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Internal Revenue Service
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Washington, DC 20044

VIA FEDERAL EXPRESS

Internal Revenue Service
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Washington, D.C. 20224-0002

Re: Proposed FASIT Regulations

Ladies and Gentlemen:

The Bond Market Association ("Association") 1 is pleased to submit comments on the proposed FASIT regulations issued on February 4, 2000 2. For the reasons outlined below, our comments focus on aspects of the regulations that are likely to affect the use of FASITs to securitize commercial mortgage loans.

REMICs have often been used to securitize residential and commercial mortgage loans. The greater flexibility of FASITs (specifically, their ability to make new advances to borrowers, to hedge, to substitute loans and to issue new securities over time) could give FASITs a significant advantage over REMICs, particularly in the commercial mortgage securitization area. To date, however, the potential has not been realized. The two principal reasons are: (1) the rule requiring gain to be recognized upon the transfer of property to a FASIT based on a value calculated under a formula, and (2) uncertainties that exist in applying the FASIT rules.

The formula for computing gain uses a discount rate of 120% of the AFR. This rate is quite low for commercial mortgages, resulting in an artificial gain. The proposed regulations would mitigate the artificial gain problem by allowing recently purchased loans to be transferred to a FASIT without a gain. This rule is helpful, but in our view does not go far enough. We believe that the artificial gain rule should not apply to a commercial mortgage loan if price quotations therefor are readily available within a reasonable time frame from dealers, brokers or traders. We have other suggestions for limiting the artificial gain rule. Our remaining comments on the proposed regulations concern the definition of "origination," the stripping of contingent payments from loans, hedges and foreign FASITs. We have also attached in an appendix some more technical comments. The Association also requests guidance on several issues that are not addressed in the proposed regulations but are important in securitizations of commercial mortgage loans, namely the treatment of prepayment penalties, the treatment as "interests" in a FASIT of rights or obligations to buy loans from a FASIT, the ability of a FASIT to treat assets as permitted assets unless and until it discovers that they are not permitted assets and the stripping of FASIT regular interests outside of a FASIT to create interest-only securities that are not high-yield interests. The balance of this letter consists of a brief description of the commercial loan market, comments on the proposed regulations, comments on other topics that should be addressed in regulations, and some contact information.

I. Description of Commercial Mortgage Loan Market

Commercial mortgage loans are made to finance or refinance commercial real estate, such as office buildings, apartment buildings, retail establishments and hotels. Loans are originated by mortgage companies, banks, securities firms and investors, such as pension plans or insurance companies. Loans may be originated to be held as investments or, as is becoming increasingly common, for resale in the whole loan market or through a securitization. Commercial loan conduit programs exist that originate loans with standardized documentation specifically for financing through a securitization. These programs focus mostly on fixed rate loans of medium or small size (e.g., $30 million or less). Outside of this context, loan documentation is not widely standardized.

Borrowers can obtain price quotations for new originations from many sources, and there is active comparison shopping. Traditionally, information about the pricing of mortgage loans was obtained through brokers and other intermediaries and from loan originators. The dissemination of pricing information has expanded quite recently as a result of the Internet, and the emergence and increasingly widespread use of other electronic communications media and trading systems 3. While there are varying views at this early stage about the significance of these advancements, there is clearly a trend toward the greater dissemination of pricing information, which is likely to narrow the range of quotations obtainable for any given commercial mortgage loan.

A borrower obtaining a loan often negotiates a rate that is fixed sometime prior to the closing date. For example, it would be fairly common for that period to be about 30 days. Longer-term rate locks are also available.

In addition to the loan origination market, there are many market participants who stand ready to bid on existing commercial mortgage loans. For example, most major securities dealers have real estate groups that both originate commercial loans and trade them in the secondary market. The time required to obtain a bid will vary depending on the size of the loan and whether its terms are standardized. For a non-standardized loan, a buyer would need more time to review a term sheet describing loan terms and property information before making a bid. It would be typical for a loan seller to seek a number of competing bids.

II. Comments on Proposed Regulations

A. Gain on Transfer of Property to a FASIT

General. When property is transferred to a FASIT, gain must be recognized by the Owner. In the case of debt instruments, the gain is calculated (1) based on fair market value, for debt instruments traded on an "established securities market", and (2) otherwise under a formula that assumes a discount rate of 120% of the AFR (or other rate provided in regulations). As noted above, a 120%-of-AFR discount rate is significantly below market for commercial mortgage loans, with the result that its use inflates values (and hence gain).

In the commercial mortgage loan area, the basic FASIT gain recognition requirement (i.e., the requirement to recognize 100% of the economic gain upfront) is unlikely to prevent use of the vehicle. In most REMIC securitizations, the sponsor sells all or substantially all of the REMIC interests and accordingly recognizes all or substantially all of any gain or loss. By contrast, the artificial valuation rule has been, for many prospective FASIT users, a "show stopper." We have set forth below a number of recommendations that are intended to narrow its reach.

Readily Quotable Test. In our earlier comments on the FASIT rules, the Association suggested that a debt instrument be considered to be traded on an established securities market if price quotations therefor are readily available from dealers, brokers or traders. The proposed regulations do not adopt this suggestion. The preamble states that the omission was not thought to be significant in light of the rule for recently purchased loans. The IRS requested comments on whether the readily quotable standard is still necessary. We believe that it is. Many potential users of FASITs hold commercial loans in portfolio for some time and would not benefit from a recent purchase rule. Further, unless the recent purchase rule is expanded considerably, it would not cover many loans that are originated specifically with a view to securitization (see comment below).

If the readily quotable standard is adopted, we suggest that it be made clear that the test will be met if there are dealers, brokers or traders who stand ready to provide quotations even if the process of obtaining a quotation may take some time (e.g., from a few days to a week). With the exception of mortgages originated for conduit programs, documentation and terms are not standardized, and a dealer, broker or trader may need to review loan terms and property information. The key factor for determining if the readily quotable standard applies to a loan ought to be whether there is an active group of competing bidders who buy similar loans in the ordinary course of business and who stand ready to give quotations in a reasonable period of time for the loans involved.

The holder of a commercial loan may be required to make follow-on financing to a borrower in some circumstances. Presumably, the "property" transferred to a FASIT would not reflect the additional commitment. We recommend that the readily quotable standard be applied to outstanding loans without regard to ancillary financing commitments of the lender.

If the IRS is concerned that the readily quotable rule could be stretched to cover consumer receivables that carry with them an element of goodwill, the straightforward way to address that problem is to provide that it does not apply to debt instruments that derive any significant value from the fact that they are held as part of an ongoing business having an element of goodwill.

Recently Purchased Loans. We appreciate the rule in Proposed Regulation § 1.860I-2(d) that allows certain recently purchased loans to be valued at cost. We believe, however, that the proposed time frame (15 days between pricing and purchase and 15 days between purchase and transfer to the FASIT) is too short. For example, it is very common to price a loan (or give a borrower a rate commitment) a month before it is closed and forward rate commitments often extend beyond this time frame. The rule would require the loan to be priced within 15 days of closing. Second, many loan originators come to market only periodically. The frequency will depend on the originator's financing needs and funding strategy, loan volume and market conditions. An originator that came to market quarterly (which would be a fairly active program) would fall outside of the rule. We recognize that one reason why the time periods in the rule are so short is that the rule allows a loan to be valued at cost, whereas the actual market value of the loan may fluctuate. We suggest that there be a second rule that would apply to loans recently purchased during a longer time frame (e.g., six months) that would require that a loan be valued at fair market value. The recent purchase would provide a benchmark for valuing the loan when it is transferred to the FASIT, with necessary adjustments reflecting changes in market conditions over the period (specifically, in the case of a fixed rate loan, changes in market interest rates).

We have some more technical comments on the recent purchase rule. It requires that a debt instrument be purchased from an unrelated person in an arm's length transaction in which no other property is transferred or services provided. Read literally, the rule would not apply to a purchase of a portfolio of loans. It is very common to buy groups of loans and, at least in the commercial loan world, individual loans are sufficiently large so that they are separately valued when acquired as part of a pool. We see no reason not to apply the rule to purchases of pools of loans where the purchase price is allocated based on separate valuations or based on a consistent methodology. In addition, a loan originator routinely provides services to a borrower in connection with the closing of a loan. We recommend that the reference to services be changed to exclude services customarily provided in connection with the closing of a loan. Finally, a loan originator that is a securities dealer may provide a hedge contract to a borrower (e.g., a rate cap agreement) in connection with the closing of a loan and an insurance company or an affiliate could provide insurance or other financial services. We do not believe that transferring other property or providing services should prevent the rule from applying if the property or services are regularly provided to customers in arm's length transactions that are not in connection with the purchase of a debt instrument by the service provider and they are priced according to an arm's length standard.

Exception for Active Loan Originators. The rule for recently purchased loans applies, we understand, to any type of purchase of a loan (new originations or secondary market trades) 4. A loan originator is required to closely monitor market interest rates and effectively sets a value on a loan when it commits to make the loan to a third party. Active originators all use a pricing model to determine the terms on which they are willing to lend. The model allows loans to be valued not only when they are originated but also over time as market interest rates change. We recommend that a commercial mortgage loan be considered to be traded on an established securities market if it was originated by an active loan originator (i.e., an entity that originates commercial mortgage loans in the ordinary course of its business), that originator is actively engaged in originating loans of a similar type at the time when the first loan is contributed to the FASIT, and the method of valuing the loan at that time is consistent with the pricing by the originator of newly originated loans.

Dealer Exception. Proposed Regulation § 1.860H-6(d) has a special rule for assets that are subject to the mark-to-market rules for securities dealers in section 475. It provides that an asset subject to that section must be marked-to-market (i.e., deemed sold at its "fair market value") immediately prior to a transfer to a FASIT. The sponsor is then required to recognize any additional gain represented by the excess of the value determined under the FASIT rules over the mark-to-market value. We believe that the IRS should consider excluding from the special FASIT valuation rule any debt instrument that is held by a securities dealer and is marked-to-market under section 475. Where a taxpayer is already required under its system of tax accounting to determine the fair market value of a debt instrument at the time when it is contributed to a FASIT, we question whether there is any policy justification for requiring further gain recognition under an artificial valuation rule. If there is any such gain, it is necessarily because the special valuation departs from "fair market value."

Section 475 permits a taxpayer to elect out of mark to market treatment for securities held for investment. We understand that the types of consumer receivables (such as credit card receivables) that gave rise to valuation concerns typically are considered to be held for investment and are not marked-to-market, for either book or tax purposes. In any event, if those types of receivables are of particular concern to the IRS, it would be possible to carve them out expressly from a dealer exception.

Calculation of Gain Under 120% of AFR rule. In a case where the 120% of AFR rule does apply and the discount rate is less than the stated rate of interest on the loan, the value will depend significantly on when the loan is assumed to be repaid. In a case where a loan is prepayable at the option of the borrower, we recommend that the value be calculated assuming that the loan will be repaid on the date that minimizes its value. This approach is consistent with the option rule in Treasury Regulation § 1.1272-1(c)(5) which assumes that the issuer of a debt instrument will exercise a prepayment option so as to minimize its yield.

To illustrate the reason for the rule, suppose that a commercial mortgage loan bears interest at a floating rate that is greater than 120% of the AFR. The loan matures in five years and is prepayable at any time without penalty by the borrower. If the rate of interest on the loan is in fact at or below a market rate, it may be reasonable to expect that the loan will remain outstanding to maturity. Because the loan is prepayable at any time, it would never have a market value greater than its face amount.

Under a mechanical application of the discount rule, the loan might be valued using (1) a discount rate of 120% of AFR and (2) a reasonable prepayment assumption determined based on actual market conditions. That combination would mean that the loan would be valued at a considerable premium, even though it can readily be demonstrated that the loan will never be worth more than its face amount. The problem arises because the prepayment assumption is not consistent with the discount rate. If a market rate of interest equaled the discount rate, then it would be reasonable to assume that the borrower would prepay the loan as soon as it could, because the stated interest rate would be higher than a market rate. In short, we recommend that if the 120% of AFR rate must be used as the discount rate, the prepayment assumption be one that is consistent with that rate.

B. Origination

The FASIT rules impose a 100% tax on income from loans "originated" by a FASIT. Given the serious consequences of having an originated loan, it is important to be able to determine whether a FASIT has originated a loan. FASITs were intended to be passive securitization vehicles and are not supposed to become active financial institutions with their own customers or employees. Although the term "originate" is not defined in the FASIT statute or legislative history, we believe that the ban on originations was essentially a proxy for addressing these active business concerns.

Proposed Regulation § 1.860L-1(a)(2)(iii) includes a very helpful rule that would treat a FASIT 5 as not originating a loan if the loan was acquired "from a person (including the Owner or related person) that regularly originates similar loans (such as through a standardized contract) in the ordinary course of its business." We believe that this rule makes good sense as an approach to the origination issue because it protects a FASIT in a case where a third party, rather than the FASIT itself, has engaged in origination activities.

We have a few comments on this rule. First, we believe that it should apply to any loan that has been originated by a person acting in the ordinary course of its business, whether or not the FASIT acquires the loan from such a person. It is very common for an originator to transfer a loan to a bankruptcy remote entity which in turn transfers the loan to a securitization vehicle. More generally, the fact that there may be intermediate holders of a loan between an originator and FASIT should if anything make it easier to conclude that the FASIT is not itself the originator.

Second, we recommend that the phrase "such as through a standardized contract" be deleted from the rule. As indicated above, aside from loans originated through a single commercial loan conduit, commercial mortgage loans typically have at least some terms that are separately negotiated. Even in cases where loan documentation is standardized, a loan originator will engage in activities other than negotiating the form that are plainly "origination," including making contact with the customer, quoting prices, and dealing with closing mechanics. We do not see why it makes any difference in determining if loan originators' activities should be attributed to a FASIT whether those activities relate to loans on standard form contracts or loans that are negotiated. The key is that a third party's origination activities (whatever they are) should not be attributed to the FASIT.

Third, we recommend that the text of or preamble to the final regulations make it clear that a person can regularly originate loans in the ordinary course of its business even if it originates them primarily or exclusively for one or more FASITs. Otherwise, an originator would be placed in the position of not being able to use a FASIT to securitize all or most of the loans it originates.

One significant issue relating to the origination test concerns modifications of loans held by a FASIT in a non-workout setting. It is fairly common for a commercial mortgage loan borrower to request changes in the terms of the loan. In some cases, those changes could amount to a "significant modification" within the meaning of the section 1001 regulations. In that event, under general tax principles, a new loan would be considered to be substituted for the old one, and a question would arise as to whether the new loan had been originated by the FASIT. We recommend that this issue be addressed in the final regulations, and that the regulations take the position that the modification of the terms of a loan not be considered to result in the new loan being originated by the FASIT, provided that the modifications are undertaken either by a person who regularly originates similar loans in the ordinary course of its business, or by a person who regularly services mortgage loans (whether or not they also originate them). It is commonplace for a securitization vehicle to hire a third party servicer to perform all of the servicing functions required with respect to loans. The servicer (and not the securitization vehicle) has its own employees and offices and provides services to the vehicle in exchange for a fee. If the activities of a loan originator acting in the ordinary course of its business are not attributed to a FASIT, then we see no reason why the activities of a loan servicer also acting in the ordinary course of its business as a professional servicer should be attributed to a FASIT. Even if a FASIT were considered to engage directly in loan modifications, those activities would be a far cry from a traditional origination business because the FASIT could only refinance its existing loans with its existing customers, and could not participate in any kind of ongoing origination business. The essence of such a business is to make new loans to new customers.

The adoption of a clear rule allowing a FASIT to modify loans is quite important in determining the usefulness of FASITs as a securitization vehicle for commercial mortgage loans. The REMIC rules generally do not allow a REMIC to acquire new mortgage loans more than three months after the startup day. One of the key advantages sought to be derived from the use of FASITs is the ability to engage in loan modifications without running afoul of tax rules.

C. Contingent Payments on Mortgages

A commercial mortgage loan may sometimes include rights to payments of contingent interest (such as equity kickers). It is commonplace in the REMIC area for rights to contingent interest to be separated from a loan before the loan is transferred to the REMIC. We do not see why the same result should not hold true in the FASIT area.

Proposed Regulation § 1.860H-2(b)(1)(vii) states that a stripped bond or coupon will be considered a permitted debt instrument if the debt instrument from which it is taken meets the requirements for being a permitted debt instrument (including the absence of contingent payments). We recommend that in determining if a debt instrument held by a FASIT bears interest at a fixed or variable rate, account be taken only of the payment rights held by the FASIT (and specifically rights to contingent payments that have be stripped off should be ignored). If the contingent payment is not run through the FASIT, then we do not see why its existence should affect the FASIT. While the existence of contingent payments could in unusual cases raise a question regarding the status of a commercial mortgage loan as debt, the FASIT rules independently require that a permitted debt instrument be debt for tax purposes.

The purpose of our recommended change would be defeated if a right to contingent payments held outside of a FASIT were brought back into the FASIT under the rule for support property in section 860I(b). The terms of a debt instrument would often provide that payments of noncontingent interest be made before payments of contingent interest. Proposed Regulation § 1.860I-1(b)(3) treats property as support property if the Owner or a related person holds an interest in the property that is subordinated to the FASIT's interest in the property (such as a subordinated interest in a pool of mortgages in which the FASIT owns the senior interest). We do not believe that this rule should apply where the ranking of payments is spelled out in the terms of the original debt instrument and is not created outside of the four corners of the loan as a way of enhancing the credit quality of the property held by the FASIT. The owner of the contingent payment right is not taking any action to enhance the FASIT's right to receive other payments on the debt instrument; it simply accepts the contingent payment right as it is. We believe the situation is analogous to one in which the Owner holds common stock of an issuer of debt. Although the stock economically supports the debt, it should not be regarded as an asset subject to the support rule because the Owner has done nothing to pledge or dedicate payments received on the stock to pay the debt. The fact that the stock is inherently subordinate to the debt should not matter.

D. Hedges

Proposed Regulation § 1.860H-2(e) would allow a hedge contract issued by the Owner or a related person to be a permitted asset only if (for non-guarantee contracts) the Owner or related person regularly provides, offers or sells substantially similar contracts in the ordinary course of its trade or business and the terms of the contract are consistent with the terms that would apply in the case of an arm's length transaction between unrelated parties. We are concerned that this rule would prohibit a range of common commercial transactions. For example, it would not be unusual for the sponsor of a securitization to enter into a hedge contract with the securitization vehicle even though the sponsor is not itself a derivatives dealer. The sponsor may then turn around and enter into one or more fully or partially offsetting contracts with third parties. This arrangement would not be allowed under the regulations.

There are a number of reasons why a FASIT may not be able to deal directly with an unrelated counterparty. One may be an unwillingness of the counterparty to accept the credit of a securitization vehicle. Another reason may be that it is economically desirable for hedges to take account of actual loan terms and hedges reflecting those terms are not readily available in the market. For example, if a loan provided for a rate of interest that was subject to a cap, and a FASIT issued regular interests that were not capped, then the FASIT may wish to purchase a cap agreement that would fill in the gap. The FASIT would want to acquire an agreement that has a term exactly matching the term of the mortgage. If the mortgage is subject to prepayment, then there may be no standard contract available in the market that would meet the FASIT's needs. In that event, the sponsor may want to enter into a contract with the FASIT having a term exactly matching the term of the mortgage, and then enter into an offsetting contract with a third party with more standard terms. All of this would be done for legitimate commercial reasons, and we do not see why arrangements of this type should not be allowed. 6

The preamble does not explain the reasons for the limitations on related party hedge contracts. If the reason is a concern that off-market contracts would be used to strip income out of a FASIT free of the rules governing FASIT income realized by an Owner, then we believe that it would be better to address the problem directly by reallocating the extra income to the Owner and then constructing a separate arrangement between the Owner and the related person. The effect would be to ensure that an amount of income equal to the reallocated amount is bearing a corporate tax. Very often, the related person entering into a hedge contract with a FASIT would itself be a profitable eligible corporation so that it would be easy to show that avoidance of the FASIT income rules is not a goal. It would seem to be quite severe to make the qualification of a FASIT or the imposition of a 100% prohibited transactions tax hinge on whether the terms of a derivative contract were or were not considered to be "consistent with the terms that would apply in an arm's length transaction between unrelated parties." It will not be easy to know whether a hedge agreement meets that test unless there are standard contracts available having identical terms, which often will not be the case.

One last point on hedges. The definition in Proposed Regulation § 1.860H-2(d)(1) of a permitted hedge allows a hedge only to offset certain risk factors between assets and regular interests the FASIT has issued or expects to issue. We believe that a FASIT should be allowed to hold hedge instruments that hedge both regular classes and the ownership interest. This point is not adequately addressed by taking account of future regular interests. The practical effect of requiring the hedge to relate only to regular interest classes is to require that hedges relate to specific regular interest classes and not to assets. We do not see a tax policy reason for imposing this result. If it is desirable economically to (for example) convert a fixed rate pool of mortgages into a floating rate pool, it should be possible to do so by having a swap that relates to the pool, whether the affected classes are regular interests or all FASIT classes. This point is particularly significant given that regular interest classes that finance a given asset pool can be refinanced or otherwise changed over time.

E. Foreign FASITs

Proposed Regulation § 1.860H-1(a)(3)(i) would prevent an entity from being a FASIT if it is created or organized under the laws of a foreign country or possession. We recommend that this restriction be eliminated. The techniques developed in the United States for securitizing commercial mortgage loans are being exported to, and being developed locally within, other countries. We are aware of securitizations involving non-U.S. commercial mortgages that involve entities established under foreign law that issue securities for sale to U.S. and non-U.S. investors. While there are no concerns about the imposition of a U.S. income tax on the vehicle, there may be doubts about the proper characterization of securities sold to U.S. investors. If the securities were considered to be equity, they generally would be regarded as stock in a passive foreign investment company ("PFIC"). As a general matter, investors prefer the tax rules for debt instruments over the PFIC regime because of the complexity of the PFIC rules. It may be desirable to make a FASIT election to remove doubts as to the status of securities as debt, and we do not see any policy reason why that should not be allowed, particularly in light of the requirement that the holder of the FASIT ownership interest be domestic. Concerns about the use of FASITs to capture foreign tax credits are dealt with by other parts of the proposed regulations.

III. Other Topics That Should be Addressed in Regulations

A. Prepayment Penalties

It is commonplace for commercial mortgage loans to provide for penalties payable by the borrower if a loan is prepaid (or prepaid prior to some specified date). In the REMIC world, these prepayment penalties can be passed through to holders of regular interest classes under Treasury Regulation § 1.860G-1(b)(2). We recommend that the same rule be adopted for FASITs. As the preamble to the proposed FASIT regulations acknowledges, a FASIT may hold loans that provide for prepayment penalties, and it should be possible to pay them out on regular interests. In the absence of a clarifying regulation, it is not clear if the REMIC rule would apply by analogy.

Treasury Regulation § 1.860G-1(b)(1) prohibits the payment of a prepayment premium on a REMIC regular interest other than one derived from the underlying mortgages. We believe that this limitation is not appropriate for a FASIT, because FASITs, unlike REMICs, can refinance outstanding debt. A FASIT should be allowed, like other borrowers, to make a financial decision whether to leave debt outstanding or to call it early and replace it with new borrowings. Commercially, investors will not give a FASIT such a right without prepayment penalties of some kind. It would be very odd to take the position that the existence of a prepayment penalty is an equity feature given that it is commonly found in plain vanilla debt instruments. Accordingly, we recommend that the FASIT regulations expressly allow regular interests to provide for prepayment penalties even if they are not derived from penalties paid on the debt instruments held by the FASIT.

B. Purchase Rights and Obligations

A REMIC can sell nondefaulted assets in connection with a qualified liquidation or a cleanup call (as defined for REMIC purposes) without incurring a prohibited transactions tax. A FASIT is also allowed to dispose of its assets in a qualified liquidation or in connection with the retirement in full of a class of regular interests. 7 The REMIC regulations (Treasury Regulation § 1.860D-1(b)(2)(iv)) treat the right to acquire or obligation to purchase mortgages or other assets from a REMIC pursuant to a qualified liquidation or cleanup call as not being an interest in the REMIC. While this result could potentially be reached under general tax principles, it would be very helpful to confirm that the existence of a right or obligation to purchase assets in connection with a qualified liquidation or retirement of a class of regular interests does not result in an interest in a FASIT.

C. Reasonable Belief Safe Harbor

The proposed regulations would create a host of technical requirements relating to permitted assets, some of which require judgment. The rules for hedges referred to above are an example. The REMIC rules (Treasury Regulation § 1.860G-2(a)(3)(iii)) permit a REMIC that discovers that a loan is not principally secured by real property to treat the loan as a permitted asset until 90 days after the date of discovery. We recommend that a similar rule be adopted for FASIT debt instruments and hedges. Specifically, a FASIT should be allowed to treat an asset as a permitted asset if it reasonably believed it to be a permitted asset when acquired until 90 days after it is discovered that the asset was not a permitted asset. A FASIT is intended to be a securitization vehicle, and investors place a premium on tax certainty. Given the punitive consequences of failing to hold permitted assets (loss of FASIT status or a 100% tax), a safe harbor rule would represent a reasonable compromise between the need to enforce the restrictions in the statute and the need to make a securitization economically workable. The proposed safe harbor rule would not create opportunities for abuse because of the reasonable believe standard plus the fact that the protection of the rule would disappear 90 days following the date of discovery that an asset did not qualify.

D. High-Yield Interests

It is very common in a commercial mortgage loan REMIC to create interest-only classes of regular interests that represent economically a strip of interest taken off of another class of regular interests. For example, if a REMIC holds $100 million face amount of mortgages bearing interest at a rate of 8%, it might issue $90 million of Class A senior regular interests entitled to the first $90 million of principal payments on the mortgages and bearing interest at a rate of 7%, and $10 million of Class B subordinated regular interests having a coupon of 8% that are entitled to the last $10 million of mortgage principal. The REMIC would then issue an interest-only Class X which is entitled to 100 basis points of interest applied to the principal balance of Class A.

As an alternative to having the REMIC issue an interest-only class, the same result could be created through a secondary market transaction. The REMIC would first issue Class A*, which is the same as Class A described above except that it has an interest rate of 8%. Class A* would then be divided in a separate transaction into a 100 basis point interest strip and a second security consisting of a right to principal and 7% interest. Regular interests are treated as debt instruments, so the two pieces would be taxed as stripped coupons and stripped bonds under section 1286. It does not much matter from an overall tax perspective whether the interest-only class is created through a direct issuance by the REMIC or in the secondary market.

The same statement would not hold true for FASITs. In particular, an interest-only strip that is issued directly by a FASIT would qualify as a high-yield interest that must be held by an eligible corporation. By contrast, an interest only strip created in the secondary market generally would not be a high-yield interest.

To explain these conclusions, consider first the general definition of a FASIT regular interest in section 860L(b)(1)(A). It requires that the interest (1) unconditionally entitle the holder to a specified principal amount, (2) have a yield not exceeding 500 basis points over the AFR, and (3) have an issue price not greater than 125% of its principal amount. Interests that fail one or more of these tests but otherwise meet the definition of a regular interest are classified in section 860L(b)(1)(B) as "high-yield interests." They are considered to be regular interests, but can be held only by eligible corporations. The reason for creating this special class of regular interests was to ensure that the income on classes having "equity characteristics" be subject to at least one corporate income tax. Under these rules, an interest-only class, such as Class X in the example above, would be a high-yield interest because it would be issued at a premium of more than 25%. A FASIT regular interest, like any debt instrument, can be separated into stripped coupons and stripped bonds. For example, a FASIT regular interest resembling Class A* above (which we assume would not itself be a high-yield interest) could be placed in a trust. The trust could then issue two classes of pass-through certificates, one representing 100 basis points of interest, and the second representing the right to principal and 7% interest. Those interests should be taxed in the same manner as other stripped coupons or bonds. Because they would not be derived from a high-yield interest, they would not themselves be high-yield interests.

One possible concern in this transaction is the entity tax imposed on certain pass-through entities by section 860K(e). That section provides that if a pass-through entity issues debt or equity which is supported by a regular interest in a FASIT and has an original yield to maturity greater than both the yield to maturity to the entity of the regular interest and 500 basis points over the AFR, then the entity is subject to a corporate income tax on income of the holder of such debt or equity class properly allocable to the FASIT regular interest. The rule does not apply to arrangements not having as a principal purpose the avoidance of the purposes of the provision. Setting to one side the principal purpose test, whether the issuance of an interest-only strip by a trust would trigger the tax under section 860K(e) would depend on the market yield of the class. Significantly, section 860K(e) does not impose a penalty tax merely because the issue price of the class exceeds its face amount by more than 25%. Accordingly, it would not prevent the stripping of FASIT regular interests, at least if the yield of the classes that are created does not exceed the yield thresholds set forth in the section.

We do not consider this result to be a mistake or a loophole in the statute, but rather a result that follows from the fact that the stripping of debt instruments is a common commercial transaction that results in two or more instruments that continue to be taxed as debt and do not change their tax character. We recommend that the FASIT regulations include an example confirming this result. In fact, we would go one step further and recommend that the FASIT regulations provide that a separation of a regular interest into stripped coupons and stripped bonds is not a transaction that frustrates the purposes of subsection 860K(e), so that it can be done whether or not the individual pieces meet the yield thresholds set forth in that section. We simply do not see why a stripping transaction should have radically different consequences in the FASIT area as contrasted with other areas of the Code.

* * *

As noted above, the Association is interested in facilitating the use of FASITs as workable vehicles for securitizing commercial mortgage loans. We believe that this result can best be accomplished through ongoing discussions between the drafters of the regulations and participants in these types of transactions. We would be pleased to meet or speak with you, or to provide additional information, if that would assist you in addressing the points mentioned above. If you have any questions or would like additional information, please feel free to contact the undersigned at 212.440.9466, or James Peaslee, Esq. of Cleary, Gottlieb, Steen & Hamilton (special outside counsel to the Association).

Sincerely,

George P. Miller
Senior Vice President,
Deputy General Counsel

Appendix--More Technical Comments.

Definition of Transfer. Proposed Regulation § 1.860H-1(c)(2) defines the word "transfer" to include any conveyance of a "legal or beneficial interest in property." The word is used in various places in the regulations. For example, under Proposed Regulation § 1.860H-6(d), a dealer must mark-to-market property transferred to a FASIT. Also, the gain recognition rule in Proposed Regulation § 1.860I-1(a)(I)(i) is based on a transfer. We are concerned that the definition of transfer is overly broad. Ordinarily, the word is understood in the tax area to mean a transfer of tax ownership. Under the proposed rule, a transfer of record ownership (legal ownership) would seem to be regarded as a transfer even if all beneficial ownership remained with the transferor. Also, the definition suggests that an item might be considered to be transferred in full if any beneficial interest therein is transferred. To conform to normal tax standards, we recommend that property be considered transferred to the extent there is a shift in tax ownership to the transferee. In the case of a segregated pool of assets, a asset would be considered to be transferred when it is identified as held by the separate pool or, under the support rule, when it supports FASIT interests.

Support Property. The FASIT rules treat "support property" as if it were deemed transferred to a FASIT. Under Proposed Regulation § 1.860I-1(b)(1), property is support property if the Owner (or a related person) pledges the property, directly or indirectly, to pay a FASIT regular interest, or otherwise identifies the property as providing security for the payment of a FASIT regular interest. We are concerned about the scope of the "otherwise identified" rule. We understand that it was not the intention of this rule to cover a case where a person provides support to a FASIT through a general recourse obligation even though that obligation is, and may be described to be, an obligation burdening all of the assets of that person. This conclusion would be reached based on the text of the proposed regulation if the term "security" meant an arrangement that gave to the FASIT a senior creditor claim as compared with other creditors. If on the other hand it meant simply "assurance" in a colloquial sense, then the result would be unclear. We would be grateful if you would confirm that general recourse obligations do not invoke the support property rule.

A further question that arises under the support property rule is how its application affects the FASIT interests test in section 860L(a)(1)(B). Specifically, support property is deemed to be held by the FASIT. If the actual owner of the property were the Owner, then it would make sense to treat the Owner's interest in the support property as being part of the FASIT ownership interest for purposes of applying the FASIT interests test. In a case where the actual owner of the support property is not the Owner but a related party, then the related party's interest in the property could again be considered to be part of the ownership interest, with a separate transaction then taking place between the Owner and the related party outside of the FASIT. We believe that the intent of the support rule was to ensure gain recognition with respect to support property and not to disqualify a FASIT by cause the interests test to be failed.

Notes

The Association represents securities firms and banks that underwrite, distribute and trade debt securities, both domestically and internationally. The Association's member firms account for in excess of 95% of all primary issuance and secondary market trading activity in the U.S. debt capital markets. Among other roles, the Association's members act as issuers, underwriters and dealers of mortgage and asset-backed securities that are characterized, for federal income tax purposes, as REMICs and FASITs. The views expressed in this letter are based upon input received from a broad range of Association members who are active in these markets, including members of the Association's Commercial/Multifamily Committee, who are actively involved in the commercial mortgage securitization markets. More information about the Association and its members and activities may be obtained from the Association's website at www.bondmarkets.com.

In 1996, the IRS requested comments on topics to be addressed in FASIT regulations, and the Association responded in letters dated January 14 and July 31, 1997. The proposed regulations do provide helpful guidance on some of the topics addressed in the earlier letters. For example, the Association's July 31, 1997 letter requested that the 120% of AFR valuation rule described below not apply to recently purchased loans or to loans for which price quotations are readily available.

A cover story in the May 1, 2000 issue of Commercial Mortgage Alert notes that more than a dozen Web sites aimed at linking borrowers or brokers with lenders have arisen in the mortgage area, including six since January of this year.

This point should be made explicitly. There are authorities that distinguish between the acquisition or purchase of a loan and the making of a loan. See, e.g., Security Bank Minnesota v. Comm'r, 994 F.2d 432 (8th Cir. 1993).

The rule is expressed as an absolute rule, although the heading refers to a presumption. We recommend that it be a safe-harbor rule taxpayers can rely on.

It is not clear if the requirement that contract terms be consistent with terms of unrelated party contracts means only that the contract be priced at an arm's length price, or rather, that there must be standard contracts available with similar terms. Under the latter interpretation, any hedge contract that reflected the particular terms of a FASIT's assets would not be allowed.

We understand that the omission of any reference to qualified liquidations in Proposed Regulation § 1.860H-3 was an oversight.