

**Supplement**  
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**TO**

**Federal Income  
Taxation of  
Securitization Transactions  
and  
Related Topics**

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## **About the Supplement**

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# **Chapter 1**

## **Tax Issues in Securitization Transactions**

# Chapter 2

## Types of Asset-Backed Securities

### A. Introduction

1. *Catalog of Securities*
2. *Avoidance of Entity-Level Tax*
3. *Uses of Securities—Summary*

### B. Pass-Through Certificates

1. *General Description*
2. *Stripped Pass-Through Certificates*

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

3. *Senior/Subordinated Pass-Through Certificates*
4. *Callable Pass-Through Certificates*
5. *LEGOs (Strips and Combinations at the Holder's Option)*

### C. Pay-Through Bonds

### D. Equity Interests in Issuers of Pay-Through Bonds

1. *Economic Features*
2. *Tax Features*
3. *GAAP Treatment*

### E. REMICs

## **F. Pass-Through Certificates Taxable as Debt**

- 1. Description and Overview of Tax Issues*
- 2. Application to Mortgages*

## **G. FASITs (Rise and Fall)**

## **H. Offshore Issuers**

- 1. General Description of CDOs*
- 2. Credit Default Swaps and Synthetic CDOs*

On September 15, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would “clarify” that a CDS is a notional principal contract, even if it provides for physical settlement. The amendments will be effective for contracts entered into after the adoption of final regulations. It is not clear whether the IRS would also take the view that physical settlement is consistent with NPC status in the case of other types of swap contracts (e.g., a total return swap).

- 3. Catastrophe Bonds*

On September 15, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would change the definition of NPC in several ways, effective for contracts entered into after the adoption of final regulations. Among other things, the amendments would expand the permitted indices on which payments may be based to include a non-financial index (any objectively determinable non-financial information that is not within the control of or unique to any party and is not reasonably expected to front-load or back-load payments accruing under the contract). An example of a non-financial index would be one based on weather.

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

- 1. NIMS*
- 2. Asset-Backed Commercial Paper and SIVs*
  - a. Description*
  - b. Tax Issues*
- 3. Covered Bonds*

Legislation is pending in Congress to provide a framework for issuing covered bonds. A bill that would enact the “United States Covered Bond Act of 2011” was introduced in the House of Representatives on March 8, 2011 by Representatives Garrett (Chairman of the Financial Services Subcommittee on Capital Markets) and Maloney (Ranking Minority Member of the House Financial Services Subcommittee on Financial Institutions). The bill was approved by the Financial Services Committee on June 22, 2011. A similar bill (H.R. 5823) was introduced in 2010 but was not passed. Most significantly, the bill would provide additional safeguards for holders of covered bonds in an insolvency proceeding of the issuer. Covered bonds could be supported by different asset classes including certain residential mortgages, home equity loans, commercial mortgages, public sector assets, auto assets, student loans, credit or charge card assets, and small business assets. Covered bonds backed

by assets in the first three of these categories would be qualified mortgages that could be held by REMICs, and under regulations would be real estate assets for a REIT. Under a special rule that could benefit offshore investment funds or securitization vehicles, the acquisition of a covered bond would be considered the acquisition of an investment security, and not an acquisition of an interest in a loan or otherwise as a lending transaction, for purposes of determining the character of any related trade or business activity of the acquirer or any asset held by the acquirer under the Code.

***4. Stranded Cost Securitizations***

**J. Synthetic Variable Rate Tax-Exempt Bonds**

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

**K. Securities Backed by Distressed Receivables**

# Chapter 3

## Sale/Financing and Debt/Equity Issues

### A. Introduction

### B. Issues Interrelated

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

1. *Tax Ownership*
2. *Creditors' Rights Issues—A “True Sale” at Law*
3. *GAAP*

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

1. *Sources of Authority on Tax Ownership*
  - a. *Installment Obligations*
  - b. *Sale/Repurchase Agreements*

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

*Samueli* (described in the same footnote) was affirmed by the Ninth Circuit in an opinion filed September 15, 2011 and available at 2011 *Tax Notes Today* 180-15 (September 15, 2011). The appellate court indicated that a facts and circumstances approach should be applied in determining whether a securities loan with a fixed term falls outside of section 1058 and then concluded that the term was too long on the facts of the case. The court also indicates that gain arising from the fulfillment of a forward contract is not gain from a termination of the contract resulting in capital gain or loss under section 1234A. The language of the opinion on this point is not very clear and the second holding may be limited to cases in which a contract provides for physical settlement (which would result in short-term capital gain if the acquired property were resold immediately, as happened in the case).

A New York State Bar Association Tax Section report seeks to limit the potential damage that *Samueli*, *Calloway* and *Anschutz* (discussed at footnote 71, below) might have in applying section 1058 to conventional securities loans. See “Report of the Tax Section of the New York State Bar Association on

Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058,” 2011 *Tax Notes Today* 112-22 (June 9, 2011). The report is discussed in the *Samueli* appellate decision.

*c. Options*

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

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

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

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

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

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

The holding obviously depends on the particular facts.

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

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

- d. Guarantees*
- e. Equipment Trusts and Similar Arrangements*
- f. Pass-Through Certificates*
- g. Leased Property*
- h. Conduit Arrangements*
- i. Short Against the Box*
- j. Forward Contracts*

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

A New York State Bar Association Tax Section report seeks to limit the potential damage that *Anschutz* (discussed at footnote 71) and *Samueli* and *Calloway* (discussed in footnote 40, above) might have in applying section 1058 to conventional securities loans. See “Report of the Tax Section of the New York State Bar Association on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058,” 2011 *Tax Notes Today* 112-22 (June 9, 2011).

- k. Timing of Sales*
- l. Stranded Cost Securitizations*
- m. Variable Life Insurance and Annuity Contracts*
- n. Agent Owned by Principal*

## **2. Transaction Patterns**

- a. Transfer With No Strings*
- b. Standard Package of Ties*

*Add to the end of footnote 96:* The 2011-2012 IRS Business Plan lists as a current project, “Guidance regarding the scope and application of the rescission doctrine.” The New York State Bar Association Tax Section has prepared a report describing the doctrine and suggesting ways in which it could be clarified. See 2010 *Tax Notes Today* 156-10 (August 11, 2010).

- c. *Credit Support*
- d. *Prepayment and Market Value Guarantees*
- e. *Call Options and Rights of Substitution*
- f. *Retention of Interest Rate Strips*

## **E. Debt/Equity Issues**

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

#### **2. Significance of Thin Capitalization and Asset/Debt Mismatches**

- a. *Overview*
- b. *High-Quality Receivables and Parity Classes*
  - (i) *The NIPSCO and Principal Life cases*
  - (ii) *Entrepreneurial risk*
  - (iii) *Relative ranking of claims*
  - (iv) *Owner with no economic stake*
  - (v) *Need for corporate tax*
  - (vi) *Resemblance to multiple-class trust*
  - (vii) *Summary and intentional mismatches for nonbelievers*
- c. *Lower-Grade Receivables and Junior/Senior Classes*
  - (i) *Is concentrated credit risk an entrepreneurial risk?*
  - (ii) *Is there a quality threshold?*
  - (iii) *If equity is needed, how much is enough?*
  - (iv) *F.S.A. 200130009*
- d. *Characterization of High-Coupon Debt*

Footnote 214: *Schering-Plough Corp. v. United States* was affirmed, sub nom. *Merck & Co., Inc. v. United States*, \_\_\_ F.3d \_\_\_ (3d Cir. 2011).

### **3. Equity Interests Treated as Debt**

- a. *Overview*
- b. *Credit Card Trusts Issuing Pass-Through Debt Certificates*
- c. *Ability of Taxpayers to Disavow Form*

*d. Other Debt-Like Equity Distinguished*

# Chapter 4

## Classification of Issuers Other Than REMICs

### A. Introduction

### B. Overview of Entity Classification Regulations

#### 1. *General*

#### 2. *Per se Corporations*

#### 3. *Default Rule and Mechanics of Election*

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

#### 4. *Effect of Elective Changes in Classification*

#### 5. *Number of Owners*

#### 6. *Treatment of Disregarded Entity*

*Add to footnote 63:* Announcement 99-102, 1999-2 C.B. 545, states that a tax exempt organization must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return. Apparently, however, the IRS has not provided clear guidance on whether contributions made to such an entity are treated the same as contributions to the parent.

##### a. *Special Rules for Banks*

##### b. *International Tax Rules*

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

**c. Legal Separateness Counts**

*Add to the end of footnote 86:* The 2011-2012 IRS Business Plan lists as a current project, “Final regulations under §§108 and 7701 regarding the bankruptcy and insolvency rules and disregarded entities.” On April 12, 2011, the IRS issued Proposed Regulation § 1.108-9, which, effective for discharges of debt after the regulations are issued in final form, will apply the section 108 insolvency and bankruptcy exceptions to disregarded entities and grantor trusts at the owner level. 76 F.R. 20593-20594, reprinted at 2011 *Tax Notes Today* 71-9 (April 13, 2011).

**d. Tax Collections and Administration**

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

**e. Other Federal Taxes**

**7. Transition Rules**

**C. Existence of an Entity**

**1. Overview**

**2. Segregated Portfolio Companies**

**a. Revenue Ruling 2008-8**

**b. Notice 2008-19**

**c. P.L.R. 200803004**

**d. Proposed Regulations**

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

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

The New York State Bar Association, Tax Section, also submitted comments on the proposed regulations. See 2011 *Tax Notes Today* 152-62 (August 5, 2011). The comments recommend, among

other things, that the final regulations: (1) provide that an entity recognized under local law is ordinarily treated as a separate entity, (2) clarify the treatment of series of stock in a corporation, (3) permit protective elections for entities intended to be treated as a series of separate entities where the separateness of the series is not respected by the IRS, (4) provide that similar principles will apply to foreign series organizations not engaged in an insurance business, and (5) provide that general tax principles apply to employment tax and employee benefits issues.

## **D. Status of Investment Trusts as Trusts or Business Entities**

### ***1. Overview—Trust Defined***

With little discussion, P.L.R. 201050011 (August 27, 2010) treats an entity organized under a foreign statute to provide disability, old-age and/or death benefits for certain covered employees as a trust. The entity was not taxed under local law.

### ***2. Family Trusts, Business Trusts, and Investment Trusts***

#### ***a. Family Trusts***

#### ***b. Business Trusts***

#### ***c. Investment Trusts***

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

### ***4. Permitted Activities of Investment Trusts***

#### ***a. Existence of a “Power”***

#### ***b. Power Under “Trust Agreement”***

#### ***c. Assets Acquired After Formation***

#### ***d. Temporary Reinvestments***

#### ***e. Modifications of and Distributions on Trust Investments***

##### ***(i) No discretion***

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

##### ***(iii) Discretion to modify with impairment***

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

##### ***(v) Discretion to modify and no impairment***

#### ***f. Partnership Interests and Loan Participations***

#### ***g. Inside Reserve Funds***

#### ***h. Nondiscretionary Reinvestments***

#### ***i. Certificate Holder Approval***



## **F. Publicly Traded Partnerships**

### **1. Overview**

### **2. Definition of PTP**

#### **a. Interests**

#### **b. Traded**

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

### **3. Passive Income Exception**

#### **a. Qualifying Income—General Definition**

The 2011-2012 IRS Business Plan lists as a current project, “Guidance under §7704 related to cancellation of indebtedness.”

#### **b. Interest From a Financial Business**

##### **(i) Traditional definitions of a financial business**

##### **(ii) Relevant factors**

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

# Chapter 5

## Taxation of Non-REMIC Trusts Issuing Pass-Through Certificates

### A. Introduction

### B. Grantor Trusts

1. *Introduction to Grantor Trust Rules*
2. *Application of Grantor Trust Rules to Investment Trusts*
3. *Certificate Holders as Co-Owners of Trust Assets*

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

4. *Income Reporting*
5. *Redemptions of Certificates*
6. *Trust Existence Given Some Effect*
7. *Senior/Subordinated Pass-Through Certificates*

### C. Trusts Taxed as Partnerships

1. *Introduction and Summary of Subchapter K*
2. *Inside and Outside Basis*
3. *Allocations of Income*
4. *Guaranteed Payments*
5. *Electing Large Partnerships*
6. *Disposition of Interests*

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

**a. *Foreign Investors***

**b. *Tax-Exempt Organizations***

**8. *Election Out of Partnership Rules***

**D. Other Differences**

# Chapter 6

## Qualification and Taxation of REMICs

### A. Introduction

### B. REMIC Qualification Tests

#### 1. *Interests Test*

##### a. *Definition of Interest*

(i) *Servicing*

(ii) *Stripped interests*

(iii) *Claims under credit enhancement contracts*

(iv) *Rights to acquire mortgages or other assets*

(v) *De minimis interests*

(vi) *Rights of others in foreclosure property*

##### b. *Definition of Regular Interest*

##### c. *Definition of Residual Interest*

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

##### e. *Other Requirements*

#### 2. *Assets Test*

##### a. *Qualified Mortgages*

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

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

(ii) *Principally secured*

*Add to the end of footnote 101:* The 2011-2012 IRS Business Plan lists as a current project, “Revenue procedure under §108(c) on the definition of ‘secured by real property.’”

- (iii) *Real property*
- (iv) *Acquisition of qualified mortgages*
- (v) *Qualified replacement mortgages*
- (vi) *Reasonable belief safe harbor and 90-day rule*

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

**b. Permitted Investments**

- (i) *Cash flow investments*
- (ii) *Qualified reserve assets*

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

- (iii) *Foreclosure property*

**3. Arrangements Test**

**C. REMIC Taxes**

- 1. Prohibited Transactions Tax**
- 2. Tax on Contributions**
- 3. Tax on Income From Foreclosure Property**

**D. Special Topics**

In the first line, replace “nine” with “eleven.”

- 1. Credit Enhancement Contracts**
  - a. Definition of Credit Enhancement Contract**

***b. Treatment of Credit Enhancement Contracts and Similar Arrangements***

***(i) Other arrangements***

***(ii) Credit enhancement contracts***

***2. Modifications and Assumptions of Mortgages***

***a. General***

***b. Likely Modifications***

***c. Material Modifications***

***(i) Definition of “modification”***

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

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

***(ii) When modification is “significant”***

***d. REMIC Regulations***

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

***3. Release Rule***

***a. Before 2009***

***b. Current Rule***

***c. Defeasance Exception***

***4. Convertible Mortgages***

***5. Prepayment Premiums***

***a. Mortgage Prepayments***

*b. Premiums on Regular Interests*

**6. Prepayment Interest Shortfalls**

**7. Distressed Mortgages**

*a. Post-Acquisition Defaults*

*b. Industry and Government Loan Modification Programs*

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

*c. Pre-Acquisition Defaults*

*(i) Qualified mortgage*

*(ii) Foreclosure property*

*d. REMICs Acquiring Mostly Defaulted Loans*

**8. Integration**

*a. Multiple-Tier REMICs*

*b. Outside Reserve Funds*

*c. Packaging REMIC Interests With Other Financial Instruments*

**9. Qualified Mortgages With Future Advances**

**10. Guaranteed Final Maturity Classes**

**11. Re-REMICs**

**E. REMIC Elections and Other Procedural Matters**

**1. Elections**

**2. Other Procedural Matters**

*a. General*

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

*b. Payment of REMIC Taxes*

*c. Recordkeeping*

# Chapter 7

## Definition of REMIC Regular Interest

### A. Overview

### B. Fixed Terms

### C. Permitted Interest Rates

#### 1. *Disproportionately High Interest*

#### 2. *Fixed Rates*

#### 3. *Variable Rates*

##### a. *Qualifying Index*

##### b. *Weighted Average Rates*

###### (i) *Identification of mortgages*

###### (ii) *Determination of rate*

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

###### (iii) *Calculation of average*

##### c. *Rate Adjustments*

##### d. *Caps and Floors*

##### e. *Combinations of Rates*

#### 4. *Specified Portions*

##### a. *Definition of Specified Portion*

###### (i) *Fixed or variable rate*

(ii) *Individual mortgages or pools*

(iii) *Marker classes*

b. *Interest Payments*

c. *Specified Portions Cannot Vary*

5. *Comparison of Specified Portion and Weighted Average Rates*

**D. Contingencies**

1. *Contingencies Affecting Principal*

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

2. *Contingencies Affecting Interest*

**E. Special Topics**

1. *Timing of Principal Payments*

2. *Non-Pro Rata Payments*

3. *Modifications*

4. *Stripping of Regular Interests*

5. *Stapling of Regular Interests*

6. *TEFRA Registration*

7. *Denomination in Foreign Currency*

**F. Examples**

**1. Single REMIC**

- a. Qualifying Variable Rates*
- b. Weighted Average Rates*
- c. Combination Rates*
- d. Specified Portion Rates*
- e. Variable Caps*
- f. Deferral of Interest*
- g. Prepayment Premiums*

**2. Two-Tier REMICs**

- a. Specified Portion Rates*
- b. Marker Classes*
- c. Variable Rates*

**3. Re-REMICs**

**4. Reverse Mortgages**

# Chapter 8

## Taxation of Holders of Asset-Backed Securities Taxable as Debt

### A. Introduction

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

### B. Overview of Taxation of Discount and Premium

### C. Original Issue Discount

#### 1. *OID Defined*

- a. *Stated Redemption Price at Maturity*
- b. *Issue Price*

#### 2. *Debt Instruments Subject to the PAC Method*

#### 3. *OID Accruals for Debt Instruments Generally*

- a. *Constant Yield Method*
- b. *Acquisition Premium*
- c. *Specified Contingencies*
- d. *Partial Prepayments*

*e. Variable and Contingent Rates*

**4. *OID Accruals Under the PAC Method***

*a. Overview*

*b. Prepayment Assumption*

*c. Accruals of OID*

*d. Example*

*e. Variable Rates*

**D. Stripped Bond Rules**

**1. *Definition of Stripped Bond or Coupon***

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

**2. *Treatment of Stripped Bonds***

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

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

**E. Market Discount**

**1. *Overview***

**2. *Detailed Discussion***

**F. Premium**

**1. *Overview***

**2. *Bond Premium Regulations***

**3. *PAC Method***

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

**1. *Overview***

## **2. *OID in Residential Mortgages and Other Consumer Loans***

### **a. *Overview***

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

### **b. *Credit Card Fees***

## **3. *Application of PAC Method***

### **a. *Overview***

### **b. *Existence of a “Pool”***

### **c. *Other Implementation Issues***

## **4. *Simplifying Conventions***

### **a. *Overview***

### **b. *Available Conventions***

### **c. *Effects of Aggregation***

#### **(i) *Uniform loans***

#### **(ii) *Loans not uniform***

## **H. *Special Topics***

### **1. *Prepayment Losses Attributable to IO Interests***

#### **a. *Overview***

#### **b. *Effect of Prepayments on Bond Premium Amortization***

#### **c. *Obstacles to Applying Section 171***

##### **(i) *Existence of premium***

##### **(ii) *TRA 1986 legislative history***

#### **d. *Other Considerations***

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

(ii) *Clear reflection of income*

(iii) *Effect on residual interests*

e. *The Glick Decision*

f. *Announcement 2004-75*

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

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

## 2. *Distressed Debt*

### a. *Overview*

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

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

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

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

***b. Market Discount on Highly Speculative Debt***

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

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

***3. Cost Recovery Where Basis Allocation is “Wholly Impracticable”***

***4. Modifications of Discount Debt Instruments***

Proposed regulations published on January 7, 2011 would eliminate the recent sales exception described in the text at footnote 315 where it otherwise would apply to determine the issue price of debt issued in a debt-for-debt exchange (which would include a deemed exchange arising from a significant modification). The change would be effective for debt issued after publication of final regulations. The regulation is part of a larger package of changes that would expand the circumstances in which debt may be considered publicly traded. The purpose of the change to the recent sale rule likely was to adopt one set of standards for determining when sales of debt instruments between holders are sufficient to allow use of a fair market value issue price for debt. Unfortunately, the proposed regulations would impose new requirements under section 1273 that would almost always preclude treating modified debt that is part of a pool of loans purchased at a discount from being treated as publicly traded. Specifically, to be publicly traded, debt must be part of an issue exceeding \$50 million and there must be actual trading in the specific debt in more than *de minimis* quantities during a 31-day period around the issue date.

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

### **a. *NPCs Generally***

On September 15, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would change the definition of NPC in several ways, effective for contracts entered into after the adoption of final regulations. The amendments would (1) clarify that an NPC requires only two or more payments by one counterparty (and provide that a payment may include an amount fixed on one date even if paid or otherwise taken into account on another date), (2) add credit default swaps to the list of NPCs (even if they are physically settled), and (3) expand the permitted indices on which payments may be based to include a non-financial index (any objectively determinable non-financial information that is not within the control of or unique to any party and is not reasonably expected to front-load or back-load payments accruing under the contract). An example of a non-financial index would be one based on weather.

Section 1256(b)(2)(B) (as added by the Dodd-Frank Wall Street Reform and Consumer Protection Act) excludes from the definition of section 1256 contract “any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.” On September 15, 2011, the IRS issued proposed regulations under section 1256 that would exclude from the definition of section 1256 contract any contract, or option on such contract, that is an NPC as defined in Treasury Regulation § 1.446-3.

### **b. *Contingent NPCs***

*Add to footnote 343:* On September 15, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would “resolve uncertainty” by including CDS in the list in the regulations of notional principal contracts, and further clarify that CDS are NPCs even if they provide for physical settlement. The amendments will be effective for contracts entered into after the adoption of final regulations.

### **c. *Call Options***

### **d. *Other Consequences of Separate Treatment***

## **6. *Integration of Debt Instruments and Hedging Contracts***

### **a. *Overview***

### **b. *Qualifying Debt Instruments***

### **c. *§ 1.1275-6 Hedge***

### **d. *Identification Requirements***

### **e. *Effect of Integration***

## **7. *Payment Lags for REMIC Regular Interests***

## **8. *REMIC Regular Interests as Investment in United States Property***

# Chapter 9

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

### A. Introduction

### B. Common Tax Characteristics

### C. Special Considerations Applicable to Trust Issuers

### D. Special Considerations Applicable to REMICs

#### 1. *REMIC Taxable Income*

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

In the case of a REMIC retiring a regular interest at a discount on account of a credit loss on the REMIC’s mortgages, the question then is whether the failure to pay the full principal amount is more akin to (1) a penalty the holder chooses to accept to exercise an optional prepayment right, which would not give rise to discharge of indebtedness income, or (2) the failure of a debtor to make a required payment on a debt instrument that is fixed in amount solely on account of the debtor’s inability to pay, which would. In the authors’ view, the latter analysis is more compelling. Although it is true that regular interests often take the form of trust equity and are entitled only to distributions from available assets according to a payment waterfall, that does not mean that the amounts to which holders are entitled absent default are not considered due under the tax law in like manner to payments on conventional debt. Specifically, to

qualify as a regular interest a REMIC interest must “unconditionally entitle the holder to receive a specified principal amount” and under regulations, interest payments must also be unconditional with limited exceptions. The fact that an instrument takes the form of equity does not cause payments thereon to be conditional if the issuer is obligated to pay absent a default on its assets. The existence of unconditional payments is part of the rationale for treating regular interests as debt for tax purposes under the REMIC rules. For a discussion of contingencies and regular interests, see Chapter 7, Part D.

## ***2. Limitations on Using REMIC Losses***

## ***3. Dispositions of REMIC Interests***

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

## ***4. REMICs as Separate Entities***

# **E. Phantom Income**

## ***1. Overview***

## ***2. Technical Description***

## ***3. Use of Phantom Losses***

### ***a. Acceleration of Net Remaining Phantom Losses Through Sales***

### ***b. Attempts to Duplicate Losses***

## ***4. Special Rules for REMICs—Excess Inclusions***

### ***a. Overview***

### ***b. Definition of Excess Inclusion***

### ***c. Pass-Thru Entities***

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

#### ***(i) Transfer tax***

#### ***(ii) Tax on pass-thru entities***

### ***e. Certain Tax-Motivated Transfers Disregarded***

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

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<sup>71a</sup> Section 1091(a).

<sup>71b</sup> The treatment of the exchange by a sponsor of mortgages for REMIC interests is discussed in Chapter 15, Part E.

(ii) *Transfers to foreign investors*

f. *Flaws in Excess Inclusion Rules*

5. *Special Rule for REMICs—Negative Value Residual Interests*

a. *Ownership*

b. *Inducement Fees*

c. *Sale or Exchange*

d. *Negative Basis or Issue Price*

# Chapter 10

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

A. Introduction

B. Taxes Imposed on TMPs

C. Taxation of Equity Owners

D. REITs

1. *Taxation of REITs*

2. *REIT/TMPs as Quasi REMICs*

# Chapter 11

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

### A. Introduction

### B. REIT Income and Assets Tests and Thrift Assets Test

#### 1. General

*Add to the end of footnote 1:* The 2011-2012 IRS Business Plan lists as a current project, “Revenue ruling on the treatment of an interest in a money market fund as a cash item under §856(c)(4)(A).”

*Comment on footnote 2:* As discussed in Chapter 6, Part D.2.d, the REMIC regulations allow a REMIC to modify a qualified mortgage without causing the loan to lose its qualified mortgage status if the modification is occasioned by default or a reasonably foreseeable default even if the value of the real property collateral has declined. Revenue Procedure 2011-16, 2011-5 I.R.B. 440, adopts similar rules for REITs for purposes of applying the REIT income and asset tests. Specifically, the revenue procedure states that the value of real property collateral need not be retested in determining if a loan is secured by real property upon a modification of a loan if (1) the modification was occasioned by default, or (2) based on all facts and circumstances, the REIT or servicer of the loan reasonably believes that (a) there is a significant risk of default of the loan upon maturity or at an earlier date, and (b) the modified loan presents a substantially reduced risk of default as compared with the pre-modified loan. Further, such a modification is not considered a prohibited transaction under section 857(b)(6).

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

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

In a letter, dated February 3, 2011, to the IRS and Treasury, Tony Edwards of the National Association of Real Estate Investment Trusts pointed out technical problems with Revenue Procedure 2011-16 that, according to the letter, will prevent REITs from acquiring distressed mortgage loans and mortgage-backed securities. The letter is available at 2011 *Tax Notes Today* 38-23 (February 24, 2011).

For an article discussing the problem, the Notice and the NAREIT response, see Robert J. Le Duc and Weiyang (Sarah) Wang, “Recent Developments for REITs Owning or Investing in Distressed Mortgages and Related Assets,” *Journal of Taxation of Financial Products* (April 2011).

## *2. Uses of REIT Subsidiaries*

### **C. Tax-Exempt Organizations**

### **D. Life Insurance Companies**

### **E. Debt Instruments Held by Banks and Thrift Institutions**

### **F. Mark-to-Market Rules for Securities Dealers**

#### *1. Overview*

#### *2. Definition of Dealer*

#### *3. Definition of Securities*

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

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

Second, if the structured notes hedge other positions that are marked to market, then Treasury Regulation § 1.446-4 would generally require a matching of the timing of income and deductions from the two positions (either both mark to market or both realization) in order to clearly reflect income.<sup>100b</sup>

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

<sup>100b</sup> Treasury Regulation § 1.446-4(b) (“To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the timing of income, deduction, gain or loss from the item or items being hedged.”). If the mark-to-market gain or loss on offsetting hedged positions is not taken into account on a consistent, matched basis, potentially significant timing distortions of income and loss could arise. See *Bank One Corporation, et al., v. Comm’r*, 120 T.C. 174, 293 (2003), *aff’d in part, vac’d in part & rem’d sub nom. JPMorgan Chase & Co. v. Comm’r*, 458 F.3d 564 (7th Cir. 2006) (“The

Often taxpayers would not identify structured notes with a hedge on the ground that it is not necessary, but the IRS has taken the view that identification is not essential under the hedging timing rules.<sup>100c</sup>

Third, mark to market treatment could be justified on the ground that, despite the carve-out in section 475, taxpayers are allowed to use mark-to-market accounting where that method clearly reflects income. This view would be based on (1) the authorities that allow the IRS to force a taxpayer using an accounting method to use a different method only if the taxpayer's accounting method is inconsistent with the Code and fails to clearly reflect income,<sup>100d</sup> and (2) the authorities that allowed dealers to mark-to-market property before there were specific rules allowing it.<sup>100e</sup>

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

##### **5. Treatment of Gains and Losses**

##### **6. Securitization Transactions**

##### **7. Issues in Valuing Securities**

###### **a. Fair Value Accounting for Illiquid Securities**

###### **b. Book-Tax Conformity**

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

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only practical way to eliminate these large and unpredictable timing distortions arising from a book of short-dated hedges and long-dated customer contracts is to adopt a mark-to-market method of tax accounting.”)

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

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

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

# Chapter 12

## Taxation of Foreign Investors

### A. Introduction

### B. TEFRA Registration Requirements

#### 1. Overview

#### 2. Asset-Backed Securities

### C. Withholding Tax

#### 1. Overview

#### 2. Portfolio Interest Exemption

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

##### a. NPC Income

Add to footnote 89: On September 15, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would “resolve uncertainty” by including CDS in the list in the regulations of notional principal contracts, and further clarify that CDS are NPCs even if they provide for physical settlement. The amendments will be effective for contracts entered into after the adoption of final regulations.

##### b. Rents

##### c. Option Income

##### d. Debt-Related Fees

*Comment on footnote 105:* In addition, P.L.R. 201105016 (October 19, 2010) holds that fees paid to holders of notes to consent to a business reorganization were considered payments under the terms of the notes, and therefore first payments of interest to the extent of accrued and unpaid interest and then a payment of principal, where the fee payment and other changes did not amount to a significant modification under section 1001. The principal repayment reduced the adjusted issue price of the notes, with the result generally that the fees would ultimately be treated as additional income (perhaps OID) on retirement of the notes. See Treasury Regulation § 1.1272-1(b)(4)(ii) (OID allocable to final accrual period is the excess of the amount payable at maturity over the adjusted issue price). Under this analysis, the consent fees generally would not be subject to withholding tax because they would be treated as either a return of capital or as interest eligible for the portfolio interest exemption.

The Tax Court’s decision in *Container Corporation v. Comm’r*, discussed in footnote 108 and the

accompanying text, has been affirmed by the Fifth Circuit in an unpublished decision (Docket No. 10-60515, May 2, 2011).

#### *4. Withholding Agents*

### **D. FIRPTA**

### **E. FATCA Reporting and Withholding Tax**

#### *1. Overview and Definitions*

#### *2. Foreign Financial Institutions*

#### *3. Non-Financial Foreign Entities*

#### *4. Implementation*

Notice 2010-60 has been supplemented by Notice 2011-34, and by Notice 2011-53, some of the highlights of which are noted here. For a more complete description of Notice 2011-34, see the Alert Memorandum dated April 13, 2011 on the Cleary Gottlieb web site at [www.cgsh.com](http://www.cgsh.com). For a collection of well written articles with particularly good graphic summaries of the relevant issues, see [www.navigant.com/fatca](http://www.navigant.com/fatca).

**Notice 2011-34.** Notice 2011-34 refines the steps that an FFI must go through to determine if an account owned by an individual is a U.S. account. The Notice requires more effort to identify existing individual U.S. accounts where the account is a private banking account or has a balance of \$500,000 or more. Other existing individual accounts need not be reviewed except by searching electronic records. Notice 2011-34 does not revise the diligence procedures applicable to new individual accounts or to accounts owned by entities.

In other respects, the Notice shows a desire to give the rules a very broad sweep. Most significantly, the proposed rules for passthru payments have the potential to extend FATCA reporting to virtually every FFI in the world without regard to the level of contact with the United States.

Specifically, a participating FFI (one that has an agreement with the IRS) is required to withhold on passthru payments to the extent they are made to a recalcitrant account holder or to another FFI that is not participating or deemed compliant. Under the Notice, a payment made by an FFI that is not a withholdable payment (i.e., generally U.S.-source payments, plus gross proceeds from the disposition of property that produces U.S.-source interest or dividend income) generally will be treated as a passthru payment based on the FFI's passthru payment percentage, which is the percentage of the assets of the FFI that are U.S. assets. U.S. assets are not only those that could produce U.S. source income but also assets that could produce passthru payments from another FFI. Thus the rule would have a cascading effect; the receipt of a passthru payment by an FFI would taint payments it makes (even commercial payments such as those under swaps or repos or overnight deposits). The passthru payment percentage is calculated quarterly and is to be updated and published quarterly. For payments of amounts held in a custodial account, the passthru payment percentage would be the one calculated for the entity issuing interests or instruments held in the account. Hopefully, the pro-rata approach in its most extreme form is a trial balloon. Something will have to give to make the system workable.

As one nod to practical concerns, the Notice creates new rules allowing certain FFIs with local operations, and certain local members of participating FFI groups, to be treated as deemed compliant pursuant to certain streamlined procedures, provided certain conditions are met.

The new Notice also indicates that the IRS will implement the rule requiring all FFIs that are part of an expanded affiliated group to be compliant (or deemed compliant) in order for any member to be compliant. Also, QI agreements will require the QI to be compliant.

The Notice indicates that certain collective investment vehicles and other investment funds would be treated as deemed-compliant if (1) all holders of record of direct interests in the fund are participating or deemed-compliant FFIs (or otherwise exempt), (2) the fund prohibits the acquisition of fund interests by anyone not described in (1), and (3) the fund certifies that it complies with obligations imposed on FFIs to calculate and publish passthru payment percentages. As a practical matter, it is unclear if investment funds currently will be able to rely on this deemed-compliant rule because most funds likely do not impose the selling and transfer restrictions required under the rule. In addition, the exception does not yet accommodate some holdings of interests through DTC or other domestic financial intermediaries.

**Notice 2011-53.** Notice 2011-53 supplements Notice 2011-34 and Notice 2010-60 and addresses certain implementation issues, including the timing of completing due diligence and reporting obligations, effective dates of withholding, and certain other miscellaneous items.

Most significantly, the Notice acknowledges the potential practical obstacles faced by FFIs in complying with FATCA and states that the Service will issue regulations that will provide for withholding on payments to FFIs to be phased in starting January 1, 2014. The withholding obligations under FATCA were originally slated to apply to payments made on or after January 1, 2013. Instead, withholding under section 1471(a) and 1472(a) for U.S. source FDAP payments will begin on January 1, 2014, and withholding agents will not be required to withhold on other withholdable payments (e.g., gross proceeds) until January 1, 2015. In addition, the withholding obligations of a participating FFI on passthru payments to recalcitrant holders, non-participating FFIs or FFIs that elect to be withheld upon with respect to their recalcitrant holders will begin, at the earliest, on January 1, 2015.

The Notice also clarifies that, for purposes of the rule grandfathering obligations outstanding on March 18, 2012, the term “obligation” means any legal agreement that produces or could produce passthru payments (including withholdable payments). This clarification addresses an ambiguity in the statute which could have been interpreted to mean that payments made by an FFI on an obligation issued prior to March 18, 2012 were not exempt from withholding to the extent such FFI held non-grandfathered obligations. The term “obligation,” however, does not include any instrument treated as equity, or any legal agreement that lacks a definitive expiration or term.

The Notice states that the Service will begin accepting FFI applications through its electronic submissions process no later than January 1, 2013. An FFI must enter into an FFI agreement by June 30, 2013 to ensure that it will be identified as a participating FFI and to avoid being withheld upon in 2014. An FFI that enters into an agreement after June 30, 2013 but before January 1, 2014 will be a participating FFI (and, theoretically, should not be withheld upon). However, as a practical matter, it may not be identified as such in time to prevent withholding against it beginning on January 1, 2014. In order not to create a disincentive for an FFI to enter into an agreement prior to July 1, 2013, the effective date of an agreement entered into before July 1, 2013 will be July 1, 2013 and the effective date of an agreement entered into on or after July 1, 2013 will be the actual date the agreement is entered into.

In terms of due diligence procedures, a participating FFI will be required to put in place account opening procedures described in Notice 2010-60 to identify U.S. accounts for accounts opened on or after the effective date of its agreement. For private banking accounts opened prior to the effective date of an agreement with a value of at least \$500,000 as of the effective date of the agreement, a participating FFI will be required to complete the due diligence procedures described in Notice 2011-34. For private banking accounts opened prior to the effective date of the agreement with a value less than \$500,000 as of the effective date of the agreement, a participating FFI will be required to complete certain private banking procedures for such accounts by the later of December 31, 2014, or the date that is one year after the effective date of its FFI agreement. For all other pre-existing accounts, a participating FFI must

complete the due diligence procedures described in Notice 2010-60, Notice 2011-34 and forthcoming regulations within two years of the effective date of its agreement. It is not entirely clear how this two-year timetable dovetails with the January 1, 2014 effective date for withholding on U.S. source FDAP payments. The Notice states that the Service expects to issue regulations to provide further guidance on private banking procedures and the required review of account holder files.

The Notice also delineates the timelines for reporting to the Service on U.S. accounts and provides for slightly more flexible reporting requirements for certain FFIs during 2014.

The Notice indicates that the Service expects to issue draft versions of an FFI agreement and reporting forms in the summer of 2012. Further, an automatic extension to December 31, 2013 of qualified intermediary agreements, withholding foreign partnership agreements, and withholding foreign trust agreements of entities qualifying as FFIs that would have expired on December 31, 2012 gives such FFIs leeway to negotiate only an FFI agreement during 2013. Any such FFI that enters into an FFI agreement by December 31, 2013 will be deemed to have renewed its qualified intermediary agreement, withholding foreign partnership agreement, or withholding foreign trust agreement, as applicable.

# Chapter 13

## Offshore Issuers

### A. Introduction

### B. Definition of Foreign Corporation

### C. Summary of Tax Rules for Foreign Corporations

### D. Taxation of Effectively Connected Income

#### 1. *Trade or Business—Common Law Definition*

#### 2. *Securities Trading Safe Harbor*

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

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

#### 3. *Special Topics*

##### a. *Derivatives*

##### b. *Loan Origination*

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

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

##### c. *Loan Waivers*

*Add to the end of footnote 72:* See also P.L.R. 201105016 (October 19, 2010), which holds that fees

paid to holders of notes to consent to a business reorganization were considered payments under the terms of the notes, and therefore first payments of interest to the extent of accrued and unpaid interest and then a payment of principal, where the fee payment and other changes did not amount to a significant modification under section 1001. The principal repayment reduced the adjusted issue price of the notes, with the result generally that the fees would ultimately be treated as additional income (possibly OID) on retirement of the notes. See Treasury Regulation § 1.1272-1(b)(4)(ii) (OID allocable to final accrual period is the excess of the amount payable at maturity over the adjusted issue price). Under this analysis, the consent fees generally would not be subject to withholding tax because they would be treated as either a return of capital or as interest eligible for the portfolio interest exemption.

*d. Foreclosure Property*

*4. Effective-Connection Test*

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

**E. Withholding Tax**

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

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

*1. Introduction*

*2. Anti-Deferral Regimes—Overview*

*3. Passive Foreign Investment Companies (PFICs)*

*4. Controlled Foreign Corporations (CFCs)*

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

*5. Overlap*

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

**H. Special Considerations Applicable to Tax-Exempt Organizations**

**I. Offshore Issuers of Catastrophe Bonds**

On September 15, 2011, the IRS issued proposed amendments to Treasury Regulation § 1.446-3 that would change the definition of NPC in several ways, effective for contracts entered into after the adoption

of final regulations. Among other things, the amendments would expand the permitted indices on which payments may be based to include a non-financial index (any objectively determinable non-financial information that is not within the control of or unique to any party and is not reasonably expected to front-load or back-load payments accruing under the contract). An example of a non-financial index would be one based on weather.

# Chapter 14

## Legending and Information Reporting

### A. Introduction

### B. REMIC Regular Interests and Pay-Through Bonds

1. *Overview*
2. *Reporting at Time of Issuance (Form 8811)*
3. *Ongoing Reporting*

### C. Pass-Through Certificates Issued by Grantor Trusts

1. *Overview*
2. *Reporting by WHFITs*
  - a. *Terminology and Overview*
  - b. *Who Reports to Whom*
  - c. *Timing and Method of Reporting—General*
  - d. *What is Reported—General*
    - (i) *Form 1099*
    - (ii) *Statement to TIH*
  - e. *What is Reported—Special Rules*
    - (i) *General de minimis exception*
    - (ii) *Qualified NMWHFIT exception*
    - (iii) *Special de minimis exception for WHMTs*
    - (iv) *NMWHFIT final tax year exception*

- f. Simplified Reporting*
  - (i) Safe harbor for certain NMWHFITs*
  - (ii) Safe harbor for certain WHMTs*
- g. Directory of WHMT Trustees*

### **3. Grantor Trusts That Are Not WHFITs**

## **D. Equity Interests in Partnerships**

- 1. General*
- 2. Synthetic Variable Rate Tax-Exempt Bonds*

## **E. REMIC Tax Returns**

### **F. Broker Reporting of Sales and Backup Withholding**

*Add to footnote 144:* Notice 2011-56, 2011-29 I.R.B. 54, provides interim guidance addressing basis and basis reporting issues relating to: (1) a taxpayer's change from a broker's default average basis method to the cost basis method, (2) the effect on the qualification of a plan as a dividend reinvestment plan of cash payments made in respect of fractional shares, and (3) lot selection methods.

## **G. Nominee Reporting to Issuers**

## **H. Offshore Issuers**

- 1. Overview*
- 2. Foreign Corporations*

Notice 2011-55, 2011-29 I.R.B. 53, suspends section 1298(f) information reporting requirements with respect to interests in a PFIC (to the extent required under the new section) until the IRS releases a revised Form 8621. When that happens, taxpayers will be required to file returns for taxable years beginning on or after March 18, 2010. The Notice does not suspend reporting obligation for PFIC shareholders who are required to file Form 8621 under the current instructions to Form 8621.

- 3. Foreign Partnerships*
- 4. Foreign Trusts*
- 5. Foreign Disregarded Entities*
- 6. FATCA Reporting and Withholding Tax*

The Loan Syndications and Trading Association (*LSTA*) has taken up the cause of raising with the IRS and Treasury concerns about how FATCA would practically apply to offshore issuers holding loans to U.S. borrowers. In a letter dated July 15, 2010, the LSTA recommends an exemption for issuers existing when final regulations are issued. The letter also recommends for non-grandfathered issuers clear procedures (including a certification procedure) that each payor in a chain from ultimate borrower to

ultimate investor can use to determine if it has FATCA withholding or information reporting responsibilities. Finally, the letter recommends that regulations allow U.S. financial institutions to be treated as a compliant FFI if it provides a certification that it will comply with the rules applicable to FFIs. This would be relevant, for example, for securities held through DTC. With this clarification, an offshore issuer could potentially avoid information reporting and withholding obligations by having all of its debt and equity securities be held through other financial institutions. To place the recommendations in context, the letter describes the importance of offshore issuers as a source of funding for domestic borrowers, particularly those without an investment grade rating, and raises concerns about the potential adverse effects of FATCA on that funding source. The letter (and some other comments) are available at [www.LSTA.org](http://www.LSTA.org).

In a comment letter dated October 3, 2011 (available at 2011 *Tax Notes Today* 193-19), the Securities Industry and Financial Markets Association asked the Treasury and IRS to treat existing and newly formed securitization vehicles as deemed compliant FFIs. The rationale for existing entities is that they are limited purpose vehicles and would not be allowed under existing documentation to take the steps necessary to comply with FATCA. For new entities, deemed compliant treatment could be limited to entities all of the securities in which are held through U.S. financial institutions or participating FFIs. Under that approach, reporting would be undertaken by those entities rather than the securitization vehicle.

### ***7. Other Measures to Enforce Reporting Obligations***

Notice 2011-55, 2011-29 I.R.B. 53, suspends section 6038D information reporting requirements with respect to foreign financial assets until the IRS releases a new Form 8938 (Statement of Specified Foreign Financial Assets). Once the form becomes available, it will have to be completed for taxable years beginning after March 18, 2010 and attached to the next filed income tax return.

### **I. Borrower and Miscellaneous Income Reporting**

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

### **J. FBAR Filings**

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

preamble for guidance. Also, for a good summary of the significant changes, see Robert S. Chase II, Carol P. Tello, and Dwaune L. Dupree, “The FBAR Reset: Final Regulations Provide Mixed Guidance,” 2011 *Tax Notes Today* 80-7 (March 30, 2011).

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

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

#### **K. Qualified Tax Credit Bonds and Build America Bonds**

# Chapter 15

## Taxation of Sponsors

### A. Introduction

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

1. *Excess Servicing*
2. *Mark-to-Market Accounting for Securities Dealers*
3. *Intercompany Transactions*

### C. Pass-Through Certificates

1. *Issuer Classified as Trust*
2. *Issuer Classified as Business Entity*

### D. Asset-Backed Securities Taxable as Debt

### E. REMICs

*Add to the end of footnote 63:* TAMRA, enacted in 1988, amended section 171(e) to eliminate any deduction for amortizable bond premium and, instead, treats it as an offset to interest payments. The legislative history indicates that the purpose of treating amortizable bond premium as an offset to interest earned (rather than as previously treated as interest expense) was to prevent limitations on interest deductions from applying and thus ensure that the taxpayer received the full benefit of the amortization. See H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 71-2 (July 16, 1988). Thus, the amendments to section 171(e) should not be read to limit the ability of a regular interest holder to deduct the excess of its basis in the regular interest over the issue price to “interest payments” and prevent the offsetting of accrued OID (of which, under section 1272(c)(1), there is none in the case of a bond to which section 171 directly applies).

# Chapter 16

## Tax Law Aggregation or Separation of Property Interests

### A. Introduction

A recent report by the United States Government Accountability Office identified aggregation and separation as a significant issue in taxing hybrid instruments. The report observed, “Derivatives can...be coupled with each other and with other types of financial instruments, like more traditional debt or equity instruments, to create hybrid securities. Because hybrid securities often do not clearly fall within a single tax category, it can be challenging for IRS and taxpayers to determine which tax rules are appropriate, and whether the hybrid should be treated as a single instrument or broken up into multiple instruments.” GAO, “Financial Derivatives—Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse,” GAO-11-750 (September 2011).

### B. Common Law Aggregation of Claims Against Unrelated Parties

1. *General*
2. *Similarity*
3. *Stapling*
4. *Offset*
  - a. *Hedging Transactions*
  - b. *Tax Straddles*
5. *Income Rights*
6. *Guarantees*

### C. Common Law Aggregation of Claims Against One Person

1. *General*
2. *Similarity*

### 3. *Stapling*

- a. *Stock Options Combined with Stock or Debt*
- b. *Stock Forward Plus Debt*
- c. *Debt and Stock*

### 4. *Offset*

The *Anschutz* case discussed in Chapter 3 at footnote 71 takes account of a forward contract with an investment bank in holding that section 1058 does not apply to a stock loan made to the same bank. A New York State Bar Association, Tax Section report argues that the case would have been better decided by simply offsetting the stock loan against the forward. It also points out that this approach should not be followed for securities loans and hedge contracts entered into with unrelated parties. See “Report of the Tax Section of the New York State Bar Association on Certain Aspects of the Taxation of Securities Loans and the Operation of Section 1058,” 2011 *Tax Notes Today* 112-22 (June 9, 2011).

### 5. *Related Party Ownership*

## D. Rules-Based Aggregation

### 1. *General*

### 2. *Debt and Hedges*

- a. *Integration*
- b. *Timing and Character Matching*
- c. *Source Matching*
- d. *Tax Straddles*
- e. *Constructive Sales*
- f. *Special Foreign Currency Rules*
- g. *Subpart F (FPHCI Income)*

### 3. *Debt Aggregation Under OID Regulations*

### 4. *Debt Pools*

### 5. *Partnership Equity*

### 6. *Section 167(e)*

For purposes of computing depreciation deductions, all mortgage servicing rights (excluding the portion treated as stripped coupons) acquired in the same transaction, or in a series of related transactions, are treated as a single asset. See Treasury Regulation § 1.167(a)-14(d)(2)(i).

### 7. *Stock Redemptions*

## **E. Common Law Separation of Single Instruments**

### **1. General**

### **2. Debt**

- a. Conventional Debt**
- b. Convertible Bonds and Exchangeable Bonds**
- c. Contingent Payment Debt**
- d. Debt Plus Ownership Interests in Tangible Property**
- e. Service Fees Plus Interest Strips**

### **3. Stock**

- a. Carving Up Conventional Stock**
  - (i) Americus Trust**
  - (ii) Dividend stripping**
  - (iii) Unbundled stock units**
- b. Unconventional Rights Against Issuer**
- c. Stock With Guaranteed Payments**
- d. Mutual Companies**
- e. Rights Against Third Parties**

### **4. Forward Contracts**

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

*Samueli* (described in footnote 174) was affirmed by the Ninth Circuit in an opinion filed September 15, 2011 and available at 2011 *Tax Notes Today* 180-15 (September 15, 2011). The appellate court disagreed with the Tax Court finding that there was no borrowing but concluded that it was harmless error because the interest cost for which the Tax Court denied a deduction had been taken into account by the Tax Court in any event as a capital cost in calculating the tax deficiency.

### **5. Option Pairs**

6. *Life Insurance Policies*

7. *Ferrer Case—Contract Terminations*

**F. Rules-Based Separation**

1. *General*

2. *Premium on Convertible Debt*

3. *CPDIs*

4. *Testing Offsets*

5. *AHYDO Rules*

6. *Section 385*

7. *Section 988*

8. *Gain Partially Characterized as Ordinary Income*

**G. Notional Principal Contracts**

Footnote 220: *Schering-Plough Corp. v. United States* was affirmed, sub nom. *Merck & Co., Inc. v. United States*, \_\_\_ F.3d \_\_\_ (3d Cir. 2011).

**H. Aggregation and Separation of Entities**

1. *Stapled Stock*

2. *REMICs*

3. *Subsidiary Tracking Stock*

4. *Tribune Case*

5. *Segregated Portfolio Companies*

6. *Separating Assets From Entities*

**I. Acquired Business Intangibles**

# Chapter 17

## Special Topics

### A. Introduction

### B. Aggressive Tax Planning, Reportable Transactions, and Covered Opinions

#### *1. Aggressive Tax Planning*

#### *Add to the end of section:*

A report of the United States Government Accountability Office explains how financial derivatives can offer opportunities for taxpayer abuse:

Unique characteristics of financial derivatives make them particularly difficult for the tax code and IRS to address. The tax code's current approach to the taxation of financial derivatives is characterized by many experts as the "cubbyhole" approach. Under this approach, the tax code establishes broad categories for financial instruments, such as debt, equity, forwards, and options, each with its own rules governing how and when gains and losses are taxed. As new instruments are developed, IRS and taxpayers attempt to fit them into existing tax categories by comparing the new instrument to the most closely analogous instruments for which tax rules exist. However, a new financial instrument could be similar to multiple tax categories, and therefore IRS and taxpayers must choose between alternatives. This could result in inconsistent tax consequences for a transaction that produces the same economic results.

Derivative contracts, particularly those traded over-the-counter, are highly flexible, allowing taxpayers to structure transactions to take advantage of the different tax rules for each tax category. Derivatives can also be coupled with each other and with other types of financial instruments, like more traditional debt or equity instruments, to create hybrid securities. Because hybrid securities often do not clearly fall within a single tax category, it can be challenging for IRS and taxpayers to determine which tax rules are appropriate, and whether the hybrid should be treated as a single instrument or broken up into multiple instruments. While the tax rules for each tax category represent Congress's and Treasury's explicit policy decisions, some of these decisions were made long before today's complex financial derivative products were created. The cumulative effect of these decisions combined with the fact that many financial derivatives do not fit neatly in any one tax category can result in mistakes or opportunities for abuse by taxpayers.

GAO, “Financial Derivatives—Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse,” GAO-11-750 (September 2011).

## **2. Reportable Transactions**

The temporary regulations under section 6707A cited in footnote 18 have been replaced with final regulations, which are effective September 7, 2011.

## **3. Covered Opinions**

### **C. Tax Strategy Patents**

On September 16, 2011, President Obama signed into law the Leahy-Smith America Invents Act, Public Law 112-29 (“Act”), which reforms the patent law in various ways and limits the issuance of new tax strategy patents. Section 14 of the Act provides that “any strategy for reducing, avoiding, or deferring tax liability [defined to cover any federal, state, local or foreign tax], whether known or unknown at the time of the invention or application for patent, shall be deemed insufficient to differentiate a claimed invention from the prior art,” which is a requirement for patentability. There are exceptions for tax preparation and financial management inventions.<sup>56a</sup> Section 14 states that nothing therein shall be construed to imply that other business methods are patentable or that other business-method patents are valid. Section 14 is effective on the date of enactment of the Act and applies to any patent application pending on, or filed on or after, and any patent issued on or after, that date (and thus does not affect previously issued patents).

The U.S. Patent and Trademark Office is reviewing the stock option grantor retained annuity trust (SOGRAT) patent that first focused attention on tax strategy patents to see if some prior art was not sufficiently considered in granting the patent. For a discussion, see Jeremiah Coder, “USPTO Reexamining Controversial Tax Strategy Patent,” 2011 *Tax Notes Today* 96-3 (May 17, 2011).

### **D. Securitization Reforms**

#### **1. Overview**

#### **2. Summary of Recommendations**

- a. Changes Relating to Revolving Pool Securitizations**
- b. Other Changes in REMIC Regulations**
- c. Changes Relating to TMPs**
- d. Foreign Trust Reporting**

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<sup>56a</sup> Specifically, section 14 does not apply “to that part of an invention that (1) is a method, apparatus, technology, computer program product, or system, that is used solely for preparing a tax or information return or other tax filing, including one that records, transmits, transfers, or organizes data relating to such filing; or (2) is a method, apparatus, technology, computer program product, or system used solely for financial management, to the extent that it is severable from any tax strategy or does not limit the use of any tax strategy by any taxpayer or tax advisor.”

# Glossary

***Add to IRS Business Plan:*** According to a September 2011 report of the United States Government Accountability Office, between 1996 and 2010 the Treasury and IRS did not complete 14 out of 53 guidance projects related to financial derivatives that they designated as a priority in their annual business plan. GAO, “Financial Derivatives—Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse,” GAO-11-750 (September 2011).

# Appendix A

## State Tax Exemptions for REMICs

# Appendix B

## Internal Revenue Code and Regulations

# Appendix C

## CDO Trade or Business Guidelines

### **A. Introduction**

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*In footnote 9, replace “Section IV” with “Part D.”*

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