

June 6, 2001

Mark A. Weinberger, Esq.  
Assistant Secretary for Tax Policy  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Room 1334  
Washington, D.C. 20020

Re: The Defenestration of FASITs

Dear Assistant Secretary Weinberger:

The FASIT rules were adopted in 1996 to achieve greater certainty in the tax treatment of securitizations of non-mortgage receivables and revolving pools of mortgage and non-mortgage receivables. The goal was a desirable one. Unfortunately, the legislation has not achieved its purpose and likely never will, at least in its present form. We are writing to suggest that the IRS and Treasury consider throwing FASITs out the window in favor of something better. Specifically, we recommend the adoption of a package of narrowly crafted tax law changes (almost all of which could be implemented through regulations) that would address the concerns that led to enactment of the FASIT statute. Once those changes were in place, taps could be played and the FASIT sections of the Code repealed.

The FASIT legislation has failed for two main reasons: interpretation risk and tax costs imposed by the statute. The statute is not well crafted technically. Many have concluded that using it in its present form without substantial further guidance from the IRS entails too much risk of unanticipated results (at least measured by the normal standards for securitizations).<sup>1</sup> This problem could be largely resolved through the adoption of comprehensive regulations. As discussed below, however, it seems quite unlikely that regulations suitable to the task will see the light of day, at least within the foreseeable future.

Second, the FASIT statute by its terms imposes tax and other economic costs that for many sponsors more than offset its potential benefits. The most significant costs result from (1) the rule requiring up-front recognition of gain measured using artificial and often inflated values, and (2) limitations on the types of investors who can hold “high-yield” interests.<sup>2</sup>

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<sup>1</sup> For a comprehensive description of problems with the FASIT statute, see James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions* (3d Edition, Frank J. Fabozzi Associates, 2001; <http://www.securitizationtax.com>), Chapter 16. References below in this letter to chapters are to chapters of this book.

<sup>2</sup> The definition of “high-yield interest” is broader than might be expected. In particular, it covers all interest-only classes issued directly by a FASIT even if those classes have a low yield and represent economically strips of interest coupons taken off of other regular interest classes that are not high-yield classes. This rule is particularly burdensome for mortgage securitizations because they typically

Another important drawback for sponsors of master trusts has been the need to set up new securitization vehicles to use the FASIT rules.<sup>3</sup> Accordingly, even if implementing regulations were issued, the statute very likely still would not be used unless it were changed in some material ways.<sup>4</sup>

The FASIT legislation was enacted in 1996. The effective date was delayed until September 1, 1997 to give the government time to issue implementing regulations. Proposed FASIT regulations were issued in February 2000. The proposed regulations include a broadly worded anti-abuse rule that was made immediately effective. The regulations have been heavily criticized, both for what they do and for what they leave out.<sup>5</sup> The regulatory guidance plan (aka “business plan”) for 2000 indicated that substantial work would be done on final FASIT regulations during 2000 with a view to completion in 2001. The recently-released plan for 2001 (or actually the period through June 30, 2002) makes no mention of FASITs, not even in the appendix listing projects on which substantial work will be completed during the plan year. On its face, the silence seems quite odd given the existence of the proposed regulations and the fact that they have in some areas a retroactive effective date. One explanation may be that the IRS has concluded (quite reasonably) that writing workable FASIT regulations would be an enormous undertaking and does not wish at this point to devote the necessary resources to the task. A contributing factor may be the fear that even if regulations were issued that met the highest hopes of taxpayers, FASITs would still wither on the vine due to the defects in the statute.

Our suggested alternative approach would allow both the FASIT statute and the regulation project to be jettisoned. The proposals would be implemented largely through regulations, so they could be criticized on the ground that they would simply substitute one regulation project for another. The scope of the two projects, however, would be vastly different. Our proposals would require only a few, rifle-shot rules. They would be (we say bravely) short and comparatively easy to draft. They could readily be understood and evaluated by tax generalists without the need for immersion (or even drowning) in a new statutory pass-through regime. Moreover, once the changes were implemented, they would be used and hence would do some real good in achieving the goals of the FASIT legislation.

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include interest-only classes. Also, the yield threshold for defining a high-yield interest (500 basis points over the AFR) is far more confining today than it was when the FASIT rules were adopted due to the widening of credit spreads (the spread over Treasuries charged by the market for different quality credits) particularly for lower-grade credits. For example, an average credit spread for a B rated corporate debt instrument on August 20, 1996 (when the FASIT rules were enacted) was 433 basis points. The same figure today would be closer to 850 basis points (i.e., almost double).

<sup>3</sup> Although the FASIT statute includes a limited transition rule that contemplates a partial FASIT election, the rule is inadequate to the task. The problems with the rule are described in Chapter 16, Parts G.2.e and H.5.

<sup>4</sup> Chapter 16 describes the advantages and disadvantages of FASITs compared with other structures for securitizing mortgage and non-mortgage receivables.

<sup>5</sup> See Chapter 16; New York State Bar Association Tax Section, “Report on Proposed Regulations Relating to Financial Asset Securitization Investment Trusts,” 2000 *Tax Notes Today* 93-17 (May 5, 2000).

## Summary of Proposals

The proposed changes are listed below and then discussed in more detail in the next section. The basic idea behind them is to ensure that securitization vehicles can pass through interest income to investors without an entity-level tax or, in the case of foreign investors, withholding tax. The underlying theory is that the activities of the entity are not active enough to warrant an entity-level tax and that interest or its equivalent paid to investors should be exempt from withholding tax under the portfolio interest exemption.

The proposals would address the entity-level tax issue in several ways. First, they would clarify the standards for determining when trust interests may be classified as debt.<sup>6</sup> Second, they would limit the risk of classification of the issuing vehicle as a corporation under the publicly traded partnership (“PTP”) and taxable mortgage pool (“TMP”) rules by clarifying the passive income exception for PTPs and narrowing and clarifying the definition of a TMP. Third, the proposals would reduce the risk of withholding taxes by clarifying that the portfolio interest exemption applies to interest allocated to a foreign partner as long as the foreign partner’s partnership interests are in registered form or were issued in compliance with the TEFRA Eurobond exception. Finally, the proposals would change the REMIC definition of qualified replacement mortgage (the one proposal clearly requiring a statutory amendment) to allow greater freedom to modify mortgage loans. The prospect of gaining greater flexibility in this area is one of the main potential benefits of the FASIT rules for mortgage securitizations.

More specifically, we suggest adoption of the following measures:

- A regulation providing that a class of beneficial interests issued by a securitization vehicle organized as a local-law trust would be classified as debt if (1) the governing agreements express the intention to treat the class as debt for tax purposes, and (2) the class would be so treated if it took the form of debt.
- A regulation providing that a securitization vehicle will not be considered to be engaged in a financial business (so that interest income is regarded as passive for purposes of the section 7704 passive income test) because it makes advances under loans or credit card or similar accounts, or because of activities of sponsors or loan servicers (including affiliates).
- Changes in the TMP regulations that would narrow the definition of a TMP in three ways: provide that an asset would be a real estate mortgage (of a type that an entity must hold to be a TMP) only if it is a qualified mortgage that can be securitized under the REMIC rules (subject to an anti-abuse exception covering loans that are deliberately structured not to be such mortgages); clarify that debt backed by revolving pools of loans does not meet the TMP relationship test; and carve out of the definition of TMP any entity (or portion thereof) if all of its debt is short term (less than three years).

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<sup>6</sup> Interest paid on debt would, of course, be deductible. Also, the public trading of debt does not convert an issuing trust into a publicly traded partnership that may be classified as a corporation under section 7704.

- Change the section 860G(a)(4) definition of qualified replacement mortgage (which is a permitted asset for a REMIC) to include any mortgage held by a REMIC that results from the modification of a qualified mortgage held by the REMIC, provided the modification does not extend the term of the mortgage or increase its outstanding principal balance.
- A regulation providing that when a securitization vehicle classified as a partnership allocates income to a foreign partner, the TEFRA registration requirements that must be met for the portfolio interest exception to apply are satisfied if the partnership interest meets those requirements.

These proposals are discussed in more detail in the following sections.

### More Detailed Description

#### Treating Trust Equity That is Intended to be Debt as if it Were in the Form of Debt

The original reason for the FASIT rules was to clarify the tax status of trust certificates issued by trusts holding credit card receivables, or, more broadly, other revolving pools of receivables. The certificates resembled debt economically but were cast in the form of trust equity (beneficial interests) for financial statement or regulatory accounting reasons.<sup>7</sup> Tax counsel have generally been willing to conclude that such interests would be classified as debt for tax purposes based on their economic characteristics if the certificates were highly rated. There has been more doubt where the securities are subordinated or have other equity characteristics. The dividing line has been drawn far more conservatively than would be the case for instruments cast in the form of debt.<sup>8</sup>

The first proposal is that the IRS issue a regulation applicable to certificates of beneficial interest issued by a securitization vehicle that is organized as a local-law trust.<sup>9</sup> The regulation would state that a class of beneficial interests in such a securitization trust would be classified as debt if (1) the governing agreements express the intention to treat the class as debt

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<sup>7</sup> The relevant financial accounting rules have changed somewhat since adoption of the FASIT legislation. Specifically, it is now possible for a trust sponsor in many cases to achieve “off-balance sheet treatment” of receivables by having them be held by a qualifying special purpose entity (“QSPE”) that issues instruments in the form of debt. The debt is recognized to be a liability of the QSPE but the QSPE is not consolidated with its equity owner, even if that owner holds a controlling interest in the issuer. The QSPE rules are quite restrictive and will not apply to all securitizations. Moreover, for banks, issuances of trust interests in the form of equity continue to be important for regulatory reasons.

<sup>8</sup> For a general discussion of the tax characterization of trust equity interests, see Chapter 3, Part E.4.

<sup>9</sup> Because of the very limited scope of the proposed rule, the definition of securitization trust could be general and fairly loose (e.g., an entity that holds a fixed or revolving pool of receivables and related assets and finances those assets by issuing one or more classes of debt or equity interests to investors).

for tax purposes<sup>10</sup> and (2) the class would be so treated under general tax law principles if it took the form of debt. In other words, under the regulation, a trust certificate would be treated as debt if it would have been so treated had it been issued in the form of a note or bond.<sup>11</sup> In order to signal clearly the intention of the rule, it should be illustrated by an example that involves a class of subordinated trust certificates issued by a typical credit card trust and concludes that the class is debt. The example should not try to set out specific payment terms or minimum standards for credit quality but should state only that the instrument's payment terms and the risk of nonpayment would be consistent with treatment of the class as debt if it were in the form of debt.

The proposal offers less than the FASIT rules in that it would not provide complete certainty regarding the tax status of a trust certificate as debt or equity. On the other hand, it would address squarely the main issue that has troubled tax advisors in this setting. Also, it should be viewed as part of a package with the next two proposals discussed below (relating to the definition of a financial business and withholding taxes). They are intended to reduce the adverse consequences of guessing wrong on the debt-equity issue and thus to make more tolerable the somewhat greater level of uncertainty.

Particularly in light of experience with the FASIT rules, a major benefit of the proposal to the government is that it is very narrow in scope. It would address only the form of an instrument, so that it would not be necessary to become enmeshed in an extended analysis of where to draw the line between debt and equity in close cases. Also, unlike the FASIT regime, the rule would be limited to issuers that are local-law trusts. Trusts are often used to hold assets as security for debt, and there is already a body of law that treats trust instruments in some circumstances as debt.<sup>12</sup> Another advantage of the rule is that it could be relied upon for new issuances by existing master trusts.

### Financial Business Safe Harbor

The adoption of the check-the-box rules effective at the beginning of 1997 has reduced the tax stakes of determining properly the status of a trust instrument as debt or equity. Specifically, under the four-factor test in effect before 1997, a trust that failed to qualify as a grantor trust was generally classified as a corporation. If such a trust issued an instrument that was intended to be treated as debt but was instead classified as equity, the consequences could be a corporate level tax on the income allocable to that class. By contrast, under the check-the-box rules, such a trust is never classified as an association unless (1) it qualifies as a PTP and has a

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<sup>10</sup> Making such a statement is already common practice for trust certificates that are intended to be classified as debt.

<sup>11</sup> A similar proposal was made in a letter from James M. Peaslee to Clarissa Potter dated September 25, 1995 (reprinted in 69 *Tax Notes* 237 (1995)). The regulation proposed in that letter would have looked to other characteristics of the instrument (e.g., interest rate) and based on specified criteria would have determined whether the instrument was debt. We believe the narrower rule proposed here addressing only the significance of form would be sufficient, more flexible, and easier for the government to accept.

<sup>12</sup> See, e.g., Revenue Ruling 76-265, 1976-2 C.B. 448, and Revenue Ruling 61-181, 1961-2 C.B. 21. There are also authorities treating pass-through certificates as debt of a guarantor. See, e.g., Revenue Ruling 97-3, 1997-1 C.B. 9, and *Bess Schoellkopf*, 32 B.T.A. 88 (1935).

more than *de minimis* amount of “active” income, or (2) holds mortgages and is a TMP. The financial business safe harbor rule discussed here relates to whether a PTP has active income. Certain issues relating to the TMP rules are addressed below.

If a securitization trust that is not a grantor trust issues a class of securities that are publicly traded and those securities are not treated as debt, then the trust would be a PTP. As a PTP, the trust would be classified as a corporation under section 7704 unless the trust meets a passive income test. That test requires that at least 90% of the PTP’s income consist of “qualifying income” as defined in section 7704(d). Qualifying income generally includes interest or discount on receivables and also income from swaps or other hedge instruments. However, interest is not considered to be qualifying income if it is derived in the conduct of a financial business (see section 7704(d)(2)(A)). There is no definition of a financial business. The legislative history indicates that acting as a broker-dealer or bank would be a financial business. Trading is not a financial business.<sup>13</sup>

Most securitization vehicles are clearly not engaged in a business, much less a financial business. They hold receivables, collect the cash payments thereon and distribute the cash to investors. However, where a securitization vehicle has a revolving feature and acquires newly originated receivables (including new credit card receivables generated through purchases or cash advances, or draws under lines of credit), some have expressed a concern that the vehicle might be engaged in a financial business, on the ground that it is originating loans and thereby acting as a finance company.

A typical securitization trust should not be considered to be engaged in a financial business. The trust acts as a financing arm for its sponsor. It has no employees, customers or good will. All of its active business activities are undertaken by affiliates. While these factors should be found controlling, given the vagueness of the term “financial business” it would be very desirable to clarify the treatment of revolving pool arrangements by creating a safe harbor exclusion from the definition of a financial business.<sup>14</sup> Although different approaches are possible, the rule we suggest is that a securitization vehicle not be considered to be engaged in a financial business because it is the first owner of newly-originated receivables, because it is obligated to acquire new receivables, or because of business activities of the sponsor or a servicer (including an affiliate).<sup>15</sup> The rule that disregards activities of a servicer is similar to one included in the proposed FASIT regulations.<sup>16</sup>

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<sup>13</sup> There is an extensive discussion of the term “financial business” in Chapter 4, Part F.

<sup>14</sup> Other commentators have made similar suggestions in the past. See letter, dated August 15, 1995, from Michael L. Schler to Commissioner Richardson, 95 *Tax Notes Today* 166-12 (August 24, 1995) (recommends a rule that a securitization trust not be considered to engage in a financial business because of the reinvestment of cash collections in new receivables pursuant to existing contractual commitments), and letter, dated July 31, 1995, from Kenneth G. Whyburn to the Service, 95 *Tax Notes Today* 161-31 (August 17, 1995) (proposes a definition of financial business that carves out a partnership that serves primarily as a financing vehicle for affiliates).

<sup>15</sup> It may also be desirable to provide that such a vehicle is not engaged in a “trade or business” other than of “trading in . . . securities” because of the same factors so as to avoid the risk of taxation by foreign investors.

<sup>16</sup> See Proposed Regulation § 1.860L-1(a)(2)(iii).

## Withholding Taxes on Income Allocable to Foreign Partners

Income paid to foreign investors on debt issued by a domestic securitization vehicle is generally exempt from U.S. withholding tax under the portfolio interest exemption.<sup>17</sup> The portfolio interest exemption requires that interest be paid on debt that either is in registered form (in which case Form W-8BENs or other identifying information generally must be obtained from foreign investors) or was issued in bearer form under the Eurobond exception (section 163(f)(2)(B)). These requirements are easily met for capital market instruments.

Most consumer receivables are not in registered form and, of course, were not issued in compliance with the requirements of the Eurobond exception. Accordingly, where a securitization vehicle holds such receivables and issues equity interests, the interest that is passed through on the equity interests would not qualify for the portfolio interest exemption if the TEFRA registration requirements were applied to the receivables and not to the equity interests. There is a regulation that applies the TEFRA rules to equity interests issued by grantor trusts (so that interest is considered to be received on an obligation in registered form if the equity interests are in registered form).<sup>18</sup> This regulation does not literally apply to a trust that fails to be a grantor trust (and is therefore classified as a partnership) because it has a power to vary its assets or has multiple classes of equity. Accordingly, if a securitization trust that is classified as a partnership issues a class of trust equity to a foreign investor, interest on consumer receivables allocated to that investor may not qualify for the portfolio interest exemption, even if the partnership interest is in registered form. There is some additional uncertainty if the income of the foreign partner is a guaranteed payment.<sup>19</sup>

As a policy matter, it is difficult to justify treating interest allocated to a partnership class as not being paid in respect of an obligation in registered form or falling within the TEFRA Eurobond exception if the security evidencing the partnership interest is in registered form or was issued under that exemption. We recommend adoption of a regulation clarifying that interest income of a securitization vehicle that is allocable to such a class be considered to be interest paid on an obligation in registered form or issued under the Eurobond exception. We further recommend issuance of a regulation clarifying that guaranteed payments paid by a securitization vehicle will be regarded for withholding tax purposes as either interest paid by the vehicle or a distributive share of partnership income.

## Change in TMP Rules

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<sup>17</sup> The withholding tax rules discussed herein are described in Chapter 12.

<sup>18</sup> Treasury Regulation §§ 1.163-5T(d) and 1.871-14(d)(1).

<sup>19</sup> Guaranteed payments have been treated at different times as interest paid by the partnership, as a distributive share of partnership income or as ordinary income of no particular character. See Sheldon I. Banoff, "Guaranteed Payments for the Use of Capital: Schizophrenia In Subchapter K," 70 *Taxes* 820 (1992). The last characterization would be troublesome from a withholding tax perspective. The recently adopted withholding tax regulations appear to treat guaranteed payments as a distributive share of partnership income at least for purposes of determining the obligations of a withholding agent. Treasury Regulation § 1.1441-5(b)(2).

The taxable mortgage pool rules were adopted as an adjunct to the REMIC rules. Specifically, they were intended to prevent mortgage sponsors from avoiding the rules for taxing the “phantom income” attributed to a REMIC residual interest. They are, however, overly broad in some respects. First, under current regulations, they apply to entities holding mortgage assets that could not qualify for inclusion in a REMIC. These include a debt that is secured by a real estate mortgage rather than directly by real estate, REMIC residual interests (which cannot be held by other REMICs) and equity interests in pass-through arrangements. It is quite unfair to treat assets of this type as falling within the TMP definition (except in cases where a taxpayer has deliberately created assets that do not qualify under the REMIC rules with a view to avoiding TMP status). It is noteworthy that most sponsors prefer REMIC structures over the alternatives and use them if possible.

Second, an issue has arisen regarding the application of the TMP rules to issuers holding revolving pools of loans. In a typical transaction, the issuer would reinvest loan principal in new obligations over a substantial period and would then allow principal payments to be applied to retire debt during an amortization period. Instruments of this type should not be considered to meet the relationship test although there are no authorities on point.<sup>20</sup> We suggest that this point be clarified. Transactions with revolving features do not, of course, qualify under the REMIC rules.

A third problem with the TMP rules is that they potentially apply to securitizations involving only short-term debt. The phantom income problem is one of timing and arises principally where debt extends over a significant term. For example, the classic collateralized mortgage obligation backed by residential mortgages has a term of approximately 30 years or just under. The tax policy reason for having the TMP rules is much less significant where the debt is short term. We suggest that the rules not apply if all debt of the issuer that could meet the relationship test has a term of three years or less.<sup>21</sup>

#### Allow Modifications of Mortgages Held by REMICs

The REMIC rules work very well in most mortgage securitizations. Although the rules do not allow revolving pools (the reinvestment of mortgage principal in new loans), for the most part, REMIC sponsors do not need this flexibility. One area where greater flexibility would be desirable relates to the ongoing servicing of commercial mortgage loans. Those loans are significant in size and often contain complex covenants and other terms. It is fairly common for such a loan to be modified over its term with the consent of lender and borrower. Under current practice, if a modification is to be made outside of a default setting, the modification must either be sufficiently trivial so as to not be “significant” under section 1001 standards, or the loan must be refinanced and removed from the REMIC. We propose that the REMIC rules be changed to permit a loan to be modified after it is contributed to a REMIC provided the term of the loan is

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<sup>20</sup> For a discussion, see Chapter 4, Part E.2.c.

<sup>21</sup> By analogy, Treasury Regulation § 301.770(i)-1(f)(3) has a rule that prevents an entity from being a TMP if in general it is formed to liquidate assets over a period beginning within three years of its formation. The three year exception we suggest would arguably require a change in the statute. It could potentially be accomplished through a regulation interpreting the relationship test, but it is a debatable point.

not extended beyond the original term, the outstanding principal balance is not increased, and the loan as modified would meet the definition of a qualified mortgage if it were contributed to the REMIC at the time of the modification.<sup>22</sup> This change would make a REMIC more active, and thus more akin to a financial business. On the other hand, the fact that loans could not be made to new borrowers, new money could not be advanced to existing borrowers and the term of existing loans could not be extended would prevent a REMIC from engaging in any kind of loan origination business in which it makes loan commitments, solicits new customers, or raises additional financing. It is also noteworthy that REITs, another type of statutory pass-through vehicle that can hold mortgages, are clearly allowed to originate loans.<sup>23</sup> The proposed change is not intended to restrict the ability of a REMIC to modify loans in default settings or otherwise as permitted under the existing REMIC regulations.<sup>24</sup> The rule would allow negotiated releases of real estate collateral but only if the remaining collateral was sufficient to meet the qualified mortgage definition.

### Some Concluding Thoughts

The proposals set out above are obviously somewhat sketchy and would require thought and clarification. Our basic point is that most of the potential benefits of the FASIT rules could be achieved in a more straightforward way by adopting a package of limited tax law changes, which mostly amount to clarifications. If the IRS and Treasury are in agreement with the basic approach, we suggest the IRS issue an announcement stating that an alternative approach to FASITs is under consideration, identifying the proposed alternatives, and asking for comments. The notice could be similar to the one issued announcing consideration of the check-the-box regime.<sup>25</sup> Such a notice would very likely result in constructive comments that would be helpful in implementing the proposals.

We would be glad to discuss these proposals and variations on them with any interested parties in the Treasury or IRS.

Sincerely,

/s/ James M. Peaslee

/s/ David Z. Nirenberg

cc: Joseph M. Mikrut, Esq.  
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<sup>22</sup> The change could be accomplished by adding a new clause (iii) to section 860G(a)(4)(B) reading as follows: “an obligation through a modification of such obligation provided the modification does not extend the obligation’s term or increase its principal amount.” The modification of the terms of a loan held by a REMIC would incidentally affect outstanding regular interest classes that bear interest at a rate equal to a weighted average of the rates of interest on the underlying mortgage pool. It is anticipated that regular interests would not be deemed reissued because of a loan modification.

<sup>23</sup> See Revenue Ruling 80-57, 1980-1 C.B. 157 (discusses REIT engaged in an active lending business).

<sup>24</sup> See Treasury Regulation § 1.860G-2(b).

<sup>25</sup> See Notice 95-14, 1995-1 C.B. 297.

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