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Memorandum

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subject:

Review of FASIT Transaction
UIL 860L.02-01

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This is in response to your request for advice as to the tax consequences of a Financial Asset Securitization Investment Trust (FASIT) arrangement.

Issues:

(1) Does the repeal of the FASIT provisions in 2004 apply to the FASIT transaction at issue?

(2) Does the stock issued to qualify as a "regular interest" under I.R.C. § 860L(b)(1)(A)(ii)?

(3) If not, does it qualify as a regular interest under I.R.C. § 860L(b)(1)(B)(ii)?

(4) If not, what tax adjustments are required to reflect the disqualification of the entity as a FASIT?

Conclusions:

(1) The FASIT transaction at issue is subject to the 2004 provisions repealing I.R.C. §§ 860H-860L.

(2) The stock issued to does not qualify as a "regular interest" under I.R.C. § 860L(b)(1)(A)(ii) because interest payments or other similar amounts with respect to such interest are not payable based on a "variable rate" as defined in Treas. Reg. § 1.860G-1(a)(3).

(3) The stock issued to does not qualify as a "regular interest" under I.R.C. § 860L(b)(1)(B)(ii)(II) because it is not a specified portion of the interest on permitted assets that remains fixed during the period the interest is held and because it was issued directly to a disqualified holder.

(4) If the entity does not qualify as a FASIT, the various interests will be treated as if the FASIT rules did not apply, under regular tax principles.

Facts:

The taxpayer is a U.S. consolidated group indirectly owned by parent , formerly . Now named , the U.S. parent was formerly known as .
, a corporation, was a wholly-owned subsidiary of .

FASIT Design

The FASIT structure at issue was promoted to the taxpayer by in . As described by the taxpayer in reporting to its management, used the FASIT concept to "develop [a] financial engineered product which takes advantage of favorable debt/equity tax treatment in different jurisdictions." The FASIT rules, as represented by , allowed preferred stock issued to a related foreign affiliate to be treated as debt in the U.S. and equity overseas. According to a proposal drafted in , the FASIT was promoted as providing "the opportunity for cross border arbitrage" attributable to the treatment of the FASIT regular interest as debt for US tax purposes. As explained in the proposal:

> Since the "form" of the Regular Interest as stock/equity will be respected in many foreign jurisdictions, notwithstanding the US tax treatment of such Interest, it is possible to create a pre-tax/after-tax arbitrage, with payments made to the holder of the Regular Interest who is a foreign corporation structured so as to qualify for an applicable participation exemption in the jurisdiction in which the foreign corporation is organized. The arbitrage will provide an economic benefit to the [Taxpayer] equal to the tax that would otherwise have been paid by on an amount equal to the dividends paid on the Preferred Stock, or, looked at differently, equal to

the benefit of the tax deduction for interest paid by
to fund its investment in the Preferred Stock.

The contemplated financing structure was described as meeting "the FASIT requirements to create a security that will qualify as tax deductible debt for US tax purposes while at the same time being a security that appears to be a typical preferred stock for which a participation exemption is available in
" The taxpayer estimated that income tax savings from the proposed transaction would be per year.

Under the structure as contemplated by , there would be three parties to the transaction, the FASIT "owner", acting as junior noteholder, the senior noteholder, (a third party bank) and the preferred stockholder, an affiliate of the taxpayer. The FASIT assets will be scheduled to mature prior to the end of the initial term or any renewal terms agreed to by the primary shareholder. The intent is that no gain or loss from the sale of FASIT assets will arise, rather such assets are expected to mature into cash on or prior to the end of the relevant initial or renewal term. With respect to the shares issued, the issuer shall calculate annually the profit of the FASIT assets, which will equal the weighted average interest earned by the Issuer on the FASIT Assets less payments to the Noteholders and FASIT expenses. Dividends equal to such profit will be paid annually when declared by the Board of Directors, as and to the extent permitted by state law, it being the intention of the issuer that such declaration and payment shall take place as soon as practicable after the end of the year. If such profit is not paid as dividends, it shall be reinvested in additional permitted assets. At termination, either at the end of the initial term or the renewal period, the shares shall be redeemed for the fair market value of such shares, which will never exceed the original issue price plus any reinvested profit, less any losses on the FASIT assets.

The preferred stock will qualify as a regular interest under the FASIT rules in part because it calls for the payment of a weighted average interest rate qualifying as a "variable rate".

explains that because the Senior Note (the third party bank) is debt and the Class share (ownership interest) is senior to the Class shares (the Preferred Stock), all losses on the FASIT Assets will be allocated to the Preferred Shares. "The Class Shares will thus substantively be the equity in the transaction bearing any losses with respect to the FASIT Assets. Economically the transaction has been structured so that the Senior Note is debt and will be priced accordingly. The fact that the Class Share is senior is economically inconsequential in view of the amount of such Share."

offered to act as the FASIT "owner" and to invest in the FASIT on that basis, in a relatively minor amount. It also offered to find a bank willing to make a more substantial investment, either directly, or by a loan to a affiliate who would then invest in the FASIT. During the planning stage, the amount of this additional

investment, and the direct or indirect nature of the interest, was variously discussed. There were also discussions about the fact that the FASIT could not be a special purpose entity (SPE) because the dividends would not be exempt under foreign law if they were paid from an entity which effectively was not subject to U.S. tax.

Asset Management Agreement

An Asset Management Agreement was executed on between (designated as "the Company"), , a affiliate and the intended Series shareholder and , a affiliate, designated as the "Noteholder" and intended FASIT owner. The purpose for the agreement was to establish a pool of assets that would be treated as a FASIT for tax purposes, to appoint as the Asset Manager, and to establish the terms for the payment of the Noteholder ( ) and the Series Stockholder ( ). investment was to be , indirectly funded by a third party investor.

Securities were never issued under the original Asset Management Agreement. The correspondence between and the Taxpayer indicates that the inability to secure timely a third party investor caused the delay in the actual culmination of the transaction. An Amended and Restated Asset Management Agreement and Amended and Restated Note Purchase Agreement were entered into on .

Asset Management Agreement

The Amended and Restated Asset Management Agreement stated that on the Funding Date, the Company will identify on its books and records a pool of assets designated as the "Initial Assets," equal to the FASIT Amount. Subsequently, additional permitted assets would be included in the FASIT asset pool as identified by the Company on its books and records.

The original assets identified as included in the pool consisted of intercompany loan receivables due from , a of .

The FASIT securities were first issued at this time. was brought in as the bank outside investor, and it was made a direct party to the "Amended and Restated Asset Management Agreement". In lieu of issuing the Note to , two notes were issued. , through an affiliate, [1], was issued a Class Note for . By separate agreement between and , loaned of this amount. was issued a Class Note for . The Class Note

[1] tax return for the fiscal year ended reflects that it previously functioned as FASIT owner for three other FASITs which were transferred to another entity as of .

and the Series stock were designated as regular interests in the FASIT. An amended and restated Note Purchase Agreement was executed to effect the assignment of the rights and obligations of to and .

Changes were made to the Asset Management Agreement with the introduction of to the arrangement. Fixed rate bank deposits, money market funds, and fixed rate debt instruments were added to permitted assets. Presumably at the request of the Class Noteholder, a new provision was added to the Asset Management Agreement guaranteeing that the FASIT assets shall accrue interest at a rate at least equal to LIBOR plus percent. Originally a fixed term, the guarantee fee to be payable to the Asset Manager was made discretionary in the event the Asset Manager agreed to guarantee any assets.

In addition to covenants regarding the issuance of only regular interests and a single ownership interest, the company further agreed not to issue any additional notes or other evidence of indebtedness payable from the FASIT assets "on a parity with or senior in right of payment" with the Notes. The Asset Manager further agreed that the FASIT assets shall at all times include not less than in obligations of affiliates of the taxpayer.

The Asset Management agreement was scheduled to terminate on the first interest payment date on or after , except that the term of the agreement may be extended for successive additional five year terms. It further provided, "[f]or the avoidance of doubt, neither the Initial Term nor any Renewal Term shall be extended except with the agreement of each of the parties hereto." The FASIT could not continue beyond years from the Funding Date. Each party was required to give notice of its decision whether or not to extend the initial term or successive terms prior to the preceding the end of each term.

The Class Note states that it is intended to constitute an "ownership interest" in a financial asset securitization trust within the meaning of section 860H. The Class Note provided for interest at the FASIT rate, plus supplemental interest at a rate of . In addition to "interest" and "supplemental interest," the Class Note also provided for "additional interest", discussed further below.

The Class Note had a maturity date of . However, if the Asset Management Agreement terminated on due to the failure of the parties to agree to a renewal term, the note was subject to redemption on that date.

The Class Note had a maturity date of and an interest rate at the FASIT rate plus supplemental interest of .[2]

[2] It appears that the supplemental interest payments were in lieu of the "commitment fee" contemplated under the original terms of the arrangement.

As of , the Series stock was issued by to . The terms of the stock were structured in consultation with the taxpayer's tax advisors with regard to the characteristics required to result in the availability of the "participation exemption" (i.e., equity treatment) for dividends on such stock. The Series stock was issued with an original issue price of per share. A total of shares were issued, for a total issue price of . The terms were set forth in the Certificate of Voting Powers, Designations, Preferences and Restriction. The provision for the payment of dividends, as applicable, was as follows:

> (A) The Board of Directors is hereby authorized to declare dividends payable on the Series Stock in accordance with this Article . On or after each Determination Date, the Holders of outstanding shares of Series stock shall be entitled to receive, when, as and if declared by the Board of Directors, cumulative annual dividends in an amount declared by the Board of Directors up to but not exceeding undistributed Profits for the then ending Accrual Period and the preceding Accrual Periods. The dividends are payable from distributable Profits, I.e., only from earnings on the FASIT Assets after payment of interest on the Notes and the Asset Manager's Fee, any Guarantee Fee and other expenses of the FASIT payable on such Determination Date.

The term "Profits" was defined as the sum of the "daily profit accruals" for the accrual period, less interest payable on the Notes in accordance with the Notes and any other expenses of the FASIT. "Daily Profit Accruals" were defined as interest at the "FASIT rate" (as defined in the asset management agreement) times the issue price of the Series stock, as adjusted for allocated losses, and increased by any cumulated and unpaid dividends, plus the principal amount of the Notes. On the "Termination Date" as defined in the Asset Management Agreement, (i.e., , unless extended) the Series shareholder will receive a "liquidation preference", defined as the fair market value of the FASIT assets (including cash) less amounts due on the Notes and fees or expenses.

The term "Notes" was defined in the (Amended) Asset Management Agreement, and referred to the ownership interest and the other regular interest.

and the Taxpayer had several discussions about the amount of fee. argued that in addition to bringing the transaction to the taxpayer, helping to set up the structure and identifying other players, they should be compensated for their ongoing responsibilities as an owner. They also were concerned that the SPE ( ) will have to pay Federal income tax on the income received with respect to the Note under the FASIT rules. Because the SPE would have an annual tax liability, they proposed an annual fee in addition to the upfront fee. In their final agreement dated , agreed to pay an upfront fee of to and an annual fee of

for as long as the Ownership Note was outstanding. These fees were paid by the Taxpayer directly to outside of the FASIT structure.

Effective , and ., also a corporation, merged into ., a corporation. At that time, each share of Series stock of was converted into an equal number of Series Preferred stock of . The terms were otherwise identical. Subsequently, was renamed .

Additional Interest

As stated above, in addition to "interest" and "supplemental interest," the Class Note also provided for "additional interest". Additional interest is the excess of the total income (other than gain) on FASIT Assets less the sum of (1) FASIT Rate Interest and Supplemental Interest under the Class and Class Note and (2) the (a) FASIT Rate minus (x) , multiplied by (b) the Adjusted Issue Price of the Series stock.

As described by the taxpayer, the purpose for the Class additional interest provision was to limit the earnings on the Series stock to the FASIT rate less basis points (by sweeping the excess to the FASIT owner). According to , contact with the taxpayer in the transaction, this feature of the ownership interest was necessary in order for the regular interest issued to the parent to comply with the FASIT rules, as a weighted average rate less a fixed spread. On its face, the Series stock interest had terms designed to comply with tax rules, giving the appearance of being merely a residual interest (i.e. at most entitled to whatever earnings remained after senior interests were paid). In order to comply with law regarding taxation of dividends, the distributions had to appear to be dividends paid pursuant to the discretion of management. The additional interest feature included in the ownership interest was designed to restrict the Series regular interest payments indirectly, so as to qualify under the FASIT rules. The effect was to give , rather than the Series shareholder, the residual interest.

The additional interest provision in the Note was structured to adjust the FASIT rate by basis points on the Adjusted Issue Price of the Series stock to account for the supplemental interest of paid to and on the principal balance of . As a result, computationally, additional interest was expected to net out close to or equal to zero. According to , it was understood that the additional interest provision was not intended to be an amount of any significance, because "the pieces all fit together" and were intended to do so.

The taxpayer did not calculate or pay additional interest at any time since the FASIT was established. The taxpayer's contemporaneous work papers and statements also did not reflect a calculation of a FASIT rate per se. Statements

reported the amount of earnings due to each of the various interests without identifying the FASIT rate used to calculate such amounts.

It was not clear from the taxpayer's contemporaneous statements and work papers how the computation of the FASIT rate took into consideration earnings on "cash flow investments", that is, short term investments of FASIT earnings in money market accounts prior to distribution. Statements of FASIT activity do not identify the principal amount of such assets, although they indicate that the earnings on such assets were included in determining the amount available for distribution. However, as reconstructed, the average balance of such accounts was taken into account in computing the FASIT rate, which was used to determine the amount of FASIT earnings to be distributed to and .

The additional interest provision purported to transfer the residual interest in the FASIT to , the owner, locking in the Series shareholder's interest at a weighted average rate computed as the FASIT rate less the spread times the Adjusted Issue Price of the Stock. Since the "adjusted issue price" of the stock did not include the money market assets, the additional interest formula mechanically resulted in the allocation of FASIT rate interest on the money market asset balances to . As an example, in , the applicable money market balance used in the calculation of the FASIT rate was and the FASIT rate was %. Thus, included in the additional interest amount purportedly due to was approximately (x %) in FASIT earnings. Additional interest attributable to money market earnings was due to in each year since the FASIT was established.

However, notwithstanding the terms of the stock certificate and the Note, no additional interest was ever reported or paid. Instead, amounts in excess of FASIT rate interest and supplemental interest on the Noteholders' principal balances were paid to the Series shareholder. Mathematically, this resulted in the shareholder receiving earnings at a rate in excess of the FASIT rate, with the rates varying depending on the money market assets and earnings.

Amended Asset Management Agreement

On a second amended and restated asset management agreement was executed. The purpose for the new agreement was to reflect changes in both the asset pool and the regular interests. The revised agreement stated that one of the FASIT assets matured, and was needed to pay the Class Note and to partially pay the Class Note, as well as to purchase another permitted asset for inclusion in the pool. A covenant was added assuring the Noteholder that the amendment of the Asset Management Agreement, the Note Purchase Agreement and the Note will not have an adverse effect on the Noteholder by resulting in taxable income to the Noteholder in excess of the cash distributions on the Note for interest or by causing the

termination of the FASIT or redemption of the regular interest in the FASIT other than the redemption of the Class Note.

The Class Note was repaid[3] and the Class Note was repaid to the extent of . An amended and restated Note was issued to , effective as of , for , with terms otherwise the same as the original note.

The departure of one of the Noteholders, and resultant issuance of a second amended asset management agreement, did not result in a change in the terms of the Series stock as stated on the face amount of the certificate, although the stock certificate referred to the asset management agreement issued in for many of its operative terms. The second amended asset management agreement simply stated that the Series Stockholder, together with the Noteholder, wished to continue the management of the FASIT Assets on terms acceptable to both of them.

Additional Interest After Departure

The revised Class Note provided for additional interest computed as the excess of the total income (other than gain) on FASIT Assets less the sum of (1) FASIT Rate Interest and Supplemental Interest under the Class Note and (2) the (a) FASIT Rate minus (x) divided by (y) 365 or 366, multiplied by (b) the Adjusted Issue Price of the Series stock. The required computation incorporated the same factor for calculating additional interest as in the prior Note. Since that amount was structured to reflect the supplemental interest paid to and , the departure of and the reduction of the Class Note meant that the pieces no longer "fit together" as necessary to make the additional interest compute to zero. Computationally, the additional interest provision as drafted would have resulted in effectively receiving as additional interest on a note of the supplemental interest it and previously received on notes totaling . When the Notes were reduced to a principal balance of , a spread of approximately was left (x %) which under the terms of the Class Note, should have been paid to .

In all years subsequent to the restructuring, return on its remaining investment ranged between and per year, consisting of FASIT interest and supplemental interest. All the parties to the transaction ignored the additional interest provision. The taxpayer's work papers

[3] It is unclear on what basis (other than the agreement of the parties) was able to receive a pre-payment of its investment, as it was not provided for in the Note agreement. The taxpayer has stated that it did not know why left the transaction. When was sold (as discussed infra) the purchasers stated that the Taxpayer represented that the structure was "redone" by in and as a result, there was no more need for a third party note.

never included calculations of additional interest. The taxpayer did not pay additional interest to and never accrued it. Instead, the departure of and the reduction of the Class note increased the earnings paid to the Series shareholder, because amounts that would have qualified as additional interest under the terms of the Note were instead distributed to the Series shareholder. The FASIT deducted the payment as interest due the shareholder.

According to the taxpayer's own reconstruction, based on the departure of , the reduction of the Class Note, and the money market earnings, additional interest was due (but never calculated, assessed or paid) in the amounts of , and or , , and , depending on the amount used as the average money market balance, for the years , , and , respectively. As a result, the Series shareholder received earnings at a rate in excess of the prescribed weighted average rate. For example, in , the FASIT rate was . If the additional interest provision had been in effect, the rate that would have been paid to the Series shareholder was , while the shareholder's actual effective rate was .

Other Changes After Departure

The asset management agreement identified new assets as included in the pool of assets held by the FASIT. At this time the FASIT receivables corresponding to the amount of the repaid regular and ownership interests were repaid and an intercompany receivable in the amount of due from to was substituted. Both and are part of the consolidated group known as , of which the former is a member. In the remaining receivables were repaid and another intercompany receivable, in the amount of , also due from to , was substituted. On , the rights and obligations of pursuant to the Notes were assigned to , a related party not included in the consolidated group.

The covenants were otherwise generally the same except that the covenant as to the minimum amount of return on FASIT assets was eliminated.

The original FASIT term was scheduled to end on . Prior to the expiration of the first term, the remaining parties agreed to extend the arrangement for an additional five years.

was renamed The company was contributed to on and then liquidated into on .

Since the stock was first issued, dividend declarations were made annually by the Board of Directors with respect to the Series (and subsequently, Series) stock. The declarations merely stated a dollar amount without specifying the manner of calculation. Although it appears the general intention of the declarations was to distribute approximately the residual income, the method of calculation was not consistent from year to year. However, as of the end of , total FASIT net earnings were distributed.

Acquires

In , became insolvent and went into liquidation proceedings. In early , as the second FASIT period was due to expire, the Taxpayer became concerned that would no longer be able to fulfill their function as FASIT owner. The Taxpayer was able to secure agreement to an additional term. However, a condition of the extension was the taxpayer's execution of a letter agreement agreeing to purchase (or to designate any other entity as the purchaser) the shares of for a price of , plus any unpaid interest on the Note. The letter agreement provided that this "put" could not be exercised until .

The taxpayer approached , now merged with , ( ) and requested that they purchase the stock of . was fully briefed on the background of the transaction and understood that it would be acting as an "accommodation party" in tax planning, which it described as a "double-dip". From perspective, while the investment was small – sole asset was the note - it historically paid a return of , which understood to be consistent with an arms-length, economic return. had a significant banking relationship with the taxpayer and accommodating them would be "of value" to the overall investment banking relationship. The taxpayer agreed to indemnify for any tax liability arising from the transaction. On or about , , and entered into a stock purchase agreement for the sale by to of the stock of for .

, President and Executive Director of following the sale, stated that it was anticipated that interest would be paid to consistently with its past experience. With respect to her understanding of the tax aspects of the transaction, she stated that she understood from the taxpayer that it was a "clean structure" and it was anticipated that there would be "no residual payments."

Discussion

(1) Does the repeal of the FASIT provisions in 2004 apply to the FASIT transaction at issue?

The FASIT provisions, I.R.C. § 860H-860L, were repealed in 2004. P.L. 108-357, § 835(a). However, section 835(c)(2) provides that the repeal "shall not apply to a

FASIT in existence on the date of the enactment of [the repealing statute, October 22, 2004] to the extent that regular interests issued by the FASIT before that date continue to remain outstanding in accordance with the original terms of issuance." P.L. 108-357, § 835(c)(2).

The FASIT was created pursuant to the Amended and Restated Asset Management Agreement together with the interests issued to the owner and regular interest holders. The "original terms of issuance" of the Series shares were set forth in the Certificate of Voting Powers, Designations and Preferences, together with the Amended and Restated Asset Management Agreement dated , the terms of which were incorporated by cross reference. Under the original terms of issuance, the stockholder's interest was to be redeemed, together with the remaining FASIT interests, on . The Amended and Restated Asset Management Agreement dated provided that if each of the parties agreed, the term of the Agreement may be extended for additional five year periods.

State law determines the nature of property interests for federal tax purposes. Morgan v. Commissioner, 309 U.S. 78 (1940).[4] The rights of preferred shareholders are primarily contractual in nature, and the construction of preferred stock provisions are matters of contract interpretation for the courts.[5] The provision for an additional period "should the parties agree" did not create a FASIT extending beyond , nor did it extend the term of the Series shares beyond . A provision that allows a contract to be extended if the parties should so agree prior to its designated expiration date does not create a contract for the additional period. Del Castillo v. Bayley Seton Hosp., 232 A.D.2d 602, 649 N.Y.S.2d 41 (1996); Candid Productions, Inc. v. International Skating Union, 530 F. Supp. 1330 (S.D.N.Y. 1982); cf. Dickerson v. Commissioner, T.C. Memo. 2012-60 (holding that under Alabama law, it is established that "agreements to agree" are not enforceable).

Thus, the current FASIT came into existence when the parties agreed to an additional term in . Similarly, the Series regular interest has not remained outstanding "in accordance with the original terms of issuance," as such terms included a termination date. Therefore, the exception to the repeal of the FASIT provisions does not apply.

(2) Does the stock issued to qualify as a "regular interest" under I.R.C. § 860L(b)(1)(A)(ii)?

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[4] The preferred shares were issued by a corporation, while the Amended Asset Management Agreement states that it is to be interpreted under law. In any case, there are no significant differences between the laws of the two states on this issue. International Equity Capital Growth Fund, L.P. v. Clegg, 1997 Del. Ch. LEXIS 59 (Del. Ch. Apr. 21, 1997) , at n. 3.

[5] Matulich v. Aegis Communs. Essar Invs., Ltd., 942 A.2d 596 (Del. 2008) ; Davison v. Parke, Austin, & Lipscomb, 285 N.Y. 500, 35 N.E.2d 618 (1941).

I.R.C. § 860L(b)(1) defines a regular interest as any interest which is issued by a FASIT on or after the startup date with fixed terms and which is designated as a regular interest if --

860L(b)(1)(A)(i). -- such interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount),

860L(b)(1)(A)(ii). -- interest payments (or other similar amounts), if any, with respect to such interest are determined based on a fixed rate, or, except as otherwise provided by the Secretary, at a variable rate permitted under section 860G(a)(1)(B)(i),

860L(b)(1)(A)(iii). -- such interest does not have a stated maturity (including options to renew) greater than 30 years (or such longer period as may be permitted by regulations),

860L(b)(1)(A)(iv). -- the issue price of such interest does not exceed 125 percent of its stated principal amount, and

860L(b)(1)(A)(v). -- the yield to maturity on such interest is less than the sum determined under section 163(i)(1)(B) with respect to such interest.

I.R.C. § 860G(a)(1)(B)(i) provides that interest payments, if any, on a REMIC regular interest must be payable at a fixed rate or to the extent provided in regulations, at a variable rate.

Treas. Reg. § 1.860G-1(a)(3)(ii) includes as a qualifying variable rate, a "weighted average rate", defined as follows:

(A) In general . -- A rate based on a weighted average of the interest rates on some or all of the qualified mortgages held by a REMIC is a variable rate. The qualified mortgages taken into account must, however, bear interest at a fixed rate or at a rate described in this paragraph (a)(3). Generally, a weighted average interest rate is a rate that, if applied to the aggregate outstanding principal balance of a pool of mortgage loans for an accrual period, produces an amount of interest that equals the sum of the interest payable on the pooled loans for that accrual period. Thus, for an accrual period in which a pool of mortgage loans comprises $ 300,000 of loans bearing a 7 percent interest rate and $ 700,000 of loans bearing a 9.5 percent interest rate, the weighted average rate for the pool of loans is 8.75 percent.

(B) Reduction in underlying rate . -- For purposes of paragraph (a)(3)(ii)(A) of this section, an interest rate is considered to be based on a weighted average rate even if, in determining that rate, the interest rate on some or all of the qualified mortgages is first subject to a cap or a floor, or is first reduced by a number of basis points or a fixed percentage. A rate determined by taking a weighted average of the interest rates on the

qualified mortgage loans net of any servicing spread, credit enhancement fees, or other expenses of the REMIC is a rate based on a weighted average rate for the qualified mortgages. Further, the amount of any rate reduction described above may vary from mortgage to mortgage.

(iii) Additions, subtractions, and multiplications . -- A rate is a variable rate if it is --

(A). -- Expressed as the product of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier;

(B). -- Expressed as a constant number of basis points more or less than a rate described in paragraph (a)(3)(i) or (ii) of this section; or

(C). -- Expressed as the product, plus or minus a constant number of basis points, of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier (which may be either a positive or a negative number).[6]

In order to qualify as a regular interest under section 860L(b)(1), the terms for payment of dividends to the shareholder must qualify as a fixed rate, or a variable rate permitted under section 860G(a)(1)(B)(i). The terms for payment of dividends clearly do not qualify as a fixed rate. Therefore, the rate will qualify as a permitted rate if it qualifies as a variable rate as described by section 860G(a)(1)(B)(i).

The taxpayer contends that the dividends payable on the Series stock qualify as a variable rate as defined under the REMIC rules. Specifically, the taxpayer argues that the dividends payable on the Series stock qualified as a “weighted average rate” as defined in Treas. Reg. § 1.860G-1(a)(3)(ii). The applicable “weighted average rate”, according to the taxpayer, was the FASIT rate “less approximately basis points.” The taxpayer contends that the stock bore interest at that rate due to the fact that the Class Note, by its terms, was entitled to additional interest. The taxpayer relies on Treas. Reg. § 1.860G-1(b)(3)(iii) as authority for allowing the weighted average rate to be adjusted by a “fixed number of basis points” prior to being paid.

Under the terms of the stock certificate, the amount of the dividend payable is based on the discretion of the Board of Directors of the issuer. The terms of the stock certificate provide for a maximum amount of dividends payable, consisting of all net profits after payments to the other holders of interests in the FASIT.

Although it acknowledges that the amount distributed is subject to authorization by the Board of Directors, and is limited to residual earnings after the payments are

[6] Treas. Reg. § 1.860G-1(a)(ii)(B) provides for reductions to the underlying assets for purposes of determining a qualifying weighted average rate. Treas. Reg. § 1.860G-1(a)(iii) provides for allowable adjustments, including additions, subtractions, and multiplications, to any variable rate, including a weighted average rate, once that rate is determined.

made to other holders, the taxpayer nevertheless contends that the dividends payable on the Series stock qualify as a weighted average rate of the underlying FASIT assets. It points out that any amounts that are available for distribution but which are not distributed increase the liquidation preference of the Series stock. The liquidation preference is based on the fair market value of the FASIT assets (including cash), less any accrued and unpaid expenses and interest due to the Noteholders. The taxpayer further explains that generally, the amount of the liquidation preference should equal the original issue price plus any accumulated and unpaid dividends. The implication of the taxpayer's position is that over the life of the FASIT, with the timing in the discretion of the payor, the Series shareholder will receive a weighted average rate by virtue of the liquidation preference, which will result in its receiving a residual interest in the FASIT assets.

This residual weighted average rate will presumably correspond to the maximum amount payable to the Series shareholder under the terms of the stock certificate. The maximum amount payable to the Series shareholder is defined as the FASIT earnings less the payment of interest on the Notes and the FASIT expenses; effectively a residual interest after other payments are made. The only fixed and foreseeable FASIT expense is the Asset Manager's Fee, which was a straight percentage of the face amount of the FASIT assets. Since the interest payable on the Notes is the FASIT rate, plus a spread, and the Asset Manager's Fee is a fixed percentage, the maximum amount payable to the Series shareholder is, according to the taxpayer, the FASIT amount as applied to the adjusted issue price of the stock less the spread payable to the owner, the fee paid to the Asset Manager, and while the issue was outstanding, the other regular interest holder.

A key component of the taxpayer's argument that the Series shareholder's interest qualifies as a regular interest is the additional interest provision in the owner's Note. The additional interest provision allocates to the owner any income remaining in the FASIT after the payment of the FASIT and supplemental interest on the Note and the payment to the shareholder of the FASIT rate less a specified spread times the face amount of the Series interest. In order to qualify for the participation exemption under law, the stock certificate had to appear to be a residual interest. However, the purpose for the additional interest provision was to transfer the residual interest to , by sweeping any residual income into the ownership interest, and indirectly limiting (although not guaranteeing) earnings allocable to the Series interest at the FASIT rate less a fixed spread.[7]

Form of the Transaction

[7] The transaction was designed on the assumption this structure would satisfy both and U.S. taxing authorities because the standards for determining whether the interest was equity in and a FASIT regular interest in the U.S. were the same. However, as the witness indicated, the language of the stock certificate was drafted to give the appearance of being a residual interest, with the limitation on the interest ascertainable only from a close reading of the terms of the Note. The witness acknowledged a weighted average rate might not have qualified for the requisite tax treatment in .

As indicated above, I.R.C. § 860L(b)(1)(A)(ii) provides that a feature of a regular interest is that interest payments or similar amounts are determined based on a fixed or variable rate. I.R.C. § 860B(a) provides that for purposes of determining the tax of a holder of a regular interest in a REMIC, the interest shall be treated as a debt instrument. I.R.C. § 860B(b) provides that the holder includes in gross income amounts with respect to the regular interest under the accrual method of accounting.

The legislative history provides that, consistent with the pass-through nature of the REMIC, the holders of regular interests general take into account that portion of the REMIC's income that would be taken into account by an accrual method holder of a debt instrument with terms equivalent to the terms of the regular interest. H. R. Rep. 99-841, 99th Cong., 2nd Sess. p. II-231. Under the accrual method of accounting, a holder of a debt instrument is taxable currently on interest at the interest rate payable under the terms of the instrument. Thus, Congress intended that a regular interest holder would be taxable currently under the accrual method on interest at the qualifying rate as specified in I.R.C. § 860G(a)(1)(B). If interest is payable at a weighted average rate, the holder would be required to accrue interest currently at the weighted average rate. Similar rules apply to FASITs. See, I.R.C. §§ 860H(c)(1), 860H(c)(3).

The shareholder's interest did not include terms that would require the accrual of current income at the weighted average or any other rate. Instead, dividends were payable at the discretion of the corporation, at some point between inception and liquidation. The basis for accrual was the declaration of dividends by the corporation, or payment on liquidation, in the same way as any equity interest in a corporation.

The taxpayer's reliance on the liquidation preference to provide the "weighted average rate" is therefore misplaced. Under the FASIT rules, and the REMIC rules by cross-reference, interest on qualifying regular interests must be subject to current accrual by an accrual basis taxpayer, in the same way as a debt instrument, not accrued by the holder that happened to hold the instrument on the date of declaration or liquidation.

Substance of the Transaction

Although the additional interest provision in form transferred the residual interest to the FASIT owner, it was designed with the expectation the other provisions of the arrangement would provide for all the cash flows of the FASIT. The FASIT was structured on the assumption that the owner's residual interest had no value. That the additional interest provision was not intended to provide value to the owner is consistent with the economics of the transaction. The taxpayer, and not the owner, had contributed the FASIT assets. The owner had made a minimal investment in the FASIT, and had a specified return on that investment. Fees compensating the owner for other services, such as bringing the transaction to the taxpayer, and assisting with the structure, were paid outside the FASIT.

However, it became clear from inception that the other provisions of the arrangement did not provide for all of the cash flows of the FASIT. Short term cash flow (i.e. money market) investments produced earnings that were not otherwise payable to either the owner or the Series shareholder. After the departure of the Class Noteholder, and the reduction of the ownership interest, additional earnings became available that were not paid out pursuant to the other terms of the ownership interest, thus bringing the additional interest provision into play. Because the parties did not intend the owner's residual interest to have any value, the additional interest provision was simply ignored and the Series shareholder was paid the residual interest. Perhaps for that reason, the taxpayer's statements as asset manager, reflecting FASIT activity each year, never included the identification of a FASIT rate.

The substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Merck & Co. v. United States, 652 F.3d 475, 481 (3rd Cir. 2011). In determining substance, we must look beyond the "superficial formalities of a transaction to determine the proper tax treatment." Blueberry Land Co. v. Commissioner, 361 F.2d 93, 101 (5th Cir. 1966), affg. 42 T.C. 1137 (1964). "Transactions, which did not vary, control, or change the flow of economic benefits, are dismissed from consideration." Higgins v. Smith, 308 U.S. 473, 476 (1940).

Applying the doctrine of substance over form, the additional interest clause in the Class Note was not intended to function as an economic residual interest, but was only included to support the taxpayer's tax position. The interest was never computed, charged, or paid. It did not provide for an arms-length return on the owner's investment, and it was not contractually negotiated as part of the fees negotiated between the parties. The parties included the provision on the assumption it could be ignored as generating only a nominal amount, and continued to ignore it even after that was no longer the case. Without the additional interest provision, the substance of the Series interest was consistent with its terms, which provided for a residual interest in the FASIT. The shareholder received all FASIT earnings after payments were made to the noteholders, without limit.

As a result, the residual interest received by the Series shareholder did not qualify as a weighted average rate, or a weighted average rate adjusted by a constant number of basis points. The addition of the money market assets ensured that the rate received by the Series shareholder exceeded the FASIT rate, with the amount of such excess depending on the amount of and earnings on such assets. Further, because the shareholder received a residual interest, the effective interest rate paid on the principal balance of the shares was subject to the interests issued to other holders. During the period in which and collectively had in outstanding notes, the FASIT interest and supplemental interest spread payable on their loans reduced the effective interest rate payable to the shareholder. When departed and the note was reduced, the FASIT earnings allocable to the shareholder, and the

effective rate of earnings allocable to the shareholder, increased.

Under Treas. Reg. § 1.860G-1(a)(3)((iii)(B), a rate will still qualify as a weighted average rate if adjusted by a "constant number of basis points more or less than" an otherwise allowable rate. Over the lifetime of the FASIT, the rate paid on the Series shares was and continues to be a residual amount dependent on the money market investments and the terms of the other interests issued by the FASIT. Over the period in which the FASIT has been in effect, the FASIT interest rate payable to the Series shareholder has been adjusted by the payments, including spreads, paid to other interest holders, which amounts have changed (and are still subject to change). Therefore the spread or multiplier to the FASIT earnings rate, for purposes of computing the residual amount payable to the Series shareholder, was not a fixed or constant amount as required to qualify as a variable rate under the REMIC rules.

(3) If the stock issued to does not qualify as a "regular interest" under I.R.C. § 860L(b)(1)(A)(ii), does it qualify as a regular interest under I.R.C. § 860L(b)(1)(B)(ii)?

I.R.C. § 860L(b)(1)(B)(i) provides that the term "regular interest" includes any high-yield interest.

I.R.C. § 860L(b)(1)(B)(ii) provides that the term "high-yield interest" means any interest which would be described in subparagraph (A) but for –

(I). -- failing to meet the requirements of one or more of clauses (i), (iv), or (v) thereof, or

(II). -- failing to meet the requirement of clause (ii) thereof but only if interest payments (or other similar amounts), if any, with respect to such interest consist of a specified portion of the interest payments on permitted assets and such portion does not vary during the period such interest is outstanding.

I.R.C. § 860K(a) provides that in the case of any high-yield interest which is held by a disqualified holder –

860K(a)(1). -- the gross income of such holder shall not include any income (other than gain) attributable to such interest, and

860K(a)(2). -- amounts not includible in the gross income of such holder by reason of paragraph (1) shall be included (at the time otherwise includible under paragraph (1)) in the gross income of the most recent holder of such interest which is not a disqualified holder.

I.R.C. § 860K(c) defines a "disqualified holder" as any holder other than --

860K(c)(1). -- an eligible corporation (as defined in section 860L(a)(2)), or

860K(c)(2). -- a FASIT.

I.R.C. § 860L(a)(2), in pertinent part, defines an eligible corporation as a domestic C corporation.

The requirements for a regular interest are set forth in section 860L(b)(1). However, the high yield interest rules allow an interest to qualify as a regular interest, even though the arrangement issues interests which do not satisfy some of those requirements for a regular interest set forth in I.R.C. § 860L(b)(1). It does so by treating a "high yield" interest as a regular interest notwithstanding its failure to satisfy certain parts of the definition. As relevant here, an interest that does not qualify as a regular interest under section 860L(b)(1) because it earns interest at a nonqualifying rate may still qualify as a regular interest if it is entitled to a specified portion of the earnings of the FASIT that remains constant over the period in which the interest is outstanding.

If a "high yield" interest is transferred to a "disqualified holder," the income allocable to that holder is shifted to the last holder of the interest, as if the transfer from the prior interest holder had not occurred. I.R.C. § 860K(a). A "disqualified holder" includes any foreign corporation. I.R.C. § 860K(c).

The legislative history indicates that where the FASIT directly issues such interest to a disqualified holder, it will not be treated as the issuance of a high yield interest.[8]

An interest will fail both the general requirements for a regular interest and the high-yield interest exception, if it does not satisfy the interest rate requirements of section 860L(b)(1)(A)(ii) and does not meet the exception in section 860L(b)(1)(B)(ii)(II). The interest will not satisfy section 860L(b)(1)(A)(ii) if the interest rate provided by the interest is not a fixed rate or a variable rate as defined under the section 860G(a)(1)(B)(i) (applicable to REMICs). The interest will not satisfy the exception set forth in section 860L(b)(1)(B)(ii)(II) if the rate does not consist of a specified portion of the interest on permitted assets that remains fixed during the period the interest is held or if the FASIT issues the interest to a foreign holder. In that event, the entity will not qualify as a FASIT under § 860L(a)(1)(B) because it has issued an interest that is neither an ownership interest nor a regular interest as defined under the FASIT rules. The consequences of that treatment are discussed in section 4, below.

The interest issued to the shareholder does not qualify as a high yield interest because it was directly issued to a disqualified holder (a foreign corporation) and therefore does not qualify as a regular interest under sections 860K(a), 860K(c), and 860L(a)(2).

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[8] Senate Report No. 104-281, at 131 n. 85 (1996).

It also fails to qualify under I.R.C. § 860L(b)(1)(B)(ii)(II). As stated above, a high-yield interest under I.R.C. § 860L(b)(1)(B)(ii) is a rate consisting of a specified portion of the interest on permitted assets that remains fixed during the period the interest is held. The Series shareholder's interest was computed as a residual interest. The percentage paid to the shareholder changed based on the amount of cash flow money market investments and the presence of other interests in the FASIT. In particular, after the Class Noteholder departed and the ownership interest was reduced, the shareholder received in its capacity as residual interest holder, the supplemental interest that previously was paid on the former interests. Since the Series shareholder's share of total earnings fluctuated, it was not a specified portion of the interest on permitted assets that remained fixed during the period the interest was held. The interest does not qualify as a regular interest under the general requirements or the high yield exception and therefore a valid FASIT was not created.

4. What are the consequences of the determination that a valid FASIT never existed?

As pertinent here, I.R.C. § 860L(a) defines a "financial asset securitization investment trust" and a "FASIT" as any entity

(1)(A) for which an election to be treated as a FASIT applies for the taxable year, and

(1)(B) all of the interests in which are regular interests or the ownership interest.

I.R.C. § 860L(a)(3) provides that an entity (otherwise meeting the requirements of paragraph (1)) may elect to be treated as a FASIT.

I.R.C. § 860L(a)(4) provides that if any entity ceases to be a FASIT at any time during the taxable year, such entity shall not be treated as a FASIT after the date of such cessation. Exceptions apply to inadvertent failures to qualify or remain qualified as a FASIT. I.R.C. § 860L(a)(5).

If a valid FASIT never existed, the underlying arrangement is no longer treated as a FASIT and generally is prohibited from making a new FASIT election, which in any case would be prohibited under the repeal of the FASIT provisions. In addition, the underlying arrangement would be evaluated under general tax principles.

Under general tax principles, the segregated pool of assets would be reclassified as assets of its actual owner, . The income pertaining to those assets is includible in the taxable income of its actual owner and recipient, . While the payments made to are deductible as interest expense, the payments made to the Series stockholder would be classified as dividends paid on equity and would accordingly not be deductible for tax purposes.

Please call (973) 645-2572 if you have any further questions.

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