It has been argued in literature[43] that sound business principles require that the deduction of the fair market value of the warrant right must be spread over the term of the warrant loan. This seems true to the extent that the conditions of the warrant right stipulate that such right is exercisable at a fixed date and hence, the annual Article 10b(3) of the CTA "costs" can indeed be recognized for each respective period. If the warrant right may be exercised at any time during the term of the loan, and hence there is uncertainty for the issuer with respect to these Article 10b(3) costs, it seems defensible to argue that it is in accordance with the prudence principle of sound business practice for the issuer to fully deduct the fair market value of the warrant right at the time of contracting the warrant loan.

Under pre-2001 legislation, it was unclear whether an additional deduction for the increase of the value of the warrant right upon exercising is available, see II.B.2.b. It has been held that such deduction would be available, if the issuer would meet its obligation to deliver shares by buying such shares on the public market instead of issuing new ones. Under new Article 10b of the CTA, this uncertainty is taken away as Para. 3 of Article 10b of the CTA is abundantly clear; *only* the fair market value of the warrant right at the time of contracting the loan is deductible.

IV. SUMMARY

In this contribution, we have discussed two types of hybrid instruments, i.e. those that contain an equity kicker (warrant loans, convertibles) and those that seek to arbitrage between differences in treatment in different jurisdictions.

As of 1 January 2001, new legislation has come into effect that codifies the treatment of hybrid instruments of the first type for issuers. Pre-2001 indistinctness is resolved to a certain extent, but new uncertainties will undoubtedly arise.

Although an attempt was made to codify the treatment of hybrid instruments of the second type as well, the relevant proposal of law was swiftly withdrawn, primarily based on heavy resistance from the professional and financial industries. For this second type of hybrid instruments, pre-2001 case law will retain its relevance, at least for the time being.

However, if the current productivity levels at the Dutch Ministry of Finance's legislative department are maintained, players in the financial markets and their advisers should remain alert for any unanticipated changes of law which may affect their business.

43. P.W. van Meeuwen and J.W. Tilstra, WFR 2000/1094.

UNITED STATES

FASIT: The Newest Securitization Vehicle

Viva Hammer and Ann Singer[1]

I. INTRODUCTION

One of the more significant developments in the finance world in the last 50 years has been the streamlining of the securitization process. Securitization involves the bundling together of assets that are not readily marketable and repackaging them into a series of marketable securities. This is accomplished through the sale of the assets into an appropriately structured entity that issues securities using the non-marketable assets as collateral. Many different types of assets can be made available to the investment community this way, such as home mortgages, credit card loans, vehicle loans, student loans, even future movie royalties.

The securitization process in the United States can be tripped up in several ways by the federal income tax laws. A sponsor must make sure that it chooses the correct entity which will purchase the assets. Any tax that is paid by the entity itself will reduce the return to the investors in the structure. In addition, the contribution of the assets must be carefully structured as sale or loan, depending on the tax result that is desired. A sale of appreciated assets to the securitization vehicle would result in taxable gain, which may not be desired by the seller. Finally, the securities issued by the vehicle have to be structured so that they receive the tax treatment the investors expect (e.g. debt or equity).

Several types of entities that already exist in the tax world are used in the United States as securitization vehicles. For example, special purpose trusts, special purpose partner-

1. PricewaterhouseCoopers, New York.

ships or corporations. The tax law has also created some special entities just to facilitate securitization. These include Real Estate Mortgage Investment Conduits (hereinafter: REMICs) and Real Estate Investment Trusts (hereinafter: REITs). Each of these vehicles have significant disadvantages, such as: entity level tax, limitations on the kinds of instruments that can securitized through them, limitations on sales into the entity after the initial sales transaction and uncertainty as to the tax treatment of the holders of interests in the vehicles.

To remedy some of the above problems, Congress passed a set of tax laws that created a vehicle called a Financial Asset Securitization Investment Trust (hereinafter: FASIT). By using this vehicle, there is certainty as to the treatment of the initial sale of the assets into the entity, it is possible to avoid entity-level tax and there is certainty in the treatment of the purchases of interests in the FASIT.

Below we outline a number of different possible scenarios in which assets are contributed to a FASIT and securities are issued secured by those assets. The requirements for classification as a FASIT, the types of instrument that can be sold to a FASIT and the treatment of FASIT interest holders will be described as the transactions unfold.

II. TRANSACTION STEPS

A. Overall facts and assumptions

- Corporation A is a US corporation.
- Debt instruments are "permitted debt instruments" within the meaning of IRC § 860L(c).
- Debt instruments are not "traded on an established securities market" as defined by Prop. Reg. 860I-2(b).
- Corporation A is an "eligible corporation" within the meaning of IRC § 860L(a)(2).
- Bank or other Counterparty will be an "eligible corporation" within the meaning of IRC § 860L(a)(2).
- Corporation A has expiring capital losses.

Scenario 1: Corporation A owns debt instruments and retains all FASIT interests

- Corporation A holds $ x in debt instruments that are not traded on an established securities market.
- Corporation A transfers debt instruments to a FASIT.
- Corporation A retains both the ownership interest and regular interests in FASIT.

Scenario 2: Bank owns debt instruments and sells assets to Corporation A, Corporation A retains ownership interests and sells regular interests to Bank

- Bank owns debt instruments and sells $ x in debt instruments to Corporation A.
- Corporation A transfers debt instruments to FASIT.
- Corporation A retains ownership interest and sells regular interests back to Bank.

Scenario 3: Bank owns debt instruments and sells debt instruments to Corporation A which retains all FASIT interests

- Bank owns debt instruments and sells $ x in debt instruments to Corporation A.
- Corporation A transfers debt instruments to FASIT.
- Corporation A retains both the ownership interest and the regular interests.

Scenario 4: Corporation A owns the debt instruments retains the ownership interests and sells FASIT regular interests to Bank

- Corporation A owns $ x in debt instruments that are not traded on an established securities market.
- Corporation A transfers debt instruments to FASIT.
- Corporation A retains ownership interest and sells regular interests (sale to Bank or public).

III. TAX ANALYSIS

A. Scenario 1: Corporation A owns debt instruments and retains all FASIT interests

1. Creation of entity that qualifies as a FASIT

Any entity such as a corporation, partnership, trust or segregated asset pool may qualify as a FASIT.

In order for an entity to be treated as a FASIT, it must make an election to be classified as a FASIT.[2]

The FASIT can be composed of only two types of interests: regular interests and the ownership interest.[3]

There may only be one ownership interest and it must be held directly by an "eligible corporation".[4]

As of the close of the third month after the day of its formation and at all times thereafter, substantially all of the assets of the FASIT must consist of "permitted assets".[5]

The entity cannot be a regulated investment company (hereinafter: RIC).[6]

As a result of classifying the entity as a FASIT, a FASIT will not be treated as a trust, partnership, corporation or taxable mortgage pool for federal income tax purposes and therefore, will not be subject to tax.[7]

2. Transfer of debt instruments to FASIT

In general, when an asset is transferred to a FASIT by the holder of the ownership interest, the holder will be required to recognize gain but not loss equal to the difference between the value of the asset as determined under the FASIT rules and its adjusted basis to the holder prior to contribution.[8] The value of the property transferred to a FASIT will be its fair market value.[9] Where a debt instru-

2. IRC § 860L(a)(1)(A). The manner of making the election will be provided in Treasury Regulations.
3. IRC § 860L(a)(1)(B).
4. IRC § 860L(a)(2).
5. IRC § 860L(a)(1)(D).
6. IRC § 860L(a)(1)(E).
7. IRC § 860H(a). Note that the FASIT will be subject to an entity level tax to the extent of any net income derived from prohibited transactions for the taxable year. IRC § 860L(e).
8. IRC § 860I(a)(1).
9. IRC § 860

ment that is not traded on an established securities market is transferred to a FASIT by the holder of the ownership interest a special valuation rule exists. In such an instance, the value of the property transferred to the FASIT will equal the sum of the present values of the reasonably expected payments under such instrument (determined in a manner to be provided by Treasury Regulations) using a discount rate equal to 120 per cent of the applicable Federal rate.[10] The legislative history to the FASIT provisions indicates that expected losses, prepayments, and reasonable costs of servicing are to be taken into account for these purposes.[11] The legislative history further indicates that the value of property calculated under the special FASIT rule may be different than the value of such assets under a willing buyer/seller standard.[12]

If property held by the holder of the ownership interest in a FASIT (or held by a related party) supports any regular interest in such FASIT, gain will be recognized to such holder in the same manner as if the holder had sold such property at its value at the time that such property was deemed to support such interest.[13]

3. Taxation of holder of ownership interest (the Owner)

a. *Upon transfer of assets to the FASIT*

The value of property transferred to the FASIT by the Owner equals the sum of the present values of the reasonably expected payments under such instrument using a discount rate equal to 120 per cent of the applicable Federal rate.

In Scenario 1, since Corporation A will hold the ownership interest in the FASIT, when it transfers the debt instruments to the FASIT, it will be required to recognize gain, calculated by determining the value of such assets under the FASIT rules. Since the debt instruments are capital assets, Corporation A will have a capital gain as a result of the transfer of these assets to the FASIT. The FASIT valuation rule results in the generation of capital gain for the owner upon contribution even if the owner has basis in the debt instruments identical to their market value.

b. *On a going forward basis*

In general, the holder of the ownership interest of a FASIT is required to treat all assets, liabilities and items of income, gain, deduction, loss and credit of the FASIT as if it were generated directly by the holder.[14] In calculating the net income of the FASIT, the Owner must report income with respect to each debt instrument in the FASIT according to the constant yield method, for purposes of determining all interest, acquisition discount, original issue discount (hereinafter: OID), and market discount and all premium deductions or adjustments.[15] Interest income that is accrued by the FASIT, which is exempt from tax, shall be taken into account by the Owner as ordinary income.[16] Income, gain, or deductions allocable to a prohibited transaction are not taken into account by the Owner; rather, the items are taxed at the FASIT entity level, and paid by the Owner.[17]

4. IRC Section 860J(a)

Section 860J(a) provides that the taxable income of an Owner or the holder of a high yield interest, cannot be less than the sum of such holder's taxable income determined solely with respect to such interests (including gains and losses from sales and exchanges of such interests), and the excess inclusion (if any) under IRC § 860E(a)(1) for such taxable year. The effect of this provision is to prohibit the holder of an ownership interest from using income from the FASIT to offset any deductions or net operating losses not attributable to the FASIT.[18]

The issue has been raised as to whether gains that are recognized by an owner upon a sale or contribution of assets to a FASIT, can be offset with the owner's capital losses. The New York State Bar Association Tax Section's report on suggested FASIT regulations, suggests that the gains that are recognized on an asset transferred in exchange for the receipt of such interest (or to increase the value of an existing interest), is not an amount that is recognized "with respect to" the ownership or high yield interest, and thus, the loss limitation rule should not apply.[19] They suggest that the Treasury issue regulations that clarify that gains recognized by an owner or holder of a high yield interest on a transfer of assets to a FASIT can be offset by the transferor's capital losses.

5. Result[20]

In Scenario 1, if the debt instruments are capital assets in the hands of Corporation A, then the transfer of the debt instruments to the FASIT should generate capital gain income to the extent that the value, as determined under the FASIT rules for non-traded debt instruments, exceeds Corporation A's basis in such assets.

Therefore, utilizing its own debt instruments, Corporation A should be able to generate capital gain to offset its expiring capital losses. Corporation A would also preserve tax benefit for the future by creating a high basis in its FASIT interests that would offset future FASIT income.

B. Scenario 2: Corporation A acquires debt instruments from Bank, retains ownership interest and sells regular interests

Lacking its own debt instruments, Corporation A must acquire such debt instruments from a financial institution. A will retain the ownership interest and will sell the regular interests back to Bank.

10. IRC § 860I(d)(1)(A).
11. 1996 Blue Book *get cite.*
12. 1996 Blue Book *get proper cite.*
13. IRC § 860L(b).
14. IRC § 860H(b).
15. IRC § 860H(b)(2).
16. IRC § 860H(b)(4).
17. IRC §§ 860H(b)(3); 860L(e).
18. IRC § 860J. This rule also applies to holders of high-yield regular interests.
19. New York State Bar Association Tax Section Report on Suggested FASIT Regulations, 7 February 1997.
20. Results in each of the following scenarios are based on the premise that the current law permits FASIT owners to offset gain on contribution of assets to a FASIT with unrelated capital losses (See III.).

1. Purchase of debt instruments

Corporation A purchases "permitted debt instruments" from Bank in order to participate in the instant transaction. Bank recognizes income on the difference between its tax basis in the financial assets and the purchase price.[21] No further tax consequences result to the seller (Bank) on the receipt of payments on the financial assets. Corporation A owns the debt instruments and then contributes the debt instruments to a newly created FASIT.

2. Mechanics of FASIT ownership

a. *Classes of interests*

Interests issued by a FASIT must be either regular interests or the ownership interest.[22] The ownership interest and regular interests are the interests designated as such and issued after the first day of the FASIT's taxable year.[23]

Regular interest

There are two categories of regular interests; in order to qualify under the first category, all of the following requirements must be met:
(1) the instrument must entitle the holder to a specific principal amount (or similar amount), which may be paid contingent on the timing (but not the amount) of prepayments on debt instruments and income from permitted assets held by the FASIT;[24]
(2) interest payments, if any, are determined based on a fixed rate, or, except to the extent provided otherwise by the Secretary, at variable rates permitted for REMIC interests;[25]
(3) unless permitted by Treasury Regulations, the instrument may not have a stated maturity, including renewal options, greater than 30 years;[26]
(4) it must have an issue price not exceeding 125 per cent of its stated principal amount;[27]
(5) its yield to maturity must be less than 5 percentage points above the applicable federal rate based on the projected maturity for the regular interest.[28]

If an instrument violates one or more of requirements (1), (4) or (5), it may qualify for the second category of regular interest, the high yield interest.[29] The major consequence to characterization as a high yield regular interest is that such interests are subject to numerous restrictions upon transfer.[30]

Ownership interest

The ownership interest is defined as the interest issued by a FASIT after the start-up day which is designated as an ownership interest and which is not a regular interest.[31] A FASIT may have only one class of ownership interest that must be held directly by an eligible corporation.[32] The holder of the ownership interest is required to treat all assets, liabilities and items of income, gain, deduction, loss and credit of the FASIT as its own.[33] Regular interests are treated as debt for income tax purposes, resulting in an interest deduction to the holder of the ownership interest.[34]

Regular instruments are treated as debt instruments for all income tax purposes. Therefore, Bank will essentially be in a similar if not identical economic position as it was prior to the sale of its debt instruments to Corporation A.

3. Result

Under Scenario 2, after purchasing the debt instruments from Bank, Corporation A would contribute the instruments to a FASIT. Corporation A would then sell the regular interests to Bank while retaining the ownership interest.

When Corporation A acquires debt instruments from Bank, Bank recognizes income on the difference between its tax basis in the financial assets and the purchase price.[35] No further tax consequences result to the seller on the receipt of payments on the financial assets. Upon contribution of the debt instruments by Corporation A to the FASIT, applying the special valuation rules of Section 860I(d)(1), Corporation A will recognize capital gain equal to the sum of the present values of the reasonably expected payments under such instrument(s) using a discount rate equal to 120 per cent of the applicable federal rate. The subsequent sale of regular interests to Bank, presumably for an amount equivalent to the amount paid by Corporation A to Bank for the initial acquisition of the debt instruments allows: (i) Bank to return to the same economic position it occupied prior to the initial sale of its debt instruments and (ii) Corporation A to utilize the tax benefits generated by the FASIT contribution without any change in its economic structure.

Illustration

$ 100x debt instruments sold to Corporation A for $ 100x (+ premium).

Bank recognizes gain/loss on the difference between its basis in the instruments and the amount received from Corporation A.

Corporation A contributes the assets to FASIT

Section 860I(d) valuation rule results in gain to A equal to 120% ($ 100x) of the present value of reasonably expected payments.

Corporation A gets basis in its FASIT interest equal to 120% ($ 100x) of the present value of reasonably expected payments.

A sells FASIT regular interest to Bank for $ 100x .

No gain results to Corporation A:
- Corporation A maintains a $ 20x tax basis in its FASIT interest ;
- as holder of the ownership interest, Corporation A is required to treat all assets, liabilities and items of income, gain, deduction, loss and credit of the FASIT as its own.

21. IRC § 1001(a).
22. IRC § 860L(a)(1)(B).
23. IRC § 860L(b)(1) and § 860L(b)(2).
24. IRC § 860L(b)(1)(A)(i).
25. IRC § 860L(b)(1)(A)(ii).
26. IRC § 860L(b)(1)(A)(iii).
27. IRC § 860L(b)(1)(A)(iv).
28. IRC § 860L(b)(1)(A)(v).
29. IRC § 860L(b)(1)(B)(ii).
30. IRC § 860K.
31. IRC § 860L(b)(2).
32. IRC § 860L(a)(2).
33. IRC § 860H(b)(1).
34. IRC § 860H(c)(1).
35. IRC § 1001(a).

C. Scenario 3: Corporation A Acquires debt instruments from Bank, Corporation A retains all FASIT interests

1. Purchase of debt instruments

Corporation A purchases "permitted debt instruments" from Bank in order to participate in the instant transaction. Bank recognizes income on the difference between its tax basis in the financial assets and the purchase price.[36] No further tax consequences result to the seller (Bank) on the receipt of payments on the financial assets. Corporation A owns debt instruments with cost basis[37] and contributes the debt instruments to a newly created FASIT.

2. Contribution of debt instruments

Upon contribution, Corporation A will be subject to the special valuation rule for instruments that are not traded on an established securities market. Therefore, the value of the property transferred to the FASIT will equal the sum of the present values of the reasonably expected payments under such instrument (determined in a manner to be provided by Treasury Regulations) using a discount rate equal to 120 per cent of the applicable Federal rate. As the holder of the ownership interest, Corporation A is required to treat all assets, liabilities and items of income, gain, deduction, loss and credit of the FASIT as its own.[38] (Consequences of contribution are discussed more full in Scenario 1)

a. *Tax consequences*

Upon contribution Corporation A will recognize gain equal to the sum of the present values of the reasonably expected payments under the instrument(s) using a discount rate of 120 per cent of the AFR. Corporation A's FASIT contribution results in an increase in basis that reflects the additional gain incurred by Corporation A due to the application of the special valuation rule. As a result, Corporation A has capital gain that may be offset against its expiring capital losses and creates a high basis in its FASIT interest that could reduce future FASIT income.

Illustration

Corporation A purchase $ 100x debt instruments for $ 100x from Bank. Bank recognizes gain/loss on the difference between its basis and the amount received from Corporation A.

Corporation A contributes the assets to FASIT.

860I(d) valuation rule results in gain to Corporation A equal to 120% ($ 100x) of the present value of reasonably expected payments.

Corporation A gets basis in its FASIT interest equal to 120% ($ 100x) of the present value of reasonably expected payments under the contributed instruments.

D. Scenario 4: Corporation A owns the necessary debt instruments, retains the ownership interest and sells FASIT regular interests to Bank or public

1. Contribution to FASIT

Corporation A possesses the necessary debt instruments and may contribute such assets directly to the FASIT. As the owner of the FASIT, Corporation A will be subject to the special valuation rule upon contribution of assets that are not traded on an established securities market. Therefore, the value of the property transferred to the FASIT will equal the sum of the present values of the reasonably expected payments under such instrument (determined in a manner to be provided by Treasury Regulations) using a discount rate equal to 120 per cent of the applicable Federal rate.[39] (Consequences of contribution are discussed more full in Scenario 1.)

2. Sale of regular interest(s)

As the holder of the ownership interest, Corporation A may sell regular FASIT interests to a bank, the public or some combination of the two. The sale price of the regular interests would approximate the value of the underlying debt instruments, which should be calculated absent the special valuation rule of §860I(d)(1). Upon sale, Corporation A will recognize gain/loss on the difference between its tax basis in the financial assets and the sale price.

3. Result

If the underlying value of $ x in debt instruments assets is $ 100x prior to contribution by Corporation A, Corporation A will recognize gain equal to $ 120x upon contribution to the FASIT. When Corporation A subsequently sells the regular interests to a third party, they will presumably receive only the value of the underlying assets ($100x). Since Corporation A has a basis of $120 x, $ 20x of capital loss will be generated on sale of the regular interests. Corporation A thereby refreshes its capital losses and may avail itself of a new 5-year carryover period.[40]

IV. PROPOSED REGULATIONS AND THE USE OF CONTRIBUTION GAINS TO OFFSET NON-FASIT LOSSES

As discussed earlier, the issue has been raised as to whether gains that are recognized by an owner upon a sale or contribution of assets to a FASIT can be offset with the owner's unrelated capital losses. The New York State Bar Association Tax Section's report on suggested FASIT regulations, suggested that the gains that are recognized on an asset transferred in exchange for the receipt of such interest (or to increase the value of an existing interest), is not an amount that is recognized "with respect to" the ownership or high yield interest, and thus, the loss limitation rule

36. IRC § 1001(a).
37. IRC § 1012.
38. IRC § 860H(b)(1).
39. IRC § 860I(d)(1)(A).
40. IRC § 1212(a).

should not apply.[41] The NYSBA has suggested that Treasury issue regulations that clarify that gains recognized by an owner or holder of a high yield interest on a transfer of assets to a FASIT can be offset by the transferor's capital losses.

On 4 February 2000 the Treasury issued proposed regulations on FASITs. Like the related Code Sections, the proposed regulations do not specifically address the use of contribution gains to offset non-FASIT losses. In addition, the proposed regulations include1 an expanded definition of "traded on an established securities market" and a broad anti-abuse rule. Each of these elements and their relation to the proposed transactions is examined in greater detail below.

A. Use of contribution gains to offset non-FASIT losses not addressed

1. Section 860J

The Senate version of Section 860J provided, in pertinent part, that the taxable income of the holder of the ownership interest or any high yield interest in a FASIT for any taxable year shall in no event be less than the sum of (i) such holder's taxable income determined solely with respect to such interests and (ii) the excess inclusion (if any) under Section 860E(a)(1) for such taxable year.

The conference agreement goes on to elaborate that "the taxable income of the holder of the ownership interest or a high-yield interest that may not be offset by non-FASIT losses, *includes gain or loss from the sale of the ownership interest or high yield interest*". As a result, Section 860J reads as follows: the taxable income of the holder of the ownership interest or any high yield interest in a FASIT for any taxable year shall not in no event be less than the sum of (i) such holder's taxable income determined solely with respect to such interests (including gains and losses from sales and exchanges of such interests) and (ii) the excess inclusion if any under Section 860E(a)(1) for such taxable year.

It is critical to note that no mention is made of gain recognized upon contribution of assets to a FASIT. The drafters of the FASIT legislation had the opportunity to clarify the ambiguous language of this provision. Upon further consideration they decided to include the elaboration that gains and losses from sales and exchanges were to be included in the offset prohibitions. At this time any further clarification of the statutory language to include other prohibited income would have been appropriate. As such, it would appear that the offset restrictions apply only to FASIT income (including gains and losses from sales and exchanges of such interests). Had Congress intended to prevent gain recognized upon contribution to a FASIT from being available to offset non-FASIT losses it would have specifically included additional parenthetical language dealing with gain upon contribution to its added clarification.

The issuance of Proposed Regulations was another opportunity to specifically exclude contribution gain from being available to offset non-FASIT losses. The Service has not deemed it necessary to include such a prohibition in its extensive proposed regulations. While the Service has not specifically provided that gains recognized by an owner or holder of a high yield interest on a transfer of assets to a FASIT can be offset by the transferors unrelated losses, they have also not stated that such gain is unavailable to offset non-FASIT losses. It therefore appears that according to Congress and the Service's subsequent interpretation of Congressional intent, the use of contribution gain to offset non-FASIT losses is not in itself impermissible.

B. Broad definition of "traded on an established securities market"

The explanation of the proposed regulations states that the intent behind the special 120 per cent valuation rule of Section 860I(d)(1) for debt instruments not traded on an established securities market is uncertain. According to the explanation, the legislative history indicates that the rule was meant to be a simple and mechanical formula that, by its nature would not produce accurate results in every case.[42] The explanation continues: "At the same time, by applying a fair market value standard to all other assets (including market traded debt), Congress showed a clear preference for using actual fair market value whenever it can be determined with reasonable accuracy".[43]

Many commentators were concerned that the special valuation rule would in many cases generate tax gains far in excess of economic gain. Seeing this overvaluation as an impediment to the use of FASITs, the Service was urged to narrow the application of the special valuation rules as much as possible. Therefore, the intent of the proposed regulations was to take a broad view of what constitutes an established securities market thereby limiting transfers subject to special valuation.

The proposed regulations provide that "For purposes if 860I(d)(1)(A), a debt instrument is traded on an established securities market if it is traded on a market described in section the Original Issue Discount (OID) regulations, Section 1.1273-2(f)(2), (3) or (4)".[44] Under the cross-reference to the OID regulations, debt is considered traded on an established securities market if (i) it is listed on certain specified securities exchanges or certain interdealer quotation systems, (ii) it is traded on a board of trade or interbank market or (iii) it appears on a quotation medium that provides a reasonable basis to determine the fair market value by disseminating either recent price quotations or actual prices of recent sales transactions.

1. Special rules

Other special rules have also been included to broaden the types of instruments that will be treated as being traded on an established securities market.

41. New York State Bar Association Tax Section Report on Suggested FASIT Regulations, 7 February 1997.
42. Explanation of Provisions, Gain recognition on property transferred to a FASIT, 3)a)[79].
43. Id.
44. Prop. Reg. §1.860I-2(b).

Beneficial ownership interests

A certificate representing beneficial ownership of a debt instrument is deemed to represent beneficial ownership of a debt instrument traded on an established securities market if the certificate is traded on an established securities market; or the certificate represents ownership in a pool of assets composed solely of debt instruments all of which are traded on an established securities market.

Stripped interests

A stripped bond or stripped coupon not otherwise traded on an established securities market is considered being traded on an established securities market, if the underlying bond is traded on an established securities market and the stripped bond or coupon is valued using a commercially reasonable method based on the market value of the underlying bond.

Contemporaneous purchase and transfer of debt instruments, "spot purchase rule"

The value of a debt instrument not traded on an established securities market is its cost to the owner (or a related person) if:

- the debt instrument is purchased from an unrelated person in an arm's length transaction in which no other property is transferred or services provided;
- the debt instrument is acquired solely for cash;
- the price of the debt instrument is fixed no more than 15 days before the date of purchase; and
- the debt instrument is transferred to the FASIT no more than 15 days after the date of purchase.

As discussed, the cross reference to the OID rules as well as the special rules were intended to allow a taxpayer to avoid recognizing tax gain in the absence of economic gain that may result from a broad application of the special valuation rule. Despite the broadening of the definition of "traded on an established securities market" there are debt instruments that will not meet any of the above criteria that will be subject to the special valuation rule. In order for any of the scenarios contemplated above to be viable, the debt instruments utilized must avoid characterization as "traded on an established on a securities market". While the proposed regulations have narrowed the pool of debt instruments subject to the 120 per cent special valuation rule provided for in Section 860I(d)(1), there remain instruments that would not qualify as "traded on an established securities market" under the proposed regulations that could be utilized in the contemplated scenarios.

C. Anti-abuse legislation

The proposed regulations include a broad anti-abuse rule modeled after the anti-abuse rule in the partnership regulations. Proposed Section 1.860L(a) provides that the FASIT provisions are intended to promote the spreading of credit risk on debt instruments by facilitating the securitization of those debt instruments. "Implicit in the intent of the FASIT provisions are the following requirements:"[45]

- assets to be securitized through a FASIT consist primarily of permitted debt instruments;
- the source of principal and interest payments on a FASIT's regular interest is primarily the principal and interest payments on permitted debt instruments held by the FASIT (as opposed to receipts on other assets or deposits of cash); and
- no FASIT provision may be used to achieve a federal tax result that cannot be achieved without the provision unless the provision clearly contemplates that result.

The regulations go on to say that if a principal purpose of forming or using a FASIT is to achieve results inconsistent with the intent of the FASIT provisions and regulations, the Commissioner may make any appropriate adjustments with regard to the FASIT or any arrangement or transaction involving the FASIT. Such adjustments include, among others, disregarding the FASIT election, reallocating items of income, deduction, loss and credits, recharacterizing regular interests and redesignating the holder of the ownership interest.

Commentators on the FASIT provisions had urged the drafters to direct any anti-abuse at the avoidance of tax on income allocated to the ownership interest, but avoid a more general anti-abuse rule based on "carrying out Congressional intent". The provisions above are clearly much broader and result in the casting of a wide net that could potentially result in the retroactive recharacterization of transactions that seem to be allowed if not sanctioned by the FASIT provisions and regulations. Such a broad anti-abuse rule with no safe harbour provisions results in a situation where there is no clear guidance and taxpayers are left to contemplate the Service's interpretation of Congressional intent. While it is likely that many of the comments received in response to the Service's request for comments on the proposed legislation will oppose the inclusion of this broad anti-abuse rule, the remainder of this document presumes that the anti-abuse language in the proposed regulations will be retained without alteration in the final regulations.

In order to avoid (or minimize) the chances of running afoul of the anti-abuse rules the legislative history of the FASIT provisions and the language of the anti-abuse rule can be used as practical guidance.

1. Legislative history

The Small Business Job Protection Act of 1996 created the FASIT to facilitate the securitization of debt obligations such as credit card receivables, home equity loans and auto loans. The intent of the FASIT legislation was to achieve more diversity and liquidity in the Nation's financial markets. According to the Joint Committee's explanation of the legislation: Congress believed that there are substantial benefits to the economy from increased securitization of assets in debt form because securitization of such assets will spread the risk of credit on the debt to others. According to the Congress, spreading this risk would lessen the concentration of such risks in banks and other financial intermediaries which in turn would lessen the pressure on Federal deposit insurance. Further, the spread-

45. Prop. Reg. 1.860L-2(a)(1)-(3).

ing of credit risk through securitization would result in lower interest rates for consumers.[46]

The FASIT provisions facilitate these ends by ensuring (i) the avoidance of entity level tax on the treatment of FASIT regular interests and (ii) the treatment of regular interests as debt for tax purposes. The certainty provided is intended to eliminate economic inefficiencies that may have been caused by the uncertain tax treatment of such arrangements in the past. In return for this certainty taxpayers must recognize taxable gain on the contribution of assets to a FASIT and face certain anti-abuse rules such as the 100 per cent tax on the holder of an ownership interest on the net income derived form prohibited transactions.

As guided by the legislative history, in order to be respected, transactions must facilitate the securitization of debt obligations. Presumably, the greater securitization and spreading of credit risk achieved, the more likely it is that a transaction will be respected.

2. Language of the proposed regulations

The proposed regulations provide that the FASIT provisions are intended to "promote the spreading of risk on debt instruments by facilitating the securitization of those debt instruments".[47] The principal purpose of forming a FASIT must also not be inconsistent with the intent of the FASIT provisions and regulations.[48] As a result, generation of capital gains to offset expiring capital losses should be reflected as an incidental benefit resulting from a business decision to participate in a FASIT. Therefore, as long as a transaction furthers the securitization of debt instruments and make their ownership less concentrated in some manner, a FASIT transaction should further the intent of the FASIT provisions and regulations.

The language of Prop. Reg. Section 1.860L-2(a)(3) poses a more challenging requirement: "No FASIT provision may be used to achieve a Federal Tax result that cannot be achieved without the provision unless the provision clearly contemplates that result". Therefore, if it is found that a FASIT transaction has been designed to achieve a result not contemplated in the provision (e.g. to offset expiring non-FASIT losses) the intended tax results may be reversed by the Commissioner. (The authors are not sure if this statement is as problematic as it initially seems since it could be argued that the generation of capital gain is not in itself a tax result that cannot be achieved without the FASIT provision.)

V. ANALYSIS OF THE SCENARIOS

Based on the legislative history and the language of the proposed regulations, the following is brief analysis of the success of the above scenarios.

Scenario 1

Corporation A owns debt instruments, contributes them to a FASIT and subsequently holds both the regular and ownership interests. This transaction would clearly be questionable under the anti-abuse provisions. No spreading of risk or increased securitization accompanies the tax benefit derived since the ownership of the assets to be securitized is identical before and after the creation of the FASIT.

Scenario 2

Corporation A purchases debt instruments and contributes them to a FASIT. Corporation A retains the ownership interest and sells the regular interests to Citibcorp. This transaction is also problematic. Essentially, Corporation A has achieved a tax benefit while leaving the economic risk associated with the securitized assets in the hands of Bank – the original owner. The FASIT provisions goals of securitization and distribution of risk are not furthered in this transaction.

Scenario 3

Corporation A purchases debt instruments from Bank, creates a FASIT and retains both the ownership interest and the regular interests. The ownership has been shifted from Bank to Corporation A with resulting in Corporation A being the sole owner of the debt instruments. This ownership shift of credit risk from a large holder of debt instruments to a Corporation A, a company which presumably has had little or no such interests in the past, is arguably more in line with the stated intent of the FASIT provisions. The argument can further be strengthened if Corporation A proceeds to sell some of the regular interests to the public.

Scenario 4

Corporation A owns debt instruments and contributes them to a FASIT. A then retains the ownership interest and sells the regular interests to Bank or the public. In the case of a sale of regular interests to the public, this transaction clearly achieves the stated intent behind the FASIT legislation. The more substantial the public participation, the more effective the distribution of risk and the likely it is that the transaction will be respected.

Of the 4 Scenarios presented above it appears that Scenarios 3 and 4 are the most likely to be respected by the Service and achieve the desired tax results since they involve a real shift of economic risk in the securitized assets. The following recommendations should also be considered when designing such a transaction in order to maximize the chance of being respected by the Service.

- Maximize the level of public involvement. The percentage of regular interests sold to the public should be more than de minimus. There should be a substantial change in ownership and economic risk after the creation of the FASIT.
- Corporation A's contribution of debt instruments of assets to a FASIT should include a mix of assets not "traded on an established securities market" as well as those whose fair market value is easily ascertainable by reference to such market.

46. JCT's General Explanation of Tax Legislation Enacted in the 104th Congress: Section 5: Revenue Offsets.
47. Prop. Reg. Sec. 1.860L-2(a).
48. Prop. Reg. Sec. 1.860L-2(b).

- Gain recognized on contribution of assets to the FASIT should exceed the amount necessary to offset the expiring losses.
- The corporate business plan should discuss at length non-tax reasons for utilizing a FASIT, (e.g. reduce corporate exposure in case of default, reduce percentage of risk in investment portfolio, increase cash flow, etc.).

VI. CONCLUSION

Due to the proposed regulation's inclusion of a broad anti-abuse rule, there can be no certainty that the transactions described in Scenarios 3 and 4 will be respected. If the final regulations include the same language as the proposed regulations, the intended tax results in the contemplated scenarios are not guaranteed and could in fact be reversed retroactively. However, Scenarios 3 and 4, if designed and carefully implemented, have the potential for succeeding. Therefore an analysis of the tax consequences of having a particular scenario found abusive should be weighed against the benefits resulting from a respected transaction. In cases where a client has significant expiring losses the potential tax benefit may be well worth the risk.