

Proposed FASIT Regulations Released

On February 4, 2000, the Treasury Department (the "Treasury") released proposed regulations (the "Proposed Regulations") relating to financial asset securitization investment trusts (or a "FASIT"). In general, the Proposed Regulations, together with proposed amendments to the interest expense allocation regulations, are proposed to apply to transactions entered into on or after the date that final regulations are filed with the Federal Register. However, the portions of the Proposed Regulations discussed below containing an anti-abuse rule and allowing the deferral of gain on assets held by a pre-effective date FASIT (generally a FASIT in existence on August 31, 1997) are proposed to apply to transactions entered into on or after *February 4, 2000*. This memorandum sets forth a description of the most significant and relevant aspects of the Proposed Regulations.

THE PROPOSED REGULATIONS

If its full potential can be realized, the FASIT vehicle would have a broad impact on the securitization industry, largely as a result of the enhanced marketability of asset-backed securities (particularly lower rated and unrated securities) to foreign and tax-exempt investors.¹ To date, the FASIT has not proliferated as a securitization vehicle, primarily because of the potential up-front gain imposed on a FASIT transaction, and also in a number of situations because of the absence of regulatory guidance on technical issues. The Proposed Regulations begin to address the up-front gain issue, would clarify many of the issues left unresolved by the statute, and establish certain anti-abuse rules.

Determination of Value for Gain Recognition Purposes.

Under Section 860I of the Code, when an asset is transferred to a FASIT by the holder of the ownership interest (i.e., the sponsor of the securitization), the holder is required to recognize gain (but not permitted to recognize loss) equal to the difference between the value of the asset as determined under

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the FASIT rules and its adjusted basis to the holder prior to the contribution.² Under the FASIT statute, the owner determines differently the value of the asset transferred to the FASIT depending upon whether or not the asset is traded on an established securities market. Assets not traded on an established securities market (within the meaning of the Proposed Regulations) are valued according to a mechanical formula which may generate a tax gain in excess of economic gain (the "special valuation rule").³ Under the FASIT legislation, the Treasury has the authority to expand the category of assets as to which a "true value" measure, rather than the special valuation rule, is permitted (i.e., to extend beyond assets that are traded on an established securities market).

Some tension exists between the Preamble to the Proposed Regulations (the "Preamble") and the language of the Proposed Regulations with respect to the possibility of expansion. The Preamble suggests a possible willingness to accept other reasonable valuation rules for a broader category of assets rather than requiring utilization of the special valuation rule:

The intent behind the special valuation rule is uncertain. The legislative history of the FASIT provisions indicates the rule was meant to be a simple and mechanical formula that, by its nature, would not produce accurate results in every case. Specifically, the legislative history states that the value of an asset is determined by the special valuation rule even if a different value would be determined by applying a willing buyer/willing seller standard. See H.R. Rept. 104-737, 104th Cong. 2d Sess., 327 (1996). At the same time, by applying a fair market value standard to all other assets (including market-traded debt), Congress showed a clear preference for using actual fair market value whenever it can be determined with reasonable accuracy.

Several commentators made suggestions on how to interpret the legislative intent behind the special valuation rule. In general, the commentators were concerned that implementing the rule without modification would in many cases generate tax gains far in excess of economic gains. Because the commentators viewed this overvaluation as a substantial impediment to the use of FASITs, they asked that the proposed regulations narrow as much as possible the debt instruments subject to the special valuation rule.

The proposed regulations attempt to reconcile the legislative intent and the commentators' concerns in a consistent and principled manner. The policy justification for the special valuation rule is strongest where it is difficult, if not impossible, to separate the value of a debt instrument from the value of the [o]wner's business relationship with the debtor. For example, the value of credit card receivables may be inferred if the receivables are placed in trust and used to create new debt instruments that are sold to the public at a disclosed price. In this case, however, the implied price necessarily includes both the value of the receivables and the value of the transferor's implicit or explicit promise to replace the receivables as they mature. Because there is no objective, easily administrable method for allocating the portion of the price allocable to the receivable (as opposed to the portion allocable to the transferor's ongoing business), the special valuation rule seems appropriate in this context.

By contrast, the policy justification for the special valuation rule is weakest in cases where the fair market value of the debt instrument can be easily established. For example, if a FASIT purchases a pool of non-market-traded securities for cash in a transaction where the FASIT maintains no continuing relationship with the seller, there appears to be no reason to distrust the value as determined by an actual arm's length bargaining.⁴

It is possible to infer from the above language that the regulation process will focus on the appropriateness of using actual fair value, except for a few asset categories. It is possible in this regard that the Treasury will prove sympathetic to other rational methods of determining fair value for certain asset categories, such as bank loans, retail instalment contracts and trade receivables.

On the other hand, an established securities market is defined in the text of the Proposed Regulations by cross-reference to the original issue discount ("OID") regulations.⁵ Defining an established securities market by cross-reference to the OID regulations is less ambitious than it may appear because the Proposed Regulations fail to include readily quotable debt instruments, which are included in the definition of debt instruments traded on an

established market for purposes of the OID rules.⁶ Debt instruments that would otherwise qualify as readily quotable debt instruments will be valued using the mechanical formula unless they qualify for the spot purchase rule exception (described below).

The text of the Proposed Regulations prescribes an exception to the special valuation rule referred to as the "spot purchase rule." The spot purchase rule applies if (1) a debt instrument is purchased from an unrelated person in an arm's length transaction; (2) the debt instrument is acquired for cash, (3) the price of the debt instrument is fixed no more than 15 days before the date of purchase, and (4) the debt instrument is transferred to the FASIT no more than 15 days after the date of purchase.⁷ The utility and intended scope of the spot purchase rule is unclear. It can be expected, however, that during the comment period industry participants will propose an expansion of the spot purchase rule and other rational alternatives for determining actual fair market value of assets transferred to a FASIT.

Non-FASIT Losses Not to Offset Certain FASIT Inclusions. Section 860J(a) provides, among other things, that a holder of an ownership interest may not use its income in respect of such interest to offset any deductions or losses (including net operating losses) not attributable to the FASIT. Although the statutory language is not entirely clear, it had been assumed, by analogy to the real estate mortgage conduit rules (REMIC) provisions, that the up-front gain should probably not be covered by this "no offset" rule. The Proposed Regulations, however, would provide that the rules of Section 860J(a) apply to the up-front gain.⁸ The Proposed Regulations would at least permit a taxpayer to offset the up-front gain with any net losses generated from a taxpayer's ownership interest in other FASITs.⁹

Interest Expense Allocation. For purposes of applying the interest expense allocation rules to the taxpayer's affiliated group under Section 864(e), the Proposed Regulations require taxpayers to use the direct allocation method.¹⁰ This method provides for the direct allocation and apportionment of all FASIT interest expense to all FASIT gross income, on the basis of all FASIT assets in which the taxpayer and any member of the taxpayer's affiliated group holds the ownership interest.¹¹ The Proposed Regulations also extend the existing asset adjustment rules under the asset method in Treasury Regulation Section 1.861-9T(g), which reduce the value of assets to reflect the principal amount of indebtedness outstanding relating to the interest which is directly allocated.¹²

The Proposed Regulations would thus, in effect, provide an additional exception to the general rule of fungibility for the allocation of interest expense between U.S. and non-U.S. operations. This could result in, among other possibilities, securitization of United States assets poten-

tially freeing-up the utilization of foreign tax credits. The Treasury recognizes the potential for taxpayers to engage in interest expense allocation planning and is considering adopting an additional rule in the final regulations to reduce distortions.

Permitted Assets. The Proposed Regulations clarify some of the more important issues with respect to the definition of permitted assets.¹³

- a. **Owner Debt.** Although generally a FASIT is prohibited from holding debt instruments issued by its owner or a person related to the owner of the FASIT,¹⁴ a FASIT would be permitted to hold certain short-term debt instruments issued by the owner.¹⁵ Moreover, the Proposed Regulations would permit FASIT tiering by allowing the FASIT owner to fund a FASIT with regular interests issued by another FASIT in which the owner holds an ownership interest.
- b. **Hedges and Guarantees.** Section 860L(c)(1)(D) provides that a contract will qualify as a permitted asset if such contract is a permitted hedge or guarantee. The Proposed Regulations would expand the types of contracts that qualify as permitted hedges or guarantees. A hedge or guarantee would be permitted if the contract is reasonably required to offset any differences that any "risk factor" may cause between the amount or timing of the receipts on assets the FASIT holds (or expects to hold) and the amount or timing of the payments on the regular interests the FASIT has issued (or expects to issue). The relevant "risk factors" are: (i) fluctuations in market interest rates; (ii) fluctuations in currency exchange rates; (iii) the credit quality of, or default on, the FASIT's assets or debt instruments underlying the FASIT's assets; and (iv) the receipt of payments on the FASIT's assets earlier or later than originally anticipated.¹⁶ In addition, the Proposed Regulations permit certain owners or related parties to enter into hedges and guarantees with the FASIT. Generally, the owner or related party must be a dealer in the contract or substantially similar contracts and must retain documentation establishing that the terms of the contract are consistent with an arm's-length transaction.¹⁷ If the contract is a guarantee, taking into account the contract's value, the value of all the FASIT's guarantee contracts issued by the owner or related party must be less than 3 percent of the value of the FASIT's assets.¹⁸
- c. **Participation Interests.** The Proposed Regulations do not specifically address whether a participation interest in a pool of revolving loans held by a FASIT is a permitted asset. The Preamble, however, addresses participation interests. The Preamble states that a fixed-percentage interest should qualify as a permitted debt instrument if the underlying debt instruments in the

pool are themselves permitted assets; however, the treatment of a participation interest based on a fixed-dollar amount of assets in a pool is unclear. The Treasury expressed a willingness to include fixed-dollar amount participation interests in the definition of a permitted asset by inviting public comments on whether and how the need for a FASIT to hold fixed-dollar amount participation interests could be accommodated.

Property Held Outside FASIT Supporting FASIT Regular Interests.

In order to prevent owners from trying to circumvent recognition of the up-front gain, Section 860I(b) requires that, in addition to property transfers to the FASIT, non-FASIT property supporting a FASIT regular interest is subject to up-front gain treatment.¹⁹ Under the Proposed Regulations, property is support property if the owner (or related person)—(1) pledges the property, directly or indirectly, to pay a FASIT regular interest, or otherwise identifies the property as providing security for the payment of a FASIT regular interest; (2) sets aside the property for transfer to a FASIT under any agreement or understanding; or (3) holds an interest in the property that is subordinate to the FASIT's interests in the property (for example, the owner holds subordinate interests in a pool of mortgages and the FASIT holds senior interests in the same pool).²⁰

Anti-abuse Rules. The general anti-abuse provision of the Proposed Regulations is patterned after the anti-abuse rule in the partnership regulations. Under the anti-abuse rules, the Internal Revenue Service (the "Service") is authorized to make "appropriate adjustments" if, based on all the facts and circumstances, a principal purpose of forming or using a FASIT is to achieve results inconsistent with the intent of the FASIT provisions.²¹ Under these provisions, the intent of a FASIT is "to promote the spreading of credit risk on debt instruments by facilitating the securitization of those debt instruments."²² Implicit in this intent is that the FASIT hold primarily debt instruments that are the primary source of payments to the regular interest holders and that "[n]o FASIT provision may be used to achieve a Federal tax result that cannot be achieved without the provision unless the provision clearly contemplates that result."²³ The Service's authority to make appropriate adjustments includes, among other things, disregarding a FASIT election; treating one or more assets of a FASIT as held by a person or persons other than the owner; treating the ownership interest in a FASIT as held by a person other than the nominal holder; and treating a FASIT regular interest as other than a debt instrument.²⁴ In addition, the Proposed Regulations also contain two specific anti-abuse rules: (i) a FASIT may not hold debt traded on an established securities market if the interest on the debt instrument is subject to foreign withholding tax;²⁵ and (ii) if a foreign resident holds a regular interest in a FASIT and the FASIT holds a debt instrument issued by a conduit debtor (generally, a 10-percent shareholder, con-

trolled foreign corporation, or other related party), then interest received or accrued by the foreign resident with respect to its regular interest is treated as received or accrued from the conduit debtor.²⁶

If there are any questions regarding the issues discussed in this memorandum (or other FASIT issues), do not hesitate to call Jeffrey P. Cantrell (704-444-3513), David M. Goldman (212-506-2534), Thomas R. Hood (212-506-2595), William Levy (312-701-8049) or John Connery (312-701-8652) for additional information.

Endnotes:

1. The lower and unrated securities can qualify as FASIT "regular interests" under the Internal Revenue Code of 1986, as amended (the "Code"). All Section references are to the Code, and references to Prop. Treas. Reg. are to the Proposed Regulations.
2. Section 860I(a)(1). Additional rules require recognition of any gain under the FASIT calculation (i) where the asset is purchased by the FASIT from an unrelated party or (ii) where the asset is transferred to the FASIT by a party related to the holder of the ownership interest. Sections 860I(a)(1) and 860I(a)(2).
3. The value of transferred debt instruments that are not traded on an established securities market is the present value of the "reasonably expected payments" under such instrument determined using a discount rate equal to 120 percent of the applicable federal rate (a rate approximating yields on Treasury securities with similar maturities). Section 860I(d)(1)(A); Prop. Treas. Reg. § 1.860I-2(a). Because 120 percent of the applicable federal rate will likely be lower than the expected yield to the FASIT on such debt instruments, the value of such instruments under this methodology would likely exceed the sponsor's tax basis in the instrument (which is typically equal to par).
4. The Preamble.
5. Prop. Treas. Reg. § 1.860I-2(b) (citing Treas. Reg. § 1.1273-2(f)(2), (3), or (4)). Treas. Reg. § 1.1273-2(f)(2)-(4) generally provide that debt is considered traded on an established securities market if (1) it is listed on certain specified securities exchanges or on certain interdealer quotation systems, (2) it is traded on a board of trade or interbank market, or (3) it appears on a quotation medium that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions.
6. As defined in Treas. Reg. § 1.1273-2(f)(5).
7. Prop. Treas. Reg. § 1.860I-2(d)(3).
8. Prop. Treas. Reg. § 1.860J-1(a).
9. Prop. Treas. Reg. § 1.860J-1(b).
10. Treas. Reg. § 1.861-10T(f)(1).
11. Treas. Reg. § 1.861-10T(f)(2).
12. Treas. Reg. § 1.861-10T(f)(2).
13. For example, the definition of cash and cash equivalents includes shares in U.S.-dollar-denominated money market mutual funds. Prop. Treas. Reg. § 1.860H-2(c)(4).
14. Under the Proposed Regulations, the term "owner debt" encompasses more than debt instruments directly issued by the owner. For example, owner debt includes a third-party debt instrument the performance of which is contingent on the performance of owner (or a related person) debt or any partial interest in owner (or related person) debt such as a principal or coupon strip. Prop. Treas. Reg. § 1.860H-2(b)(3)(v), (vi).
15. Prop. Treas. Reg. § 1.860H-2(b)(2). In order to be classified as a permitted debt instrument, the owner debt must: (1) be a fixed rate debt instrument or variable rate debt instrument if such instrument provides for interest at a qualified floating rate within the meaning of Treas. Reg. § 1.1275-5(b); (2) have an original stated maturity of 270 days or less; (3) be at least investment quality and (4) be used to invest cash temporarily awaiting reinvestment in a permitted asset or distribution to the FASIT's owner or regular interest holders. *Id.*
16. Prop. Treas. Reg. § 1.860H-2(d)(1).
17. Prop. Treas. Reg. § 1.860H-2(e).
18. Prop. Treas. Reg. § 1.860H-2(e)(2)(iii). For this purpose value is determined in accordance with Section 860I(d) and Prop. Treas. Reg. § 1.860I-2.
19. Section 860I(b)(2) treats the supporting property as being held by the FASIT for purposes of applying the FASIT rules.
20. Prop. Treas. Reg. § 1.860I-1(b).
21. Prop. Treas. Reg. § 1.860L-2(a),(b), (c).
22. *Id.*
23. *Id.*
24. Prop. Treas. Reg. § 1.860L-2(b).
25. Prop. Treas. Reg. § 1.860H-2(b)(3)(vii).
26. Prop. Treas. Reg. § 1.860H

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