securing the swap would be support property if the collateral were considered to "provide security for" the regular interests. It is certainly arguable that the collateral performs that function. It is very common for swap obligations to be collateralized, so extending the support property rule that far would pose practical problems.

The FASIT regulations also treat as support property an interest in property that is subordinated to the FASIT's interest in the property (for example, a subordinated interest in a pool of loans in which a FASIT holds a senior interest). This approach is consistent with treating pledges of property to secure a credit enhancement contract as FASIT property, but would not make sense if such pledges were excluded as argued above. One question is whether the subordinated interests that are considered support property are all subordinated interests in the pool held by the Owner or only those that are proportionate to the senior interest held.[381]

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380 Proposed Regulation § 1.860H-1(c)(2) (definition of "transfer").

381 In other words, if a FASIT owns half of a senior class, is all of the subordinated class or only half treated as support property?

One problem with applying a pledge test that does not look to the expected use of the property is that the amount of property that is deemed contributed to the FASIT may bear no relationship to the value of the contract or the amount of expected contributions. For example, suppose that a sponsor grants a blanket lien over all of its assets to secure a guarantee of regular interests. The effect under the regulations would be that all of the sponsor's assets are deemed contributed to the FASIT and gain is recognized thereon. That is true even if the amount of assets is, say, 100 times the maximum amount that could ever be expected to be due.

Unsecured obligations are sometimes accompanied by negative pledges (a promise by the obligor not to grant a senior security interest to others). A negative pledge would clearly not be a "pledge." Also, a negative pledge would not ordinarily involve an identification of property to provide a source of payment and, thus, should not involve "providing security" or "setting aside" property.

When support property is deemed contributed to a FASIT, it is not actually contributed. As a result, the owner of the property continues to have an economic interest in the property. There is no guidance in the Code, legislative history or FASIT regulations on how that economic interest should be treated for purposes of the FASIT interests test. However, it surely was not intended that every application of the support property rule would automatically void a FASIT election through a violation of the FASIT interests test. The best approach would seem to be to fold the interest in support property into the ownership interest (and where the owner is not the Owner but rather a related person, to construct a side transaction between the related person and Owner to account for the fact that the owner of the property is not the Owner).[382]

Suppose that support property is owned by a related person, and the relationship between that person and the Owner changes so that they are no longer related (e.g., the Owner transfers the ownership interest to an unrelated person). It would seem that the property would cease to be support property. Although the result is plainly absurd, the deemed withdrawal of

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382 The Bond Market Association comment letter referred to in footnote 6, above, proposes this approach. This issue is discussed further in the text at footnote 102, above.

property from the FASIT could be regarded as a disposition that triggers the prohibited transactions tax.[383]

2. *Anti-Abuse Rule*

The FASIT statute provides authority for the Service to issue regulations "as may be necessary or appropriate to carry out the purposes of [the part of the Code dealing with FASITs], including regulations designed to prevent the abuse of the purposes of [such] part through transactions which are not primarily related to securitization of debt instruments by a FASIT."[384] The legislative history does not explain what type of anti-abuse measures (if any) the drafters had in mind. Specifically, the FASIT statute imposes very tight limitations on the permitted assets and activities of a FASIT, and it is not clear why those specific measures would not suffice to determine the purposes for which a FASIT may be used. There is no general anti-abuse rule in the REMIC regulations, although there are a number of provisions that seek to prevent taxpayers from taking actions that run against the grain of the REMIC rules.[385]

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383 As indicated in footnote 224, above, in other settings, the removal of an asset from a FASIT is regarded as a disposition for purposes of the prohibited transactions tax.

384 Section 860L(h).

385 Two of these prevent residual interests from being transferred in circumstances in which tax on excess inclusion income from the residual interest is not likely to be paid. See Treasury Regulation §§ 1.860E-1(c) (transfer of noneconomic residual interest is disregarded if a significant purpose of the transfer was to enable the transferor to impede the assessment or collection of tax) and 1.860G-3 (transfers of residual interests with tax avoidance potential to foreign taxpayers are disregarded). The first of these rules applies to transfers of FASIT ownership interests. See Part G.6.d, above. The second one is not relevant to FASITs because ownership interests cannot be held by foreign persons. Another anti-abuse rule relates to funds available caps. They may not be used as a device to define a rate of interest on a regular interest that is not a permitted variable rate (specifically, a rate that passes through contingent interest received on qualified mortgages). The same test applies to FASITs, although the opportunities for abuse are more limited because FASITs cannot hold debt instruments paying contingent interest. See text accompanying footnote 57, above.

The anti-abuse rule contemplated by the statute is one that would (1) define a "securitization of debt instruments" and (2) limit the use of FASITs to transactions that "primarily relate" to such a transaction. The quoted phrases are inherently vague. It was hoped that the Service would follow the REMIC model and use the authority in a considered manner to address specific problem cases. Unfortunately, that was not done. The FASIT regulations include an anti-abuse rule[386] that basically incorporates the statutory language into regulations (while at the same time expanding its reach in some respects). The anti-abuse regulation was made effective when proposed (on February 4, 2000), without a grandfather rule for existing FASITs.[387]

While it is hard to disagree with the principle that a statute should not be "abused," the difficulty is always to figure out what constitutes an abuse. A broad rule would run the risk of being overly inclusive and limiting legitimate transactions. A special concern with the adoption of a vaguely worded rule in the FASIT area is that it would frustrate the basic purpose of the legislation, which was to facilitate securitizations by reducing legal uncertainty (specifically regarding the status of interests as equity or debt). That goal will be met only if the FASIT rules can be readily understood and applied. An anti-abuse rule that grants the Service discretion to change significant tax results if a taxpayer commits an abuse but fails to define with some care what an abuse is would make FASITs far less attractive as an alternative to other structures. That is particularly so if making a FASIT election and running afoul of the anti-abuse rule could leave taxpayers with materially higher tax costs than if the election had never been made.

The anti-abuse regulation has three basic parts: a description of the intent of the FASIT rules, a requirement that a FASIT be used to carry out such intent, and a description of potential remedies.

The portion of the regulations relating to intent is worth quoting in full:

> Part V of subchapter M of the Internal Revenue Code (the FASIT provisions) is intended to promote the spreading of credit risk on debt instruments by facilitating the securitization of those debt instruments. Implicit in the intent of the FASIT provisions are the following requirements–

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386 Proposed Regulation § 1.860L-2.

387 Proposed Regulation § 1.860L-2(d).

(1) Assets to be securitized through a FASIT consist primarily of permitted debt instruments;

(2) The source of principal and interest payments on a FASIT's regular interests is primarily the principal and interest payments on permitted debt instruments held by the FASIT (as opposed to receipts on other assets or deposits of cash); and

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

The regulation then requires the FASIT statute and regulations to be applied in a manner consistent with their intent as described above. Therefore, if "a principal purpose" of forming or using a FASIT is to achieve results inconsistent with such intent, the Service may make any "appropriate adjustments." Whether a FASIT is created or used for a principal purpose of achieving an improper result is determined "based on all of the facts and circumstances, including a comparison of the purported business purpose for the transaction and the claimed tax benefits resulting from the transaction."

The Service's authority to make "adjustments" includes the following (again quoting from the regulation):

(1) Disregarding a FASIT election;

(2) Treating one or more assets of a FASIT as held by a person or persons other than the Owner;

(3) Allocating FASIT income, loss, deductions and credits to a person or persons other than the Owner;

(4) Disallowing any item of FASIT income, loss, deduction, or credit;

(5) Treating the ownership interest in a FASIT as held by a person other than the nominal holder;

(6) Treating a FASIT regular interest as other than a debt instrument; and

(7) Treating a regular interest held by any person as having the same tax characteristics as one or more of the assets held by the FASIT.

There are no examples illustrating the rule, either in the regulations or in the preamble.

Taking separately the three parts of the rule, the rule describes the purposes of a securitization quite narrowly as being the spreading of credit risk on debt instruments. The part of the legislative history explaining the reasons for the FASIT rules mentions that there are benefits to the economy from securitizations due to the spreading of credit risk,[388] but this is not in the context of attempting to define what a securitization is for purposes of the anti-abuse rule. Indeed, right after the discussion of credit risk, the legislative history mentions that credit card securitizations are done to achieve a balance sheet benefit. Indeed, in many cases the risk shifting benefit is in substance limited because the sponsor will bear all expected credit losses. Also, in another section, the legislative history defines securitization very broadly: "Securitization is the process of converting one type of asset into another and generally involves the use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the debt instruments securitized."[389] Despite the breadth of this description, it still includes the qualifiers "generally" and "typically." The legislative history would support a definition of securitization as "a transaction that is intended to transform debt instruments into one or more interests having characteristics that differ from the underlying debt instruments for a reason other than to achieve a federal income tax benefit."[390]

The description in the regulations of the intent of the FASIT provisions includes two other more specific purposes relating to the assets and cash flows of a FASIT, namely that securitized assets consist primarily of

388 1996 Senate Report at 126; 1996 Blue Book at 258-259.

389 1996 Senate Report at 125; 1996 Blue Book at 258.

390 The differences could relate to credit quality, differences in the pattern of cash payments, accounting treatment or more qualitative factors (e.g., replacing a debt evidenced by a loan agreement with a bond that is considered more liquid). The definition should not require that the non-tax benefit be more important than the tax benefit derived from the FASIT rules, because as discussed below, that standard is not appropriate for securitizations.

permitted debt instruments and that the source of principal and interest payments on regular interest be primarily principal and interest payments on permitted debt instruments. Given the limitations on what a FASIT can hold, these tests seem to require that the assets of the FASIT consist mostly of debt instruments as compared with cash or cash equivalents that are not permitted debt instruments, hedge and guarantee contracts and foreclosure property. As a practical matter, these tests are likely to be met in most securitizations without difficulty. There have been securitizations of short-term receivables of highly rated corporations that could qualify as cash equivalents. In such a case, the receivables would ordinarily qualify as both permitted debt instruments and cash equivalents, however, so that the regulation should not apply. Another category of permitted asset is hedge contracts. It is possible to imagine circumstances in which the source of principal and interest payments on regular interests would be primarily payments on hedge contracts. It is not clear whether the regulation was intended to rule out such arrangements.[391] Even if the asset and cash flow portions of description of the intent test would not pose a problem in most cases, it is quite unfortunate to layer on additional, vaguely worded asset

391 To give one example, suppose that a FASIT holds fixed rate receivables that provide for monthly payments and issues floating rate regular interests that require quarterly payments. It would be quite normal in these circumstances for the FASIT to enter into a swap contract under which it pays to the swap counterparty each month the amounts received on the receivables and receives back quarterly the amounts due on the regular interest. The swap would effectively convert fixed interest to floating and also serve to reinvest monthly receipts through the end of the quarter. While this arrangement would be a straightforward commercial one, it could be said that the source of interest and principal payments on the regular interest is primarily payments on the hedge contract rather than debt instruments. More generally, if a hedge contract were used to convert interest received at a fixed rate into floating rate interest, it could well happen that, as a result of increases in interest rates, more than half of the interest payments on regular interests would consist of payments under the swap. Presumably, the regulation was not aimed at such a case although it might be read to cover it. It is not clear if the primary-source-of-payment test is to be applied period by period or over the life of a transaction, and whether it looks to actual results or expectations. One further ambiguity is whether principal and interest payments are treated separately or are aggregated.

tests to the ones already in the statute and to introduce an additional cash flow test.

Finally, the description of intent states that a FASIT provision may not be used to achieve a federal tax result unless the provision "clearly contemplates" that result. This rule can be read as a canon of construction that simply resolves any ambiguity in the statute in favor of the government. As this chapter has shown, the FASIT statute is not well drafted; it is rife with ambiguities and inconsistencies. Suppose that there is some doubt about what a particular provision means, but the taxpayer believes that the "better view" of the rule (the interpretation that is more likely than not to be correct) is in its favor. The clearly contemplated rule may mean that the taxpayer loses because the more liberal reading is not clear. Surely Congress did not intend this result.

A second way to read the rule is that the FASIT provision must be used in a context that was clearly contemplated by the drafters. That reading could arguably limit the FASIT rules to transaction patterns involving revolving pools of consumer receivables that are securitized to achieve accounting benefits, because that is the only use of the FASIT rules described in the legislative history. Again, it is difficult to imagine that Congress intended the FASIT legislation to have such a limited reach.

It will be helpful in assessing the potential scope of the FASIT intent rule to apply it to two simple examples that (1) do not seem in fact to involve tax abuse but (2) arguably would run afoul of the anti-abuse rule as now written. Suppose that a corporation, X, owns a callable bond issued by an unrelated corporation, Y. Assume the Y bond has a principal amount of $100 due in ten years and pays interest of 8 percent annually. It is callable by the issuer at any time after seven years without a premium. X wishes to dispose of its economic interest in the Y bond, but believes that it will achieve a better price if it can split the bond into two instruments consisting of an amortizing loan and a zero coupon bond. It also wishes for commercial reasons to cast the instruments it sells in the form of debt. To do this, X places the Y bond in a trust. The trust issues two classes of notes, A and B, each of which has a principal amount and bears interest thereon of 8 percent. Interest on class B compounds and is paid at one time together with note principal. In general, class A entitles the holder to the interest payments on the bond, and class B entitles the holder to the principal payment on the bond. However, if the bond is prepaid (or accelerated following a default), then each class will have a claim to an amount equal to the present value of the payments it would receive in the absence of a prepayment cal-

culated using a discount rate of 8 percent. The treatment of this arrangement under general tax principles would not be clear, for two reasons. First it would not be clear whether the A and B notes would be recognized to be debt of the trust or would be recast as equity interests.[392] Second, if the debt were recast, it is not clear if it would be treated as equity in a tax partnership or an ownership interest in the Y bond.[393]

X makes a FASIT election for the trust. The arrangement would meet all of the technical requirements of the FASIT rules, but would it be consistent with their intent as set forth in the proposed anti-abuse rule?

The answer is not clear. The purpose of the transaction is to divide up cash flows by time rather than to reallocate credit risk. Also, the transaction does not involve the pooling of multiple debt instruments, revolving accounts or an accounting benefit through the issuance of equity securities. It can fairly be argued that a securitization of this type was not in fact in the minds of the drafters. On the other hand, there is nothing in the statute that requires revolving pools. While this would normally put to rest any doubts, the overarching function of the anti-abuse rule as written is to test transactions against some larger purpose that is not evident in the words of the statute.

The second example involves a corporation X that issues an instrument that is debt for tax purposes but for regulatory reasons takes a form that makes it impossible to sell directly (or through the issuance of participations or other ownership interests).[394] To allow the X obligation to be marketed, it could be purchased by corporation Y which would issue a bond

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392 The trust would have no equity, although none would be needed to repay the notes. For a discussion of the significance of thin capitalization in securitizations on the classification of instruments as equity or debt, see Chapter 3, Part E.2.

393 If the A and B notes were recast as ownership interests in the Y bond, the arrangement might not qualify as a bond stripping transaction because of the fact that the principal may be reallocated from class B to class A in the event of a prepayment. See Chapter 4, Part D.6.b.

394 One example is certain investment contracts issued by insurance companies that are cast in the form of insurance policies in order to take advantage of the higher priority that policy claims have over general creditor claims in an insolvency proceeding. It may not be possible for regulatory reasons to sell ownership interests in such policies (or beneficial interests in trusts holding such policies) to a wide group of investors.

having terms that mirror the X obligation. To achieve tax certainty, a FASIT election would make sense. By comparison with the last example, the transaction is even less like a traditional securitization than the one just discussed because it does not involve any division of cash flows. On the other hand, the transaction does have the effect of changing the investment characteristics of the X obligation to make it more saleable to a wide group of investors, which is the basic point of a securitization.

Once the intent of the FASIT rules has been identified, the anti-abuse rule would impose sanctions if "a principal purpose" of forming or using a FASIT is to achieve results inconsistent with such intent. By contrast, the statutory language refers to transactions which are "not primarily related" to securitizations of debt instruments.

In determining whether a FASIT is created or used for a principal purpose of achieving an improper result, all facts and circumstances are to be considered, including a comparison of the purported business purpose of a transaction and the claimed tax benefits. It is not clear how this test would be applied, but under at least one plausible interpretation, no securitization transaction that has ever been done would meet it. The main tax benefit to be derived from the FASIT rules is certain treatment of regular interests as debt. If the claimed tax benefit of a FASIT election were considered to be the avoidance of corporate level tax on income equal to the deduction for interest on regular interests, then that benefit would *always* outweigh the economic advantages of a securitization. Securitization is a financing technique. Those who engage in such transactions usually have other financing alternatives, and the advantages of securitization are measured in basis points. The magnitude of the benefit will invariably be less than 35 percent (the corporate tax rate) applied to the income allocated to investors in the securitization.

It can fairly be argued that the tax benefit of a FASIT election is not 35 percent of the interest expense because, absent the FASIT election, the FASIT sponsor would never engage in a securitization transaction that involved imposition of the corporate tax. Thus, the tax benefit should be the benefit compared with the next-best alternative. Such an approach would be difficult to administer, and in any event would still very often mean that the tax benefits outweigh economic gains.[395] The comparison test in the

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395 To give an example, suppose that a credit card trust issues senior and subordinated classes of trust certificates. Assume that there is some doubt regarding the status of the subordinated class as debt under general tax law principles.

regulations simply does not work to distinguish abusive transactions from legitimate ones in the securitization area.

Once it has been decided that a transaction is abusive, the list of sanctions that may be imposed by the Service is very broad.[396] The list essentially permits the Service to jettison the FASIT statute and other Code provisions in any way it sees fit. There is no requirement that the sanctions be related in some way to the identified abuse, other than the general statement that the Service may make "appropriate adjustments."

The Service can potentially leave the parties in much worse shape than if no FASIT election had been made. Specifically, the Service can recognize the FASIT election and disallow deductions for interest on FASIT regular interests.[397] The effect would be that the gross income from FASIT assets would be subject to corporate income tax in the hands of the Owner.[398] In that event, income would be taxed twice (once to the Owner

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Absent the FASIT election, the subordinated securities would be subject to transfer restrictions preventing them from being held by tax-exempt organizations or foreign investors, and from being publicly traded (so that the issuing trust would not be classified as a corporation under the PTP rules). If a FASIT election were made in order to permit free trading of the subordinated class, in applying the business purpose/tax purpose test in the regulations, it would seem to make sense to compare (1) the pricing benefit to be derived from issuing a more liquid security with (2) the tax benefit. The tax benefit might fairly be calculated as (1) the saving of the corporate tax that would be imposed if the issuer were a PTP, or (2) the saving of the tax that would be imposed on any holders of the more liquid securities who are tax-exempt organizations or foreigners (which could be computed based on actual holdings, expected holdings, or maybe, given the overall tone of the rule, an assumption that all holders are tax-exempt organizations or foreigners).

396 Note that the list of possible sanctions begins with the phrase "The Commissioner's authority includes" and hence is not exclusive. See section 7701(c) (word "includes" is not exclusive).

397 Apparently, deductions could be disallowed even on classes that would be recognized to be debt under general tax principles.

398 The preamble to the FASIT regulations indicates that the FASIT anti-abuse rule is patterned after the partnership anti-abuse rule in Treasury Regulation § 1.701-2. 2000-1 C.B. 690. The Service does not, however, have the ability under that rule to force a partnership to be treated as a corporation and to disallow all of its deductions.

and second to holders of the regular interests). Indeed, to the extent the income relates to high-yield interests, there would be a triple tax (taking account of the corporate tax imposed on the holder of the high-yield interest and the tax on its shareholders).

To illustrate the point, return to the example above in which X places a Y bond in a trust and issues class A and B notes. If no FASIT election were made, there would be uncertainty as to the tax treatment of the A and B notes. The alternative characterizations would be to recognize the notes to be debt (and allow an interest deduction to the trust and hence to X) or to treat them as stripped bonds and coupons or partnership interests. It would not be possible to subject income from the bonds to a corporate tax. By contrast, under the anti-abuse rule, the Service could accept the FASIT election yet disallow deductions for interest on the A and B notes. The result would be that X is taxed on income from the Y bond as if it had never been sold. However, the A and B noteholders would also be taxed on the same income, a truly disastrous result.

The potential list of sanctions also includes treating a FASIT regular interest as not a debt instrument. Accordingly, the rule could be applied to "shoot innocent bystanders" by changing the tax treatment of investors who were not parties to the abuse.

It is possible to have a general anti-abuse rule that is clear and workable. An example of one in a related area is found in the regulations defining a TMP.[399] It differs from the FASIT rule in four respects. First, it has a fairly clear threshold test. It applies to transactions that are entered into with a view to achieving the economic effect of a TMP while avoiding the technical definition. Second, it is explained through a series of examples (which emphasize the artificial separation of mortgages from borrowings or of real estate collateral from debt). Third, it has an exception for investment trusts, which amounts to a clear safe-harbor. Finally, the sanction the Service can impose is clear, which is finding that an arrangement is a TMP. This is an appropriate result given that the rule applies only where the economics of a TMP are created but the taxpayer artificially obscures the fact.

It is unlikely that the Service will rethink the wisdom of including a general anti-abuse rule in the FASIT regulations. Unless the final regulations cut back the scope of the rule substantially, or at least clarify it, the rule's existence will prevent the use of FASITs in any but the simplest circumstances.

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399 Treasury Regulation § 301.7701(i)-1(g), discussed in Chapter 4, Part E.2.g.

3. *Anti-Conduit Rules*

Ordinarily, FASIT regular interests are treated as debt of the Owner rather than as ownership interests in the underlying assets of the FASIT. The FASIT regulations, however, include a look-through rule that treats interest income received on a regular interest by a foreign resident as if it were received or accrued directly on any debt instruments held by the FASIT that are issued by a domestic resident debtor (referred to in the regulations as a "conduit debtor") that is related to the foreign resident holder.[400] Among other possible consequences, the look-through rule is intended to achieve the following: (1) to prevent interest paid indirectly from the conduit debtor to the foreign resident holder from qualifying for the portfolio interest exemption, so that it will be subject to a 30 percent withholding tax under the Code,[401] (2) to subject interest deductions to the so-called "earnings stripping" limitations,[402] and (3) to prevent interest from being deducted before it is paid.[403] The required relationship between the foreign resident holder

400 Proposed Regulation § 1.860H-5. A domestic branch of a non-U.S. debtor is also treated as a conduit debtor. The amount of interest so treated is limited to the lesser of the income received or accrued by the foreign resident holder with respect to the FASIT regular interest, or the amount paid or accrued by the conduit debtor with respect to the debt instrument held by the FASIT, within the same period. There need not be any connection between the two payment streams.

401 The 30 percent withholding tax and the portfolio interest exemption are described in Chapter 12, Part C.2. The exemption does not apply to payments made to "10-percent shareholders" of the debtor as defined in section 871(h)(3)(B), or received by a controlled foreign corporation from a related person within the meaning of section 864(d)(4) (see section 881(c)(3)(C)).

402 In very broad terms, section 163(j) limits the deduction of a corporation for net interest expense (interest expense less interest income) to 50 percent of the corporation's income before net interest expense (with various adjustments). The amount of disallowed interest may not exceed the interest paid by the taxpayer to related persons who are not subject to U.S. income tax on such interest (including, as relevant here, foreign taxpayers not subject to U.S. withholding tax on such interest). The definition of related person is generally a person related within the meaning of section 267(b) or section 707(b).

403 See sections 163(e)(3) and 267(a)(3) and Treasury Regulation § 1.267(a)-3. These rules apply to persons who are related within the meaning of section 267(b). In a case where the conduit debtor has made a payment to the FASIT

and the conduit debtor is defined with these three sets of rules in mind.[404] The look-through rule, however, is not limited to these cases. It applies for all income tax purposes, even if a look-through approach would benefit the parties. The look-through rule is intended to affect the tax treatment of the foreign holder and conduit debtor, and does not change the amount or character of income of the FASIT and the Owner.[405]

As regards the portfolio interest exemption, this special set of rules is unnecessary. There already exists a comprehensive set of rules governing the use of conduit arrangements to avoid withholding taxes that would apply to FASITs (and, to avoid any doubt, could have been invoked by a cross-reference).[406] The main difference between the two approaches is that the existing conduit rules require a tax avoidance purpose. By contrast, the FASIT rules will apply automatically. An automatic approach does not seem justified in cases where there are significant economic differences between the regular interest held by the foreign holder and the loan to the conduit debtor and commercial reasons for use of the FASIT.

Applying a look-through approach is particularly questionable where the parties are not even aware of the cross-ownership (e.g., when a foreign insurance company buys a FASIT regular interest as an investment, and a related group operating company finances an office building with a mortgage placed in the FASIT, and neither one is aware of the other's interest). Under the regulations, if 1 percent of the assets of the FASIT consisted of the loan to the affiliate and the insurance company's investment represented 1 percent of the outstanding regular interests, the look-through rule would potentially apply to cause all of the interest paid to the insurance company

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but the FASIT has not yet made a corresponding payment to the foreign holder, it would seem to be appropriate to allow an interest deduction because a net payment has been made to an outside party. It is not clear, however, that a deduction would be allowed under the look-through rule until a payment is received by the foreign holder.

404 The test is met if the foreign holder is as to the conduit debtor a 10-percent shareholder or related controlled foreign corporation (which is relevant to the portfolio interest exemption; see footnote 401, above) or a related person under sections 267(b) or 707(b) (relevant to the limitations on interest deductions described in footnotes 402 and 403, above).

405 See the preamble at 2000-1 C.B. 692. The possible liability of the FASIT or Owner as a withholding agent is discussed below.

406 For a description, see Chapter 3, footnote 55.

to be subject to withholding tax. The look-through rule would seem to require that statements be included in FASIT offering documents qualifying the availability of the portfolio interest exemption even in cases (which would exist more often than not) where the offering documents do not include enough information about the identity of the obligors on debt held by the FASIT to allow investors to determine if there are related parties involved. Further, the very purpose of the FASIT rules is to allow revolving asset pools. In many cases, it would be simply impossible to restrict purchases of assets to parties unrelated to all foreign holders. Thus, a foreign holder could not protect itself against the imposition of withholding tax because of a future asset purchase. Although it could be said that a foreign investor could address the problem by monitoring who owns debt issued by related parties, borrowers who issue debt instruments that are intended to be securitized very often have no idea (and no control over) who owns the debt. Also, a system to allow such monitoring may simply not exist within a large corporate group.

In addition to these concerns, one issue for the FASIT itself is whether it will be liable as a withholding agent for interest that becomes subject to withholding tax under the automatic look-through rule. The existing conduit rules do not impose withholding tax unless a withholding agent knows or has reason to know of facts sufficient to establish that an intermediary will be disregarded under the conduit rules (including facts showing that the participation of an intermediary is part of a tax avoidance plan).[407] The preamble to the FASIT regulations indicates that the Service intends to issue regulations treating a FASIT as a withholding agent with respect to payments subject to the look-through rule and solicits comments with respect to circumstances where it would be inappropriate to impose liability as a withholding agent due to lack of knowledge or other appropriate circumstances.[408] The regulations are expected to include a presumption that the FASIT has knowledge of a relationship invoking the withholding obligation where the foreign regular interest holder owns 10 percent or more of the total value of the FASIT's regular interests and the debt of the related obligor accounts for 10 percent of the total value of the FASIT's assets. Simply hitting these thresholds would provide no useful information to the FASIT unless the FASIT was aware of the identities of the beneficial own-

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407 Treasury Regulation § 1.1441-7(f)(2).

408 2000-1 C.B. 692.

ers of its regular interests, was aware of the identities of the true parties having an interest in the borrower (real estate borrowers, for example, are very often special purpose entities), and was aware of the relationship between the lenders and borrowers. FASIT regular interests are likely to be registered in the name of nominees, or if targeted to foreign investors may be in bearer form, so that the FASIT would not have much information regarding the identity of beneficial owners. In addition, the look-through tests apply on an ongoing basis, and if the proposed 10 percent tests were also applied that way, they could be met simply because of dispositions or prepayments of assets. If the look-through rule is implemented as proposed, it would likely have an adverse effect on the use of FASITs that is wholly disproportionate to the scope of the problem.

4. Two-Tier FASITs

As explained in Chapter 6, Part D.7.a, two-tier REMICs are common. In a typical structure, a lower-tier REMIC issues all of its regular interests to an upper-tier REMIC, which then issues regular interests to investors. Both REMICs are created under the same document, so that the lower-tier REMIC is largely a tax fiction. The primary reason for creating two tiers of REMICs in a single transaction is to allow the creation of interest-only classes of regular interests that represent strips taken off of classes of regular interests rather than strips off of mortgages.[409]

Turning to FASITs, two questions arise: is it possible to create similar two tier structures, and is there a reason to do so. The answers are "yes" and "generally no." In other words, although two-tier structures can be created, there is little reason to do so. The FASIT statute treats FASIT regular interests as a separate class of permitted assets, so that one FASIT can hold

409 To illustrate, suppose a REMIC holds 8 percent mortgages and wants to issues a fast-pay A class of regular interests bearing interest at 7 percent, a slow-pay B class of regular interests bearing interest at 8 percent, and an interest-only X class that is entitled to 100 basis points of interest on class A. The way the securities would be created is to have a lower-tier REMIC issue two classes of regular interests (call them LA and LB) that are identical to classes A and B, except that class LA would bear interest of 8 percent. The upper-tier REMIC would then issue class X as a specified portion (a fixed strip of interest) taken off of class LA (which is a qualified mortgage in the hands of the upper-tier REMIC). This convoluted approach is necessitated by the definition of specified portion.

regular interests in another.[410] On the other hand, as discussed in Part D.1.c.(ii), above, it appears to be possible to create regular interests that bear interest at a fixed or variable rate applied to a notional principal amount. If that is so, then there would be no need to use two-tiers to create strips taken off of other regular interest classes. That result could be achieved simply by having the notional principal amount of the strip class equal the actual principal balance of the other regular interest class.

5. *Election by Existing Entities*

By contrast with the treatment of REMICs, a FASIT election clearly can be made by an existing entity.[411] As a practical matter, however, because of uncertainties in how the statute applies and concerns over changing the tax treatment of securities already in the hands of investors, it is quite unlikely that such an election would ever be made by an entity that has outstanding interests held by investors unrelated to the sponsor.

The Code provides that all property held by an entity on the startup day for a FASIT is deemed to be contributed to the FASIT by the Owner. Subject to a transition rule for pre-effective date FASITs, the Owner is taxable on any resulting gain.[412] To the extent the entity has outstanding inter-

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410 One potential technical issue is the rule in section 860L(c)(2) that prevents a FASIT from holding a debt instrument issued by the Owner. If two FASITs have the same Owner, regular interests issued by one FASIT might be regarded as debt of the Owner. However, the rule against related party debt should be read to apply only to assets that qualify as permitted assets solely because they are debt instruments described in section 860L(c)(1)(B). FASIT regular interests are listed separately in section 860L(c)(1)(F). The FASIT regulations confirm this reading. Proposed Regulation § 1.860H-2(b)(1)(iv). There is no explicit FASIT rule allowing two FASITs to be created in the same set of documents, but it would make sense to follow the REMIC rule allowing that result. See Treasury Regulation § 1.860F-2(a)(2).

411 See section 860L(d)(2) (deemed contribution of assets by Owner to a FASIT upon the making of an election); the transition rule for pre-effective date FASITs described in Part G.2.e, above; Proposed Regulation § 1.860H-1(b)(5)(ii) (describes who is authorized person to sign FASIT election in case where an outstanding interest in a segregated pool of assets is designated as a FASIT interest). For a discussion of REMIC elections by existing entities, see Chapter 6, Part B.1.d.

412 See footnote 411, above.

ests, they presumably would be considered to be "reissued" as FASIT interests on the startup day, on the theory that because the FASIT did not exist until that day, it could not have issued them before. More pragmatically, any other reading would preclude a FASIT election by an existing entity, because the FASIT statute requires FASIT interests to be issued on or after the startup day. There is no rule that allows pre-FASIT interests to be disregarded in applying the FASIT interests test. Thus, each outstanding interest must qualify as a regular interest.[413] In a case where an interest would have been an equity interest in the absence of the FASIT election, its conversion from equity to debt (in the form of a regular interest) would involve a new issuance (and for holders a taxable exchange).[414] Where a FASIT regular interest did qualify as debt in its pre-FASIT life, one significant open question is whether the exchange of such debt for a FASIT regular interest with at least somewhat different tax characteristics would automatically involve a taxable exchange.[415] If not, a further question is

413 To qualify as a FASIT interest, the interests would need to be designated as FASIT interests. A designation of outstanding interests is contemplated by Proposed Regulation § 1.860H-1(b)(5)(ii). The transition rule for pre-effective date FASITs referred to in Part G.2.e, above, clearly assumes that the electing entity has outstanding interests. Indeed, its only effect is to defer gain with respect to assets allocable to such interests. It is simply remarkable that the transition rule does not address how the FASIT interests test would apply to outstanding interests. The New York State Bar report cited in footnote 3, above, suggested that a pre-effective date FASIT benefiting from the gain recognition transition rule be treated as a hybrid that is part FASIT and part non-FASIT. The FASIT regulations make no mention of the suggestion.

414 Compare the treatment of FASIT terminations discussed in Part I.3, below. The amount realized in an exchange of property for debt of the person acquiring the property is generally the face amount of the debt. See footnote 248, above. The FASIT regulations provide that notwithstanding general Code principles, the issue price of regular interests issued in exchange for property is always the fair market value of the regular interests on their issue date. Proposed Regulation § 1.860H-4(a)(2). The preamble does not explain the reason for this rule.

415 Under general tax principles, a new debt instrument would be considered to be issued if the FASIT election were considered to involve a "significant modification" of the old debt instrument according to standards set forth in Treasury Regulation § 1.1001-3. The making of a FASIT election would not involve a significant modification unless subjecting the instrument to the FASIT rules were thought to involve a sufficient change in tax characteristics to change the

whether the status of a regular interest as a high-yield interest would be tested as of the date of the FASIT election or as of the actual issue date. If a class of interests that were already in existence when the FASIT election was made were transformed into a high-yield interest through the election, they would have to be held by eligible corporations or other FASITs. There could be no assurance of that result unless the governing documents imposed ownership restrictions. As a general rule, it would seem to be impossible for commercial reasons for a FASIT election to be made if its effect would be to convert equity interests into debt or debt into high-yield interests or the election otherwise would change the tax treatment of holders in any material way, unless either the affected holders consented or the offering materials for the securities disclosed the possibility of making the election.

6. Foreign Tax Credit Limitation—Allocation of Interest Expense

A domestic corporation generally is allowed to credit foreign taxes only up to a limitation amount equal to a fraction of its U.S. taxes. The fraction is foreign source taxable income (gross income less deductions), divided by

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overall character of the instrument. Treasury Regulation § 1.1001-3(c)(2)(ii) treats the change in an instrument from debt to something other than debt as a modification, but does not address changes in the type of debt. The changes in tax treatment would be most significant if the instrument were considered a high-yield interest, because it could then be held only by eligible corporations and FASITs, and income thereon could not be offset with non-FASIT losses. Two other changes would be the requirement that income from FASIT regular interests always be reported under an accrual method and the treatment of FASIT interests as transparent for purposes of asset tests applicable to REITs and thrifts. See Part F.1, above. The significance of these last two changes will vary depending on the circumstances (the identity of the holders and whether interest would in any event be taxed on an accrual basis under the OID rules). Where a FASIT terminates, there is a deemed exchange of FASIT regular interests for interests in the FASIT having a character determined under general tax principles. The FASIT regulations state that where an interest would be debt under general tax principles, whether the exchange of a regular interest for debt is taxable to the holder depends on whether the debt instrument is materially different in kind or extent from the regular interest (which is the standard for testing exchanges under section 1001). Proposed Regulation § 1.860H-3(c)(3). See footnote 437, below, and accompanying text.

worldwide taxable income.[416] In calculating foreign source taxable income, interest expense is ordinarily allocated to foreign sources under a "fungibility-of-money" approach, which treats borrowed funds as being equally applicable to all activities of a taxpayer. Generally, a taxpayer must classify its assets as domestic or foreign based on the income they do or may produce. Interest is then allocated between domestic and foreign sources based on the tax basis or fair market value of the assets, without regard to the use of proceeds or the nature of any collateral securing the debt. Where the taxpayer is a member of an affiliated group of corporations, the entire group is considered a single taxpayer for purposes of allocating interest expense.[417]

The FASIT regulations include a proposed regulation that would require a taxpayer (including an affiliated group) to specially allocate all interest expense that it deducts as the Owner of FASITs (and certain related hedging costs) against the income it earns as the Owner of FASITs. The grouping together of multiple FASITs would apply regardless of whether there was any factual linkage between the two.[418]

The preamble to the regulations does not explain what there is about FASITs that justifies a departure from the fungibility-of-money rule.[419] For example, FASIT regular interests can be full recourse obligations of the Owner or of another member of its affiliated group. Most taxpayers would welcome the proposed change because it would allow more interest expense to be offset against domestic source income in securitizations of domestic assets.

I. FASIT Elections and Other Procedural Matters

This Part I discusses the mechanics for making a FASIT election, ongoing information reporting by Owners, the termination of a FASIT election, and the payment of various taxes imposed under the FASIT rules.

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416 Section 904(a).

417 Section 864(e); Treasury Regulation §§ 1.861-9T through -12T.

418 Proposed Regulation § 1.861-10T(f).

419 The preamble (at 2000-1 C.B. 692) states that the proposed rule is an administrable and appropriate way to limit distortions (favorable or unfavorable), but does not explain why there are distortions (given the premise that money is fungible) or why they are a particular problem for FASITs.

1. *Making a FASIT Election*

The definition of a FASIT includes a requirement that an entity be one "for which an election to be treated as a FASIT applies for a taxable year."[420] The statute states that a qualifying entity may elect to be a FASIT (implying that the entity itself makes the election), and that, once made, the election applies to the taxable year for which it is made and all subsequent taxable years unless revoked with the consent of the Service.[421] An entity will lose its status as a FASIT if it ceases to meet the requirements for being a FASIT.[422] The FASIT regulations would impose a permanent ban on the making of a new FASIT election without consent by the Service for an entity that was a FASIT and ceased to be a FASIT.[423] Presumably in the case of a segregated pool of assets, the ban would apply only to the assets included in the FASIT and not to other assets owned by the same corporation.

The FASIT regulations state that the FASIT election is made by having the corporation that is the Owner on the startup day[424] attach a statement to its corporate income tax return.[425] The statement must be attached to a timely filed return (including extensions) for the taxable year of the Owner that includes the startup day.[426] There is no specific form for the statement, but it must include identifying information, the startup day and the name and title of the persons signing the statement.[427] The signatories must be a

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420 Section 860L(a)(1)(A).

421 Section 860L(a)(3).

422 Section 860L(a)(4). See Part I.3, below, for a general discussion of FASIT terminations.

423 Proposed Regulation § 1.860H-3(c)(1).

424 Proposed Regulation §§ 1.860H-1(b)(1) and (b)(6).

425 Proposed Regulation § 1.860H-1(b)(2).

426 Proposed Regulation § 1.860H-1(b)(3). Because the time for filing the FASIT election is not specified in the Code, presumably procedures under Treasury Regulation §§ 301.9100-1 et seq. would apply to permit delayed elections in "my accountant had a nervous breakdown" cases. As described in Chapter 6, Part E.1, numerous rulings along these lines have been issued granting extensions for making REMIC elections.

427 Proposed Regulation §1.860H-1(b)(4). The statement must, for an entity other than a segregated pool, include the name, address and taxpayer identification number of the arrangement (if one was issued prior to making the election), or for a segregated pool, the name, address and taxpayer identification

person who could sign a return for the entity that is the FASIT if no FASIT election was made, or, for a segregated pool, the tax owner of the pool assets when FASIT interests are issued.[428]

Although the FASIT election is made only when the corporate tax return for the year is filed, and not when the FASIT is organized, the FASIT interest test does require that FASIT interests be designated as such, which presumably would be done no later than the date of issuance of those interests.[429] Further, the Owner of a FASIT may be required to file Form 8811 within 30 days after the date of issuance of any class of regular interests.[430]

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number of the persons or persons holding legal title to the pool of assets, the name, address and taxpayer identification number of the person or persons that, immediately before the startup day, are considered to own the pool for federal income tax purposes, and information describing the "origin of the pool" including the caption and date of execution of any indenture or similar documents governing the pool.

428 Proposed Regulation § 1.860H-1(b)(5). For example, an authorized signatory for a local-law corporation or trust would be a corporate officer or trustee. The regulations state that the person signing for a segregated pool must be the owner of pool assets immediately before the earlier of the date on which an outstanding interest in the pool is designated as a regular or ownership interest in a FASIT or the pool issues an interest designated at the time of issuance as a regular or ownership interest in a FASIT. Given that the ownership interest would in all events need to be designated as such on the startup day, it is not clear why the regulations do not simply define the signatory as the Owner on the startup day.

429 See Parts D.1.b. (regular interests) and D.1.d(i) (ownership interest), above. See Chapter 6, Part E.1 for a discussion of the possibility of choosing after the startup day not to file a REMIC election. A similar strategy could be applied to a FASIT if it was determined after the startup day that the costs of the election would outweigh the benefits (and any required consents of affected parties to the change in course are obtained).

430 The requirement to file Form 8811 is described in Chapter 14, Part B.2. The form must be filed for any class of "collateralized debt obligations" described in section 1272(a)(6). The FASIT regulations would treat FASIT regular interests as collateralized debt obligations for purposes of information reporting whether or not they would be so treated for substantive tax purposes. See footnote 267, above. The current version of the form (reproduced in Appendix D) requires that it be filed on behalf of a FASIT by the Owner (provided that the FASIT is considered to issue a collateralized debt obligation within the meaning of Treasury Regulation § 1.6049-7(d)(2)).

2. *Ongoing Information Reporting*

For substantive tax purposes, all tax items of a FASIT are attributed to the Owner. Following this pattern, there is no separate information return for a FASIT. Rather, the FASIT regulations require each person that is the Owner of a FASIT at any time during a taxable year to attach a statement to its corporate tax return for the year, including the following:[431]

- information relating to the FASIT items of income, gain, loss, deduction or credit for the period (listing separately items from prohibited transactions, and identifying any tax-exempt income that is converted into ordinary income under the FASIT rules)
- if an ownership interest was acquired or transferred during the year, the date of the transfer and the name and address of the transferor or transferee, and, if the ownership interest was transferred, whether the transferee is an eligible corporation
- a description of prepayment and reinvestment assumptions made under section 1272(a)(6) with respect to any classes of regular interests that are issued during the year,[432] and
- if the qualifying arrangement ceases to be a FASIT during the year, the date of cessation, a description of how the cessation occurred and whether the arrangements will continue after the cessation (and if so, the continuing arrangement's name, address, and taxpayer identification number).

3. *Termination of FASIT*

A FASIT could potentially terminate in one of three ways. It could:

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431 Proposed Regulation § 1.860H-6(e).

432 Presumably this information is required only if the regular interests are in fact subject to section 1272(a)(6). For a discussion, see footnote 266, above. Curiously, the FASIT regulations do not require that the Owner provide in the FASIT statement a more general description of the terms and conditions of FASIT regular interests, either when the FASIT election is made, or more appropriately, during the year in which FASIT regular interests are issued. The REMIC regulations do include such a requirement. See Treasury Regulation § 1.860D-1(d)(2)(ii).

- liquidate by collecting cash receipts on assets and passing them through (without reinvestment) as distributions on FASIT interests until there are no assets left
- sell assets as part of a qualified liquidation and apply the proceeds and other cash to the retirement of FASIT interests,[433] or
- cease to qualify as a FASIT while it still holds assets by failing one of the FASIT qualification tests (e.g., through a transfer of the ownership interest to a person other than an eligible corporation, or by issuing an interest that is not permitted or holding a more than *de minimis* amount of nonqualifying assets).

In the first case, no special tax issues arise. The FASIT would cease to exist in the ordinary course, but the FASIT would be treated through the date of cessation as if it were continuing. When the FASIT did cease to exist, it would no longer have any assets or outstanding interests so there could not be any material consequences associated with their disposition or retirement.

In the case of a qualified liquidation, the FASIT would engage in extraordinary sales of assets. Income or loss from those sales would be reported on the Owner's tax return, but other than that, the treatment of the FASIT through the date of termination should be the same as if it simply ran out. Gain from sales during the liquidation period would not be subject to the prohibited transactions tax. Following the REMIC model, the Owner presumably would specify the first day of the liquidation period on the FASIT statement for the taxable year of the Owner which includes that day.[434]

The third case, in which the FASIT ceases to qualify as a FASIT, deserves special attention. Under the Code, the FASIT would lose its status as such at the time of the failure and for subsequent periods and could not make a new FASIT election without Service consent.[435] The Service may, however, waive an inadvertent FASIT termination subject to making such

433 FASIT qualified liquidations are discussed at footnote 227, above.

434 See section 860L(e)(3)(A)(i) referencing section 860F(a)(2)(A)(iv) (REMIC qualified liquidation) and Treasury Regulation § 1.860F-1 (REMIC rule).

435 See footnotes 422 and 423, above, and accompanying text.

adjustments (including paying a corporate tax on income) as the Service may require.[436]

In the absence of a waiver (or when the failure to qualify is not inadvertent), the effect of the termination of a FASIT at the time when it still has assets and outstanding interests should be that the arrangement comprising the FASIT and the interests therein revert to the status they would have under general tax principles. The substantive income tax consequences would thus depend on how the arrangement would be treated under general tax principles. For example, if the FASIT were a segregated pool of assets of the Owner, and the FASIT regular interests would be treated as debt, then the termination might be considered to have no significant consequences.[437] If FASIT regular interest were considered equity, the consequences would depend on how the entity was characterized. If the entity were a corporation, then the exchange of FASIT regular interests for stock should be treated essentially the same as if the stock were issued for cash in an amount equal to its fair market value and the debt were retired for that cash amount. Normally, there would be cancellation of debt income or, apparently, a deductible retirement premium, to the extent the deemed cash

436 Section 860L(a)(5), which states that rules similar to the rules of section 860D(b)(2)(B) (dealing with inadvertent terminations of REMICs) shall apply to inadvertent failures to qualify or remain qualified as a FASIT. The REMIC termination rule is described in Chapter 6, Part E.1. Proposed Regulation § 1.860H-3(d) paraphrases the REMIC statute. Thus, if (1) the Service determines that the cessation was inadvertent, (2) no later than a reasonable time after the discovery of the event resulting in the cessation, steps are taken so that all of the requirements for a FASIT are satisfied, and (3) the qualified arrangement constituting the FASIT and each holder of an interest therein at any time during the period the arrangement failed to qualify as a FASIT agrees to make such adjustments (consistent with the treatment of the arrangement as a FASIT or the treatment of the Owner as a C corporation) as the Service may require with respect to such period, then the Service may either deem the arrangement as continuing to be a FASIT notwithstanding the cessation, or allow the arrangement to re-elect FASIT status. An outcome that requires the holders of regular interests to agree to make adjustments would not seem to be practicable in cases where the regular interests are widely held.

437 One issue would be whether the mere change in the status of an interest from a FASIT regular interest to a non-FASIT obligation of the Owner would be a material enough change to trigger a deemed section 1001 exchange. See Proposed Regulation § 1.860H-3(c)(3); see also footnote 415, above.

payment was less or greater than the adjusted issue price of the debt.[438] The tax issues would be more complex if the equity were in a partnership.[439] In any event, it would seem under the statute that any prohibited transaction tax on the disposition of assets could be avoided simply by designating the day prior to the FASIT termination as the first day of a liquidation period.[440]

The FASIT regulations would treat the cessation of a FASIT without Service consent as the tax equivalent of a capital crime.[441] The results would be as follows:

- The FASIT would be required to mark-to-market each of its assets, using the subsection (d) value, and would be subject to a 100

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438 "Loss of FASIT status is to be treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule which deems regular interests of a FASIT to be debt. The Finance Committee understood that this treatment could result in the creation of cancellation of indebtedness income where the new instruments deemed to be issued are treated as stock under general tax principles." Conference Report at 322. Section 108(e)(8) treats an exchange of stock for debt as a retirement of the debt for money equal to the fair market value of the stock, but only for purposes of determining income of a debtor from discharge of indebtedness. There is no comparable rule governing retirement premium, although it would be difficult to justify a different result. An issuance of debt in exchange for stock is treated the same as an issuance for cash for purposes of determining the issue price of the debt. Special rules for issuances of debt in reorganizations (including recapitalizations) previously found in section 1275(a)(4) were narrowed and eventually repealed in 1990. Section 249 limits deductions for retirement premiums attributable to the conversion feature of a convertible debt, but the retired FASIT regular interests at issue here would not be convertible.

439 Where debt of a partnership is exchanged for an interest in a partnership, the consequences are more complex and beyond the scope of this book. For a discussion, see William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* (3d Ed., Warren, Gorham & Lamont), ¶ 4.02[3]. In a case where the FASIT is a separate entity that is distinct from the former FASIT Owner, a further issue would be whether the FASIT liquidation would involve an exchange of debt of the Owner for debt of a different person (the resulting partnership).

440 See footnote 434, above, and accompanying text. The FASIT regulations would impose more severe consequences as described below in the text.

441 See Proposed Regulation § 1.860H-3(c).

percent prohibited transactions tax "without exception" on any resulting gains. To the extent assets had losses, they would not be allowed. The FASIT's assets would take a fair market value basis (not the subsection (d) value), so there would be no basis step up for gains in excess of fair market value that have borne the 100 percent tax. Apparently, losses would be permanently disallowed.

- The Owner must recognize cancellation of indebtedness income in an amount equal to the adjusted issue price of the regular interests outstanding immediately before the cessation over the fair market value of those interests immediately before the cessation (on a regular-interest-by-regular-interest basis). Apparently, if the fair market value is greater than the adjusted issue price, no deduction would be allowed.[442]

- Regular interest holders must recognize gain (but not loss) upon an exchange of regular interests for other interests in the arrangement, unless those interests are classified as debt and the debt does not differ materially either in kind or extent from the regular interests. The basis equals the old basis increased by any gain.

These one-sided results are not called for by the statute or legislative history. The only specific result addressed in either one is a statement in the legislative history that an exchange of debt for stock may result in cancellation of debt income. As described above, the statute and legislative history would surely support not imposing any prohibited transactions tax. They also support determining the other consequences under general tax principles as if assets held by a corporation and secured by debt were transferred to the entity that is considered to own them following termination of the FASIT election and debt of the corporation were exchanged for the interests that exist following such termination. The highly adverse consequences listed in the regulations are particularly troublesome in that the regulations fail to distinguish among the three distinct circumstances in which a FASIT could terminate. For example, they ignore altogether the

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442 Proposed Regulation § 1.860H-3(c)(2)(ii) states, after describing the treatment of cancellation of debt income, that the Owner cannot take any deduction for "acquisition premium." Although not certain, most likely the drafters intended to refer to retirement premium.

qualified liquidation option. It is understood that this omission was simply an oversight.

Although the results spelled out in the regulations can potentially be avoided by seeking Service consent to a termination, the FASIT regulations give no reason to hope that the Service will consent to more lenient treatment, particularly in cases where the termination is not considered to be inadvertent. Indeed, they say nothing at all about the standards to be applied. Further, the delay and cost involved in obtaining a Service ruling makes that option impractical in many cases.

Unless the approach taken by the regulations in this area is reconsidered, the rules for FASIT terminations will surely serve to discourage use of the FASIT vehicle even in the cases where Congress clearly intended it to be available.

4. Payment of FASIT Taxes

As discussed in Part G.1, above, income of a FASIT is attributed to its Owner and included in the Owner's corporate income tax return. Thus, no special procedures are needed for paying and collecting any resulting tax.

Any prohibited transactions taxes are imposed on the Owner (presumably the Owner at the time when the income or gain subject to tax is recognized under general tax principles).[443] Although neither the Code nor the FASIT regulations address the point (or indeed discuss any procedural aspects of the prohibited transactions tax), it is likely that the tax would be due on or before the due date for the corporate income tax return on which the related income item is reported.[444]

The FASIT rules impose two excise taxes (that are intended to replace corporate income taxes) on noncorporate holders of FASIT regular interests: a tax on dealers that cease to hold high-yield interests in a dealer capacity,[445] and a tax on pass-thru entities that issue interests resembling high-

443 See footnote 214, above.

444 The annual FASIT information statement that must be filed by each Owner requires a separate listing of items attributable to prohibited transactions. See Proposed Regulation § 1.860H-6(e)(5). As discussed in Chapter 6, Part E.2.b, the REMIC prohibited transactions tax is payable by a REMIC together with the filing of the annual REMIC tax return (Form 1066). No estimated tax payments are required.

445 See Part F.2.c, above.

yield interests.[446] The FASIT regulations state that the first tax is due on or before the due date of the dealer's federal income tax return for the year in which the event occurs that triggers the tax[447] and that the second is due on or before the due date of the pass-thru entity's federal income tax return for the year in which the interests are issued that trigger the tax.[448] These provisions assume that the taxes are one-time taxes, which is not the case. They are imposed on income arising in taxable periods that can extend beyond one year. Hopefully, the regulations will be corrected to say that the taxes for any period included in a taxable year will be due on or before the due date for the taxpayer's federal income tax return for that year.

The Code states that the excise tax imposed on securities dealers is subject to the deficiency procedures of subtitle F (section 6211 through 6215).[449] As a result, a deficiency in such a tax is subject to review by the Tax Court prior to payment. There is no similar statement regarding the tax on pass-thru entities. Presumably, this difference was unintended.[450]

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446 See Part F.2.d, above.

447 Proposed Regulation § 1.860H-4(b)(1)(i).

448 Proposed Regulation § 1.860H-4(b)(2)(i).

449 Section 860K(d)(2)(C).

450 A very similar tax imposed on pass-thru entities holding REMIC residual interests is subject to the subtitle F deficiency procedures. See section 860E(e)(8).