Preface

This book is the fifth edition of *Federal Income Taxation of Securitization Transactions and Related Topics*. The last edition was published in 2011. The phrase "and Related Topics" was added in the fourth edition to reflect the fact that the book is not limited to securitizations. Rather, it is intended to serve more broadly as a practitioner's handbook, addressing a range of topics that are important in a financially-oriented tax practice. Some of the related topics are listed in the preface to the fourth edition, which is reproduced below. Also, Chapter 1, Part B, describes the contents of each chapter of the book.

One important innovation with the fifth edition is that the book is now available not only in hard copy but also in a searchable electronic form through the Tax Analysts web site. Thus, readers can now consult the book on a tablet; or get extra help in finding materials that may be of interest in what has become quite a voluminous tome. Also, to make the book more accessible, the price of the printed version has been reduced significantly.

The fifth edition mostly updates the last edition to reflect changes in law and practice over the past seven years. The law changes include the enactment at the end of 2017 of what is known popularly as the Tax Cuts and Jobs Act (*TCJA*). To state the obvious, TCJA made very significant changes in the Code. Chapter 1, Part C, summarizes the ones that are most consequential for securitizations.

Two particularly noteworthy new rules are: (1) section 163(j) (a new version), limiting deductions for net business interest (a surprisingly intricate provision, covered in Chapter 9, Part C.2), and (2) section 451(b), requiring large taxpayers with audited financial statements to accelerate an item of gross income as needed to match book reporting (the details are in Chapter 8, Part I). The book income acceleration rule is aimed at certain fees earned by credit card issuers, but has a much broader reach.

TCJA also overhauled the law relating to foreign corporations with U.S. shareholders. However, the changes mostly affect corporations with active businesses. Thus, they should have limited effects on foreign corporations with passive income, such as offshore issuers in securitizations. Explaining why that is so technically is still a bit of a story, which is told in Chapter 12, Part G.

The fifth edition also has new or expanded coverage of:

- credit risk transfer securities, which have been added to the catalog of securities discussed in Chapter 2 (focusing on CRTS issued by Fannie Mae and Freddie Mac that shift the risk of mortgage losses to investors)

- partnership issuers (which, among other things, are now being used more often as offshore issuers of CDOs), in Chapter 2, Part M, Chapter 5, and Chapter 13, Part J
- revised partnership audit procedures that became effective starting in 2018 and may result in liabilities imposed at the partnership level (see Chapter 5, Part C.5), and steps that can be taken to reduce creditor exposure to them (in terms of potential entity-level tax liabilities, TCJA also expanded the existing partnership withholding tax on U.S. business income allocable to a foreign partner)
- in Chapter 3, Part E.4, new case law treating instruments in the form of equity as debt, and in Part E.1, the implications for securitizations of the 2016 section 385 debt/equity regulations (in the Trump era, much less than once was feared, to the extent the regulations survive at all)
- short-term REMICs used to accelerate built-in mortgage losses, and the application of the economic substance doctrine to REMICs (Chapter 6, Part D.12, and Chapter 15, Part E.2)
- the effect on REMICs of receiving settlements relating to breaches of representations about the quality of acquired mortgages (Chapter 6, Part D.13)
- an important 2013 revenue procedure relating to OID on credit card receivables, which will need to be rethought in light of the addition by TCJA of the book income acceleration rule (see Chapter 8, Parts G.4.c and I)
- significant developments in the application of the TEFRA registration rules, and portfolio interest exemption, to pass-through certificates and participation interests (Chapter 12, Parts B.4 and C.2)
- FATCA, including a rewrite, with the benefit of several years of experience, of the entire FATCA discussion (found in Chapter 12, Part E) to reflect the law as it has developed through years of furious rule writing, and how securitization issuers have coped
- effects on offshore issuers of the aggressive expansion of the inversion rules (Chapter 13, Part B)
- changes in reporting rules for foreign assets aside from FATCA (Chapter 14, Parts H.6 and J)
- discussion of new law (or proposed law) for bifurcating derivatives as part of the general discussion of when property interests are aggregated or separated for tax purposes (Chapter 16, Part F.9)
- the use of a segregated portfolio company to create within a single legal entity a tax law partnership and a tax law corporation with stapled interests, where the use of a single entity is required to address a regulatory requirement (Chapter 16, Part H.1)

- changes in reportable transaction rules and Circular 230 as they relate to securitizations (Chapter 17, Part B)
- the demise, courtesy of a patent law change, of tax strategy patents (Chapter 17, Part C), which were once a significant concern for securitizations, and
- the addition to the CDO guidelines in Appendix C of special rules for broadly syndicated loans, including those sold in best efforts placements (see Appendix C, Part E).

Appendix B in prior editions had the text of some of the Code sections and regulations that were most important for securitizations, which are now readily available to all online. Appendix B in the fifth edition has a new mission. It groups by subject matter many of the more significant Code and regulation sections a tax professional working in the financial products or financial institutions field ought to know about. It also lists significant IRS forms. Thus, it is a brief guide (a Code Baedeker) to primary sources for those who either are new to the area or simply want a checklist.

Many people have contributed to the fifth edition. The authors wish to acknowledge with thanks the efforts of their colleagues at Cleary Gottlieb Steen & Hamilton LLP and Chapman and Cutler LLP, including Mary E. Alcock, S. Douglas Borisky, Allison H. Breault, David S. Fisher, Corey M. Goodman, Seth Grosshandler, Nicholas Gumas, Cynthia Hiris, Mandeep Kalra, Steven Kopp, Maria Littrell, Susanna E. Rebecca Reeb, Sandra M. Rocks, Beau Sterling, and Derek E. Wallace.

We also appreciate the efforts made by the people at Tax Analysts to make the book available through their web site.

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Preface to Fourth Edition

This book is the fourth edition of *Federal Income Taxation of Securitization Transactions*. The last edition was published in 2001. The phrase "and Related Topics" has been added to the title to reflect the fact that the book is not limited to securitizations. Rather, it is intended to serve more broadly as a practitioner's handbook, addressing a range of topics that are important in a financially-oriented tax practice but generally not covered, at least in the same depth, in other sources.

To give some examples of such topics, the new edition discusses:

- authorities in fourteen different areas analyzing who is the tax owner of debt instruments or other property where multiple parties have economic interests in the property (the tax ownership tests are also contrasted with the requirements for a sale under GAAP, and for a "true sale" that removes property from the reach of creditors)
- various debt/equity issues that arise in financial transactions, including the need for equity to support debt in the case of borrowers holding financial assets, and when instruments in the form of equity may be treated as debt (and more broadly when tax planners may depart from form)
- the circumstances in which "disregarded entities" are in fact recognized to be entities for tax purposes, when a tax "entity" exists more generally, when a person is treated as the owner of an entity, and the tax classification of segregated portfolio (or series) companies
- the classification and treatment of trusts in commercial settings, including an in-depth discussion of grantor trust rules and how they compare with partnership rules
- the multiple class trust (or Sears) regulations
- the passive income exception for publicly traded partnerships, with a focus on when interest income is considered to be earned in a financial business (and thus is not passive)
- the contours of the election out from subchapter K for investment trusts
- stripping of bonds and stocks, including variable strips, strips of tax-exempt and tax-credit bonds, and LEGO certificate structures that allow investors to rearrange partial interests in bonds at their election in the after-market
- the tax treatment of pools of debt instruments, including when a pool is treated as a single property unit and simplifying assumptions
- the existence of original issue discount in consumer receivables, including the treatment of credit card fees
- the treatment of interest-only securities, including when prepayment losses are deductible

- the tax treatment of defaulted debt instruments purchased at a discount (including the ability to use basis first recovery methods for individual debt instruments or pools, the triggering of artificial gains from loan modifications, and the effect of the PAC method in section 1272(a)(6))
- the treatment of debt instruments combined with various other financial instruments
- special bank rules for determining the character of gains or losses from debt instruments and issues arising under those rules when debt is owned by a bank through a partnership or disregarded entity
- the mark-to-market rules for securities dealers (there is a detailed discussion of section 475), including issues raised by difficult-to-value securities
- the application of the TEFRA registration rules to various categories of securities with pass-through features
- FATCA withholding and information reporting
- the foreign withholding tax rules applicable to debt instruments and ancillary income, such as consent fees
- offshore issuers of securities that hold U.S. debt assets and related derivatives with U.S. counterparties (including the securities trading safe harbor, and the line between loan origination and trading or investing and guidelines for policing that line)
- information reporting affecting a wide range of domestic and foreign issuers
- an extensive discussion of when state law property interests are aggregated or bifurcated for tax purposes, using common law and rules-based examples taken from a wide range of tax law sources (including a description of various financial products and transaction structures that have over the years raised aggregation or separation issues, including business intangibles, contingent payment debt, convertible and exchangeable debt, Feline PRIDES, guarantees, hedges, income deposit securities, income rights, notional principal contracts, partnership equity, prepaid forward contracts, PRIMEs and SCOREs (Americus Trust interests), shared appreciation mortgages, stapled stock, stock with unusual features, straddles, and unbundled stock units)
- tax strategy patents affecting financial instruments, and
- the rules for reportable transactions, Circular 230 covered opinions, and other tax shelter measures, focusing on the financial area.

Needless to say, as in prior editions, the book addresses core topics directly relevant to securitizations, such as fixed investment trusts issuing pass-through certificates, REMICs, and taxable mortgage pools, and the PAC method for accruing original issue discount. It has a comprehensive description of the many different categories of instruments issued in securitizations

with an explanation of how they are taxed and why they were developed. The list has been expanded to include some new entries (described below).

Securitizations themselves are undergoing a period of retrenchment following the financial crisis of 2007 and 2008. Shaky mortgages and securities representing interests in them obviously contributed to the problem. CDOs have been equated by critics to weapons of mass destruction. Derivative instruments, including particularly those that shifted credit risks relating to securitized assets, have entered the popular culture with a negative spin. In October 2008, Garrison Keillor had a segment on his radio show, a *Prairie Home Companion*, in which the detective Guy Noir was hired by Hank Paulson to find out what credit defaults swaps are. At least the *tax* treatment of securitizations has not been blamed for bringing the economy down!

The responses to the losses associated with securitizations have included a tightening of financial accounting rules (specifically, the adoption of FASB Statements 166 and 167) to bring more securitized assets on balance sheet, and increased regulation or at least threats of same (including stricter underwriting standards and disclosure about receivables and in some cases requirements for sponsors to retain risk). As these blows are absorbed and understood, and investors lick their wounds, for some considerable period new issues of asset-backed securities without government backing will be far below the peaks reached in the early parts of the decade.

Despite these changes, two basic economic facts remain: there is a continuing need to finance receivables and—a lesson from the thrift crisis of the 1980s—there is a benefit in shifting associated risks and returns away from financial intermediaries with short-term funding to longer-term investors. One past goal of securitizations, to transfer assets off balance sheets without shedding too much in the way of risks or rewards, will play a smaller role going forward.

Paradoxically, perhaps, from the perspective of a tax advisor, the future of securitizations seems fairly bright, at least in the sense of embarking upon interesting times. Market participants will of necessity try new things, and novelty is more beguiling for tax advisors than repetition. Further, achieving GAAP sale treatment for a pool of receivables will require a greater portion of the associated benefits and burdens to be shifted to investors, and generally transactions in which investors are more like owners and less like creditors raise harder tax questions.

No one can predict what securitization practices will be in the future, but the book is designed to be useful regardless of how the market develops. Thus, while the book describes specific types of asset-backed securities and structures for issuing them, it is mostly organized around the broader substantive issues that must be addressed in analyzing the tax treatment of a proposed structure, whatever the specifics may be. These include sales versus financing (and other tax ownership issues), debt versus equity, entity classification, tax rules for debt instruments, tax rules for foreign investors and other specific

categories of taxpayers (including securities dealers), tax rules for foreign issuers, and when state law property units are bifurcated or aggregated.

We have deliberately retained the discussion of some securitization structures that likely will not be widely used for nontax reasons in the near term where they raise tax issues of broader interest. One example is pass-through debt certificates, which are securities that take the form of equity but are intended to qualify as debt. When interests in an entity taking the form of equity can or must be treated as debt is a significant concern in a number of areas.

A new edition offers a welcome opportunity to bid farewell to the FASIT regime, which was the subject of a lengthy chapter (Chapter 16) in the third edition. Those rules became effective in 1997, and were (1) not workable and therefore hardly ever used for their intended purpose, (2) abused by Enron and featured in a Joint Committee on Taxation staff report on Enron's tax shenanigans, and (3) repealed in 2004. *Veni, dormivi, cecidi.*[1] The discussion of FASITs in this edition is limited to a brief historical survey in Chapter 2. For anyone having a more than passing interest in the FASIT era, Chapter 16 from the last edition is available on the book's website.

Some of the principal changes from the last edition, chapter-by-chapter, are as follows.

Chapter 2 discusses some additional categories of asset-backed debt (NIMS, asset-backed commercial paper, covered bonds, and notes issued in stranded cost or transition cost securitizations) and tender option bonds (which we call generically synthetic variable rate tax-exempt bonds), which are created through a multiple-class trust structure. Chapter 2 considers the important effect that GAAP consolidation rules have historically had on securitizations and describes the changes wrought by FASB Statement 167 adopted in 2009. The discussion of CDOs now covers synthetic versions. The discussion in Chapter 2 of securities backed by financially distressed receivables has references to the different parts of the book (an expanded list) addressing the topic.

Chapter 3, which considers sale/financing and debt/equity issues, has an updated comparison of tax and GAAP standards for sales, reflecting the adoption in 2009 of FASB Statement 166. Chapter 3 summarizes authorities in a number of areas analyzing the tax ownership of debt instruments and adds to the list (now at fourteen) forward contracts (including the prepaid variety), stranded cost securitizations, variable life insurance and annuity contracts, and the treatment of an entity as an agent of its owners (the *Bollinger* fact pattern). The discussion of debt/equity issues has been updated to reflect additional case law and other authorities, and (in summary form) changes in bank regulatory capital standards, which we point to as a possible analogy in determining the amount of equity needed to support debt.

Chapter 4 describes the tax classification of entities other than REMICs. It has two new sections that describe when disregarded entities are not in fact

[1] "I came, I slept, I fell."

disregarded (a surprisingly rich topic), and segregated portfolio (or series) companies. The latter have come into widespread use in the last decade and receive a full treatment, including a description of recently proposed regulations. Chapter 4 has a revised discussion of permitted variable rate bond stripping structures allowed under the Goldman Sachs private letter ruling and stripping transactions involving stocks.

Chapter 5 compares the tax treatment of local-law trusts classified alternatively as grantor trusts or partnerships. As new topics, it discusses mandatory basis adjustments under section 743 for transfers of interests in partnerships with substantial built-in losses and the exceptions for securitizations. It also discussed significant developments relating to the election out of subchapter K.

Chapter 6 on REMICs has an expanded discussion of the release rule (disqualifying loans as REMIC assets upon a release of real property collateral), the effect on qualified mortgage status of paperwork and other defects, uses of REMICs to hold mostly distressed loans, programs to facilitate mortgage modifications, mortgages providing for future advances such as reverse mortgages, regular interest classes with a guaranteed final maturity, and re-REMICs.

Chapter 7, dealing with REMIC regular interests, adds a discussion of how to carve up cash flows on specified portion classes in re-REMICs and adds an example on specified portion classes carved from accreting reverse mortgages.

Chapter 8 describes the tax treatment of holders of securities taxable as debt. It covers a number of new topics. One is the treatment of credit card fees as original issue discount. Another is stripping tax-exempt and tax-credit bonds. There is an expanded discussion of distressed debt generally and of the circumstances in which an owner of a pool of distressed assets may be able to apply payments received as an offset to basis before reporting income. The chapter also considers the artificial gain that may be realized when debt purchased at a discount is significantly modified (producing a realization event under section 1001). Chapter 8 has new sections discussing payment lags on REMIC regular interests and also investment in U.S. property issues that arise when a controlled foreign corporation holds a REMIC regular interest.

Chapter 9, which deals with equity interests in trust issuers of debt and REMIC residual interests, discusses a number of new topics. They include the treatment of foreign withholding taxes imposed on interest income of a REMIC, the aggregation of REMIC tiers in calculating and reporting excess inclusion income, the character of losses from sales of REMIC residual interests, a number of new issues relating to residual interests held by pass-through entities, changes in safe harbor rules relating to transfers of residual interests, regulations relating to the timing of income from inducement fees, and tax law changes that limit the duplication of built-in losses in residual interests.

Chapter 11 discusses among other things special rules for REITs, financial institutions and securities dealers. The discussion of REITs has been expanded to describe when mezzanine debt secured by an interest in a pass-through entity holding debt may be considered a real property mortgage for REIT qualification purposes, foreign currency issues faced by REITs holding mortgages denominated in a nonfunctional currency, and structures in which domestic and foreign issuers of asset-backed securities are treated as qualified REIT subsidiaries. The discussion of mark-to-market rules for dealers in Chapter 11 considers difficulties that have been encountered in recent years in marking to market derivatives and illiquid securities and book-tax conformity rules. It describes the GAAP standards for valuing securities under FASB Statement 157 and related controversies.

The discussion of foreign investors in Chapter 12 has been updated to describe new source and withholding tax rules for income from REMIC residual interests, rules explaining how the portfolio interest exemption applies to debt held through partnerships, and the recent HIRE Act legislation that, among other things, eliminates the Eurobond exception prospectively and adds the FATCA regime. FATCA requires foreign entities to report on U.S. accounts and owners or suffer a punitive withholding tax. Chapter 12 adds a discussion of the withholding tax treatment of fees relating to debt instruments.

Chapter 13 discusses issuers that are foreign corporations. It describes when the inversion rules in section 7874 may apply in securitizations to cause foreign corporations to be treated as domestic. It also has a more extensive and updated discussion of lending activities in the United States (including related guidelines). The discussion of anti-deferral regimes applicable to investments in stock of foreign corporations has been rewritten to reflect the 2004 consolidation of those rules.

Chapter 14 discusses legending and information reporting. Since the last edition, an extensive and highly complex reporting regime for widely-held fixed investment trusts (WHFITs) has been adopted. It is described in detail. A new discussion has been added of the tax penalties that apply to REMIC returns, the reporting of foreign disregarded entities, and new requirements for PFICs. The chapter also describes FATCA and FBAR reporting, which may affect securitizations. There are new sections on reporting by issuers of tender option bonds and with respect to tax-credit bonds.

Chapter 16 in the last edition described FASITs. With their repeal, that chapter has been dispatched to the ash bin, although it is still available on the book's website at www.securitizationtax.com. Since nature abhors a vacuum, there is a new Chapter 16, which discusses a tax topic that runs throughout securitizations and tax practice generally. It is when property interests as defined by local law are aggregated or separated for tax purposes. The chapter describes both common law principles and specific rules in the Code or regulations. The topic is almost impossible to research except in narrow areas, and

the discussion is intended as a gift to young tax professionals who might be called upon (unjustly) to do just that.

Chapter 17 discusses three special topics: (1) instances of aggressive tax planning in the securitization area and the related topics of reportable transactions and Circular 230 covered opinions, (2) tax strategy patents, and (3) proposals to reform the tax treatment of securitizations. Most tax planning in the securitization area is defensive and conservative, but there have been a few exceptions that have come to light. In any event, the reportable transaction and covered opinion rules that have been adopted to curb tax shelter activity apply to all areas of tax law. They are summarized, with a focus on their application to securitizations. Tax patents are discussed because a number of them pertain to the tax treatment of securitizations. Unless and until tax patents are killed off by case law or statute, the topic is worth knowing about. The discussion of reforms is based largely on an extensive 2002 New York State Bar Association, Tax Section report (written principally by one of the authors of this book). Chapter 17 provides a scorecard of recommendations that have and have not borne fruit.

We have dropped from the last edition the appendix with IRS forms, as they are now readily available to all on the IRS website. Appendix B with relevant Code sections and regulations remains but has been moved to the book website.

A new Appendix C has illustrative trade or business guidelines for offshore CDO issuers. The guidelines seek to steer such an issuer clear of activities that would cause it to be engaged in a U.S. trade or business and incur a related U.S. net income and branch profits tax. The guidelines may also be useful for offshore investment funds having the same tax concerns.

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