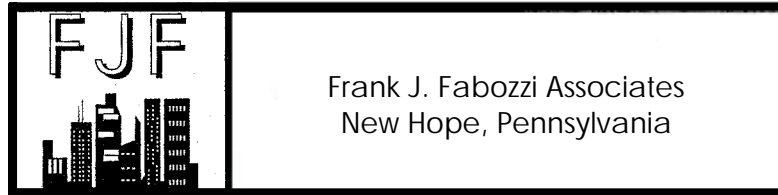


Federal Income Taxation of Securitization Transactions

Third Edition

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David Z. Nirenberg**

Published by Frank J. Fabozzi Associates



Book Web site: www.securitizationtax.com

FJF Web site: www.frankfabozzi.com

Cover design: Randall O. Hamilton

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ISBN 1-883249-93-7

Printed in the United States of America

For
Rickie, Lauren, and Alexandra
Elaine, Paul, Sarah, and Eric

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Preface

This book is a new edition of *The Federal Income Taxation of Mortgage-Backed Securities* (Revised Edition, Probus Publishing Company, 1994). It has been expanded to cover securities backed by non-mortgage assets (including revolving pools) and updated to reflect the many changes in the law and in practice that have occurred since 1994. The title of the book has been changed from prior editions to reflect not only the inclusion of other asset-backed securities within its scope but also the fact that it addresses securitization transactions broadly, from the perspective of the sponsor, issuer, and investors, and not just the resulting securities. The three most notable tax law changes are the adoption of a check-the-box system for determining the tax classification of trusts, limited liability companies, and other unincorporated entities; the enactment of the FASIT rules; and the extension of the prepayment assumption catch-up method (PAC method) for calculating accruals of discount and premium to pools of debt instruments, including pass-through certificates representing interests in such pools. Significant changes also have occurred or are proposed relating to information reporting by trusts and holders of trust interests. For periodic updates on pertinent tax law developments after December 2000, readers are referred to the book's Web site (see page ii, the copyright page, above).

In preparing the third edition, changes have been made throughout the book. Chapter 1 has been revised to provide an outline and overview of the topics covered in the book. The description of the different types of asset-backed securities in Chapter 2 has four new entries, reflecting tax law changes and market developments: callable pass-through certificates, LEGO certificates (our term for pass-through certificates that can be pulled apart or recombined by investors), FASIT interests, and securities issued by offshore corporations.

In expanding the book beyond mortgage-backed securities, we have dealt more comprehensively with some of the core tax issues that affect a

broad range of securitization transactions. A new Chapter 3 addresses the tax law distinction between a sale and a financing and between equity and debt. The sale/financing discussion contrasts the governing tax standards with the tests that apply under GAAP (FASB 140, the successor to FASB 125) and in testing if there is a true sale that removes assets from the reach of creditors of a transferor. The chapter also addresses the risk that debt will be recharacterized as equity based on the thin capitalization of the issuer as well as the arguments for upholding the intended treatment as debt of trust certificates backed by revolving pools of loans (a structure used most prominently to finance credit card balances).

Chapter 4 discusses the tax classification of issuers (other than REMICs or FASITs), including the new check-the-box classification system. The new rules make it easier to avoid classification of a trust or other unincorporated entity as a taxable corporation. Nonetheless, it is still the case that an unincorporated entity will be treated automatically as a corporation (subject to the corporate income tax) if it has outstanding publicly traded equity and fails to meet a passive income test (requiring 90 percent of its income to be passive). Passive income generally includes interest unless the interest is derived from a financial business. A financial business includes securities dealing and loan origination, but not investing or trading in securities. The publicly traded partnership rules received little attention in prior editions because the passive income test would invariably be met in any fixed-pool securitization, which is the common pattern for mortgage-backed securities. Non-mortgage securitizations, on the other hand, often involve revolving pools. Chapter 4 includes an extensive discussion of when an issuer holding changing pools of receivables crosses the line and is engaged in a financial business. A similar distinction also is important in taxing offshore issuers (more about them below) and FASITs. Chapter 4 also includes a new section discussing how the definition of a taxable mortgage pool applies to revolving pool structures.

The check-the-box rules change the standards for classifying business entities, but do nothing to clarify the tests for deciding whether an entity organized as a trust under local law will be classified for tax purposes as a trust (and therefore taxed as a grantor trust) or instead will be classified as a business entity (and, assuming more than one owner, taxed as a partnership). Although neither a grantor trust nor a partnership is subject to the corporate income tax, it is still important to know how a local-law trust is classified. To assist readers in understanding the stakes, a new Chapter 5

describes and compares the substantive tax rules governing grantor trusts and tax law partnerships.

Chapter 8 addresses the tax treatment of investors holding securities taxable as debt, including pass-through certificates representing interests in grantor trusts holding debt instruments. The chapter includes a new discussion of how discount and premium rules apply to such certificates in light of the change in law extending the PAC method to pools of debt instruments.

A mark-to-market system applies to asset-backed securities held by securities dealers. For this purpose, the definition of dealer is quite broad, and generally includes any person who originates loans for resale. In addition, securitization transactions raise many technical issues in applying the dealer rules. Chapter 11 includes an expanded discussion of this topic.

Offshore issuers are widely used in securitizations of high-yield bonds and loans. The tax issues faced by offshore issuers and holders of interests in those issuers are considered in a new Chapter 13. It includes a brief discussion of offshore issuers of catastrophe bonds.

Chapter 16 addresses the qualification and taxation of FASITs and the tax treatment of FASIT sponsors and investors. Market participants welcomed the FASIT rules with some enthusiasm when they came into the world in 1996 (effective September 1, 1997). Unfortunately, the legislation is not user-friendly. While the Internal Revenue Service could have taken action to remedy some of the problems, the agency has proceeded at a most deliberate pace. In the second month of the new millennium, proposed FASIT regulations were issued that, in brief, need work. In practical terms, the FASIT vehicle is not likely to be viable in most settings until revised regulations are issued.

In prior editions, we reproduced Internal Revenue Service rulings and advice. Because those materials are now readily available electronically to any reader, we have dropped them from this edition.

Many people have contributed to the third edition. The authors wish to acknowledge the efforts of their colleagues at Cleary, Gottlieb, Steen & Hamilton and Orrick, Herrington & Sutcliffe LLP, including Eric Atkerson, Linda M. Beale, S. Douglas Borisky, Jennifer M. Brown, Bobby Chan, Kenneth W. Chase, Leonard M. Cole, Sherri Druckman, Lita Inderjit, Kristofer W. Hess, Richard Horan, Kim Killion, Rachel Kleinberg, Steven L Kopp, Janet Rothholz, and Ann Wood.

We also wish to acknowledge the contributions of Martin J. Rosenblatt and Terence B. Meyers, who commented on accounting and information

reporting matters, and the efforts of Frank J. Fabozzi and the other people of Frank J. Fabozzi Associates.

James M. Peaslee
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New York City
January 2001

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Chapter 1

Tax Issues in Securitization Transactions

The subject of this book is the U.S. federal income taxation of securitization transactions.¹ The securitized assets may be real estate mortgages or other types of consumer or commercial payment obligations (collectively, *receivables*). The securities supported by the receivables (whether they be mortgages or other obligations) will be referred to as *asset-backed securities*.² The book discusses tax consequences for all of the principal participants: issuing vehicles (sometimes *issuers*), investors, and sponsors. This chapter provides an introduction to the book and an outline of the topics it covers.

In a typical securitization transaction, an owner of a pool of receivables conveys them, directly or through an intermediary, to a trust or other legal entity, which in turn issues securities backed by those assets. For

1 The discussion in this book is current through December 2000, and is, of course, subject to change through subsequent legislation, administrative actions, or judicial decisions. The authors intend to provide periodic updates, as warranted by developments, through the book's Web site (see page ii, the copyright page, above). Except where otherwise noted, section citations in this book are to the Internal Revenue Code of 1986 (*Code*). There are citations throughout the book to private letter rulings, technical advice memoranda, general counsel memoranda, field service advices, and other informal Internal Revenue Service (*IRS* or *Service*) guidance. While these sources are not binding on the Service and may not be used or cited as precedent (see section 6110(k)(3)), they are nonetheless helpful in determining the views of the Service.

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

mortgages and other long-dated receivables, the pool typically is fixed or substantially fixed. In the case of short-term receivables, such as credit card balances, payments on receivables may be reinvested for some periods, producing a revolving asset pool. In a fixed-pool securitization, the issuer acts largely as a cash funnel, collecting and combining payments on the pooled assets and directing them to different investor groups. When there is a revolving pool, the issuer takes on the added role of reinvesting payments for some limited term. While the issuer's role as an intermediary is economically useful, a securitization transaction almost certainly would not be viable if passing cash through the issuer resulted in significant additional tax burdens. One of the main goals of tax planning in this area—indeed the *sine qua non*—is to ensure that no such tax costs are incurred.

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

- pass-through certificates issued by grantor trusts (including stripped certificates representing non-pro rata rights to principal and interest, senior/subordinated certificates, callable certificates, and LEGO certificates which can be separated or combined)
- pay-through bonds (debt instruments that receive cash based on collections on underlying assets) issued by domestic issuers
- equity interests in issuers of pay-through bonds
- REMIC interests
- pass-through debt certificates (instruments taking the form of trust equity that are intended to be classified as debt under general tax principles—these types of securities are most often issued by credit card trusts)
- FASIT interests, and
- interests in foreign corporations (which may be debt or stock).

REMICs and FASITs are pools of receivables that elect to be subject to special sets of tax rules for securitization vehicles. They are discussed further below in this chapter. Pass-through certificates issued by grantor

trusts and REMIC interests are backed by fixed asset pools. Pass-through debt certificates generally are suitable only for revolving pools. FASIT assets may be fixed or revolving. Pay-through bonds were traditionally backed by fixed pools but more recently have begun to be used to securitize revolving pools as well. Offshore issuers may be used to securitize fixed or revolving pools.

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

In order to analyze properly a securitization transaction, it is necessary to know whether the conveyance of receivables to an issuing vehicle by the sponsor should be treated for tax purposes as a sale or instead as a financing (that is, a pledge of assets to secure indebtedness). Chapter 3 discusses the standards used in distinguishing a tax sale from a financing. It compares tax law criteria with criteria under U.S. GAAP (specifically, FASB 140) and with the standards for testing creditors' rights in a bankruptcy of the transferor (in the jargon of securitizations, whether there is a *true sale*).

The sale/financing distinction asks whether a transferee of an interest in an asset acquires an ownership interest therein, or instead a debt claim backed by the asset. Viewed from the perspective of an issuer of asset-backed securities, a similar question arises in determining if securities it issues are properly classified as debt or equity for tax purposes. Chapter 3 also addresses debt/equity distinctions of this type. This topic has a rich history in the tax law generally. The chapter focuses on aspects of the problem that are of particular interest in securitizations. These include: the need for minimum equity where purported debt classes are adequately supported without it, the need for a minimum principal amount, and the ability to classify instruments that are in form equity (specifically, pass-through certificates issued by a trust) as debt. The debt/equity issue affects not only whether the issuer is allowed to deduct income it pays to investors (interest is deductible, equity distributions are not), but also, potentially, how the issuer is classified for tax purposes (as a corporation or something else) and how investors are taxed.

The best way to ensure that an issuing vehicle is not itself taxed is to avoid having it classified for federal income tax purposes as a corporation. With very limited exceptions, federal income taxes apply only to entities

that are considered corporations.³ While business corporations are not often used as issuers of asset-backed securities, federal tax law also treats unincorporated business entities as corporations in some circumstances. The relevant classification tests are found largely in Treasury regulations. These regulations were overhauled, effective at the beginning of 1997, to introduce an elective (*check-the-box*) classification system. Two important exceptions to the elective feature of the regulations are Code rules that automatically treat as corporations *publicly traded partnerships (PTPs)* that engage in some active business (including a financial business) and *taxable mortgage pools (TMPs)*. (The TMP rules are described further below in this chapter.)

Entities that are classified for tax purposes as trusts are not considered business entities that may be classified as corporations under the Treasury regulations, and therefore avoid being classified as corporations under general classification standards. Unfortunately, the tax status of an entity as a trust is not determined solely by whether it is organized as a trust under local law. Largely in response to developments in the securitization area, a set of complex rules have been devised to make the determination (the rules dealing with multiple-class trusts are found in Treasury regulations that are known to many as the *Sears regulations*).

Chapter 4 discusses the tax classification of unincorporated entities (other than REMICs or FASITs), and addresses specifically the check-the-box rules, the classification of trusts (including the *Sears regulations*), and the TMP and PTP rules. As noted above, a PTP may be classified as a corporation if it is engaged in a *financial business*, and the meaning of this term is discussed in some detail. REMICs and FASITs are considered in later chapters.

The check-the-box rules have accomplished a good deal by making it easy to avoid the unintended classification as a corporation of an entity organized as a local-law trust (assuming the PTP and TMP rules do not apply). They do nothing, however, to crystallize the standards for testing whether a local-law trust with multiple owners should be classified as a trust or instead as a partnership. While neither type of entity would suffer the burden of corporate taxation, the substantive tax rules for the two are quite different. A trust is taxed as a *grantor trust* and is generally ignored.

³ It is worth noting that a number of those exceptions arise only in the securitization field, where taxes may be imposed on pass-through entities in lieu of taxes that otherwise would be imposed on nontaxable equity owners. See Chapter 9, Part E.4 (REMICs); Chapter 16, Part F.2.d (FASITs).

By contrast, a partnership is recognized to be a separate entity for many tax purposes and is subject to a complex set of tax rules found in subchapter K of the Code. Because of the importance of this distinction in the securitization area, Chapter 5 describes the substantive tax rules governing grantor trusts and partnerships and compares the two. In almost all cases, trust status is preferred by market participants. The chapter also discusses a limited right of investment partnerships to elect out of subchapter K. (Information reporting rules also differ significantly for trusts and partnerships; information reporting is discussed further below in this chapter.)

Apart from the TMP discussion, Chapters 2 through 5 address topics that are relevant to securitizations of all types of receivables. Chapters 6 and 7, by contrast, are devoted to the *real estate mortgage investment conduit (REMIC)* rules, which as the name implies are a set of tax rules for pools of real estate mortgages and interests therein. The REMIC legislation was added to the Code by the Tax Reform Act of 1986 (*TRA 1986*)¹ in response to the issuance (in proposed form) of the Sears regulations two years before. A REMIC can issue multiple-class pass-through securities without an entity-level tax. Although the REMIC regime is elective (subject to inducements provided by the TMP rules, as discussed below) and has certain anti-avoidance features, REMICs have become the tax vehicle of choice for issuing multiple-class, sequential-pay mortgage-backed securities. A REMIC can issue only two types of interests: a single residual class and one or more classes of regular interests which resemble debt (or rights to payments on debt instruments). Chapter 6 discusses the REMIC qualification tests apart from the definition of a regular interest, as well as the tax treatment of, and procedural rules affecting, a REMIC.

The advent of the REMIC rules has led to a blossoming of financial engineering in the mortgage-backed securities area. From a tax advisor's perspective, the main brake on the engineers' creativity has been the need to ensure that REMIC classes (except for the one residual class, which usually has nominal value) meet the definition of a regular interest. The definition involves formulas that can be manipulated (using that term with no pejorative connotation) to produce strange and wonderful results, particularly when more than one tier of REMICs is employed. All of this necessitates a separate chapter on the definition of a regular interest, which is Chapter 7.

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

holding debt instruments. The chapter describes the general tax rules governing debt instruments, including those relating to *original issue discount (OID)*, market discount, and premium. It also addresses the special rules in section 1272(a)(6) (added to the Code by TRA 1986) dealing with REMIC regular interests and non-REMIC debt that is subject to prepayment based on the prepayment of debt collateral. The scope of section 1272(a)(6) was broadened in 1997 to apply to any pool of debt instruments, whether or not part of a securitization. The handling of prepayment contingencies is a particularly sensitive issue for high-coupon, premium debt classes or low-coupon, discount classes backed by prepayable receivables. Those classes have yields highly sensitive to prepayment speeds. The chapter also discusses the bond stripping rules of section 1286, which subject to the OID rules any discount at which stripped bonds or coupons are acquired.

Not all asset-backed securities are taxed as debt instruments. One exception is equity interests in trusts issuing debt; another is residual interests in a REMIC. Where a trust or REMIC issues sequential-pay securities with increasing yields (lower yields for short-term classes and higher yields for long-term classes), the result may be a mismatch in the timing of income and deductions that produces *phantom income* for the holders of the equity or residual interest. Phantom income, as the term is used in this setting, is taxable income that necessarily will be reversed through later losses and never will be realized in cash.⁴ The REMIC rules incorporate a host of special measures to ensure that holders of residual interests are always subject to tax on phantom income, even if they are otherwise generally exempt from income tax. These rules were adopted in recognition of the fact that a residual interest need have no economic value, so that it could be “parked” with a tax-exempt holder at no economic cost. Chapter 9 discusses equity interests in trusts issuing debt, REMIC residual interests, the sources of phantom income, and the special rules to prevent the avoidance of tax on phantom income realized by holders of REMIC residual interests.

The REMIC regime is elective. When it was adopted in 1986, it was not clear that REMICs would be used in light of their anti-tax avoidance and other restrictive features. In order to ensure that phantom income would not escape tax through the use of non-REMIC vehicles, the TMP rules were adopted by TRA 1986 (effective, however, only in 1992 in order

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

to give time to correct any perceived defects in the REMIC rules). They generally define as a TMP any entity or portion of an entity (other than a REMIC or FASIT or a thrift institution meeting certain tests) that holds debt obligations consisting predominantly of real estate mortgages and issues multiple maturity classes of debt payable out of the cash flows on those obligations. An entity meeting the TMP definition is treated as a corporation (regardless of which boxes the taxpayer may wish to check) and denied the ability to join in a consolidated return with another corporation. It is intended that any phantom income arising in the arrangement will be realized by the TMP and subjected to the corporate income tax.

While the general purpose of the TMP rules is to force issuers of mortgage-backed securities to make REMIC elections, the TMP definition covers considerable ground where a REMIC may not tread. Thus, issuers may be, and often are, faced with the prospect of meeting the TMP definition without being able to avoid it through a REMIC election. Where the election is available, it is the preferred route.⁵

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

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

Chapter 12 addresses foreign investors. In the absence of a treaty or Code exemption, interest paid by U.S. borrowers to foreign lenders is subject to a 30 percent withholding tax. The portfolio interest exemption is the principal non-treaty exemption from the tax. There are some rules unique to securitizations that affect the portfolio interest exemption and they are discussed in this chapter.

⁵ In certain circumstances where a REMIC election cannot be made, a FASIT election may be a viable alternative. FASITs are discussed further below in this chapter.

For the most part, issuers of asset-backed securities supported by debt instruments of U.S. borrowers are organized under U.S. law and are considered for tax purposes to be domestic entities. In circumstances in which it is desirable or unavoidable for a securitization vehicle to be classified as a corporation for tax purposes, it may be possible to avoid an entity-level tax by locating the vehicle outside of the United States. Chapter 13 addresses the tax treatment of offshore issuers of asset-backed securities.

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

In addition to issuers and investors, the third principal category of participants in securitization transactions is sponsors. The treatment of sponsors is the topic of Chapter 15.

Finally, Chapter 16 describes the newest tax securitization vehicle, a *financial asset securitization investment trust (FASIT)*. The FASIT rules were added to the Code by the Small Business Job Protection Act of 1996 (*SBJPA 1996*) and became effective in 1997. This legislation was enacted at the behest of sponsors of credit card securitization trusts who wanted to clarify the tax treatment of pass-through debt certificates. The chapter discusses all aspects of the FASIT rules, including the qualification of an entity as a FASIT and the tax treatment of FASITs, sponsors, and investors.

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

This book addresses only federal income tax issues. Readers are cautioned that while the state or local income or franchise tax consequences of issuing, investing in, or sponsoring asset-backed securities often mirror the federal consequences, there can be material differences. Many states have adopted whole or partial tax exemptions for entities that qualify as REMICs under federal law. A list of these exemptions may be found in Appendix A. A shorter list of state tax exemptions for FASITs is in Appendix B.

The principal Code and Treasury regulation sections discussed in the book are reproduced in Appendix C. Relevant IRS forms (mostly relating to REMICs) are reproduced in Appendix D.

