REPORT #793

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED "FASIT" LEGISLATION

May 26, 1994

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May 27, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
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John L. Buckley
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Re: Draft FASIT Legislation

Dear Secretary Samuels and Mr. Buckley:

Enclosed is a report of an ad hoc committee of the Tax Section on draft legislation provided to us by the Treasury Department relating to "financial asset securitization investment trusts" or "FASITs". The Tax Section takes no position on the desirability of enacting legislation of this nature. Rather, in the report, the ad hoc committee points out some of the pros and cons of the proposed legislation and also provides a number of technical comments for consideration in the further development of the legislation.

Please do not hesitate to contact the Tax Section if we can be of further assistance.

Sincerely,

Carolyn Joy Lee
First Vice-Chair,
Tax Section

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Tax Report #793

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED "FASIT" LEGISLATION

May 26, 1994

This report comments on the draft legislation dated December 1, 1993 relating to Financial Asset Securitization Investment Trusts (MFASIT"s).[1] These comments were requested by officials of the Treasury Department, who provided us with a copy of the draft legislation as well as the related technical explanation. Copies of the draft legislation and technical explanation are attached.

In general, the draft legislation would provide for the creation of a new type of vehicle principally for use in the securitization of a wide variety of financial assets. The draft legislation provides detailed rules for qualifying as a FASIT, for transfers of assets to or from the FASIT and for the ongoing treatment of holders of interests in the FASIT.

Enactment of legislation of this nature would facilitate a variety of securitization transactions by eliminating tax law considerations, such as distinctions between debt and equity and between borrowings and dispositions, that frequently hinder or render securitization transactions less efficient. The draft legislation contains thoughtful provisions that attempt to address both the revenue (erosion of the corporate tax base) and policy (clear reflection of income) concerns that are invoked by a regime that eliminates such considerations.

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[1] This report was prepared by an ad hoc committee (the "Committee") comprising Thomas Humphreys, co-chair of the Committee on Pass-Through Entities, and Bruce Kayle, co-chair of the Committee on Financial Instruments. Helpful comments were received from David Brockway, Carolyn Lee, Richard Loengard and David Nirenberg.

By making the tax treatment of these vehicles more certain, the legislation could be expected to improve both the efficiency of this kind of financing technique and the likelihood that its users will properly account to the fisc. The draft legislation is, however, quite complex, reflecting the complexity and variety of the transactions for which the legislation is intended. Most of the complexity would be borne voluntarily by the sponsoring organizations that will use the FASIT vehicle, and relatively little additional complexity would be visited upon the investing public. Nonetheless, the proposed FASIT legislation is a complex piece of legislation that will apply principally to a single industry. The Committee is not in this report recommending either the adoption or rejection of the draft legislation. The proposal offers both advantages and disadvantages, but overall we have no position as to whether the benefits gained by encouraging this kind of transaction justify the additional complexity. Our comments are instead limited to technical issues raised by the draft legislation should the Treasury Department decide it wishes to pursue legislation of this nature. These comments do not include relatively minor drafting points that we assume will be addressed as the legislation is refined.

I. FASIT Definition (section 855A).

A. Section 855A(a)(2)(B).

Section 855A(a)(2)(B) provides that "debt obligations" (other than debt obligations that carry contingent interest described in section 871(h)(4)(A)) are qualified assets for a FASIT. The term "debt obligations" is not defined in the statute. We assume, however, that a FASIT can hold trade or service receivables and that such instruments would be "debt obligations" under section 855A(a)(2)(B).

To make this absolutely clear, section 855A should be supplemented by adding the phrase, "including trade or service receivables which entitle the holder to a fixed amount" after the phrase "debt obligations"; and the legislative history should make clear that a receivable does not fail to entitle the holder to a fixed amount if the amount can be adjusted to reflect returns, nondelivery, damages or similar offsets. Alternatively, the term debt obligation could be defined in Section 855E, using a broad definition such as that in section 1275(a)(1)(A).

By providing that permitted assets in a FASIT include debt obligations, without other restrictions the possibility exists that mortgages could be contributed to a FASIT rather than to a real estate mortgage investment conduit ("REMIC").[2] We think this flexibility is warranted and avoids the difficulty of having to delineate between instruments that could be contributed to a REMIC and those that could be contributed to a FASIT. While we think this flexibility is important, it is also important to ensure that a sponsor seeking to securitize real estate mortgage assets receives treatment that is no better with a FASIT than with a REMIC. Otherwise, sponsors will use REMIC or FASIT depending upon which vehicle minimizes the sponsor's or investor's taxes. This equivalency between REMIC transactions and FASIT transactions should be a guiding principle in drafting the FASIT legislation.

B. Section 855A(a)(2)(C).

Section 855A(a)(2)(C) describes property acquired in connection with the default or imminent default of a debt obligation

[2] Importantly, however, the FASIT rules preserve the integrity of the taxable mortgage pool ("TMP") rules in section 7701(i) by providing for a system under which "residual income" is subject to tax in all events. See sections 855B(c) and 855D. Therefore, taxpayers will not be able to circumvent the TMP rules by using a FASIT.

held by a FASIT (but only if such property would be in compliance with the limitations of paragraphs (2) and (3) of section 856(e) if the FASIT were a real estate investment trust). Sections 856(e)(2) and (3) define the period during which property will be characterized as foreclosure property, and provide for a two year grace period with extensions up to six years. Section 855A(a)(2)(C) should be clarified regarding whether the other restrictions in section 856(e)(4), i.e., restrictions that are directed to foreclosures of real property, apply, but in any event should be clarified to indicate that they never apply unless the property that the FASIT forecloses on is real property. It should also be made clear, in the statute or the legislative history, that no election under section 856(e)(5) is required to be made.

C. Section B55(a)(2)(D).

Section 855A(a)(2)(D) permits a FASIT to own contractual rights in the nature of hedges or guarantees, "but only to the extent reasonably required to protect against the risk that the FASIT would not otherwise be able to make timely payments on debt instruments issued by the FASIT out of payments received on debt obligations held by the FASIT". While this section permits "interest rate swaps," it is unclear whether there is any requirement that the payment terms of the debt instruments issued by the FASIT bear any particular relationship to the debt obligations held by the FASIT. Thus, for example, it is unclear whether an interest rate swap that converted, for example, a floating interest rate on the FASIT's debt obligations to a fixed interest rate on the FASIT's outstanding securities "protects against the risk that the FASIT would not otherwise be able to make timely payments on debt instruments issued by the FASIT". Also, it is unclear whether this clause is designed to restrict a FASIT from hedging or obtaining guarantees on its assets that back ownership

interests (as defined in section 855E(c)) in the FASIT (as opposed to debt instruments, as defined in section 855E(b)). In many cases a hedge or guarantee will cover all assets held by the FASIT; it would be unfortunate if such a hedge or guarantee was not a qualified FASIT asset merely because some of the cash flow on the FASIT's assets was used to pay ownership interests as opposed to debt instruments. This is particularly important because an ownership interest may be structured as a debt instrument under local law and in fact may be credit enhanced. Furthermore, it is unclear whether the "protects against the risk" clause prohibits minimum prepayment guarantees that are permitted by the parenthetical language immediately preceding such clause. For all these reasons, it seems to us that the language beginning with "but only to the extent" is superfluous and could be omitted. We note that the principal policy consideration behind limiting the FASIT's use of hedging or other similar devices should be protected by the prohibited transaction rules of section 855A(b).

Section 855A(a)(2)(0) refers to hedging or guaranteeing against the "economic risks associated with debt instruments issued or held by the FASIT". The term debt instrument is defined in section 855E(b) as "any permitted debt instrument or qualified debt instrument". Thus, the statute literally only permits hedges or guarantees of other FASIT instruments held by the FASIT. This is clearly unintended and the language should be supplemented to provide that hedging or guaranteeing against the "economic risks associated with debt instruments issued by the FASIT or debt obligations, including trade or service receivables which entitle the holder to a fixed amount, held by the FASIT . . ." (suggested language underlined). We also suggest that section 855A(a)(2)(D) be modified to make clear that a FASIT may hold contract rights that protect against currency fluctuations, provided the other requirements of that section are met.

Section 855A(a)(2) also should provide that a FASIT may hold a contract right to acquire any assets that a FASIT otherwise is entitled to hold. This would accommodate the very common transactions in which receivables would be transferred to a FASIT pursuant to a contract that required the FASIT to use collections with respect to those receivables to purchase subsequently originated receivables for a period of time. Because the subsequently originated receivables might have a value exceeding the FASIT's purchase price, the FASIT's rights under the agreement could be viewed as a valuable asset, which might have the effect of disqualifying the FASIT if the suggested provision is not added.

D. Section 855A(a)(31).

Section 855A(a)(3) provides that all of the interests in a FASIT must be "ownership interests, permitted debt instruments or qualified debt instruments". This section is patterned after section 860D(a)(3) under the REMIC rules. Guidance issued by the Internal Revenue Service ("Service") makes it clear that a servicing fee, even a servicing fee that is in an amount greater than reasonable compensation for services rendered (so-called "excess" servicing), is not an interest in a REMIC.[3] Absent a similar rule under section 855A(a)(3), FASIT qualification will depend on the difficult factual determination of whether servicing compensation is reasonable.[4] In the mortgage context, most servicing is computed as a fixed number of basis points. Therefore,

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[3] Treas. Regs. $1.860D-l(b)(2)(1) and §1.860D-l(b)(2)(ii).

[4] Determining whether servicing compensation is reasonable in a FASIT transaction is likely to be considerably more difficult than in a mortgage securitization transaction because the assets involved may be less standardized and the market for third party servicers less developed. Without a rule similar to that provided for REMICS, there would be great potential for disputes over the level of reasonable servicing, and a FASIT could be disqualified if a servicing fee exceeded a "reasonable" amount by even $1.

if the servicing is excess servicing, it would constitute a “coupon strip” from the mortgage loans. This was the conclusion of Revenue Ruling 91-46, 1991-2 C.B. 358. In the asset-backed context, however, a sponsor may retain all cash flow on the receivables in excess of a floating interest rate paid on asset-backed securities. It is unclear under current law whether such a “variable strip” is a coupon strip under section 1286. In addition, the treatment of excess servicing in a revolving pool of assets raises additional concerns because the excess servicing is a right in an asset that is yet to be originated. It is unclear whether or how the coupon stripping rules apply to these sorts of interests and accordingly/ whether the same analysis could be relied upon to avoid disqualification of a FASIT. Thus, we suggest that Section 855(A)(a)(3) be clarified to provide that servicing, including (i) variable servicing, (ii) variable servicing in excess of reasonable servicing compensation under section 162, and (iii) the right to receive future servicing fees, whether fixed or variable and whether or not reasonable compensation under section 162, on debt obligations transferred to the FASIT, should not be treated as an interest in the FASIT. Because the suggested clarification would only address whether any variable coupon strip created is an interest in a FASIT for purposes of Section 855A(a)(3), we would assume that a variable strip created by the servicing arrangement relating to a FASIT would have the same consequences as any otherwise similar variable coupon strip. The federal income tax treatment of variable coupon strips, however, would be left to future Service guidance. Accordingly, the suggested clarification should not be viewed as expanding the opportunity for creating such variable strips.

E. Section 855A(a)(5).

Section 855A(a)(5) provides that a FASIT must make reasonable arrangements designed to ensure that its ownership interests and permitted debt instruments are held by, among others, "corporations to which the provisions of section 11 apply." It is not entirely clear how foreign corporations would be treated under this provision. Foreign corporations are not excepted from section 11. However, under section 11(d) and section 882(a)(1), a foreign corporation that is engaged in a trade or business in the United States is "taxable as provided in section 11 . . .on its taxable income that is effectively connected with the conduct of a trade or business within the United States." Based on the apparent policy of assuring that income derived from owning an ownership interest or permitted debt instrument is subject to United States corporate income tax, if the income the foreign corporation would derive from FASIT holdings would be treated as effectively connected income and not exempted from U.S. taxation by reason of a treaty, it would seem inappropriate to prevent a foreign corporation from holding these FASIT interests merely because not all of its income is subject to section 11. At the same time, we assume it would not be intended that a foreign corporation that has some effectively connected income, but whose income from an ownership interest or permitted debt instrument would not be effectively connected or would be exempt under a treaty, should be allowed to hold these FASIT interests.

We note that even if it were clarified that a foreign corporation is for these purposes treated as being subject to section 11 to the extent that income from the FASIT is effectively connected and not exempt under a treaty, there could be some difficulty satisfying the reasonable arrangements test. because of

the possibility that the foreign corporation's income at some time would cease to be subject to U.S. tax.

Accordingly, we propose that the reasonable arrangements test be considered met if a FASIT prohibits transfers of ownership interests and permitted debt instruments to any non-U.S. person for whom income derived from the ownership interest or permitted debt instrument would not at all times be effectively connected or would at any time be exempted under a treaty. The FASIT would be required to receive an affidavit to this effect from the proposed transferee. To ensure the effectiveness of these arrangements, however, we would support a provision in section 855(a)(5) which provides that the transferor of an ownership interest to a foreign person is liable for the tax on income from the ownership interest or permitted debt instrument if the foreign transferee's income from the ownership interest or permitted debt instrument is established at any time not to be effectively connected with a U.S. trade or business and therefore not subject to tax. As a practical matter, such a limitation would cause U.S. transferors to be very selective about their foreign transferees. We believe, however, that this is consistent with the tax policy of not allowing income from ownership interests to go untaxed.

In addition, certain life insurance companies and mutual savings banks conducting a life insurance business are not directly subject to tax under section 11. See section 11(c)(1) and (2). Nonetheless, these entities are, in general terms, subject to tax "as though" they were subject to section 11. Section 801(a)(1); section 594. There does not appear to be any policy reason for preventing these taxpayers from holding ownership interests in FASITs and section 855A(a)(5)(A) should be modified to include not

only corporations to which section 11 applies but also corporations to which sections 594 and 901 apply.[5]

F. Section 855A(b)(1).

Section 855A(b)(1) provides that rules "similar to those provided by section 860D(b)(2)(B) shall apply to inadvertent failures to comply with the requirements for qualifying as a FASIT." Section 860D(b)(2)(B) has been criticized because by its terms it only applies where an entity "ceases to be a REMIC". Therefore, it does not apply in the most common situation where an entity fails to qualify as a REMIC for its first year because of an inadvertent act. Section 855A(b)(1) appears to recognize this problem by specifying that it applies to "inadvertent failures to comply with the requirements for qualifying as a FASIT", rather than terminations of FASIT status. Unfortunately the cross-reference to section 860D(b)(2)(B) contradicts this. Therefore, we would suggest that section 855A(b)(1) repeat the language of section 8600(b)(2)(B) but substitute "inadvertent failure to comply with the requirements for qualifying as a FASIT" for the language "an entity ceases to be a REMIC".[6]

G. Section 855A(b)(2)

Section 855A(b)(2) of the proposed legislation provides for a 100 percent "prohibited transaction" tax on certain income derived by a FASIT. The principal purpose for imposing the tax is to assure that the FASIT own only the assets and engage only in

[5] Nonetheless, a rule similar to section 860E(f) (no adjustment permitted in the reserve for variable rate contracts to the extent of any excess inclusion) should be applied to the income required to be included in income of the holder of a permitted debt instrument or ownership interest in a FASIT.

[6] Consideration should also be given to simply making a technical correction to section 860D(b)(2)(B) to permit relief for inadvertent failures to qualify as a REMIC.

those activities for which it is intended. Income subject to the prohibited transaction tax would include amounts derived from "the acquisition or disposition of an asset for the primary purpose of recognizing gains or decreasing losses resulting from market value changes. . . ."

The apparent intention of creating such a prohibited transaction is to assure the requisite degree of "passivity" for the FASIT to merit pass-through treatment, and also to preserve the integrity of the regulated investment company ("RIC") rules of sections 851 et seq. The prescribed standard is obviously vague. Although the same standard is relevant in applying certain provisions of the Investment Company Act of 1940 (the "1940 Act"), related 1940 Act provisions significantly limit in practice the circumstances under which the "primary purpose" test is applied. We believe that there is a significant possibility that extremely difficult interpretive issues could arise in attempting to apply this test to FASITs.

Moreover, from the standpoint of maintaining the proper degree of passivity for a FASIT and the related concern regarding potential avoidance of the RIC rules, we believe that a somewhat more stringent set of rules to limit the FASIT's activities should be imposed. To this end, we generally would recommend the approach adopted for REMICs under section 860F. Such an approach would treat all dispositions of FASIT assets, including distributions to the holders of ownership interests, as prohibited transactions, with enumerated exceptions. The exceptions provided for REMICs would also be appropriate for FASITs. However, to accommodate the expected differences between the expected uses of FASITs relative to REMICs, the former should be afforded certain additional exceptions. In particular, for a FASIT, dispositions pursuant to commercially reasonable agreements providing for substitutions of collateral should not be treated as prohibited transactions.

II. Treatment of FASIT Securities (Section 855B).

A. Section 855B(b)(1).

Section 855B(b)(1) provides that "[e]xcept as otherwise provided by regulations, items of FASIT income or loss shall have the same character, in the hands of a holder of an ownership interest, as such items would have if they were incurred directly by such holder." This is a sensible proposition but it is not clear whether the tax exempt character of income received by a FASIT would pass through to the holder of an ownership interest. Even if it is contemplated that the tax exempt character of income should be passed through to the holder of an ownership interest, it does not appear intended that a FASIT can pass through tax exempt income to the holder of qualified or permitted debt instruments. In general, if it is believed desirable that a vehicle such as a FASIT should be available to allow the division of tax exempt income, it would be relatively simple to clarify that the tax exempt character of income received by the FASIT is passed through to holders of ownership interests and to extend the ability of a FASIT to pass through tax exempt income to holders of qualified and permitted debt instruments.[7] If such changes to the FASIT statute were made to accommodate the division of tax-exempt income, we would recommend the following technical modifications.

To the extent that tax exempt income is passed through to holders of ownership interests, it would be appropriate, in computing the net income of the FASIT to be allocated to the holder

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[7] Such a feature would also avoid the need for tax-exempt municipal investment conduit (TEMIC) legislation currently being proposed by the members of the Public Securities Association. With a TEMIC, it is proposed that tax-exempt bonds that have already been issued could be pooled and put into a tax-exempt trust and derivatives or other products could be created from the pooled bonds entitling the holders thereof to the tax-exempt income from the bonds. See Derivatives Week. January 17, 1994; The Bond Buyer, November 2, 1993; and The Bond Buyer. September 14, 1993.

of ownership interests, to disallow deductions attributable to "interest" accruing on qualified or permitted debt instruments.[8] Because a "tracing" rule such as that imposed by section 265(a)(2) could not be meaningfully administered in all but the most extreme circumstances, disallowance of deductions probably should be by multiplying the otherwise deductible "interest" amounts by a fraction the numerator of which is the adjusted basis of the assets of the FASIT that produce tax exempt income and the denominator of which is the adjusted basis of all of the FASIT's assets. This rule would require some modification if the pass through of tax exempt income is permitted to holders of qualified or permitted debt instruments. Specifically, no deduction should be allowed to the holder of an ownership interest for the amount of tax exempt interest passed through to the holder of a qualified or permitted debt instrument. However, to prevent a "double disallowance," the fractional disallowance of "interest" deductions described above should be reduced. One reasonable mechanism for doing so would be to reduce the numerator and denominator of the disallowance fraction by that portion of the basis of the FASIT's assets that generate tax exempt income allocated to the qualified or permitted debt instruments. The modified disallowance fraction would be multiplied by the total interest deductions of the FASIT, excluding any amount of tax exempt interest passed through to holders of qualified or permitted debt instruments. The total "interest" disallowed would be the sum of that product and the tax exempt interest passed through to the qualified or permitted debt instruments.

B. Section 855B(b)(2)(B)

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[8] We also would recommend that rule be added to the FASIT legislation requiring at least 80 percent of a FASIT's assets to be tax exempt bonds if the FASIT wants to pass through tax exempt income to holders of its securities. Such a rule would avoid the use of FASITs to allow parties to effectively swap taxable and tax exempt income without relinquishing ownership of the obligations that generate the income.

Section 855B(b)(2)(B) provides that “the principles of Section 1272(a), including paragraph (6) thereof, shall apply in determining all interest and discount income and all premium deductions or adjustments with respect to all debt obligations held by the FASIT.” We assume that this provision is intended to require a FASIT to include on a current basis accrued market discount on debt instruments that the FASIT holds. This should be clarified, and it also should be clarified that section 1277 would not apply to the FASIT.

C. Section 855B(b)(2)(D).

Section 855B(b)(2)(D) provides that “any deduction for interest or original issue discount with respect to a permitted debt instrument that would cause the FASIT's deductions to exceed its income for a taxable year shall be treated as incurred in the succeeding taxable year.” This provision appears to be aimed at the use of high-yielding permitted debt instruments to generate tax shelter. We believe, however, that the basis limitations on using net losses from a FASIT (section 855B(b)(4)) are sufficient to prevent abuse and that this provision will add needless complexity to the FASIT rules. Accordingly, we would urge that it be dropped from the proposed legislation.

D. Section 855B(c).

Section 855B(c) provides that the taxable income of a holder of an ownership interest or permitted debt instrument for any taxable year shall in no event be less than the amount required to be taken into account with respect to such interest or instrument. This rule is designed to provide excess inclusion-type treatment for income from FASIT ownership interests and permitted debt instruments. There is a significant exception to the rule,

however, for ownership interests and permitted debt instruments held by an originator or members of its affiliated group. This exception applies so long as (i) the ownership interest or permitted debt instrument is part of a class that has a fair market value at issuance equal to at least 2 percent of the fair market value of the assets transferred in exchange therefor, (ii) the ownership interest's or permitted debt instrument's anticipated weighted average life at issuance is at least 20 percent of the anticipated weighted average life of the assets transferred in exchange therefore and (iii) the ownership interest or permitted debt instrument was not issued by a FASIT that would have been treated as a TMP.

The REMIC rules permit only thrift institutions and qualified subsidiaries to use net operating losses to offset excess inclusion income on REMIC residuals.[9] The proposed statute on the other hand, in effect, expands the class of persons that can use losses to offset FASIT income to include any type of originator, including commercial banks and finance companies. When the REMIC legislation was enacted, the thrift industry was given a special exception because of "the difficulties currently being experienced by such industry".[10] Thus, to date special treatment for excess inclusion income has been allowed under the tax law only to a troubled industry. We question whether it is appropriate to extend such special treatment to an entire class of taxpayers and whether it is appropriate to discriminate between originators and other taxpayers that merely purchase loans and securitize them. At the same time, it should be recognized that the relatively harsh general rule is necessitated only by reason of the possibility of tax revenues being diminished on account of the creation of ownership interests with a "front-loaded" income pattern that might

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[9] Section 860E(a)(2).

[10] H. Rep. No. 99-841, 99th Cong. 2d Sess. II-234.

be held by corporations with net operating losses.[11] Accordingly, rather than discriminating between originators and other possible holders of ownership interests, we would recommend adoption of a rule like that contained in Section 860E that identifies all or a portion of the income allocable to the holder of ownership interests as "front-loaded" income and prevents sheltering of the income with losses regardless of the identity of the holder of the ownership interest.

Finally we recommend the adoption of rules similar to those applicable to transfers of REMIC residual interests that would disregard any transfer of an ownership interest or permitted debt instrument to a foreign person or to any U.S. person not eligible to hold such instruments under section 855A(a)(5) or in any circumstances where a significant purpose of the transfer is to impede the assessment of tax.[12]

III. Treatment of Transfers to and Distributions From FASITs and Related Provisions (Section 855C and Sections 855B(b)(3) and (5)).

The provisions of the proposed legislation relating to transfers to and distributions from FASITs are highly complex. In general, transfers of property to a FASIT in exchange for FASIT securities are nonrecognition transactions (referred to as "qualified exchanges"), with the FASIT taking a carryover basis in the assets transferred and the transferor taking a substituted basis in the FASIT securities received. Qualified debt instruments and permitted debt instruments received in such nonrecognition

11 See H.R. Rep. No. 99-841, 99th Cong. 2d Sess., pp II-234 - II-235 (Conference Report).

12 See Reg. $1.860E-1(c)(1); Reg. $1.860G-3.

transactions have an adjusted issue price equal to their fair market values, unless the instrument is issued in a public offering, in which case such issue price is determined under section 1273. The excess of the issue price of a qualified debt instrument or permitted debt instrument over a transferor's (substituted) basis in the instrument is taken into account over the life of the instrument as if such excess were original issue discount. Special rules provide for the amortization of certain differences between "inside basis" and "outside basis" for holders of ownership interests, and for recognition of gain by holders of ownership interests in connection with certain distributions made (or deemed to have been made) with respect to the ownership interests.

We note as a preliminary matter that these provisions are significantly different in their general approach from the Code provisions governing transfers to and distributions from REMICs. The REMIC provisions are considerably less complex in this respect and thus may have some appeal relative to the provisions as drafted. Nonetheless, the departure in general approach appears necessary to accommodate the most significant differences between REMIC transactions and those for which the FASIT will be used, i.e., the ongoing transfers of assets to and issuance of instruments by the FASIT. Extension of the general approach for REMICs to address such transactions would likely result in inappropriate opportunities to defer gain recognition with respect to subsequently transferred assets and to other planning opportunities, unless equally complex provisions were adopted.

Some simplification of these provisions as drafted, however, may be possible. A great deal of the complexity is derived from the treatment as a qualified exchange of a transfer of property for debt securities of the FASIT whether or not ownership

interests are received. Treating an exchange of property for FASIT debt securities as a taxable transaction would minimize the need for the basis amortization account referred to in section 855B(b)(5) (and the additional rules that we suggest below to address possible anomalies).[13] Moreover, it is not clear that deferral of gain recognition upon such an exchange is appropriate in all cases. For example, if the holder of a debt instrument that matures in a relatively short period of time, and whose basis in the debt instrument is less than its fair market value, transfers the debt instrument to a FASIT in exchange for a FASIT security with a long maturity, the transferor will recognize its gain under the draft legislation only as original issue discount over the long maturity of the FASIT debt instrument. We understand that this problem has been identified, but that the proposal to address the problem is to require the deferred gain to be recognized over a period not to exceed the remaining life of the transferred obligation. The proposed solution nonetheless assumes that allowing any deferral of gain remains appropriate where the use of the installment method of accounting for the gain would either be limited or denied if the economically identical exchange of debt instruments were made without a FASIT.

We recognize, however, that recognition treatment for all exchanges of debt obligations for FASIT debt securities also would be problematic and could render the FASIT vehicle less useful. For example, a holder of all of the ownership interests in a FASIT that wished to transfer property to the FASIT in exchange for permitted debt instruments that it would retain for some period, would be required to recognize gain or loss on the exchange even though the transferor may in all substantive respects have retained ownership of all the economic attributes of the transferred property. It is

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[13] The basis amortization account rules would still need to be retained, but would need to be applied only where ownership interests are transferred or in circumstances where principles of section 704(c) would apply.

in fact common for sponsors of transactions that would be executed in FASIT form to retain subordinated debt securities of the issuing vehicle. Accordingly, we would not recommend eliminating nonrecognition treatment for all transfers of property to FASITs in exchange for debt securities. Rather, nonrecognition treatment could be limited to transferors that also own ownership interests at the time of the exchange for the FASIT debt securities.

If this approach were adopted, provision would need to be made for transferors that own less than 100 percent of the ownership interests at the time of the transfer[14] and for devices whereby a transferor may own FASIT ownership interests for a brief period in order to take advantage of nonrecognition treatment.[15] Issue price of the FASIT securities, amount realized and FASIT basis would be governed by the rules of section 1273(b) as applied to the FASIT debt security issued for the property in recognition transactions. These same issue price, amount realized and FASIT basis rules could be applied to nonrecognition transfers, and any unrecognized gain or loss should be amortized over the life of the asset transferred, as is the case in connection with transfers of property to a REMIC.[16]

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[14] Gain recognition in proportion to the percentage of ownership interests not owned would appear appropriate to address transferors that own less than 100 percent of the ownership interests.

[15] A general anti-avoidance rule coupled with a presumption that a transfer in exchange for a FASIT debt security is within the scope of the anti-avoidance rule if the transferor disposes of an ownership interest within a specified period of time (say six months) following the transfer would seem appropriate to curb this abuse.

[16] An anti-abuse rule would be needed to prevent transfers of appreciated assets to a FASIT in exchange for debt securities followed by a disposition of the asset (which would have a stepped up basis in the FASIT's hands) resulting in no additional income for the holder of the ownership interests. Although a rule such as that of section 704(c) would prevent such an abuse, tracing of assets through a FASIT will in most cases be impractical. Accordingly, we would recommend an anti-abuse rule similar to that provided in proposed section 855C(c)(1)(C) that would accelerate gain recognition for FASIT debt instruments received in qualified exchanges for appreciated assets as part of a plan to defer recognition of gain upon the disposition of those assets.

If, on the other hand, the proposed regime for gain recognition, issue price and FASIT basis contained in the draft legislation were adopted, we believe that one particular amendment would be appropriate to eliminate certain possible abusive transactions. The amendment would require amortization of the basis amortization account to reflect the maximum possible reduction in differences between the FASIT's asset basis and fair market value of its assets, in a manner similar to that provided by section 755. Absent such a rule, if one party transferred a long term debt instrument that had depreciated in value to a FASIT in exchange for a FASIT debt instrument (with terms matching the debt instrument transferred) and another party transferred short term debt instruments to the FASIT in exchange for all of the ownership interests, and any of the "additional basis" attributable to the depreciation in the transferred debt instrument were allocated to the short term instruments held by the FASIT, the holder of the ownership interests would have losses over the life of the short term instruments and would recognize corresponding amounts of additional income only over the life of the long term instruments through reductions in interest deductions. The proposed rule would prevent such a result by allocating the basis adjustment to the long term assets.

In addition, certain other clarifications to the provisions of section 855C would be desirable. Thus, section 855C(a) provides for nonrecognition upon transfer of property to a FASIT in exchange for a FASIT security. It further provides that this treatment extends to "a transfer in exchange for an increase in value of a previously issued FASIT security". It is unclear, however, what sort of transfers this latter provision is designed to cover. Apparently the provision is designed to cover a transaction where a sponsor retains a FASIT security and then adds to the FASIT pool. It is also possible that the provision is

intended to cover a case where FASIT securities are held by third parties who invest additional funds in the FASIT in exchange for the sponsor's agreement to deposit additional collateral. If this is what the provision is intended to cover, then it raises questions about the appropriate issue price of the FASIT debt security after the FASIT has been expanded. In general, the draft legislation should clarify that the issue price rules should be applied separately to each new issuance of FASIT debt securities as if those securities would be treated as a separate issue under the original issue discount rules.

IV. Definitions (Section 855E).

Section 855E(c) defines a qualified debt instrument and section 855E(c)(6) requires that such a qualified debt instrument "not have a yield to maturity as of the date of issuance that is more than five percentage points higher than the yield to maturity on outstanding marketable obligations of the United States with comparable maturity (based upon a statistically significant sampling, a published index, or a similar objective determination)." It appears that the AFR is not used because the AFR for a given month reflects interest rates during the one month period ending on the fourteenth day of the preceding month and may be "stale" as of the issue date in a given month. Nevertheless, a bright line test is needed. For example, the maximum rate could be the average of rates for the previous seven days as shown in a particular designated federal publication.

In order to prevent the inadvertent disqualification of a debt instrument, section 855E(d)(6) should be modified to permit the determination of the yield to maturity of the debt instrument and the comparable Treasury security to be determined as of the "pricing date" of the FASIT securities generally, taking account of

a reasonable prepayment assumption for the FASIT's assets and a reasonable estimate the issue price of the debt instrument. In the absence of such a rule it may be impossible to be certain a debt instrument would qualify at the time the FASIT is structured.

DATE: December 1, 1993

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(Original signature of Member)

___ CONGRESS

____Session **H.R.**_____________________

To Facilitate the Creation of Financial Asset Securitization Investment Trusts

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IN THE HOUSE OF REPRESENTATIVES

______, 1993

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MR. ______________________________

introduced the following bill; which was referred to the Committee on ____

A BILL

To Facilitate the Creation of Financial Asset Securitization Trusts

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE

This Act may be cited as "The FASIT Provisions."

SEC. 2. FINANCIAL ASSET SECURITIZATION INVESTMENT TRUSTS

(a)The heading and table of sections of Part II of Subchapter M of Chapter 1 of the Internal Revenue Code of 1986, relating to real estate investment trusts is amended to read as follows:

“PART II - INVESTMENT TRUSTS

Sec. 855A. Taxation of financial asset securitization investment trusts.
Sec. 855B. Treatment of FASIT securities.
Sec. 855C. Gains and losses on transfers to FASITs and distributions by FASITs to transferors.
Sec. 855D. Taxes related to certain transfers of securities.
Sec. 855E. Definitions.
Sec. 856. Definition of real estate investment trust.
Sec. 857. Taxation of real estate investment trusts and their beneficiaries.
Sec. 858. Dividends paid by real estate investment trust after close of taxable year.
Sec. 859. Adoption of annual accounting period.”

(b) The title of Part II in the table of parts of Subchapter M of Chapter 1 of the Internal Revenue Code of 1986 is amended to read as follows:

“Part II. Investment Trusts.”

(c) The following new sections are added to Part II of Subchapter M of Chapter 1 of the Internal Revenue Code of 1986:

“Sec. 855A. TAXATION OF FINANCIAL ASSET SECURITIZATION INVESTMENT TRUSTS.“

(a) DEFINITION[1]. -- For purposes of this title, the term

[1] It is anticipated that entities required to register as investment companies under the Investment Company Act of 1940 would be unable to utilize the FASIT provisions. FASITs are not pennitted to profit from market value changes in their assets, may only be used to securitize debt instruments, and are able to avoid a two-level tax only to the extent they pass through income to holders of qualified debt instruments. It appears that virtually any entity able to operate under such limitations would qualify for an exemption from the registration requirement under rule 3(a)(7) of the Investment Company Act of 1940. Thus, the FASIT provisions will not provide a meaningful alternative for most entities currently treated as regulated investment companies under the provisions of section 851, et seq. The bill does not provide an explicit cross-reference to any provisions of the securities laws, in order to ensure that

financial asset securitization investment trust" and "FASIT" mean any entity or arrangement --

"(1) for which an election to be treated as a FASIT applies for the taxable year and all prior taxable years,

"(2) substantially all of the assets of which, as of the close of the second calendar quarter following its formation and each calendar quarter ending thereafter, consist of –

"(A) cash,

"(B) debt obligations (but only if any coupons thereon representing rights to contingent interest to which the provisions of section 871(h)(4)(A) would apply are not held by the FASIT),

"(C) property acquired in connection with the default or imminent default of a debt obligation held by a FASIT but only if

(i) such property would be in compliance with the limitations of paragraphs (2) and (3) of section 856(e) if the FASIT were a real estate investment trust, and

(ii) such debt obligation was not acquired with an intent to foreclose.

"(D) instruments or contractual rights in the

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eligibility for FASIT status is determined entirely by applicable tax laws and not by the securities laws.

nature of a hedge or guarantee against the economic risks associated with debt instruments issued or held by the FASIT (including, but not limited to, interest rate swaps, credit enhancements, minimum and maximum prepayment guarantees, and liquidity arrangements), but only to the extent reasonably required to protect against the risk that the FASIT would not otherwise be able to make timely payments on debt instruments issued by the FASIT out of payments received on debt obligations held by the FASIT, and

"(E) ownership interests in other FASITs,

"(3) all of the interests in which are ownership interests, permitted debt instruments or qualified debt instruments,

"(4) which has one and only one class of ownership interests, and

"(5) with respect to which there are reasonable arrangements designed to ensure that its ownership interests and permitted debt instruments are-held exclusively by –

"(A) corporations to which the provisions of section 11 apply,

"(B) other FASITs, or

"(C) pass-thru entities.

"(b) TAXATION OF FASITS. –

"(1) GENERAL RULE. -- Except as otherwise provided in this subsection, a FASIT shall not be subject to taxation under this subtitle (and shall not be treated as a trust, partnership, corporation or taxable mortgage pool). Rules similar to those provided by section 860D(b)(2)(B) shall apply to inadvertent failures to comply with the requirements for qualifying as a FASIT.

"(2) PROHIBITED TRANSACTIONS TAX. -- A tax is hereby imposed for each. taxable year of a FASIT equal to 100 percent of the net income derived with respect to any asset during the taxable year from --

"(A) the acquisition or disposition of an asset for the primary purpose of recognizing gains or decreasing losses resulting from market value changes,

"(B) the ownership of an asset which is not described in subsection (a)(2) of this section, or

"(C) the receipt by the FASIT of any amount representing a fee or other compensation for services (not including, for this purpose, any payments received pursuant to the terms of assets described in section 855A(a)(2)).

"(3) TAX ON INCOME FROM FORECLOSURE PROPERTY. --

"(A) IN GENERAL. -- A tax is hereby imposed for each taxable year on the net income from foreclosure property of each FASIT. Such tax shall be computed by multiplying the net income from foreclosure property by the highest rate of tax specified in section 11(b).

"(B) NET INCOME FROM FORECLOSURE PROPERTY. – For purposes of this part, the term "net-income from-foreclosure property" means the amount which would be the FASITs net income from foreclosure property under section 857(b)(4)(B) if the FASIT were a real estate investment trust and all property acquired by the FASIT in connection with the default or imminent default of a debt obligation were treated as if it were real property and as if it were foreclosure property.

"(4) TREATMENT UNDER SUBTITLE F. -- For purposes of subtitle F, a FASIT shall be treated as a partnership (and holders of ownership interests in such FASIT shall be treated as partners). The determination of who may sign any FASIT tax returns shall be made without regard to the first sentence of this paragraph.

See. 855B. TREATMENT OF FASIT SECURITIES.

"(a) TREATMENT OF DEBT INSTRUMENTS. -- For purposes of this subtitle any debt instrument issued by a FASIT shall be

treated as a debt obligation of the FASIT (and as a debt obligation of a corporation). The amounts includible in gross income with respect to any debt instrument shall be determined under the accrual method of accounting.

"(b) TREATMENT OF OWNERSHIP INTERESTS.

"(1) PASSTHROUGH OF FASIT INCOME. -- The holder of an ownership interest in a FASIT shall take into account its daily portion of the amount of FASIT taxable income (or net loss). The daily portion shall be computed in the same manner as prescribed in section 860C(a) with respect to the daily portion of REMIC income taken into account by the holder of a residual interest therein. Except as otherwise provided by regulations, items of FASIT income or loss shall have the same character, in the hands of a holder of an ownership interest, as such items would have if they were incurred directly by such holder.

"(2) DETERMINATION AND ALLOCATION OF FASIT INCOME. -- The taxable income (or loss) of a FASIT shall be determined in the same manner as for a corporation having a calendar year taxable year and reporting on an accrual method of accounting, except that –

"(A) the basis of any property (and the adjusted issue price of any debt obligation) received by a FASIT in a qualified exchange shall be equal to the property's basis in the hands of the transferor immediately before the exchange,

"(B) the principles of section 1272(a), including paragraph (6) thereof, shall be applied in determining all interest and discount income and all premium deductions or adjustments with respect to all debt obligations held by the FASIT,

"(C) section 163(e)(5) shall not apply with respect to any debt instrument,

"(D) any deduction for interest or original issue discount with respect to a permitted debt instrument that would cause the FASITs deductions to exceed its income for a taxable year shall be treated as incurred in the succeeding taxable year,

"(E) any distribution of property with respect to a FASIT security (other than a distribution described section 85SB (d)) shall be treated as if the FASIT had sold such property for cash (in an amount equal to the property's fair market value) and distributed such cash,

"(F) the principles of section 860C(b)(1)(C) and (E) shall be applied.

"The Secretary may by regulation modify the provisions of this paragraph, and the provisions governing the treatment of permitted debt instruments, to the extent necessary to clearly reflect the portion of total FASIT income or loss properly allocable to holders of ownership interests and permitted debt instruments and the appropriate character thereof.

"(3) DISTRIBUTIONS AND BASIS ADJUSTMENTS.

"(A) DISTRIBUTIONS. -- Except as otherwise provided in section 855C(e), a distribution by a FASIT with respect to an ownership interest shall not be included in gross income to the extent it does not exceed the adjusted basis of the interest, and shall be treated as gain from the sale or exchange of such interest to the extent it exceeds the adjusted basis of the interest.

"(B) BASIS RULES. -- The basis of any person's ownership interest in a FASIT shall be increased by the amount of any taxable income, and decreased (but not below zero) by the amount of any loss, taken into account under paragraph (1) of this subsection by such person with respect to such interest. Such basis shall also be increased by the amount of any money (and the transferor's basis in any property) contributed by such person with respect to such interest, and decreased (but not below zero) by any distributions to such

person with respect to such interest. Such basis shall also be adjusted to reflect any amortization of income or deductions under paragraph (5) and any gain recognized under section 855C(e).

"(4) LIMITATION ON LOSSES. - The amount of the net loss of any FASIT taken into account by any holder under paragraph (1) of this subsection with respect to any calendar quarter shall not exceed the adjusted basis of the holder's ownership interest in such FASIT as of the close of such calendar quarter (determined without regard to any basis reduction for net losses taken into account by such holder for such quarter). Any loss disallowed by the preceding sentence shall be treated as incurred by the FASIT in the succeeding calendar quarter with respect to such holder.

"(5) AMORTIZATION OF DIFFERENCE BETWEEN INSIDE AND OUTSIDE BASIS. --

"(A) IN GENERAL. -- If the holder of an ownership interest has a positive or negative balance in its basis amortization account as of the end of an accrual period, the holder shall include as additional. Income in the following period an amortizable portion of the amount of any negative balance, and shall be entitled to a deduction in such period for the amortizable portion of the amount of

any positive balance.

"(B) AMORTIZATION METHOD. -- The amortizable portion of any positive (or negative) balance shall equal the reduction (or increase) in taxable income that would arise to the FASIT for such period if the FASITs aggregate tax basis for its assets were increased (or decreased) at the beginning of such period by the amount of such positive (or negative) balance.

"(C) LIMITATION ON DEDUCTIONS. -- Notwithstanding paragraph (A), to the extent a deduction described in paragraph (A) would cause the holder's basis to be reduced below zero, such deduction shall be disallowed and treated as if incurred in the succeeding accrual period.

"(D) BALANCE DEFINED. -- The balance of a holder's basis amortization account shall be the positive or negative amount equal to --

"(i) the holder's aggregate tax basis for its ownership, interests, plus

"(ii) the holder's pro rata share (based on its percentage ownership of all ownership interests) of the aggregate adjusted issue price of all debt instruments issued by the FASIT, minus

"(iii) the holder's pro rata share (determined as in (ii)) of the FASIT's aggregate tax basis for its assets.

"(E) SPECIAL RULE. — Under regulations (which may be applied retroactively to the effective date of this provision), the method of amortizing a positive balance with respect to any ownership interest received in a qualified exchange (or any ownership interest the basis of which is determined with respect to the basis of a holder that received such interest in a qualified exchange) may be modified to prevent a mismatch between the amortization of deductions and the inclusion of corresponding amounts of discount with respect to FASIT debt instruments issued in the same or a related qualified exchange.

"(c) INCOME ON OWNERSHIP INTERESTS AND PERMITTED DEBT INSTRUMENTS MAY NOT BE OFFSET BY NET OPERATING LOSSES. –

"(1) IN GENERAL. — Except as provided in paragraph (3), the taxable income of any holder of an ownership interest or permitted debt instrument for any taxable year shall in no event be less than the amount required to be taken into account by such holder solely with respect to such interest or instrument.

For purposes of the preceding sentence, all members of an affiliated group filing a consolidated return shall be treated as one taxpayer.

"(2) COORDINATION WITH SECTION 172. - For purposes of section 172, income to which this section applies for a taxable year shall be treated in the same manner as an excess inclusion under section 860E(a)(5).

"(3) EXCEPTION.—

"(A) Paragraph (1) shall not apply to a holder of a FASIT security for the taxable year to the extent that the security represents an interest in —

"(i) debt obligations originated by the holder (including any corporate predecessor), or any member of the same affiliated group of corporations joining in the filing of a consolidated return for the taxable year, or

"(iii) property bearing the relationship to such debt obligations described in section 855A(a)(2)(D).

"(B) The preceding subparagraph shall not apply unless the security

"(i)was part of a class whose fair market value at issuance was at least equal to 2 percent of the fair market value of the assets transferred in exchange therefor, and whose anticipated weighted average life at issuance was at least 20 percent of the anticipated weighted average life of such assets, and

"(ii) was not issued by a FASIT that would have been treated as a corporation under section 7701(i), but for the application of section 855A(b)(1)).

"(d) DISTRIBUTIONS OF CERTAIN PROPERTY TO TRANSFERORS. - Notwithstanding any other provision of this subpart, if a FASIT distributes property with respect to any of its FASIT securities, and such property (or substantially identical property) was transferred to the FASIT by the distributee (or a party bearing a relationship to the distributee described in section 267(b) or section 707(b)), then gain or loss shall not be recognized by the FASIT or by the distributee. Except as otherwise provided in regulations, the distributee's basis in such property shall be equal to the FASIT's basis in such property immediately preceding the distribution, and the distributee shall reduce by that amount its basis in the FASIT securities with respect to which the distribution was made.

“Sec. 855C. GAINS AND LOSSES ON TRANSFERS TO FASITS AND DISTRIBUTIONS BY FASITS TO TRANSFERORS.

“(a) NONRECOGNITION RULE. –

(1) IN GENERAL. -- No gain or loss shall be recognized to the transferor or the FASIT in a qualified exchange.

(2) QUALIFIED EXCHANGE DEFINED. -- For purposes of sections 855A through 855E, a qualified exchange is any transfer of property to a FASIT in exchange for FASIT securities of the FASIT. A qualified exchange shall include a transfer of property in exchange for an increase in the value of a previously issued FASIT ownership interest, and an issuance of FASIT debt instruments in exchange for a decrease in the value of a previously issued FASIT ownership interest.

“(b) CHARACTERIZATION OF CERTAIN EXCHANGES.--

“(1) BOOT TREATED AS DISTRIBUTION. -- If, immediately after a*transfer of assets to a FASIT, the transferor (or a member of the same affiliated group of corporations joining in the filing of a consolidated return) holds any ownership interests in the FASIT, and any part of the consideration for the transfer consists of cash or other property other than securities in the FASIT, then the transaction

shall be treated as a transfer solely in exchange for FASIT securities followed by a distribution of such cash or other property with respect to the transferor's ownership interests.

"(2) BOOT TREATED AS SALE.- If paragraph (1) does not apply, and the consideration for a transfer of property consists in part of debt instruments and in part of cash or other property other than FASIT securities, then the transaction shall be treated under generally applicable tax principles in part as a transfer in exchange for FASIT securities and in part as a sale of assets to the FASIT for such cash or other property.

"(3) FASIT DEBT ISSUANCES. — The issuance by a FASIT of a debt instrument shall not be recharacterized as an issuance to (and disposition by) the holders of ownership interests in the FASIT.

"(c) TRANSFEROR'S BASIS AND ISSUE PRICE IN SECURITIES. -

"(1) EXCHANGED BASIS.--

(A) IN GENERAL. - Immediately after a qualified exchange, the transferor's adjusted basis in the FASIT securities received shall be equal to the transferor's basis in the property transferred. In the case of any increase in value of previously issued FASIT securities

attributable to such an exchange, the transferor’s basis in such securities shall be increased by the transferor’s basis in the property transferred.

(B) MULTIPLE CLASSES EXCHANGED. - If FASIT securities of two or more classes are received in a single qualified exchange, the transferor’s aggregate basis in the securities received shall be allocated among the different classes of securities based on their relative fair market values.

(C) ANTI-ABUSE RULE. - If assets are transferred to a FASIT as part of a plan to transfer assets with substantially different amounts of built-in gain (or loss) in exchange for different FASIT securities, the holder’s aggregate basis in its FASIT securities shall be reallocated upon such transfer in the same manner as if all of the holder’s FASIT securities were reissued to the holder in a single qualified exchange.

“(2) TREATMENT OF DEBT INSTRUMENTS. -

(A) FAIR MARKET VALUE ISSUE PRICE. -- The issue price of any debt instrument issued in an exchange to which subsection (a) applies shall be equal to its fair market value. The preceding sentence shall not apply in the case of any debt that is issued as part of a public offering, in which case the issue price shall

be determined under section 1273.

“(B) REQUIRED ACCRUAL OF MARKET DISCOUNT. - In addition to taking into account any original issue discount, the holder of a debt instrument that was issued to the holder (or a person with respect to whose basis the holder’s basis is determined) in a qualified exchange shall take into account, in the same manner as original issue discount, any excess of the issue price of such debt instrument over the holder’s basis therein.

“(d) BASIS ALLOCATION UPON DISPOSITION OF SECURITIES.—

“(1) GENERAL RULE. - If a transferor disposes of a portion of the FASIT - securities that it received from a FASIT in one or more qualified exchanges, the transferor’s aggregate basis in such FASIT securities shall be allocated, immediately prior to the disposition, between the securities disposed of and the securities retained. Except as otherwise provided in paragraphs (2) and (3) such allocation shall be in accordance with the relative fair market values - of such securities. Immediately after a disposition to which this paragraph applies, the transferor’s aggregate basis in its retained FASIT securities shall be allocated among such retained FASIT securities (and the adjusted issue price of any retained debt instruments shall be redetermined) in the same manner as if such retained FASIT securities were reissued in a single qualified exchange.

"(2) NO LOSSES ON NON-PRO-RATA DISPOSITIONS. -Except to the extent paragraph (3) applies, the portion of the transferor's aggregate basis allocable to any disposed FASIT security under paragraph (1) shall not exceed the amount realized therefor (in the case of a disposition on which gain or loss would be recognized) or the fair market value of the disposed security (in all other cases). Any portion of the transferor's aggregate basis not allocated to disposed FASIT securities shall be allocated to the transferor's retained FASIT securities.

"(3) PRO-RATA DISPOSITIONS.-- This paragraph applies to the extent that a transferor, in a single day (or in a single accrual period in which there are no qualified exchanges or distributions described in subsection (e)) disposes-of FASIT securities received in qualified exchanges that in the aggregate represent the same fractional portion of each class of FASIT securities received from the FASIT in qualified exchanges and held by the transferor prior to such day (or prior to the beginning of such accrual period). If this paragraph applies to a series of dispositions in a single accrual period, the amount of basis allocable under paragraph (1) and the fair market values described in paragraph (1) shall be determined as of the beginning of such accrual period.

"(4) DISPOSITIONS COVERED. - For purposes of this subsection, no distribution by the FASIT to a transferor with respect to a FASIT security shall be treated as a disposition of all or any portion of such FASIT security. The adjustments to the transferor's basis in such FASIT security required by section 855B(b)(3)(B) or the rules applicable to holders of debt obligations shall be in lieu of any allocation of basis under this subsection.

"(5) CONSOLIDATED RETURNS.- This subsection shall be applied treating all members of the same affiliated group of corporations joining in the filing of a consolidated return as a single transferor, subject to such adjustments and modifications as may be prescribed by regulations.

"(e) RECOGNITION OF GAIN ON CERTAIN DISTRIBUTIONS. -

"(1)IN GENERAL. –

"(A) RECOGNITION REQUIREMENT. - If a FASIT distributes cash with respect to an ownership interest for an accrual period in an amount that exceeds the income required to be taken into account for such period by the holder under section 855B(b)(1), and the holder is described in subparagraph (B), the holder shall recognize gain equal to the excess, if any, of the amount described in paragraph (2) over the amount described in paragraph (3).

"(B) HOLDERS DESCRIBED. -- A holder is described in this subparagraph if the holder, or a person with respect to whose basis in the ownership interest the holder's basis is determined, received the ownership interest in a qualified exchange.

"(C) LIMITATION. -- Notwithstanding subparagraph (A), in no event shall the amount of gain recognized under this subsection exceed the amount by which the distribution exceeds the income required to be taken into account by the holder under section 855B(b)(1).

"(D) CONSOLIDATED RETURNS. - This subsection shall be applied treating all members of the same affiliated group of corporations joining in the filing of a consolidated return as a single holder, subject to such adjustments and modifications as may be prescribed by regulations.

"(2) CUMULATIVE RECOGNITION REQUIREMENT. - The amount described in this paragraph is the product of the holder's disposition ratio and the holder's total gain amount.

"(A) HOLDER'S DISPOSITION RATIO. The holder's disposition ratio is equal to 1, minus the amount by dividing —

"(i) the fair market value, determined immediately after the distribution, of the holder's FASIT securities that were issued by the FASIT to such holder (or a person with respect to whose basis in such securities the holder's basis is determined) in qualified exchanges, by

"(ii) the holder's pro rata share, based on its percentage ownership interest, of the fair market value of all assets held by the FASIT determined immediately after the distribution.

(B) HOLDER'S TOTAL GAIN AMOUNT. The holder's total gain amount is the sum of --

"(i) any excess of the fair market value, determined immediately prior to the distribution, of the securities described in paragraph (2)(A)(i), over the holder's basis therein immediately prior to the distribution, and

"(ii) the amount described in paragraph (3).

"(3) PREVIOUSLY RECOGNIZED GAIN AMOUNT. –

"(A) IN GENERAL. – Except as otherwise provided in subparagraph (B), the amount described in this paragraph is the aggregate positive balance

(if any) of the basis amortization accounts (within the meaning of section 855B(b)(5)(D)) maintained by the holder with respect to ownership interests in the FASIT that were acquired by the holder (or a person with respect to whose basis in such securities the holder's basis is determined) in qualified exchanges. Such balance shall be determined immediately prior to the distribution taking into account any dispositions of securities treated as occuring-prior to such distribution and any adjustment to the holder's basis in its ownership interests attributable to the application of section 855B(b)(5)(A) for the period in which the distribution is treated as occurring.

"(B) LIMITATION. - The amount described in this paragraph shall not exceed the portion of the amount described in subparagraph (A) that is attributable to gain previously recognized by the holder (or a person with respect to whose basis in such securities the holder's basis is determined) with respect to assets of the FASIT acquired in qualified exchanges.

"(4) EXCEPTION. - Paragraph (1) shall not apply to the extent the holder demonstrates to the satisfaction of the Secretary, based on all of the facts and circumstances of a transaction, that recognition of gain under such paragraph would be inconsistent with the policy of requiring recognition of gain only to the extent a transferor of assets has,

directly or indirectly, disposed of FASIT securities that represent interests in the cash flow on such assets.

"(f) VALUATION OF ASSETS AND SECURITIES. -

"(1) REPLACEMENTS OF ASSETS BY TRANSFEROR. - The anticipated cash. flow and fair market value of any FASIT securities received by a transferor in a qualified exchange, and any assets acquired by a FASIT in such an exchange, shall be determined without regard to any future transfers of assets in qualified exchanges that the transferor may be obligated or permitted to make.

"(2) TREATMENT OF REVOLVING LOAN POOLS. - In the case of any FASIT acquiring obligations representing extensions of credit on revolving loan accounts having substantially the same terms —

"(A) each extension of credit shall be treated as a separate obligation,

"(B) the anticipated cash flows and fair market value of each such obligation shall be determined using a periodic principal payment rate equal to the reasonably anticipated periodic rate at which principal payments on the accounts will be made, as a proportion of their aggregate outstanding principal balances,

"(C) actual payments of principal (and losses of

principal) shall be allocated among all outstanding obligations in proportion to their outstanding balances, and

"(D) the deemed exchange of a new extension of credit, in return for a principal payment on an existing obligation and an-increase in the value of an existing FASIT ownership interest, shall be an exchange subject to the provisions of this section.

"(g) INVESTMENT PARTNERSHIP RULES APPLICABLE. -- Notwithstanding subsection (a), gain shall be recognized (and appropriate basis adjustments shall be made) to the extent that gain would be required to be recognized under section 721(b) if the FASIT were a partnership (treating as a single taxpayer all transferors that are members of the same affiliated group of corporations joining in the filing of a consolidated return).

"Sec. 855D. TAXES RELATED TO CERTAIN TRANSFERS OF SECURITIES.

"(a) IN GENERAL. — A tax is hereby imposed on any transfer of an ownership interest or a permitted debt instrument in a FASIT to any party not described in section 855A(a)(5)(A), (B), or (C). Except as otherwise provided in this section, the amount of the tax shall be determined, and the tax shall be assessed and collected, in the same manner and to the same extent as the tax imposed by section 860E(e) with respect to the transfer of residual interests in REMICs to disqualified organizations.

“(b) TREATMENT OF PASS-THRU ENTITIES. — If, at any time during a taxable year of a pass-thru entity a party not described in section 855A(a)(5)(A), (B), or (C) is the record holder of an interest in such entity, and such entity holds an ownership interest or permitted debt instrument in a FASIT, there is hereby imposed on such entity for such taxable year a tax. Except as otherwise provided in this section, the amount of the tax shall be determined, and the tax shall be assessed and collected, in the same manner and to the same extent as the tax imposed by section 860E(e)(6) with respect to disqualified organizations that are record holders of interests in pass-thru entities owning residual interests in REMICs.

“(c) TAX BASE. — In determining the taxes imposed by this section —

“(1) there shall be substituted for the present value of the total anticipated excess inclusions (described in section 860E(e)(2)(A)) the excess of the present value of the total anticipated net income over the present value of the total anticipated net losses, with respect to such interest or instrument, and

“(2) there shall be substituted for the amount of excess inclusions (described in section 860E(d)(6)) the amount of taxable income includible with respect to the ownership interest or permitted debt instrument.

“(d) CERTAIN PASS-THRU ENTITIES. -

“(1) DEFINITION. -- For purposes of this section and section 855A(a)(5)(C), a pass-thru, entity shall have the same meaning as is provided in section 860(e)(6), except that such term shall also include any S corporation.

“(2) EXCEPTIONS. -- No tax shall be imposed by subsection (b) to the extent a pass-thru entity --

“(A) holds an ownership interest or permitted debt instrument in a FASIT representing a retained economic interest in debt obligations originated by the pass-thru entity in connection with the pass-thru entity’s sale of goods or services, or

“(B) holds an ownership interest or permitted debt instrument in a FASIT for sale to customers in the ordinary course of business, or is a dealer in securities and holds such an interest or instrument for no more than one month.

“Sec. 855E. DEFINITIONS. - For purposes of sections 855A through 855E -

“(a) FASIT SECURITY. - A FASIT security is any ownership interest or debt instrument issued by a FASIT.

“(b) DEBT INSTRUMENT - A debt instrument is any permitted

debt instrument or qualified debt instrument.

"(c) OWNERSHIP INTEREST. - An ownership interest is an interest issued by a FASIT that is designated as such (regardless of its form).

"(d) QUALIFIED DEBT INSTRUMENT. - A qualified debt instrument is an instrument issued by a FASIT if —

"(1) it is designated as such (regardless of its form),

"(2) it unconditionally entitles the holder to receive a specified principal amount (or other similar amount),

"(3) it has a stated maturity at issuance no longer than thirty years (or such longer period as may be permitted by regulations),

"(4) its issue price does not exceed 125 percent of its stated principal amount,

"(5) its interest payments (or other similar amounts), if any, would qualify as eligible interest payments for a REMIC regular interest under section 860G(a)(1)(B), and

"(6) it does not have a yield to maturity as of the date of issuance that is more than five percentage points higher than the yield to maturity on outstanding marketable obligations of the United States with a comparable maturity (based upon a statistically significant sampling, a published index, or a similar objective determination).

"(e) PERMITTED DEBT INSTRUMENT. - A permitted debt instrument is an instrument issued by a FASIT if --

"(1) it is designated as such (regardless of its form), and

"(2) it is described in subparagraphs (2), (3), and (5) of section 855E(d).

"(f) STRIPPED INSTRUMENTS. -- In lieu of issuing a single debt instrument, a FASIT may issue certificates of ownership in specified scheduled payments of principal or interest on such debt instrument (or such portions thereof that are properly treated as stripped bonds or coupons). Such certificates shall be aggregated and treated by the FASIT as a single debt instrument, but shall be treated by their respective owners as stripped bonds or coupons.

"(g) ACCRUAL PERIOD. - Except as otherwise provided in regulations, an accrual period shall be a calendar month (or such other regular monthly period as may be designated by the FASIT).

SEC. 3 CONFORMING AMENDMENTS

(a) The last sentence of paragraph (1) of Section 582(c) of the Internal Revenue Code of 1986 is amended to read as follows:

"For purposes of the preceding sentence, any regular or residual interest in a REMIC and any FASIT security (as defined in section 855E) shall be treated as an evidence

of indebtedness.”

(b) Sections 593(d)(4), 856(c)(6)(E), and 7701(a)(19)(C) of the Internal Revenue Code of 1986, are each amended by adding at the ends thereof the following sentence:

“The provisions of this section applicable to regular and residual interests in a REMIC shall also apply to FASIT securities (as defined in section 855E).”

SEC. 4 EFFECTIVE DATE

The amendments made by Sections 2 and 3 shall be effective upon the date of enactment.

Draft: December 1, 1993

GENERAL EXPLANATION OF PROPOSED FASIT PROVISIONS

Background and Policy Considerations

The FASIT provisions are intended to facilitate the securitization of loans by authorizing a new tax vehicle called a Financial Asset Securitization Investment Trust or "FASIT". FASITs will share some characteristics of Real Estate Mortgage Investment Conduits ("REMICs"). In particular, the income earned by a FASIT will generally be exempt from tax at the entity level. Instead, the FASIT's income will be passed through to -- the holders of "interests" in the FASIT, which are called FASIT securities. The anticipated economic benefits of increased securitization under the Bill include enhanced liquidity and diversification of financial risk, as well as increased credit availability.

FASITs are designed to encompass many transactions that are currently unable to use existing tax law securitization vehicles, such as REMICs or fixed investment trusts. The differences between FASITs and REMICs principally reflect the differences between typical mortgage loan securitizations and securitizations involving other types of debt obligations.

Unlike a REMIC, a FASIT will generally be permitted to acquire debt obligations, and to issue securities backed by its debt obligations, at any time. This flexibility is intended to accommodate features that have become commonplace in non-mortgage loan securitizations treated as structured financings under current law. These features include (1) the issuance of debt securities having a longer maturity than the entity's underlying

debt obligations (e.g., one-year bonds backed by 45-day trade receivables), (2) the issuance of debt securities backed by the balances of revolving loan accounts, and (3) the issuance of securities that take advantage of the efficiencies in credit enhancement that can result from commingling different "vintages" of loans or receivables in a single issuing entity.

These features are not typical of the mortgage loan securitizations that were structured as financings (i.e., collateralized mortgage obligations) prior to the enactment of REMIC. The desired maturity of most mortgage-related debt obligations is shorter-than, not-longer than, the stated maturity of most mortgage loans. In addition, most mortgage loans do not have revolving balances. In addition, for many mortgage backed securities the cost of credit enhancement is not as significant a factor as it is in non-mortgage securitizations. This is particularly true where the securities are guaranteed by the government, or government sponsored enterprises. Thus, although mortgages will be eligible investments for FASITs, it is not anticipated that the availability of a FASIT election will increase the extent to which mortgage loans are securitized, with the possible exception of mortgage loans with revolving balances. It is anticipated that most non-revolving mortgage loan securitizations will continue to be structured as fixed investment trusts or as REMICs.

Although FASITs will enjoy greater structural flexibility than REMICs, they will be more limited than REMICs in their ability to pass through income without the imposition of a single level of corporate tax. Because beneficial ownership of permitted debt instruments and ownership interests will generally be limited to corporations subject to U.S. taxation, the portion of the FASITs income that is passed through on such securities

will generally be subject to the U.S. corporate income tax.[1] Qualified debt instruments, in contrast, may be held by individuals, foreign persons, and tax-exempt entities, as well as corporations subject to U.S. taxation. Accordingly, the portion of the FASIT's income that is passed through to non-corporate holders of qualified debt instruments may effectively be passed through without the imposition of an intervening corporate income tax (and without Sie imposition of any foreign withholding taxes or unrelated business income taxes).

FASITs are not permitted to acquire or dispose of assets for the primary purpose of recognizing gains or decreasing losses from market value changes. Thus, bond mutual funds currently required to register as investment companies will not be able to utilize FASITs as a viable alternative to the tax rules governing regulated investment companies.

Explanation of Provisions

Overview

The Bill provides rules relating to "financial asset securitization investment trusts" or "FASITs." A FASIT is an entity that holds debt obligations and certain related assets, and issues to investors interests in the cash flow received from the FASIT's assets. Interests in a FASIT are generally referred to as "FASIT securities."

[1] In addition, certain corporations holding such securities will be limited in their ability to offset such income with net operating losses or other deductions. This limitation is intended to prevent revenue losses that would otherwise arise from the utilization of FASITs to create and market investments with substantially "front-loaded" income.

Generally, a FASIT may acquire debt obligations and issue new securities at any time. However, a FASIT may not acquire or dispose of any assets for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.

This restriction on trading is the same as that imposed by the Securities and Exchange Commission for asset securitization vehicles seeking to qualify for exemption from treatment as “investment companies” under Rule 3 (a)(7) of the Investment Company Act of 1940. In this respect, the FASIT provisions conform to the standards of the securities laws for distinguishing asset securitization vehicles (which are essentially permitted to buy and sell assets only to faciliate securitization) from mutual funds (which are permitted to engage in active trading of assets for the purpose of benefitting from market value changes). The trading restriction ensures that the FASIT provisions will not provide a viable alternative to the regulated investment company rules (IRC Section 851, et seq.) for entities required to register under the Investment Company Act of 1940. However, the statutory requirements for qualification as a FASIT are not direcdy dependent upon an entity’s status under the securities laws or any other laws other than the Internal Revenue Code.

The Bill provides rules prescribing (1) the Federal income tax treatment of the FASIT, (2) the treatment of taxpayers who exchange property for FASIT securities, (3) the treatment of taxpayers holding FASIT securities, and (4) the treatment of dispositions of FASIT securities. In general, if the specified requirements are met, the FASIT is not treated as a separate taxable entity. Rather, the income of the FASIT is allocated to, and taken into account by, the holders of the FASIT securities

issued by the FASIT.

FASIT securities can be issued as “qualified debt instruments”, “permitted debt instruments” or “ownership interests.” Holders of qualified debt instruments and permitted debt instruments generally take into income that portion of the income of the FASIT that would be recognized by an accrual method holder of a debt obligation having the same terms as the FASIT debt instrument. Holders of ownership interests take into account all of the net income of the FASIT that is not taken into account by the holders of qualified or permitted debt instruments.

Rules are provided that generally preclude beneficial ownership of ownership interests or permitted debt instruments by individuals, foreign persons, or entities exempt from U.S. taxation. In addition, the income on ownership interests or permitted debt instruments generally may not be offset by a holder’s net operating losses or other deductions. This limitation does not apply where the security represents a substantial economic interest in loans that were originated by the holder (or certain related parties) and transferred to the FASIT in exchange for the security. Because these limitations address the same concerns that the taxable mortgage pool rules were intended to address, the Bill provides that an entity that would otherwise be treated as a taxable mortgage pool may avoid such classification by electing to be treated as a FASIT.

Requirements for qualification as a FASIT

Under the Bill, any entity (including, a-corporation, partnership, or trust) that'meets specified requirements would be permitted to elect to be treated as a FASIT. In addition, a segregated pool of assets also may qualify as a FASIT as if it

were an entity meeting the requirements. To elect FASIT status, requirements relating to the composition of assets and the nature of the investors' interests must be satisfied, and an election to be treated as a FASIT must be in effect for the taxable year, and if applicable, all prior taxable years.

The asset test

Under the Bill, in order to qualify as a FASIT, substantially all of the assets of the entity or segregated pool, as of the close of the second calendar quarter beginning after its formation, and as of the close of every quarter of each calendar year thereafter, must consist of one of five permissible types of assets.[2] It is intended that the term substantially all should be interpreted to allow the FASIT to hold only de minimis amounts of other assets. In general, the five permissible types of assets are (1) cash, (2) debt obligations, (3) property acquired in connection with the default or imminent default of a debt obligation held by die FASIT, (4) instruments or contractual rights in the nature of a hedge or guarantee against the economic risks associated with issuing debt instruments backed by the FASIT's debt obligations, and (5) ownership interests in other FASITs.

A debt obligation includes any instrument treated as debt for Federal income tax purposes regardless of its form, including a permitted or qualified debt instrument-issued by another FASIT, or a participation or certificate of beneficial

[2] The FASIT provisions adopt a quarterly testing rule, rather than the daily testing rule used in the REMIC provisions. There does not appear to be any useful purpose served by daily testing, in light of the fact that all income from non-permitted assets is subject to a 100 percent prohibited transaction tax.

ownership interest in a debt obligation.[3] If a debt obligation provides for any payments of contingent interest that would be considered ineligible for treatment as portfolio interest in the hands of a foreign person, the right to such payments must be separated from the principal and any other interest payable on the debt obligation before it is acquired by the FASIT.

Property that is acquired in connection with the default or imminent default of a debt obligation held by the FASIT must generally be disposed of by the FASIT within two years of its acquisition, under the rules of paragraphs (2) and (3) of section 856(e), as applicable to real estate investment trusts. In addition, such property will not qualify if the debt obligation secured by the property was acquired by the FASIT with an intent to foreclose.

Instruments or contractual rights in the nature of a hedge or guarantee against the economic risks associated with debt instruments issued or held by the FASIT are intended to include such items as interest rate swaps, credit enhancements, minimum and maximum prepayment guarantees, and liquidity arrangements. However, such instruments or rights are permissible assets for a FASIT only to the extent they are reasonably required to protect against the risk that the FASIT would not otherwise be able to make timely payments on debt instruments issued by the FASIT out of payments received on debt obligations held by the FASIT.

Investors' interests

In order to qualify as a FASIT under the Bill, all of

[3] It is intended that debt obligations would include stripped coupons and stripped bonds (within the meaning of sec. 1286), and senior and subordinated interests in debt obligations of the type described in Treas. Reg. sec. 301.7701-4(c)(2)(Example 2).

the interests in the FASIT must consist of one or more classes of qualified or permitted debt instruments, and a single class of ownership interests. Except as may otherwise provided in regulations, it is intended that the term "interests" have the same meaning as under the REMIC provisions.

Qualified debt instruments. - A qualified debt instrument is an interest that (1) is designated as such (regardless of its form), (2) unconditionally entitles the holder to receive a specified principal (or similar) amount, (3) has a stated maturity no longer than thirty years (or such longer period as may be permitted by regulations) (4) has an issue-price that does not exceed 125 percent of its stated principal amount, (5) does not provide for interest payments (or similar amounts) other than fixed or variable payments that would qualify as eligible interest payments for a REMIC regular interest, and (6) does not have a yield to maturity as of the date of issuance that is more than five percentage points higher than the yield to maturity on outstanding marketable obligations of the United States with a comparable maturity (based upon a statistically significant sampling, a published index, or a similar objective determination).

Permitted debt instruments. - A permitted debt instrument is an interest that is designated as such (regardless of its form), and that satisfies all of the requirements for qualification as a qualified debt instrument other than the limitations on the instrument's issue price and maximum yield to maturity (i.e., items (4) and (6) described above).

Rules applicable to qualified and permitted debt instruments. –

An amount of principal (or a similar amount) will be

considered unconditionally payable even if its payment is contingent on the absence of defaults on assets held by the FASIT (or on assets that may be acquired to replace assets that are retired after the issuance of the debt instrument). Thus, it is intended that an interest in a FASIT would not fail to be treated as a debt instrument solely because payments of principal or interest (or similar amounts) with respect to such instrument are subordinated to payments on other FASIT securities in the event of defaults on the FASIT's assets. Debt instruments in a FASIT may thus resemble regular interests in a REMIC, or the types of interests described in Treas. Reg. sec. 301.7701-4(c)(2)(Example 2). However, the extent to which qualified debt instruments may be subordinated will effectively be limited by the requirement that such instruments have a maximum yield to maturity no greater than 5 percentage points above comparable Federal borrowing rates.

The timing (but not the amount) of principal (or similar) payments on debt instruments may be contingent on the extent of prepayments on debt obligations held by the FASIT, on the level of defaults or changes in applicable interest rates on assets held or to be acquired by the FASIT (i.e., events triggering "early amortization") and similar economic factors.

If the terms of a qualified or permitted debt instrument are modified after its original issuance, such that the instrument is treated as being reissued under generally applicable tax principles, the debt instrument will be tested under its modified terms as if it were a new debt instrument issued in exchange for the original debt instrument. Under certain circumstances the holder and the FASIT may also be required to recognize gain or loss upon such a deemed exchange.

In lieu of issuing a single qualified or permitted debt instrument, a FASIT may issue to different holders certificates of ownership in specified scheduled payments of principal or interest on such debt instrument (or portions thereof that would be Seated as stripped bonds or coupons). In such event, the certificates will be aggregated and treated by the FASIT as a single debt instrument (e.g., for purposes of determining whether the issue price and yield requirements for a qualified debt instrument are satisfied). Nevertheless, the certificates will be treated by their respective owners as stripped bonds or coupons, in the same manner as if the FASIT had issued a debt instrument that was stripped in a separate fixed investment trust.

It is intended that debt instruments in FASITs may be issued in the form of debt, stock, partnership interests, interests in a trust, or any other form permitted by state law. Thus, if a debt instrument is not in the form of debt, it is understood that the interest would not have a specified principal amount, but that the interest would qualify as a debt instrument if there is a specified amount that could be identified as the principal amount if the interest were in the form of debt. For example, an interest in a partnership could qualify as a debt instrument if the holder of the partnership interest were to receive a specified amount in redemption of the partnership interest, and if the amount of income allocated to such partnership interest were based on the application of a fixed percentage of the specified outstanding redemption amount.

Ownership interests. - In general, an ownership interest in a FASIT is any interest in the FASIT so designated by the FASIT, provided that there is only one class of such interest, and that all distributions (if any) with respect to such interests are pro rata. For example, assume that the ownership

interest in a pool of loans and related assets that otherwise qualifies as a FASIT is held by two taxpayers, one of whom has a 25 percent interest in the pool and the other of whom has a 75 percent interest. Except for their relative size, the interests of the two taxpayers are identical. Provided that all distributions to the ownership. interest holders are pro rata, the pool would qualify as a FASIT because there is only one class of ownership interest. If, however, the holder of the 25 percent interest is entitled to receive all distributions to which ownership interest holders combined are entitled for a specified period (or up to a specified amount) in return for the surrender of his interest, then the pool would be considered to have two classes of ownership interests and would not qualify as a FASIT.

It is intended that an interest in a FASIT could qualify as a ownership interest regardless of its value. Thus, for example, an interest need not entitle the holder to any distributions in order to qualify as a ownership interest.

Where any of the FASITs assets are stripped coupons or stripped bonds (within the meaning of section 1286), it is not intended that any other stripped coupons or stripped bonds arising from the same debt obligation would be treated as a second class of ownership interest in the FASIT. In addition, it is intended that the right to receive payment from the FASIT for goods or services rendered in the ordinary operation of the FASIT would not be considered to be an interest in the FASIT for these purposes.

Special rules for ownership interests and permitted debt instruments

In order to qualify as a FASIT, the FASIT must make

reasonable arrangements designed to ensure that its ownership interests and permitted debt instruments are not held by holders other than corporations subject to the U.S. corporate income Tax, pass-through entities, or other FASITs. These rules are intended to be substantially similar to the REMIC rules that require reasonable arrangements to ensure that residual interests are not held by disqualified organizations.

In addition, the Bill imposes taxes on persons that transfer ownership interests and permitted debt instruments to parties other than permitted holders, and effectively requires pass-through entities holding such FASIT securities to withhold and remit taxes to the extent the holders of interests in the pass-through entity are not permitted holders. Mechanically, these rules are intended to be substantially similar to the REMIC rules imposing similar taxes with respect to residual interests transferred to disqualified organizations or held by pass-through entities for the benefit of disqualified organizations. The tax bases are computed differently, however. Whereas the REMIC provisions impose taxes based on the portion of the residual holder's income treated as excess inclusions, the FASIT provisions impose taxes based on all of the income that is passed through to holders of ownership interests or permitted debt instruments. This reflects the fact that the REMIC restrictions were intended only to prevent deferral of tax on front-loaded income (i.e., income that accrues faster than it would if the investment were taxed under the principles of the constant yield method).[4] In contrast, the FASIT restrictions are intended to prevent avoidance of corporate income tax on the entire amount of that portion of the FASIT's income that would not qualify to be passed through to holders of qualified debt instruments,

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[4] Excess inclusions, which are generally defined as income on a residual interest in excess of income that would accrue at 120 percent of the Applicable Federal Rate, represents an imperfect approximation of front-loaded income.

regardless of whether it is front-loaded.

The Bill provides that the taxes imposed on pass-through entities will not be applied to the extent a pass-through entity is holding a FASIT security representing a retained economic interest in debt obligations that were originated by the pass-through entity in connection with the entity's sale of goods or services. This is intended to allow businesses operating as partnerships or S corporations to retain FASIT securities in connection the securitization of their trade receivables without the imposition of a corporate tax. This exception is premised on the fact that such entities would not have been taxed as corporations if they had retained economically similar interests in connection with non-FASIT financings of their receivables.

Thus, there should be no loss of corporate tax revenues attributable to the fact that such retained interests are FASIT securities, as opposed, say, to interests in a trust or partnership holding receivables and issuing debt under generally applicable tax principles. In addition, the tax on pass-through entities does not apply with respect to ownership interests or permitted debt instruments that are held by a pass-through entity for sale to customers in the - ordinary course of its business (whether or not the entity is also a dealer in any other securities), or that are held by an entity that is a dealer in any type of securities (whether or not the entity is a dealer in FASIT securities) for no more than one month.

The portion of FASIT income taken into account by permitted holders of ownership interests or permitted debt instruments generally may not be offset by any net operating losses of the holder. This restriction is intended to prevent the avoidance or deferral of corporate income tax on the portion of

FASIT income passed through on such securities that may be front loaded.[5] However, in the interests of administrative convenience, the limitation applies to all of the income passed-through on such securities.

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5 No deferral of taxable income can be attributed to a loss corporation's use of its net operating losses or other deductions to offset income from FASIT ownership interests or permitted debt instruments (or REMIC residual interests), unless that income accrues faster than the alternative investments the corporation could have acquired in lieu of the FASIT securities (or REMIC residual interests). Assuming that most comparable alternative investments would be taxed under the constant yield method, a revenue problem arises only to the extent FASIT ownership interests or permitted debt instruments accrue income faster than would be required under the constant yield method.

For example, assume that a corporation with $15 of unused net operating losses holds a two-year bond costing $100, yielding taxable interest income-of $10 annually for two years and providing for repayment of the $100 of principal at the end of the second year. Current law would allow the corporation's net operating losses to offset $10 of interest income in the first year and $5 of interest income in the second year. Assume, then, that the corporation sold the bond for $100 to a taxable corporation and acquired for $100 all of the ownership interests in a FASIT having no liabilities and holding as its sole asset an identical two-year bond. In that event, the FASIT would pass-through to the loss corporation income of $10 each year for two years. Again, no revenue loss would occur from allowing the loss corporation to use its net operating losses against the FASIT income, since the total income subject to tax in the hands of the loss corporation and the taxable corporation would be the same (i.e., $10 in the first year and $15 in the second year) regardless of which corporation held the FASIT ownership interests and which held the bond outright.

In contrast, assume that a FASIT ownership interest could be created with identical cash flows that produced taxable income of $15 in the first year and $5 in the second year (i.e., a front-loaded pattern of taxable income, assuming the same cash flows). Revenue losses could result from allowing the loss corporation to use its net operating losses against such income. If one assumes that, but for the FASIT provisions, the equivalent front-loaded non-FASIT investment would have been held by a taxable corporation (such as the originator of the FASIT's underlying loans) revenue losses will result if the FASIT provisions result in that front-loaded investment being sold by the taxable corporation and acquired by the loss corporation. Under the base line assumption (without FASIT). the taxable corporation would report income of $15 in the first year and $5 in the second year. Under the FASIT provisions, assuming that the taxable corporation sold its front-loaded investment to the loss corporation and acquired the loss corporation's economically equivalent bond, the taxable corporation would report income of $10 in the first and second years from the bond, and the loss corporation would report (but pay no taxes on) the FASIT income of $15 in the first year and $5 in the second year. Thus, government revenues would be reduced in the first year, and increased by the same amount in the second year, as a result of the FASIT provisions. This timing difference could become a permanent difference, but only if the loss corporation's losses could be expected to expire unutilized in the absence of the FASIT provisions.

The Bill provides a special exception from this rule in the case of certain FASIT securities received by originators of debt obligations (or certain related parties) in exchange for such debt obligations (including for this purpose property constituting a permissible hedging instrument or guarantee with respect to such debt obligations). This exception is premised on the fact that revenue losses could not be expected to arise from a holder's use of losses to offset front-loaded income if those losses could have been used to offset such front-loaded income even in the absence of the FASIT provisions (e.g., in a non-FASIT issuance of debt securities by a financing entity owned by the originator of the underlying debt obligations). To qualify for this exception, the FASIT security must be part of a class of securities whose fair market value at issuance was at least equal to 2 percent of-the fair market value of the assets transferred in the qualified exchange in which such securities were received. In addition, the security must have an anticipated weighted average life immediately after the transfer at least equal to 20 percent of the anticipated weighted average life of the debt obligations transferred in the qualified exchange. These limitations are intended to ensure that the FASIT transaction resembles the type of non-FASIT transaction that, all other things being equal, the issuer could have engaged in without the FASIT provisions. These limitations are intended to ensure that the FASIT transaction resembles the type of non-FASIT transaction that, all other things being equal, the issuer could have engaged in without the FASIT provisions.[6] This exception does not apply, however, in the case of a FASIT that would be treated as a taxable mortgage pool, but for the FASIT provisions. This is

[6] See the discussion of revenue considerations in the previous footnote. As long as any front-loaded income remains in the hands of the party that would have reported such income even in the absence of the FASIT provisions, no revenue losses should arise from allowing that party to offset such income with its net operating losses or other deductions. This is because, - even without the FASIT provisions, an equivalent amount of front-loaded income would be offset by those net operating losses or other deductions under current law.

because the taxable mortgage pool rules of current law do not provide any generalized exception for originators securitizing their own loans.[7]

Inadvertent terminations

The Bill provides regulatory authority to the Treasury Department to "issue regulations that address situations where failure to meet one or more of the requirements for FASIT status occurs inadvertently and disqualification of the FASIT would occur absent regulatory relief. It is anticipated that the Treasury regulations would provide relief only where the failure to meet any of the requirements occurred inadvertently and in good faith. It is also intended that the relief may be accompanied by appropriate sanctions, such as the imposition of a corporate tax on all or a portion of the FASIT's income for the period of time in which the requirements are not met. It is anticipated that such sanctions would not place the FASIT in a worse position than if a FASIT election had not been made and the transaction were instead governed by generally applicable tax principles.

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[7] In theory, the failure of the taxable mortgage pool rules to provide such an exception results in those rules being overbroad. Be that as it may, a revenue loss could arise from providing such an exception through the FASIT provisions, if one assumes that originators of mortgage loans with net operating losses would, absent the FASIT provisions, voluntarily subject themselves to the taxable mortgage pool rules and incur taxes on the front-loaded portion of income from their securitization transactions.

Federal income tax treatment of the FASIT

Pass-through status

In general, the Bill provides that a FASIT is not a taxable entity for Federal income tax purposes. The income of the FASIT generally is taken into account by the holders of the FASIT's securities. Nevertheless, the FASIT is subject to a 100 percent tax on net income from prohibited transactions, and a tax at the highest corporate rate on income that would be net income from foreclosure property if the FASIT were treated as a real estate investment trust and if the property securing its debt obligations were treated as real property.[8]

The pass-through status of the FASIT provided by the Bill applies regardless of whether the FASIT otherwise would be treated as a corporation, partnership, trust, or any other entity. Where the requirements for FASIT status are met, the Bill is intended to be the exclusive set of rules for the treatment of all transactions relating to the FASIT and of holders of interests therein. Thus, for example, in the case of a FASIT thatwould be treated as a partnership it if were not otherwise a FASIT, the provisions of subchapter K of the Code would not be applicable to any transactions involving the FASIT or any of the holders of FASIT securities.[9]

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[8] The most common form of "net income from foreclosure property" would be rental income that would not qualify as "rents from real property" under Treas. Reg. Sec. 1.856-4, if the property were treated as real property. In most cases, a fixed rent paid for the use of -property (and not for the provision of services) by a party that is unrelated to-the FASIT would qualify as "rents from real property". Examples of impermissible rents would include rents that depend on the net income or profits of any person, or rents paid by certain related parties.

[9] For purposes of subtitle F of the Code (relating to certain administrative matters) the FASIT is treated as a partnership in which ownership interests are the partnership interests, however. It is intended that the initial election of FASIT status is to be made on the first partnership information return that the FASIT is required to file.

Prohibited transactions

Under the Bill, a FASIT is required to pay a tax equal to 100 percent of the FASITs net income from prohibited transactions. For this purpose, net income from prohibited transactions is computed without taking into account any losses from prohibited transactions or any deductions relating to prohibited transactions that result in a loss. Prohibited transactions for a FASIT are (1) the acquisition or disposition of an asset for the primary purpose of recognizing gains or decreasing losses resulting from market value changes, (2) the receipt of any income from assets other than assets permitted to be held by the FASIT, and (3) the receipt of any compensation for services (not including, for this purpose, any payments received pursuant to the terms of any instruments or contractual rights in the nature of a hedge or guarantee that are permitted to be held by the FASIT).

Characterization of investment in FASIT securities

Under the Bill, FASIT securities are treated as qualifying assets for purposes of section 593(d)(1) and section 7701(a)(19), in the same proportion that the assets of the FASIT would be treated as qualifying under those sections. It is intended that the amount treated as a qualifying asset not exceed the adjusted basis of the security in the hands of the holder. FASIT securities are treated as real estate assets under section 856(c)(6), and the income from such securities is treated as interest qualifying under section 856(c)(3)(C), in the same proportion that the assets of the FASIT would be treated as real estate assets for purposes of determining eligibility for real estate investment trust status. These rules are to be applied to FASITs in the same manner as they are applied to REMICs

(including the rule disregarding non-qualified assets constituting less than 5 percent of the FASIT's assets).

Taxation of the holders of debt instruments

In general

Under the Bill, holders of qualified or permitted debt instruments generally are taxed. in the same manner as holders of any other debt instrument to which the rules of taxation generally applicable to debt instruments apply, except that the holder of a qualified or permitted debt instrument is required to account for income relating to such interest on the accrual method of accounting regardless of the method of accounting otherwise used by the holder.[10] In the case of qualified or permitted debt instruments that are not issued in die form of debt instruments, the amounts treated as principal would generally be any unconditional payments the amount of which does not depend upon the time the payment is made. Amounts treated as interest would generally be those payments the amount of which depends upon the period of time amounts treated as principal are outstanding

It is intended that qualified and permitted debt instruments are to be treated as if they were debt instruments for all other purposes of the Internal Revenue Code. Thus, for example, qualified or permitted debt instruments would be treated as market discount bonds, where the revised issue price (within the meaning of section 1278) of the instrument exceeds the holder's basis therein. Moreover, it is intended that the FASIT be subject to all information reporting requirements applicable

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[10] It is intended that periodic payments of interest (or similar amounts) are to be treated as accruing pro rata between the dates that such interest (or similar amounts) is paid.

to the issuance of debt instruments. In addition, FASIT debt instruments are to be treated as evidences of indebtedness under section 582(c)(1), so that gain or loss from the sale or exchange of debt instruments by certain financial institutions would not be treated as gain or loss from the sale or exchange of a capital asset In addition, any market premium on a FASIT debt instrument could be amortized currently under section 171.

The issue price of debt instruments issued by the FASIT are generally determined under the rules of section 1273(b). In the case of debt instruments issued in qualified exchanges, however, the issue price of the regular interest is equal to its fair market value upon issuance. A holder's basis in a debt instrument generally is equal to the holder's cost there for, but in the case of holders who received their interests in qualified exchanges, then as discussed below, the holder's basis is equal to the allocable portion of the basis of the property exchanged for the FASIT debt instrument.

Taxation of holders of ownership interests

In general

In general, the Bill provides that at the end of each calendar quarter, the holder of an ownership interest in a FASIT takes into account his daily portion of the taxable income or net loss of the FASIT for each day during the holder's taxable year in which such holder held such interest. The amount so taken into account is treated as ordinary income or loss. The daily portion for this purpose is determined in the same manner as it is determined for holders of residual interests in a REMIC. That is, the portion is determined by allocating to each day in any

calendar quarter a ratable portion of the taxable income or net loss of the FASIT for such quarter, and by allocating the amounts so allocated to any day among the holders (on such day) of ownership interests in proportion to their respective holdings on such day.

For example, a FASITs taxable income for a calendar quarter (determined as described below) is $1,000. There are two holders of ownership interests in the FASIT. One holder of 60 percent of the ownership interest holds such interest for the entire calendar quarter. Another holder has a 40 percent interest, and transfers the interest after exactly one half of the calendar quarter to another taxpayer. As of the end of the calendar quarter, the holder of the sixty percent interest would be treated as receiving $600 ratably over the quarter. Each holder of the 40 percent interest would be treated as receiving $200 ratably over the portion of the quarter in which the interest was held.

Except as otherwise provided under the distribution rule applicable to ownership interests received in qualified exchanges, distributions from the FASIT are not included in the gross income of the ownership holder to the extent that such distributions do not exceed the adjusted basis of the interest. Any excess is treated as gain from the sale of the ownership interest. Ownership interests are treated as evidences of indebtedness for purposes of section 582(c).

The amount of any net loss of the FASIT that may be taken into account by the holder of an ownership interest is limited to the adjusted basis of the interest as of the close of the quarter (or time of disposition of the interest if earlier), determined without taking into account the net loss for the

quarter. Any loss that is disallowed on account of this limitation may be carried over indefinitely by the holder of the interest for whom such loss was disallowed and may be used by such holder only to offset any income generated by the same FASIT.

Determination of amount and character of FASIT taxable income or net loss

In general, under the Bill, the taxable income or net loss of the FASIT for purposes of determining the amounts taken into account by holders of ownership interests, is determined in the same manner as for a corporation having the calendar year as its taxable year and using the accrual method of accounting, with certain modifications.

First, the basis of any property received by a FASIT in a qualified exchange will be equal to that property's basis in the hands of the transferor immediately before the exchange. The FASIT's basis in any such property that is a debt obligation will be treated as the adjusted issue price of the debt obligation, for purposes of the FASIT's accrual of any discount or premium thereon.

Secondly, the principles of the constant yield method (as reflected in section 1272(a), including paragraph (6) thereof) will be applied in determining all interest and discount income and all premium deductions or adjustments with respect to all debt obligations held by the FASIT.

Third, the provisions of section 163(e)(5), relating to the deferral or disallowance of deductions on certain high yield debt obligations, will not apply with respect to any debt

instrument of the FASIT."[11]

Fourth, any deduction for interest or original issue discount with respect to a permitted debt instrument that would cause the FASIT's deductions to exceed its income for a taxable year will be treated as incurred in the succeeding taxable year.

Fifth, any distribution of property with respect to a FASIT security (other than certain distributions of property transferred to the FASIT by the distributee, or substantially similar property) will be treated by the FASIT as if the FASIT had sold such property for cash equal to the property's fair market value and distributed such cash.

Sixth, the FASIT will apply principles of section 860C(b)(1)(C) and (E) of the REMIC provisions (providing that any income and deductions attributable to prohibited transactions are to be disregarded, and reducing the amount of any net income from foreclosure property by the amount of tax imposed thereon).

The Secretary is given authority to issue regulations modifying these rules, and modifying the treatment of holders of permitted debt instruments, to the extent necessary to clearly reflect the portion of total FASIT income or loss properly allocable to holders of ownership interests and permitted debt instruments, and the appropriate character thereof. Except as otherwise provided in regulations, items of FASIT income or loss will have the same character, in the hands of a holder of an ownership interest, as such items would have if they were incurred directly by the holder.

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[11] The FASIT provisions have their own limitations on the permissible yield of qualified debt obligations. Permitted debt obligations are not intended to

Transfers of assets to FASITs and related rules for ownership interests

Nonrecognition upon transfers of assets for securities

Under the Bill, no gain or loss is recognized to the transferor or the FASIT upon the transfer of property to a FASIT in a qualified exchange. A qualified exchange is generally defined as the transfer of assets to a FASIT in exchange for FASIT securities (i.e., qualified or permitted debt instruments, or ownership interests) issued by the FASIT. A qualified exchange also includes the transfer of assets to a FASIT in exchange for an increase in the value of a previously issued ownership interest, or an issuance of FASIT debt instruments in exchange for a decrease in the value of previously issued ownership interests.

Any property acquired in a qualified exchange will have a carryover basis in the hands of the FASIT (i.e., a basis equal to the transferor's basis, immediately prior to the exchange). The securities received from the FASIT in a qualified exchange will, in the aggregate, have a basis equal to the aggregate basis of the transferred property. The aggregate basis for FASIT securities received in a qualified exchange is to be allocated among the securities received in proportion to their relative fair market values.

Recognition of transferor's gain or loss

As illustrated below, gain is recognized to the transferor to the extent a transferor, in a taxable transaction, disposes of FASIT securities that were received in a qualified

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be subject to any such limitation because they are only generally permitted to

exchange. This is generally accomplished under a "basis allocation rule" by requiring that the transferor, immediately prior to a disposition of FASIT securities, allocate its basis in FASIT securities received in qualified exchanges between the securities disposed of and the securities retained.

The required basis allocation is generally to be made on the basis of the relative fair market values of the securities retained and the securities disposed of. However, basis may not be allocated to disposed securities in excess of their fair market value. Thus, losses will not be accelerated upon the disposition of FASIT securities. The only exception to this loss deferral rule applies when a holder disposes of the same fractional interest in all of its securities received from the FASIT in qualified exchanges. Since the transferor is disposing of the same fractional portion of all of its FASIT securities received in qualified exchanges, there can be no question that the holder is disposing of the same fractional portion of the securities that would have represented the "ownership" of the transferred assets for tax purposes if the transaction had been structured as a financing. Thus, recognition of the loss, to that extent, is appropriate.

In addition, under a "distribution rule" certain amounts of gain are recognized upon certain distributions of cash or property by the FASIT to holders of FASIT ownership interests.[12]

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be beneficially owned by corporations subject to U.S. taxation.

[12] Under the distribution rule, a transferor is generally required to recognize gain equal to the amount determined by the formula DR x (PG + (FMV - B)) PG, where DR ("disposition ratio") represents the proportion of the FASIT's assets that the transferor no longer-retains an economic interest in after the distribution; FMV represents the fair market value, and B represents the basis, of the FASIT securities the transferor continues to hold after the distribution; (FMV-B) thus represents the built-in gain inherent in such retained FASIT securities; and PG ("previously recognized gain amount") represents the gain previously recognized by the transferor with respect to assets transferred to, and still held by, the FASIT. PG is generally, though not always, equal to the positive balance, if any, of the holder's basis amortization account, described below in the text. In general, the distribution rule operates as a "catch-up" rule that ensures that the total amount of gain recognized is the same regardless of the order of transfers of assets to a

As illustrated below, the distribution rule is intended to ensure that the Federal income tax consequences of transferring assets to a FASIT, and receiving cash in excess of the transferor's allocable share of FASIT operating income, are the same regardless of whether (1) FASIT securities are issued and disposed of by the transferor simultaneously with, or subsequent to, the transfer of assets, (2) FASIT securities are issued and disposed of prior to the transfer of assets, or (3) FASIT securities are issued directly by*the FASIT in connection with a distribution of cash to holders of FASIT securities.

Losses realized by a transferor are generally taken into account only over time, in the same manner as would occur in a transaction structured as a financing.

Interpretive rules for qualified exchanges

To implement the policy of the Bill that gain (but not loss) should be recognized to the extent (and only to the extent) that a transferor has effectively disposed of securities representing interests in the cash flow of the assets transferred to a FASIT, certain interpretive rules are applied to transactions involving qualified exchanges. It is anticipated that other generally applicable tax principles (such as the step transaction doctrine) will not be applied if doing so would produce a substantially different result than that which would be required under these interpretive rules.

The first interpretive rule is that the direct issuance by a FASIT of a debt instrument will not be recharacterized as (1) an issuance of the debt instrument to holders of ownership interests in the FASIT, followed by (2) the disposition of such

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FASIT, dispositions of FASIT securities, or distributions to holders of FASIT

debt instrument in exchange for the issue price of the debt instrument. Thus, instead of triggering gain recognition upon such a debt issuance (under the basis allocation rule), gain will be triggered only to the extent required under the distribution rule if the FASIT distributes cash received from the debt issuance (or any other cash or property) to the holders of FASIT ownership interests.

The other interpretive rules apply to transfers involving cash (or other property other than FASIT securities) as well as FASIT securities. If a transferor (or any member of the same affiliated group of corporations joining in the filing of a consolidated return) holds any ownership interests in the FASIT immediately after a qualified exchange, an cash or other property (other than FASIT securities) received in the transaction will not be treated as part of the qualified exchange. Instead, the transaction will be treated as (I) a transfer solely in exchange for FASIT securities, followed by (2) a distribution of such cash or other property with respect to the transferor's ownership interests. Thus, the cash distribution will cause gain recognition only to the extent required under the distribution rule, and losses will generally not be recognized. In other cases where a transferor receives cash (or other. property other than FASIT securities) in addition to FASIT debt instruments, the transaction will be treated under generally applicable tax principles in part as a qualified exchange for the FASIT debt instruments, and in part as a sale of assets to the FASIT for the cash or other property, upon which gain or loss will be recognized.

Treatment of debt instruments issued in qualified exchanges

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ownership interests.

A transferor that receives a debt instrument in a qualified exchange will assign to such debt instrument, as the transferor's basis therein, an allocable portion of the transferor's basis in the transferred property. The issue price of the debt instrument, however, will be its fair market value. Accordingly, a special rule requires the transferor to accrue, in the same manner as original issue discount ("OID"), any difference between its basis in the debt instrument and the instrument's issue price. Thus, the entire difference between the transferor's basis and the instrument's stated redemption price at maturity will be treated by the transferor as OID.

Under certain circumstances, a transferor's aggregate basis in its FASIT securities received in qualified exchanges will be reallocated based on the relative fair market values of the securities, in the same manner as if all of such securities were treated as having been reissued in a qualified exchange. Basis will be reallocated in this manner immediately after a transferor's disposition of any of its FASIT securities that were received in qualified exchanges. In addition, under an anti-abuse rule, basis is reallocated immediately after any transfer of assets in exchange for FASIT securities that is part of a plan to transfer assets with substantially different amounts of built-in gain (or loss) in exchange for different FASIT securities.

Amortization of differences between inside and outside basis

In order to account properly for the income of a transferor of assets to a FASIT, the Bill provides for an adjustment to the holder's income that is passed-through from the FASIT. The provision also applies to secondary purchasers of ownership interests. The adjustment may be reflected as an additional deduction (economically comparable to a deduction or

adjustment for bond premium) or as additional income (economically comparable to the inclusion of market discount income). The rules governing these adjustments are based in part on concepts that are embodied in sections 754 and 704(c), relating to certain transfers of interests in partnerships and certain contributions to partnerships.

Under the Bill, the holder's adjustment is determined by reference to the balance of the holder's "basis amortization account", which is equal to the holder's tax basis in its ownership interests (i.e., its "outside" basis), plus the holder's pro-rata share of the amount (sometimes referred to as the FASIT's "net asset basis") equal to the adjusted issue price of the FASIT's outstanding debt instruments minus the FASIT's tax basis in its assets. If this balance is positive the holder is entitled to amortize the positive balance as a series of deductions. If the balance is negative the holder is required to amortize the negative balance as a series of income inclusions. In practice, the circumstances in which negative and positive balances can arise depends in part on whether the holder received its ownership interests in a qualified exchange or in a secondary purchase.

Where the holder of an ownership interest received the interest in a qualified exchange, and such holder is the only party that has transferred assets to a FASIT in qualified exchanges, it is anticipated that the balance of such holder's account will always be positive or zero. In addition, it is anticipated that any positive balance will reflect the amount of gain such holder has previously recognized with respect to assets that are still held by the FASIT that were transferred to the

FASIT in qualified exchanges.[13]

It is anticipated that a negative balance, with respect to ownership interests received in qualified exchanges, should only arise where there are multiple transferors of assets, and each transferor has transferred assets with different amounts of built-in gain (or loss). In such a case, one or more of the transferors may have a positive balance, one or more of the transferors may have a negative balance.

In addition, a holder's positive balance will not necessarily reflect previously recognized gain with respect to assets transferred in qualified exchanges.[14]

In the case of a secondary purchaser of ownership

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[13] For example, if a transferor transfers assets with a basis of $100 and a value of $110 to a FASIT in exchange for $55 face amount of debt instruments that are immediately sold for $55, and an ownership interest worth $55, the holder will recognize $5 of gain under the basis allocation rule, attributable to the allocation of $50 of basis to the debt instruments disposed of for $55. The holder's remaining basis in its ownership interests will be $50. The holder's basis amortization account will equal $50, plus the holder's share (i.e., 100 percent) of the FASIT's liabilities (i.e., $55) minus the holder's share (i.e., 100 percent) of the FASIT's basis in its assets (i.e., $100). This formula ($50 plus $55 minus $100) produces a positive basis amortization account of $5, the amount of gain the transferor recognized.

[14] For example, assume that K and L each transfer debt instruments with a value and face amount of $100 and an interest coupon of 10 percent, but that K's basis is $50 and L's basis is $100. K and L each receive 50 percent of the FASIT's ownership interests. Before taking into account the basis adjustment account mechanism, K and L would each report the same income from the FASIT, which would consist of $50 of discount income in addition to their respective shares of the coupon interest. Thus, $25 of the FASIT's discount income would be taken into account by each holder. This would overtax L and undertax K, since the FASIT's discount income is entirely attributable to the fact that it acquired K's asset with a below-market carryover basis.

The basis adjustment account provisions address this problem with adjustments outside the FASIT. K's basis in its ownership interest will be $50. Its basis amortization account balance will equal $50, plus $0, minus $75 (i.e., K's 50 percent share of the FASIT's aggregate carryover asset basis of $150), or negative $25. Thus, K will be required to take into account $25 of discount income, in addition to the $25 of discount income passed-through by the FASIT. L's basis will be $100. Its basis amortization account balance will equal $100, plus $0, minus $75, or positive $25. Thus, L will be entitled to

interests, a positive balance will arise whenever the purchase price includes an amount that is economically equivalent to a market premium with respect to the underlying assets of the FASIT. For example, if a FASIT has $10 of liabilities and holds debt obligations with a basis of $100 but a value of $110 due to an above-market interest rate, a secondary purchaser might pay $100 for the ownership interests. The secondary purchaser would have a basis of $100. Its basis amortization account would equal its basis of $100, plus the adjusted issue price of the FASIT's liabilities (i.e., $10), minus the inside basis of the FASIT's assets (i.e., $100) or $10. Thus, the secondary purchaser would have a basis amortization account balance of $10, and would be permitted to amortize that balance as a series of deductions. These deductions will ensure that the purchaser is not overtaxed, since the purchaser is in a situation comparable to that of having purchased a $100 bond at a $10 premium due to its above market interest rate.

A negative balance for a secondary purchaser will arise whenever the purchase price reflects the economic equivalent of a market discount with respect to the underlying assets of the FASIT. For example, assume the same facts as described above, except that due to increases in market interest rates a secondary purchaser is only willing to pay $85 for the ownership interest. The basis amortization account would equal $85, plus the adjusted issue price of the FASIT's liabilities (i.e., $10), minus the inside basis of the FASIT's assets (i.e., $100) or negative $5. Thus, the secondary purchaser would have a basis amortization account balance of negative $5, and would be required to include that balance as a series of income inclusions. This will ensure that the purchaser is not undertaxed, since the purchaser is in a situation comparable to that of having purchased a $100 bond at a

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$25 of premium deductions that will offset the $25 of discount income passed

$5 discount due to its below-market interest rate.

Adjustments to basis of ownership interests

The generally applicable basis rules of the Bill provide that a holder's basis in an ownership interest is increased by the amount of the taxable income of the FASIT that is- taken into account by the holder, and decreased (but not below zero) by the amount of any distributions received from the FASIT and by the amount of any net loss of the FASIT that is taken into account by the holder. In the case of a holder who disposes of a ownership interest, the basis adjustment on account of the holder's daily portions of the FASIT's taxable income or net loss is deemed to occur immediately before the disposition.

In addition to all other basis adjustments required with respect to ownership interests, a holder's basis is increased by the amount of gain, if any, taken into account under the distribution rule, and is reduced by the amount of deductions (and increased by the amount of income) taken into account under the rules applicable to the amortization of differences between inside and outside basis.

Illustrations of gain recognition and basis rules

The application of the Bill's gain recognition and basis adjustment provisions can best be understood with a series of examples.

1. Non-revolving transactions.

a. Assume that T has a $100 basis in a 12 percent bond

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through by the FASIT.

providing for a single, balloon payment of $100 of principal at the end of two years, plus two annual interest payments of $12. Because market interest rates are 10 percent, the bond has a value of $103.47. This is comprised of the value of a ten percent bond ($100) plus the present value of $4 of excess cash flow over a two-year period ($3.47). Assume that T transfers the bond to a FASIT in exchange for $100 of FASIT debt instruments with a 10 percent coupon, and an ownership interest representing the right to $2 of excess cash flow each year for two years.

T's $100 basis in its contributed bond will be allocated among the FASIT securities it received in the qualified exchange. Accordingly, T's basis (and its adjusted issue price) in the $100 of FASIT debt instruments will be $100/$103.47 of $100 or $96.65, and its basis in the ownership interest will be $3.47/$103.47 of $100 or $3.35.

If T does not dispose of any of its FASIT securities, there will be virtually no tax effect to the transaction.

With respect to the FASIT debt instruments, T will report $10 of interest income each year, and will report OID of $3.35 over a two year period, $1.58 in the first year and $1.77 in the second year.

With respect to the FASIT ownership interest, T will report the FASIT's taxable income which will equal $2 each year (based on the excess of coupon interest received over coupon interest paid).

T's basis in its ownership interests will be $3.35. Accordingly, the balance of T's basis amortization account will equal $3.-35, plus the adjusted issue price of the FASIT's

liabilities ($100), minus the FASIT's basis in its assets ($100) or $3.35. This positive amount will be amortized over the life of the assets of the FASIT in the same manner as an equivalent amount of premium on the FASIT's assets would be amortized. Thus, T will be entitled to deductions of $1.59 in the first year and $1.76 in the second year. The net effect is that T's overall income will be $11.99 in the first year and $12.01 in the second year, almost identical to what would have occurred absent the FASIT election.

As can be seen, there is a slight mismatch between the amortization of the $3.35 positive balance in T's basis amortization account, and T's inclusion of $3.35 of accrued market discount with respect to its retained debt instrument.It appears that this phenomenon also occurs under the REMIC rules, to the extent the transferor retains regular and residual interests in the REMIC.[15] If this mismatch is viewed as a significant revenue problem for the FASIT legislation, it could be corrected in a number of different ways. The draft bill provides regulation authority for the Treasury to modify the amortization rules to address this problem.[16]

b. Assume that T retains the ownership interest but

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[15] If the above-described transaction involved a mortgage-backed debt obligation, and were structured as a REMIC, the REMIC would acquire its asset with a basis of $103.47 and would amortize a $3.47 premium on the constant yield method over a two year period, producing amortization deductions of $1.65 and $1.82. Combined with the REMICs' other income of $2 per year, the net income passed through to T as the holder of the residual interest would be $0.35 and $0.18. In addition, T would amortize $0.12 of deferred gain over the life of the- residual interest, producing additional income of $0.06 in each year for a total of $0.41 in the first year and $0.24 in the second year. With respect to T's retained regular interests, T would report coupon income of $10 in each year, plus $3.35 of deferred gain taken in as accrued market discount on a constant yield method. That would require T to accrue market discount _ of $1.58 in the first year and $1.77 in the second year. Thus, the total income taken into account by T would be $11.99 in the first year ($10, plus $1.58, plus $0.41) and $12.01 in the second year ($10, plus $1.77, plus $0.24).

disposes of the debt instruments for $100. T will recognize gain of $3.35. The resulting taxable income to T will be as follows:

> In the first year, $3.35 of gain, $2 of income passed-through the FASIT, and $1.59 of basis amortization account deductions, for a total of $3.76.

> In the second year, $2 of income from the FASIT, and $1.76 of deductions for a total of $0.24.

The total income for the two year period will be $4.00 — the same amount that T would have reported in a non-FASIT financing. In a financing, however, $2 would be reported in the first year and $2 the second year, a slower pattern.

c. Assume the same facts as in c. except that T does not dispose of the $100 of debt instruments until the beginning of the second year. Accordingly, no gain would be recognized in the first year.

At the end of the first year, T's basis in its debt instruments would be $96.65, plus $1.58 (reflecting accrued OID) or $98.23. Thus, if T sold its $100 debt instrument for $100, it would recognize gain in the beginning of the second year of $1.77.

T's income with respect to its debt instruments would thus be $11.58 in the first year ($10 interest plus $1.58 OID), and $1.77 of gain at the beginning of the second year.

T's income with respect to its ownership interests would

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[16] If this anomaly does present a significant revenue problem, correcting the problem under the REMIC rules as well would presumably raise revenue.

be $0.41 in the first year and $0.24 in the second year.[17].

The secondary purchaser of T's FASIT debt instrument would report $10 of coupon interest in the second year.

Thus, with respect to all taxpayers, the total income taken into account would be $11.99 in the first year and $12.01 in the second year. Note that, although this example provides a good illustration of the computations involved when securities are issued after assets are contributed, no net acceleration of income is shown because the example uses a two-year asset and computes income on an annual basis. An example in winch gain was computed on a monthly or quarterly basis would demonstrate that /there was significant acceleration of income in this case.This can be seen by computing T's income in the second year on a quarterly basis. In that event, the $1.77 of gain would be included in the first quarter, while the related amortization deductions of $1.76 would be spread over the entire year. Again, the Treasury would enjoy regulatory authority to eliminate the slight mismatch between accrual of OID with respect to retained debt instruments and the amortization of the holder's positive basis in its basis amortization account with respect to retained ownership interests.

d. Assume that the FASIT had only issued $75 of debt instruments which T sold at the beginning of year one. T would be treated as having retained an ownership interest that entitled it to $25 of principal with interest at 10 percent, in addition to the excess cash flow of 2 percent on $100. The fair market value of that ownership interest would be $28.47 (i.e., $25 par value of a market rate debt instrument, plus $3.47 value of excess cash flow).

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[17] Under regulations, that income could be modified, presumably to be $0.42

Accordingly, T would allocate to the $75 of debt instruments 75/103.47ths of its $100 basis ($72.49) and would recognize gain upon a disposition for $75 equal to $2.51.

T's resulting basis in its retained ownership interest will be $27.51. The balance of T's basis amortization account would be $2.51. This is equal to T's basis ($27.51), plus T's share of the FASIT's liabilities ($75), minus T's share of the FASIT's asset basis ($100). The $2.51 positive account balance will be deductible by T following the same pattern that the FASIT would use to amortize a $2.51 inside premium on its assets. This will result in deductions of $1.20 in the first year and $1.31 in the second year.The resulting taxable income to T will be as follows:

> In the first year, $2.51 of gain, $2 of income passed-through the FASIT, and $1.20 of deductions, for a total of $3.31.
>
> In the second year, $2 of income from the FASIT, and $1.31 of deductions for a total of $0.69.

This example illustrates that acceleration of income occurs only to the extent that the transferor disposes of securities in the FASH. Because only $75 of debt instruments were disposed of, there is less acceleration of income than in example 1(b).

e. Assume that T (i) purchases $75 of 10 percent Treasury bonds, (ii) transfers the bonds to a FASIT in exchange for a zero-value ownership interest and $75 of FASIT 10 percent debt instruments, and (iii) sells the $75 FASIT debt instrument in the

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in the first year and $0.23 in the second year. See discussion above.

market for $75. 100 percent of T’s $75 basis in the Treasury bonds would be allocated to the $75 of sold FASIT bonds, so there would be no gain recognition upon the receipt of the $75 cash sales price.

In addition, because T would have no basis in its retained ownership interest, there would be a zero balance in its basis amortization account.

Assume, then, that T transfers $100 face amount of debt obligations identical to those described in example 1(a), in exchange for an increase in the value of its ownership interests from zero to $103.47 (reflecting the fair market value of the right to receive the principal and interest on a $100.00 face amount, 12 percent bond). No gain is recognized on the transfer. Immediately after the transfer, assume that the FASIT sells its $75 of Treasury bonds in the market for $75 of cash. No gain or loss is recognized by the FASIT since its $75 basis in the Treasury bonds equalled the amount realized on their sale.

Finally, assume that the FASIT then distributes the $75 of cash to T with respect to its ownership interest.

Economically, T is in a comparable position as if (i) T had transferred the $100 face amount of debt obligations to the FASIT and (ii) immediately thereafter the FASIT has issued to T $75 of FASIT debt instruments which T had immediately sold to the public for $75. In other words, T is in the same position described in example 1(d). The distribution rule is designed to produce the same tax effect as that produced in example 1(d).

The distribution rule requires gain recognition equal to the result of the formula: DR x (PG + FMV - B) - PG, where

PG is the positive balance (if any) before the distribution of the transferor's basis amortization account (which is equal to T's basis in its ownership interests, plus T's share of FASIT liabilities, minus T's share of the FASIT's asset basis); generally, this amount will reflect previously recognized gains on assets held by the FASIT;

in this case: PG = $100 + $75 - $175, = $0

FMV is the fair market value of*T's retained securities, before the distribution, or in this case $103.47 (i.e., $75 of undistributed cash, plus $103.47 value of debt obligations, minus $75 of liabilities)

B is T's basis in its retained securities, before the distribution, or in this case $100;

DR (disposition ratio) is 1, minus the ratio of FMV (determined after the $75 distribution) over T's share of the value of all assets held by the FASIT;

In this case: 1 - 28.47/103.47 or 72.49%

The overall formula produces: 72.49% x ($0 + $103.47 - $100) - $100, or 72.49% x $3.47, or $2.51. This is the same amount of gain recognized in example 1(d), where the transactions were done in a different order.

f. Assume that T has a $100 basis in $100 of Treasury bonds, with two years to maturity, paying 8 percent interest when market rates are 10 percent. Thus, T has a built-in loss, rather than unrealized appreciation. T securitizes the bonds by contributing them to a FASIT, obtaining from the FASIT (and

selling in the market) $100 face amount of FASIT debt instruments bearing 8 percent interest. Because of their below-market coupon, the issue price of the FASIT debt instruments would be only $96.53, which is the amount T would realize upon their immediate sale in the market.

Under the normal basis allocation rule, T would allocate 96.53/96.53ths of its $100 basis to the FASIT bond, since the ownership interest would be worthless. This would generate a loss of $3.47. However, the loss limitation rule prevents T from allocating more than $96.53 of basis to the sold FASIT bond. Accordingly, T would allocate $96.53 of basis to its FASIT debt instruments and $3.47 of basis to its ownership interest, which is worthless.
T’s ongoing income, as the holder of the ownership interest, would be the excess of the coupon interest on the bonds ($8 in each year), over the sum of the FASIT’s coupon interest deductions on its debt instruments ($8 each year), plus the FASIT’s OID deductions (totalling $3.47) on a debt obligation having an issue price of $96.53 and a stated redemption price of $100. The OID deductions would be $1.65 in the first year and $1.82 in the second year. The resulting losses of $1.65 and $1.82 would reduce T’s $3.47 of basis to zero after two years.

Note also that T would have a basis of $3.47 in its ownership interests, but a zero balance in its basis amortization account (i.e., $3.47, plus $96.53, minus $100). Thus, there would be no income adjustments outside the FASIT.

Note that, in this example, since there is no value to the ownership interest, T could easily accelerate the loss by disposing of the ownership interests. This is entirely appropriate since T has, in fact, realized the loss by disposing

of all economic interests in the original Treasury bond. An example where the loss could not be accelerated without economic consequences is provided next.

g. Assume the same facts as example 1(f), except assume that the FASIT debt issued and disposed of has a face amount of $80 and a coupon of 10 percent, and is sold for $80. All of the interest on the Treasury bond (i.e., $8) is used to pay the interest on the FASIT debt instrument. T’s ownership interest represents an entitlement to $20, with no interest, at the end of two years. At a ten percent discount rate, this ownership interest has a fair market value of $16.53.The normal basis allocation rules would allocate 80/96.53ths of $100 (or $82.88) to the $80 bond generating a $2.88 loss (i.e., 82.88 percent of the economic loss of $3.47). However, T may not allocate more than $80 to the disposed FASIT interest. Accordingly, the loss is deferred, and T’s remaining basis in its retained ownership interests is $20.

T’s ongoing income will consist entirely of the excess of the FASITs coupon interest income on its assets ($8 in each year) over the FASIT’s coupon interest deductions on its debt instruments ($8 in each year). (T’s basis amortization account balance will equal $20, plus $80, minus $100, or zero.) Thus, T will have no income for two years, and will receive the $20 of principal as a tax-free return of capital at the end of the transaction. In effect, T’s tax posture has been preserved exactly as it would have been in a financing, where the interest deductions on the $80 of borrowed funds would equal the interest income on the $100 of assets, and $20 of principal would be released without tax consequences at the end of the transaction.

In order to accelerate its tax loss, T would need to sell all or

a portion of its entitlement to the $20 principal distribution. If T disposed of 50 percent of that right (by selling 50 percent of its ownership interests) a loss would be allowed as follows. T’s basis would be $20. $10 of that basis would be allocated to the 50 percent of the ownership interests sold. Assuming that the amount realized on the sale would be the present value of a right to $10 with no interest after two years, or $8.26, a loss of $1.73 (half of the embedded $3.47 loss) would be allowed.

2. Revolving transactions

a. In a typical revolving transaction, T would periodically replace retiring, short-term FASIT assets with similar assets, in order to facilitate the issuance of a FASIT debt instrument with a term in excess of the maturity of the FASIT assets. Assume that T securitizes the same asset assumed in example 1 (a), above, by contributing the asset to a FASIT and issuing $100 of debt instruments. The debt instruments have a stated maturity of ten years, however, and T is accordingly obligated to contribute comparable replacement loans from its inventory to replace assets in the FASIT as they pay off. Thus, T will be contributing additional assets with a face of $100, and receiving cash distributions of $100, at the beginning of years 3, 5, 7, and 9.

All of the computations are exactly as in example 1 (b) for the first two years. At the beginning of the third year, however, T contributes a replacement $100 asset, and receives a $100 distribution. The distribution rule will determine the amount of gain recognized on the distribution.

The rule requires gain recognition equal to the result of the formula: DR x (PG + FMV - B) - PG, where —

PG is the positive balance (if any) before the distribution of the transferor's basis amortization account (which is equal to T's basis, plus T's share of FASIT liabilities, minus T's share of FASIT asset basis);

in this case: T's basis will be $100, its share of FASIT liabilities will be $100, its share of FASIT asset basis will be $200, so PG = zero.

FMV is the fair market value, before the distribution, of T's retained securities;

in this case: $103.47;

B is T's basis in its retained securities, before the distribution, or in this case $100;

DR (disposition ratio) is 1 minus the ratio of FMV (determined after the distribution) over T's share of the value of all assets held by the FASIT;

In this case: 1 - 3.47/103.47 or 96.65%

The overall formula produces: 96.65% x ($0 + $103.47 - $100) - $0, or 96.65% x $3.47, or $3.35. Thus, $3.35 of gain will be recognized in year three, the same amount that was recognized in year one.

The pattern established in years one and two will, thus, continue in years three and four (etc.) until the deal terminates at the end of year 10. The resulting pattern of income for T will be $3.76 in years 1, 3, 5, 7, and 9, and $0.24 in years 2, 4, 6, 8, and 10.

This example illustrates the operation of the distribution rule, but does not produce a typical income pattern. In a more typical revolving securitization, assets will be paying off at a relatively constant rate each month. Accordingly, instead of an "up and down" income pattern (e.g., $3.76 in odd-numbered years and $0.24 in even-numbered years) there will be an acceleration of income in the first month that mil be maintained throughout the life of the transaction and will not be reversed until the amount of assets held by the FASIT begins to be reduced (e.g., as retiring assets are used to retire bonds instead of being used to acquire replacement assets).This can be visualized with the following example.

b. Assume that T utilized two separate FASITs, for assets identical to those securitized in the previous example. Assume that in 1994, T securitizes $100 of newly originated loans in FASIT I, and that in 1995, T securitizes $100 of newly originated loans in FASIT II. At the end of each year, T replaces $100 of assets that retire, alternately, in FASIT I and FASIT II. In such a case T's income from FASIT I would be $3.76 in even-numbered years beginning in 1994 and $0.24 in odd numbered years beginning in 1995. T's income from FASIT II would be $3.76 in odd-numbered years beginning in 1995, and $0.24 in even- numbered years beginning in 1996.

The net effect in 1994 would be that T's income would be $1.76 greater than the $2 of income that T would have been reported if T had not made any FASIT elections and had securitized the assets in financings. In 1995 through 2003, T's income would be the same as if T had done the transactions as financings. In 2004, T would use the proceeds of retiring assets in FASIT I to retire FASIT I debt (rather than replacing the

retiring asset and keeping the FASIT I debt outstanding). As a result, in 2004, T's income would be only $0.24, $1.76 less than the income that would have been reported in that year if T had done the transactions as financings. This would produce a "reversal" of the $1.76 of income acceleration experienced in 1994.

In a more realistic example, a pool of $100 assets with an anticipated weighted average life of two years might experience prepayments at a constant rate (e.g., 50 percent per year). Thus, of the $100 of assets contributed at the beginning of year one, $50 would prepay at the end of the year, $25 would prepay at the end of the second year, $12.50 at the end of the third year, etc.

In such a case T would, at the beginning of year two, replace $50 of retiring assets from the initial transfer. Then, at the beginning of year three, T would replace $25 of retiring assets from the initial transfer, together with $25 of retiring assets from the first $50 replacement, for a total of $50. Then, at the beginning of year four, T would need to replace $12.50 of assets from the initial transfer, $12.50 that would have prepaid from the first $50 replacement, and $25 that would have prepaid from the second $50 replacement. This pattern would continue, with the result that in each period T would be replacing $50 of assets.

The acceleration of income that would be produced by such a pattern is an increase in the first period (equal to the built-in gain on a single $100 asset), followed by no net change in all succeeding periods until T ceased replacing assets, at which time there would be a reversal of the acceleration that occurred in the first year. Assuming that the transferor does not

reduce the volume of assets being securitized, the amount of "permanent" acceleration of income in any particular FASIT transaction is essentially equal to (1) the excess of the fair market value of securitized assets over their basis in the hands of the transferor, times (2) 1, minus the ratio of the fair market value of any securities retained by the transferor over the fair market value of all outstanding securities of the FASIT.

In a typical securitization of newly originated loans, item (1), will equal the present value of the excess interest that is not needed to cover anticipated losses and debt service costs. The size of this amount is a function of the periodic spread and the anticipated life of the assets being securitized. For example, in the case of a pool initially comprised of $100 million face amount of notes with an anticipated annual spread of, say, 360 basis points (30 basis points on a monthly basis) and an anticipated life of two years, the maximum amount of gain that would be subject to acceleration would be the present value of $300,000 per month for 24 months. At a 10 percent discount rate, this would equal approximately $6.5 million. Note also, that, inasmuch as FASIT is primarily helpful for transactions that might not otherwise be assured of achieving "debt" status under generally applicable tax principles, the typical transaction that would be induced by passage of the FASIT legislation will be one in which there will be relatively thin capitalization (i.e., where the size of the retained interests is quite small, as a fraction of the total value of all FASIT securities). Thus, in any transaction which can reasonably be viewed as having been permitted or induced solely by the FASIT legislation, nearly all of the potentially accelerated gain (i.e., $6.5 million in the example described above) would be accelerated.

c. Assume the same facts as in example 2 (a). Thus, T's income pattern is $3.76 in odd-numbered years and $0.24 in even numbered years. Assume that at the beginning of year seven, T contributes an additional $100 of assets having the same characteristics as the existing assets. T does not issue any additional debt securities, however. Thus, T will have contributed a total of $200 of assets, and received a distribution of $100. T may do this to "warehouse" the additional assets until market conditions warrant an additional issuance of securities.

No gain is recognized on the contribution, and no additional securities are issued or disposed of that might require gain recognition as a result of the basis allocation. Application of the distribution rule produces the following results:

The rule requires gain recognition equal to the result of the formula: DR x (PG + FMV - B) - PG, where –

> PG is the positive balance (if any) before the distribution of the transferor's basis amortization account (which is equal to T's basis, plus T's share of FASIT liabilities, minus T's share of FASIT asset basis);
>
> in this case: T's basis will be $200, its share of FASIT liabilities will be $100, its share of FASIT asset basis will be $300, so PG = zero.
>
> FMV is the fair market value, before the distribution, of T's retained securities. In this case, the fair market value includes a $100 entitlement to a $100 cash distribution, $103.47, representing the fair market

value of a warehoused $100 asset, and $3.47 representing the fair market value of the excess cash flow generated by the "securitized" asset. Thus, FMV is $206.94.

B is T's basis in its retained securities, before the distribution, or in this case $200;

DR (disposition ratio) is 1 minus the ratio of FMV (determined after the distribution) over the value of all assets held by the FASIT.

In this case: 1 - 106.94/206.94 or 48.32%

The overall formula produces: 48.32% x ($0 + $206.94 - $200) - $0, or 48.32% x $6.94 or $3.35. Thus, T will not recognize any more gain than the amount that would have been recognized absent the warehousing transfer.

3. Discount Loans

a. T advances $100 to a borrower in exchange for an obligation to pay $125.44 at the end of two years. The note bears no coupon interest and has a yield to maturity of 12 percent (determined on an annual basis). T contributes the note to a FASIT in exchange for a debt instrument paying $121 at the end of two years, and an ownership interest representing the right to any excess cash flow at the end of the transaction (i.e., a maximum of $4.44, assuming no losses).

T will allocate its $100 basis among the securities received in accordance with their fair market values. Thus, T's basis and adjusted issue price for its FASIT debt securities will be $96.46, and its basis in its ownership interests will be $3.54.

Assume that T does not dispose of the debt instrument. The FASIT will be treated as acquiring an obligation with a basis and an adjusted issue price equal to T's basis of $100. Thus, the FASIT will accrue OID income of $12 in year one and $13.44 in year two. The FASIT will also accrue OID deductions of $10 in year one and $11 in year two on the FASIT debt instrument. Thus, the FASIT's income will be $2 in the first year and $2.44 in the second year. This income will be passed through to T as the holder of the FASIT's ownership interests. In addition, T will have a $3.54 positive balance in its basis amortization account ($3.54 basis, plus $100 adjusted issue price of FASIT liabilities, minus $100 of FASIT asset basis) which will give rise to deductions computed on the constant yield method. Those deductions will equal $1.57 in the first year and $1.97 in the second year. The overall income on T's ownership interests will be $0.43 in the first year, and $0.47 in the second year for a total of $0.90.

With respect to the FASIT debt instrument, T will report OID of $24.54, equal to the difference between its adjusted issue price (i.e., $96.46) and the stated redemption price of $121. T's OID will be $11.57 in the first year and $12.97 in the second year. The overall income on T's debt instruments will be $24.54.

Overall, T's income in the first year will be $2, plus $11.57, minus $1.57,*or $12. In the second year, T's income will be $2.44, plus $12.97, minus $1.97, or $13.44. This is the same as the income T would have reported without a FASIT election.

b. Assume the same facts as example 3(a)., except that T sells the FASIT debt instrument for $100. T recognizes gain of $3.54 upon the sale. The rest of the computations are essentially as in the previous example.