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Internal Revenue Service
Couriers Desk
1111 Constitution Avenue, N.W.
Washington, D.C. 22204
Attn: CC:DOM:CORP:R (FASIT Solicitation)

Re: Comments on FASIT Statute

Ladies and Gentlemen:

On November 18, 1996, the Internal Revenue Service ("IRS") in Announcement 96-121, invited interested persons to submit written comments on issues arising under the FASIT provisions of the Small Business Job Protection Act of 1996. This letter is being submitted by PSA The Bond Market Trade Association ("PSA") in response to the IRS's request for comments on issues which will be addressed in regulations to be issued by the IRS (the "Regulations").

PSA represents approximately 225 securities firms and banks that underwrite, distribute and trade a wide range of debt securities, both domestically and internationally. This letter has been prepared by the staff of PSA in conjunction with our special outside tax counsel, Brown & Wood LLP, and reflects input from numerous member firms active in the mortgage-backed and asset-backed securities markets. As underwriters and dealers in these types of products, such firms have an obvious interest in, and will be directly impacted by, the FASIT legislation and the related Regulations.

To preface our specific comments, we think the FASIT statute accomplishes its purpose of setting forth the basic tax rules with respect to the FASIT vehicle and the taxation of FASIT investors. Within these broad outlines established by Congress, PSA believes that in several key areas there is a need for clear, logical and administratively workable regulatory guidance from the IRS. We think the clarifications and suggestions described below will help to effectuate Congress' intent and encourage the use of FASITs while addressing valid tax policy concerns. Our comments do not purport to address the full range of transitional and longer-term tax compliance issues that may need to be addressed as part of the IRS's rule-making process, but only those that PSA at this stage regards as most significant.

I. Gain Recognition Provision

Section 860I(a)(1) requires the holder of an ownership interest in a FASIT to recognize gain (if any) upon the transfer of debt instruments to a FASIT. For purposes of determining the amount of gain recognized, the value of the debt instruments contributed to a FASIT (other than debt traded on an established securities market) equals the present

value of the reasonably expected payments under such instrument determined by using a discount rate equal to 120 percent of the applicable federal rate. Although this statutory provision provides a specific discounting rate to determine the present value of reasonably expected cash flows on the debt instruments transferred to a FASIT, there is no guidance with respect to what information FASIT issuers may rely upon in determining the reasonably expected payments on such instruments.

We believe that FASIT can have the greatest impact in the securitization of debt instruments that are not traded on an established securities market because these instruments will benefit most from additional secondary liquidity. The usefulness of FASIT will be greatly enhanced if the Regulations provide a clear and objective methodology for computing the "reasonably expected payments" to be used in the gain calculation. Such clarity will allow issuers to predict accurately the economic consequences to them of a FASIT transaction.

In practice, the "reasonably expected payments" on debt instruments depend on many parameters, including (1) the specific contractual provisions of the debt instruments, (2) the level of defaults expected, (3) the anticipated loss in the event of default and (4) the anticipated prepayment rate in the case of prepayable instruments.

Due to the numerous types of financial assets which may be securitized and the variety of originators of such assets, reasonably expected payments and contributing parameters may differ widely, even within the same asset category or among different transactions by the same issuer. For example, different servicing practices among issuers can cause different payment behavior on similar assets, and an issuer may originate assets under different programs resulting in apparently similar assets that perform differently.

To the extent that a parameter contributing to "reasonably expected payments" is validated through use in the pricing of FASIT interests, we believe that the holder of the FASIT ownership interest should be allowed to rely upon such a pricing assumption in their gain calculation. There are, however, many instances where parameters relevant to "reasonably expected payments" for the purpose of calculating gain are not relevant to purchasers of FASIT interests and may not be validated in the market. For example, although prepayment rates may be relevant to the gain or loss calculation, they may not be relevant to investors insulated from prepayment risk through a revolving mechanism. Similarly, investors in senior securities protected by credit enhancement many times the level of historical losses may never form a precise view of expected losses. They may simply determine that available credit enhancement is sufficient to cover whatever losses may realistically occur.

Because of this possible lack of market validation for certain parameters, we believe that the Regulations should provide that issuers can rely, as a safe harbor, on a determination of these parameters made by a Nationally Recognized Statistical Rating Organization ("NRSRO") rating the transaction. Specifically, if a NRSRO rating the transaction specifies parameters to be used as a "base case" or "expected scenario", the issuer should be allowed to rely upon such parameters in computing gain. In the absence of a specific

label of "base case" or "expected scenario", the issuer should be allowed to use the parameters for the BBB/Baa, or equivalent, scenario, if provided.

II. Permitted Assets

Section 860L(c) provides that permitted assets of a FASIT include any asset "which is an interest rate or foreign currency notional principal contract, letter of credit, insurance contract, guarantee against payment defaults, or other similar instrument permitted by the Secretary" and which is "reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor on interests issued by the FASIT."

The Regulations should clarify the broad nature of the types of instruments contemplated by the statute. The Regulations should provide examples of instruments which constitute permitted assets. For example, swap contracts that cover prepayment risk as well as default risks on the FASIT's assets (i.e., swaps and other derivative products such as caps and floors, whose notional amounts amortize in relation to the prepayments experienced by a reference security or group of securities used to determine the timing of distributions on a FASIT regular interest) should be permitted to the extent they protect the FASIT's ability to make payments under the specific payment terms, priorities and timing established for the regular interests. Furthermore, where payments to a FASIT on a swap by the holder of the ownership interest in a FASIT are based on a reference security or group of securities, the Regulations should clarify that such reference security or securities should not be treated as "supporting a regular interest in such FASIT," unless the holder of the ownership interest has pledged such security or securities to the FASIT through a perfected security interest with no right of substitution.

Specific guidance should also indicate that a permitted asset includes a swap that obligates the FASIT to make payments based upon cash flows of the FASIT's assets. In addition, the Regulations should clarify that a financial contract may constitute a hedge or guarantee regardless of its form and regardless of whether it qualifies as a "notional principal contract" within the meaning of Treasury Regulation Section 1-446-3 (i.e., forward and option contracts regardless of form of documentation).

III. Prohibited Transactions

FASIT was enacted to facilitate the securitization of a wide range of debt obligations by providing clear tax treatment for investors and owners. However, FASIT was not intended to provide a vehicle through which an active trade or business could be conducted. Accordingly, Section 860L(e) imposes a tax on a FASIT equal to 100 percent of the net income derived from certain prohibited transactions including "the receipt of any income derived from any loan originated by the FASIT." Treatment of loan origination as a prohibited transaction ensures that a FASIT will not be utilized as a vehicle to carry on the business of a financing company. However, uncertainty exists regarding what constitutes "origination" for purposes of this provision.

Because numerous securitizations involve revolving pools of debt instruments, the Proposed Regulations should clarify that the revolving nature of a FASIT will not by itself cause the FASIT to be treated as having originated loans. For example, the acquisition of additional loans pursuant to a fixed agreement with the holder of the ownership interest, or an affiliate thereof, or a third party originator is consistent with a non-active securitization and should not be treated as a prohibited transaction.

Furthermore, certain assets such as credit card accounts and home equity lines of credit, may grant the obligor the ability to borrow additional amounts from the lender. Regulations should indicate that where a FASIT, as owner of such loans, is required to lend additional amounts to current borrowers at the request of the borrowers, such additional borrowings will not constitute loans originated by the FASIT for purposes of the prohibited transaction rule.

IV. Transfers of High-Yield Interests

Section 860K(a) provides that if a high-yield interest is transferred to a disqualified holder, income attributable to such interest shall be included in the gross income of the most recent holder that is not a disqualified holder. However, Section 860K also establishes exceptions to this rule where the high-yield interest is transferred to a dealer or the transferor receives certain statements from the transferee.

Under Section 860K(d)(1), a transferor is not required to include income attributable to a high-yield interest where such interest was (i) transferred to a otherwise disqualified holder that is a dealer in securities and (ii) such dealer acquired the high-yield interest exclusively for sale to customers in the ordinary course of business and not for investment. A dealer is not treated as holding an interest for investment before the thirty-second day after the date such dealer acquired the interest unless such interest is held as part of a tax avoidance plan. In addition, Section 860K(b) provides that, under rules similar to the rules of paragraph 860E(e)(4) (relating to transfer affidavits with respect to REMIC residual interests), a tax will not be imposed on the transferor of a high-yield FASIT interest if the transferor receives a proper transfer affidavit.

One of FASIT legislation's main objectives and benefits is to provide a vehicle that will facilitate institutions' ability to raise capital through the sale of lower rated (and therefore, higher yielding) classes of securities. Secondary liquidity is essential to the success of such a market. In furtherance of this objective, the legislation permits any transfer to a dealer without the imposition of tax on the transferor, unless the transfer is pursuant to a tax avoidance plan. If a dealer that would otherwise be a disqualified holder has inappropriately acquired the high-yield interest for investment (but not otherwise pursuant to a tax avoidance plan), the dealer (and not the transferor) is subject to tax. This rule greatly facilitates transactions between investors and dealers and among dealers by eliminating paperwork and reducing clearance cost. The Regulations should clarify this by specifying that the transferor of a high-yield interest to a dealer is not subject to tax unless such transferor has actual knowledge that the transfer is part of a plan to avoid the purposes of Section 860K.

For purposes of this safe harbor, a dealer should be defined to include regulated entities the identities of which are readily ascertainable, such as broker-dealers that are registered under Section 15 of the Securities Exchange Act of 1934, as well as securities affiliates of bank holding companies approved by the Federal Reserve Board under Section 20 of the Glass-Steagall Act. By appropriately defining the entities that are treated as "dealers" within the meaning of the statute, the Regulations will facilitate transactions while assuring that a financially responsible entity bears the cost if a transfer was inappropriate.

In addition, as expressly provided by the statute, the Regulations should provide safe harbors from transferor tax liability for transfers of high-yield FASIT interests to non-dealers. These rules should be similar to the rules governing transfers of real estate mortgage investment conduit residual interests. Such guidance would, in our view, achieve an appropriate balance between the need for clear and administratively feasible rules governing such transfers, and legitimate tax policy concerns. For example, we believe that a transferor that receives an affidavit under penalty of perjury from a transferee as to the transferee's status as an eligible corporation should be relieved of tax liability unless the transferor has actual knowledge that the statement is false.

We hope you find these comments useful. If you have any questions, please call the undersigned at (212) 902-6376 or George Miller, PSA Vice President and Deputy General Counsel, at (212) 440-9403.

Very truly yours,

Thomas D. Lasersohn
Chairman, PSA Asset-Backed Securities Committee

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