WHEN the subject is simplifying the tax law, an almost unlimited number of potential opportunities spring to mind. While simplification can be difficult without making tradeoffs, there is almost no corner of this massive, messy old edifice that could not be improved if one had the will. The one small corner that attracts my attention is the relatively new statutory provisions governing asset-backed financing.¹ These statutory provisions create a special purpose vehicle for accomplishing securitizations: a financial asset securitization investment trust, or FASIT for short.²

The tax treatment of asset securitization is an obscure topic that most sensible people, including tax experts, prefer to avoid. Yet securitization is an important activity in our economy. It is a significant means by which firms monetize assets such as trade receivables, loans, rents, and payments on licenses of patents and copyrights. In a securitization, an owner of cash-flow-producing assets (usually referred to as the originator or sponsor) transfers those assets to a special purpose entity. The entity issues securities to investors that represent portions of the cash flows from those assets. The cash produced by the issuance is transferred to the originator. The terms of the securities are tailored to bear different levels and types of risk and to satisfy diverse investment objectives. Securitization, it is argued, contributes to more liquid capital markets, improved availability of credit, lower interest rates, and better risk spreading.

Congress has enacted two regimes to provide special tax treatment for securitization arrangements. As part of the Tax Reform Act of 1986,³ Congress created the real estate mortgage investment conduit (the “REMIC”), a special purpose tax entity for securitizing real estate mortgage loans.⁴ By 1996 it had become clear that that a large and growing volume of securitizations were not accommodated by the REMIC provi-

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1. The author must disclose that she worked on the FASIT legislation as a congressional staffer and at the Department of the Treasury. She does not, however, feel any compunction about expressing views inconsistent with the opinions she had or the positions she took at the time, if she could even remember what they were.


Congress then created the FASIT. The FASIT rules were to provide a regime within the tax code for securitizing credit card receivables, home equity loans, auto loans and other debt instruments. Although the FASIT rules could also be used for securitizations of real estate mortgage loans, Congress left the REMIC rules largely intact.

The REMIC and FASIT legislation responded to problems financial institutions and others faced in structuring securitizations. In each case, advocates of the regime argued that the income tax law prevented securitizations from fulfilling their market-enhancing potential.

The REMIC and FASIT rules are not unique. The Internal Revenue Code contains a number of specific tax regimes that encourage or facilitate investment. These special rules typically allow entities to escape entity-level tax without being classified as partnerships, and their investors often get simplified, usually advantageous, tax treatment. These special regimes include the regulated investment company rules, which govern mutual funds, and the real estate investment trust rules, which govern investment in real estate.

By some measures, this approach to addressing the tax impediments to specific transactions can be considered successful. On the other hand, addressing specific transactions individually creates virtually separate and highly specialized bodies of tax law, which in turn cause discontinuities and give rise to complexity. The REMIC and FASIT regimes seem especially problematic because they represent elaborate statutory structures created to solve problems faced by a narrow interest group. Nonetheless, special purpose entities have reached high levels of acceptance among users and providers of capital. For example, regulated investment companies hold large amounts of investment capital and can be credited with increasing the participation of individuals in the debt and equity markets by offering diversification for even the smallest investment. Real estate investment trusts make a similar benefit available for real estate investors. REMICs play a significant role in the liquidity and

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7. The requirements for obtaining the special status include limits on the entity's activities, the types of assets it owns, the type of income it earns, the characteristics of the instruments (debt or equity) it issues, the distributions it makes to investors, and in some cases the identity of its owners. See, e.g., I.R.C. §§ 851(b), 856(b) (2002).
10. See, e.g., N.Y. State Bar Ass'n Tax Section, NYSBA Reports on Proposed "FASIT" Legislation, 94 TAX NOTES TODAY 111-50 (1994) (questioning whether it is appropriate to add so much complexity when the "legislation . . . will apply principally to a single industry").
12. At the end of September 2002, real estate investment trusts had an aggregate market capitalization of $163 billion. Nat'l Ass'n of Real Estate Inv. Trusts, Constituent Companies and Relative Weights in the NAREIT Real-Time Index (Oct. 1, 2002), available at
depth of the mortgage market by facilitating direct investment pools of mortgages.\textsuperscript{13}

The FASIT is a glaring exception to these successes. The regime has failed miserably to live up to its promise.\textsuperscript{14} While trillions of dollars of asset-backed securities are outstanding, few were issued under the FASIT rules.\textsuperscript{15} Instead, financial institutions and other originators of receivables continue to securitize assets using many of the same techniques relied on before the enactment of the FASIT provisions. Still, the FASIT provisions lurk in the tax code, occasionally drawing controversy, but largely ignored. This state of affairs supports arguments in favor of rethinking the FASIT rules. But what should be done about them? There are several choices.

First, the FASIT rules could be left as they are, condemned to dead wood status. The problem with this approach is that it would essentially maintain the status quo. So while Congress could be understood to have abandoned the regime by failing to fix it, the abandonment would be implicit. The continued existence of the statutory provisions could invite wasteful investments of Internal Revenue Service and Treasury Department resources.\textsuperscript{16} Moreover, it would continue the risk that taxpayers

\textsuperscript{13} Seven hundred twenty-three billion dollars of mortgage-backed securities were outstanding at the end of September 2001. Almost all of those securities were interests in REMICs. The Bond Mkt. Ass’n, An Investor’s Guide To Collateralized Mortgage Obligations, available at \texttt{http://www.investinginbonds.com/info/igcmo/an_investors_guide_to_cmos.pdf} (last visited Oct. 26, 2002).


\textsuperscript{15} See, e.g., \textit{NYSBA Recommends Changing FASIT Rules, supra note 14 (“[I]t is clear the FASIT rules are not being used to any significant degree . . . .”); Colman J. Burke et al., \textit{Do the Proposed Regulations Administratively Repeal the FASIT Provisions?}, 93 J. TAX’N 229 (2000) (only a “handful” of transactions); JAMES M. PEASLEE & DAVID Z. NIRENGER, \textit{FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS} 17 (3d ed. 2001) (“To date, the FASIT structure has not been widely used, even by the groups that sponsored the legislation.”); Adam Tempkin, \textit{FASIT Structure Loses Market’s Interest: Bond Market Association Points Out Disadvantages for CMBS, ABS, Asset Sales Rep., July 10, 2000 (“The FASIT became effective September 1, 1997, and since then there were approximately three FASIT deals done.”) (quoting Stephen Whelan, chairman of the corporate department of Thatcher, Proffitt & Wood)).

would use the provisions in unanticipated ways.17

Alternatively, the FASIT rules could be repealed entirely. Some, most notably the Joint Committee on Taxation and the Tax Section of the New York State Bar Association, have suggested this as a measure to simplify the tax code.18 Repeal of the FASIT rules would make abandonment of the regime explicit. It would eliminate the risk that the rules could be used in unanticipated ways or that the IRS or the Treasury Department would waste limited resources on a regime that is probably unworkable.19 It would also reduce the size and complexity of the tax code and the regulations. On the other hand, this approach would constitute an abandonment of the effort to reduce the tax and tax-related transaction costs associated with securitizations unless other measures were taken.20

Finally, Congress could make substantial changes in the FASIT regime. The statute charges a substantial toll for the creation of a FASIT and imposes corporate tax on a portion of FASIT net income. These provisions are the major reasons taxpayers do not utilize the structure. But more than just making it expensive to use, these taxes communicate a broader, more fundamental uncertainty about how tradeoffs should be made between reducing the tax burden on securitizations and the loss of revenue that might ensue. While the statute permits the IRS to mitigate

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19. Cf. Peaslee & Nirenberg, It’s Time to Bag the FASIT Rules and Start Over, supra note 18 (considering why FASIT rules are not imminent, “[o]ne explanation may be that the IRS has concluded (quite reasonably) that writing workable FASIT regulations would be an enormous undertaking and does not wish at this point to devote the necessary resources to the task . . . FASITs would still wither on the vine due to the defects in the statute.”).

20. James Peaslee, a leading expert on the tax treatment of securitization and the most vocal advocate for abandoning the FASIT regime, also has often proposed a number of alternative, incremental statutory and regulatory changes that he argues would accomplish as much as improved FASIT rules. See e.g., Peaslee & Nirenberg, It’s Time to Bag the FASIT Rules and Start Over, supra note 18; James M. Peaslee, Peaslee Suggests Alternative to FASIT Legislation, 1995 Tax Notes Today 198-100 (1995).
the effects of some of these provisions through regulations.\textsuperscript{21} Congress provided no guidance on how the regulations should resolve the inevitable conflict between complexity and revenue loss: Congress could not resolve the conflict itself. With this background, the only way to make FASITs workable is to confront and deal with the revenue issue.

Recommending that the FASIT provisions remain in the law in their current state is just not worth the breath. So the question is whether the provisions should be repealed, leaving taxpayers with the methods they currently use to securitize non-mortgage debt, or whether fixing the FASIT regime would be worth the revenue cost. In exploring this question, one must ask what securitization contributes, and whether revenue sacrifices are justified. There are reasonable arguments that securitization represents a meaningful improvement over other financing techniques by reducing inefficiencies. Even if securitization does not have unique benefits, it is at least comparable to other transactions that are subject to more favorable tax rules. As a policy matter, this leads me to be weakly in favor of making legislative changes to better accommodate securitization transactions. But if revenue cannot be devoted to this project, then the FASIT legislation should be jettisoned.

This article will first provide a brief introduction to non-tax aspects of securitization transactions. The second part will describe the arguments about whether securitization is an efficiency-enhancing activity that should be encouraged, or at least not discouraged, by the tax law. I will shift in the third section to a description of the general tax rules other than the FASIT provisions that apply to securitizations. Rather than providing a full and detailed analysis, this section is intended to establish a context for the FASIT regime and to give the reader a sense of the ways securitizations can be accomplished without resort to that regime. Finally, I will discuss FASITs, the rules that impede their use, why such a flawed law was enacted, and what can be done about it now.

\section{Securitization in Brief}

The term "securitization" describes a large category of transactions. It is a strategy whereby assets representing rights to cash flows are pooled and monetized. The originator of assets\textsuperscript{22} can securitize them by transferring them to a special purpose vehicle ("SPV"), often a trust, which issues marketable securities. The securities entitle investors to some portion of the cash flows from the assets.\textsuperscript{23} The proceeds from the issuance of the securities are used to reimburse the originator for the assets. In some cases this transaction is a sale of the assets, and others it is a borrowing secured by the assets. At times the originator intends to characterize the

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\item 21. I.R.C. § 8601(c) (2002).
\item 22. For purposes of this paper, I will refer to the firm that arranges the securitization and transfers the assets as the originator, although at times this firm will have acquired, rather than originated, the assets. This firm is also frequently referred to as the sponsor.
\item 23. These interests are often called asset-backed securities.
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transaction differently for different legal and non-legal purposes.  

The types of assets that are securitized include real estate mortgage loans, credit card receivables, auto loans, other consumer debt, home equity loans, and commercial mortgages. Rental payments, royalties, and franchise fees are also securitized. One extreme example of a securitization is the infamous Bowie Bonds, which securitized the royalties from rock star David Bowie's recordings.

The cash flows from the securitized assets are generally collected on behalf of the SPV and then used to make payments on the securities. Payments to the investors are closely linked to the cash flows from the securitized assets, and the aggregate payments on the securities usually represent a large portion of the cash flows. But most securitization arrangements provide that payments must be made on securities even if the SPV does not receive the corresponding payments on the assets.

Payments on the securities can be assured through several different techniques. The aggregation of large numbers of similar debt instruments, receivables or other assets in the SPV diversifies risk and makes default rates highly predictable. Cash flows from excess assets held by the SPV usually cover the predicted defaults and delinquencies. This is referred to as overcollateralization. Overcollateralization is but one type of credit support utilized in securitizations. Others include reserve funds created with excess cash flow from the pooled assets and letters of credit, irrevocable lines of credit, or guarantees from banks or other institutions that have high credit ratings.

The SPV can issue securities representing an interest in the pool of assets in a number of different forms. They are often divided into classes having different risk, duration, and payment characteristics. In the simplest structure the SPV issues securities that represent pro-rata interests in the pool's cash flows. A slightly more complex structure is one that accomplishes the equivalent of coupon stripping—the securities provide for payments that are measured by a particular payment or payments on

24. Usually, as discussed below, it is desirable for the securitization transaction to be treated as a sale to an unrelated entity for bankruptcy, accounting, and regulatory capital purposes. See infra notes 33-38 and accompanying text. A transaction may be more advantageously treated for tax purposes either as a sale or as a secured borrowing depending on the particular circumstances of the originator, the assets, the investors, and the overall transaction.


30. Proposal to Expand the REMIC Provisions, supra note 28, at 310.
the underlying assets. Conversely, a class of securities may provide for payments that are seemingly unrelated to the cash-flow on the underlying assets. An SPV's securities often have allocations of default or delinquency risks, "prepayment risks," or interest rate risks that vary by class. Naturally, the class that bears the most risk also provides the highest yield.

There are several other almost universal elements of securitization transactions. First, the pool of securitized assets is usually held by an entity that is legally separate from the originator, and the assets are transferred in a way that qualifies as a "true sale." This makes the assets inaccessible to the originator's creditors in most cases. Second, the transaction must protect the SPV against being placed in bankruptcy, whether voluntarily, involuntarily, or upon bankruptcy of the transferor, and against government claims. An SPV that has these two characteristics is often referred to as being "bankruptcy remote." This allows the SPV and its assets to be isolated from the risks undertaken by the originator in its business, and offers investors a risk profile different from investments in debt issued directly by the originator, even when that debt is secured by the assets similar to those in the pool. These measures often permit the

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31. An example of this is synthetic floating rate securities issued by an SPV that holds fixed rate debt. The securities provide for payments equal to the principal amount of the debt. They also provide for payments based on an interest rate set by a reference interest rate index, capped at the fixed rate on the debt. The SPV issues another class of securities that entitle the holders to payments determined by the difference between the interest rate determined under the reference interest rate index and the fixed rate on the debt. Thus, in the aggregate the securities provide for payments equal to the cash flow on the securitized assets. See Peaslee & Nirenberg, supra note 15, at 207-08.

32. SPVs often issue subordinated interests. The holders of the subordinated interests receive their payments only after the senior security holders are paid. If the structure includes subordinated securities, excess cash will be allocated to make up delayed payments on the interests before amounts are paid to the originator. In absorbing such losses the subordinated investors can further insulate the more senior holders from unexpected defaults on the underlying assets. See Schwartz, supra note 27, § 2:4 at 2-17 to 2-18; Sunil Gangwani, Securitization 101, in 3 Speaking of Securitization 4-1, 5 (1998), available at http://www.securitization.net/pdf/sec101.pdf (last visited Oct. 26, 2002).

33. See Schwartz, supra note 27, § 3:2.2 at 3-14.

34. Those structuring securitization transactions control these risks using a number of techniques. The SPV's charter or governing documents can limit the circumstances in which the entity can file a bankruptcy petition. Ensuring the SPV is not owned or controlled directly by the originator also reduces bankruptcy risk. See Schwartz, supra note 27, § 3:2.2 at 3-14. Originators often accomplish this by selling assets to a wholly owned subsidiary that engages in no business other than participating in the securitization. The subsidiary then transfers the assets to the SPV. This two-tiered structure is referred to as the FINCO structure. Id. § 3:2.2 at 3-14. It is used to manage the conflict between the need for a true sale and the need to provide recourse through overcollateralization or other means. This structure also allows gain (or loss) on the sale of the assets to the subsidiary to go unrecognized if the subsidiary is a disregarded entity for tax purposes. If the subsidiary is a corporation for tax purposes, the gain (or loss) on the sale can be deferred under the consolidated return rules. Treas. Reg. § 1.1502-13 (as amended in 2000). Schwartz, supra note 27, § 3:2.2 at 3-14; see also Peaslee & Nirenberg, supra note 15, at 63-66, 891-99.

35. Commentators often cite the benefit of bankruptcy remoteness for originators having below investment grade credit ratings. The securities issued by a special purpose entity can easily have a higher credit rating, and therefore lower cost of capital, than the
securities issued in the securitization to have a higher credit rating, and thus bear lower interest rates, than debt issued directly by the originator. They also may allow the originator to account for the transfer of the SPV’s assets as a sale to an unconsolidated entity under generally accepted accounting principals. This can eliminate the assets and the offsetting obligations represented by the securities from the originator’s balance sheet, and can allow the originator to recognize financial statement income on the transfer.

Illustration: A simple illustration of a securitization follows.

A bank originates 100 unsecured loans with similar terms and a remaining term of 10 years to maturity. The loans have slightly different interest rates and remaining durations, but their rates and remaining durations do not diverge greatly, and their weighted average interest rate is 10%. The aggregate principal amount of the loans is $5,000,000. They are pooled and transferred to a trust, along with an amount to fund a reserve account. The trust holds the loans for the benefit of 90 certificate holders, each entitled to receive a payment of $50,000 of principal and interest thereon at a market rate of interest (assume for this purpose 9.5%), determined by the weighted average rate of interest on the loans held in the pool, minus a servicing fee. Each certificate holder is entitled to the equivalent of 1/100 of each payment of principal and interest less a discount on each loan held in the pool.

The ownership of the remaining $50,000 of principal, and the interest thereon, is represented by a subordinated interest in the pool. This interest is held by an investor other than the bank. Payments on subordinated interests generally cannot be made unless the reserve account is fully


36. Schwarcz, supra note 35, at 136-38; Gangwani, supra note 32, at 3.


38. Similar, but slightly different factors allow a regulated entity, such as a bank or a securities dealer, to exclude the assets from their net capital subject to regulatory capital requirements. See Schwarcz, supra note 27, § 1.2 at 1-7; Michael S. Gambro & Scott Leichtner, Selected Legal Issues Affecting Securitization, 1 N.C. Banking Inst. 131 (1997).
funded and all payments to the other certificate holders are up to date. The certificate holders and the subordinated interest holder pay, in the aggregate, $5,000,000 for the interests, and that money is transferred to the bank in exchange for the loans.

The bank will continue to service the loans, collecting interest and principal, and otherwise dealing with the borrowers, including making attempts to collect if there is a default. This makes the pooling of the loans in the trust essentially transparent to the borrowers. The bank subtracts from the collections of interest some portion as its fee, placing the remainder in an account to be disbursed to the holders of the SPV’s securities or the reserve account.

The trust may also obtain a guarantee of timely payment or a letter of credit from a bank or other financial institution with a high credit rating. There are various mechanisms for paying credit support fees, but the fees are often charged as a percentage of the interest collections on the underlying loans.

II. THE BENEFITS OF SECURITIZATION

In this section I will discuss why firms securitize assets and what benefits commentators attribute to securitization. In considering whether the FASIT provisions should be extended or abandoned, one should compare the economic effects of securitization and other types of funding mechanisms. A review of the literature reveals that the claims about the advantages of securitization tend to be echoed repeatedly without critical examination. Nonetheless, securitization does appear to be an evolutionary step in corporate finance, and the qualities attributed to securitizations cannot be totally discounted. Moreover, it does not appear the securitization movement is driven by income tax considerations.

The proponents of the FASIT legislation explained the need for the legislation by extolling the important benefits that increased securitization provides. For example, when Representative Clay Shaw introduced FASIT legislation in 1995, he said that simplifying the tax treatment of securitizations would make credit easier to obtain and less expensive for borrowers, especially small and medium-sized businesses, and would increase the safety and soundness of the U.S. banking system. Professor Steven Schwarcz, one of the leading advocates of securitization, says the transaction has “unique benefits,” and the claim is frequently repeated. But the unique benefits of securitization are hard to pin down. Most descriptions of the benefits are based on a narrow conception of costs incurred by the firm engaging in the transaction. Broader statements about the economic benefits of securitization as a financial trend tend to be conclusory or superficial. More thorough inquiries into the question

40. Schwarcz, supra note 35, at 133.
are largely theoretical. There appears to be little empirical evidence to support the many benefits attributed to securitization.

Observers give a number of explanations for the existence of securitization transactions. In general, one can say that the transactions occur because the pooling of assets in a securitization provides diversification. If individual loans of the type securitized were sold to investors the loans would be highly discounted for the risk associated with the volatility of a single loan. While the behavior of any particular borrower is hard to predict, if large numbers of similar loans are combined into a pool, risk is reduced because it becomes possible to statistically predict rates of default and other behaviors with accuracy.\(^{41}\)

In addition, pooling can allow the returns on the assets to be segregated into different kinds of investments with different risk characteristics. This allows investors to tailor their risk exposures. For example, the critical feature of the REMIC provisions is that it allows SPVs holding real estate mortgage loans to issue fast-pay and slow-pay classes of securities. The fast-pay class absorbs prepayments of principal on the underlying mortgage loans, and so may mature sooner than it would if payments on the loans were made according to schedule. The slow-pay class, which appeals to investors who are sensitive to reinvestment risk, receives only scheduled payments of principal until the fast-pay class matures.\(^{42}\) Because payment rates on real estate mortgage loans can be very sensitive to changes in market interest rates, the fast-pay, slow-pay structure allows investors to take different positions on interest rates.

These considerations would explain why an investor would prefer to invest in a pool of loans rather than in a single loan, but they do not show that securitization’s benefits are unique. They do not explain why securities issued by an SPV would or should be preferred over debt issued by a diversified corporation, particularly if that debt is secured by similar assets. The pooling that occurs through a securitization need not be performed by a specially created trust. Any entity with sufficient resources can accomplish the same thing. Thus, a corporation that holds many loan assets reduces its risk through diversification. That corporation can (in theory) issue debt instruments with the same terms as securities issued in a securitization.

The significant feature of securitization is that it insulates investors from changes in the originator’s financial status.\(^{43}\) Securities issued in a securitization transaction can obtain credit ratings that are higher than the alternative debt securities issued by the originator. For this reason, securitization is often said to reduce the cost of funds to a firm.\(^{44}\) A similar, but often separately articulated benefit is access to funds from investors

\(^{41}\) See Schwarcz, supra note 27, § 2:1 at 2-1 to 2-2.

\(^{42}\) See Gangwani, supra note 32, at 3; Proposal to Expand REMIC Provisions, supra note 28, at 330.

\(^{43}\) See supra notes 33-36 and accompanying text.

\(^{44}\) See, e.g., Schwarcz, supra note 35, at 137. ("Even an originator with an investment grade rating may derive benefit from securitization if the SPV can issue debt securities with..."
tors who would not invest in securities issued directly by the originator.\textsuperscript{45}

Indirect benefits to originators are also cited in favor of securitizations. The benefit most commonly noted is the off-balance sheet financing which securitizations allow.\textsuperscript{46} Thus, securitization transactions raise funds in much the same way as borrowing, and yet do not increase the originator's debt-to-equity ratio.\textsuperscript{47} Some cite the utility of securitizations in allowing originators to avoid violating restrictive debt covenants.\textsuperscript{48} Other benefits include improved ability to meet minimum capital rules, increased fee income (substituted for interest on assets), less expensive management of asset and liability risk, and less expensive credit enhancement.\textsuperscript{49}

The problem with stating the benefits of securitization this way is that it focuses the issue too narrowly. The question is whether these savings identified with securitization reflect an absolute reduction in a firm's cost of capital, or whether the savings are offset elsewhere. The evidence on this is muddy.\textsuperscript{50}

There is an argument that the cost-of-capital savings generated by securitizations are not absolute, but represent a mere shifting. Here the debate about the economic effect of secured financing is instructive. Some observers argue the savings on capital costs obtained through secured borrowing come at the expense of other stakeholders. In theory, secured debt should reduce the cost of borrowing because it reduces the risk that insolvency or bankruptcy will prevent repayment. But some believe that secured borrowing reduces the cost of new debt at the expense of the issuer's unsecured creditors.\textsuperscript{51} When a firm pledges security it
reduces the assets from which other debts can be repaid. This is detrimental to the position of preexisting unsecured creditors.\textsuperscript{52} If unsecured creditors can adjust interest rates to offset this detriment, the benefit of lower interest costs from the secured debt is reduced or eliminated. Alternatively, secured debt might produce cost savings by externalizing costs onto the firm's involuntary creditors\textsuperscript{53} that have no ability to adjust interest rates.\textsuperscript{54} If this occurs, the lower rates obtained through secured borrowing provide no net economic benefit even when they provide a lower net cost of capital.

This argument may be extended to securitizations. Securitizations resemble more conventional secured debt in many ways.\textsuperscript{55} The problem is that observed behavior does not seem to support the analogy, so even if these theories about secured debt are true, they may not hold for securitizations. Firms reportedly avoid issuing secured debt if possible,\textsuperscript{56} and enjoy no significant interest rate advantage (if they are financially healthy) when they borrow on a secured basis.\textsuperscript{57} In contrast, the cost of funds obtained through securitization can be lower than the costs associated with direct borrowing, whether secured or unsecured, because of the better credit rating associated with a securitization.\textsuperscript{58} Moreover, securitizations have increased dramatically over the past decade.\textsuperscript{59} According

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\item SCHWARCZ, supra note 27, at A-2. Here there may be some difference between secured debt and securitization. Secured debt has a separate claim on assets, but to the extent those assets are insufficient it may also have recourse to the firm's other assets, thus diluting the claims of the unsecured creditors. A securitization seems different because the holders of the SPV's securities do not have recourse against the originator. However, overcollateralization may create a similar effect because it replaces assets held by the firm with less cash than those assets are, in some sense, worth. For a general discussion on the literature and analysis of evidence, see Claire A. Hill, \textit{Is Secured Debt Efficient?}, 80 TEX. L. REV. 1117 (2002).
\item See SCHWARCZ, supra note 27, at A-1. Professor Schwarcz calls this the principle of exposure conservation. \textit{Id.} at A-4 & n.8 (citing Alan Schwartz, \textit{The Continuing Puzzle of Secured Debt}, 37 VAND. L. REV. 1051, 1054 (1984)).
\item Tort plaintiffs and government entities are examples of involuntary creditors. These creditors have no ability to adjust interest rates.
\item See, e.g., Claire A. Hill, \textit{supra} note 51, at 1129 ("A securitization transaction is a complex version of a pledge of receivables."). \textit{See also} Ngo, \textit{supra} note 47, at 459.
\item \textit{Id.} at 448. This may only be true for firms in reasonably good financial health. Riskier firms experience a bigger bonus from issuing secured debt. \textit{See} Hill, \textit{supra} note 51, at 1155-58.
\item Ngo, \textit{supra} note 47, at 460; Schwarcz, \textit{supra} note 56, at 446.
\item The amount of outstanding securities backed by credit card receivables and auto, home equity, and manufactured housing loans has grown rapidly over the last eight years, from $316 billion in 1995 to $1.421 trillion at the end of the second quarter of 2002. The Bond Market Association, \textit{Asset Backed Securities Outstanding, available at http://www.bondmarkets.com/Research/absos.shtml} (last visited Oct. 26, 2002). In the first half of 2002, $237.9 billion of these securities were issued, up 6.2 percent from the $223.9 billion issued during the same period in the prior year. Corporate issuances during the same period, by comparison, fell by 25.6 percent, and this drop occurred in all corporate sectors. The Bond Market Association, \textit{Res. Q.} 5-6 (Aug. 2002), \textit{available at http://bondmarket.com/Research/Res_Qtly_802.pdf} (last visited Oct. 26, 2002). For more complete, but perhaps dated evidence of the difference in rates of securitization versus secured
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to Professor Schwarcz, the tremendous rate of increase in outstanding securitizations relative to other forms of corporate borrowing is evidence that firms prefer securitization to other methods of raising capital. This suggests, at a minimum, that the theory of cost shifting as applied to securitization is flawed. Nonetheless, one might be tempted to argue that the lower capital costs associated with securitization are simply evidence that it is a more effective cost shifting technique than secured borrowing.

The most plausible argument that securitization produces net economic benefit is that it has lower agency costs relative to other forms of financing. If secured borrowing represents a method of reducing agency costs, then securitization may simply be a better mousetrap. Different mechanisms by which creditors seek to control the risk of borrower insolvency may make securitizations less costly. Professor Claire Hill argues that securitization reduces the informational costs associated with raising capital. Firms may use securitization to take advantage of economies of scale by developing more standardized receivables and acquiring specialized ways of disseminating information about the receivables and the securities they back. In addition, Professor Hill says, securitization may enhance specialization, allowing originators to transfer risk to firms better situated to bear it, and to concentrate on originating and servicing receivables. This specialization should reduce costs and increase efficiencies. Securitization reduces the costs of monitoring and does not impose the restrictive debt covenants associated with secured borrowing. In addition, the costs incurred by secured creditors upon debtor insolvency are likely higher than those suffered by holders of asset-backed securities on the insolvency of the originator. These cost differences may aggregate to make securitization an evolutionary improvement over secured debt, and may help explain a preference for financing through securitization over other forms of borrowing.

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60. Ngo, supra note 47, at 459 (stating that "securitization is the fastest-growing form of capital asset formation in the United States," and is growing world-wide) (citing Schwarcz, supra note 35, at 133).
62. Ngo, supra note 47, at 462-63. Ngo argues that costly debt covenants have little benefit in reducing the likelihood of creditor insolvency for financially sound firms, and that securitization is a much better strategy for ensuring repayment than collateralization. Id. at 452. The very structure of securitization operates to radically reduce the cost of monitoring the borrower and the collateral. Id. at 462. See also SCHWARCZ, supra note 27, at A-7 (citing Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143 (1979)).
63. Ngo, supra note 47, at 462. Secured creditors must participate in a debtor's bankruptcy to collect on their claims. Holders of asset-backed securities might be drawn into the originator's bankruptcy proceedings, but do not necessarily have to participate to protect their claims on the assets that collateralize their interests. Thus, the expected costs of a debtor bankruptcy to a secured creditor are likely to be higher than those of an originator bankruptcy to an asset-backed security holder.
Securitizations also may entail unique costs, but the comparatively higher interest rates imposed on firms that raise capital through secured borrowing "strongly indicate that . . . the unique costs to creditors associated with secured loans are greater than the unique costs" to originators of securitized assets. These reduced costs do not entail a greater claim over a firm's assets than made by secured creditors, so the lower interest rates that originators obtain in securitizations (relative to secured borrowing) should not be offset by higher rates demanded by unsecured creditors or increased costs imposed on involuntary creditors.

Additional claims are made about the benefits of securitization, including that securitization creates informational efficiencies. Other claims include that asset-backed securities can be designed to satisfy previously unmet investor demands and that they make it possible for otherwise illiquid assets (such as consumer credit) to be traded in broader and more efficient markets. This would reduce the costs of financing these assets, and consequently reduce interest rates and increase access to credit for consumers.

After reviewing these arguments it is hard to be certain that asset securitization represents an improvement in financial technology that should be fostered by tax rules. It does, however, seem that taxes do not play a principal role in explaining why corporations increasingly utilize securitization to raise capital even if tax considerations play an important role in how securitization transactions are structured. Moreover, none of the arguments about the economic function of asset securitizations support the position that securitizations should be treated significantly worse under tax rules than economically comparable transactions, or that it would be wise to purposefully impede securitizations through the tax system.

III. GENERAL FEDERAL INCOME TAX APPROACH TO SECURITIZATIONS

Although securitizations share many of the same general characteristics, small differences have large implications for tax purposes and result in a number of different approaches to their treatment under the income tax laws. But a single consideration dominates: securitizations are usually structured to avoid an additional layer of tax at the SPV level. Significant tax imposed on the SPV is generally thought to make securitization trans-

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64. Id. at 463.

65. Professor Schwarcz argues that the ability of a securitization to allocate credit risk differently among different classes of interests helps reduce costs of asymmetric information among creditors, thus resulting in a lower blended rate of interest. Schwarcz, supra note 27, at A-9 & n.17. See also Hill, supra note 61, at 1086-100.

66. "[S]ecuritization provides efficient functional segmentation in that it allocates the risks and tasks associated with financial intermediation to the parties who can most cheaply and effectively bear those risks and perform those tasks." Proposal to Expand REMIC Provisions, supra note 28, at 311.
The principal dilemma is that while the originator wishes to avoid consolidation with the SPV for accounting and other purposes, this also makes consolidation for tax purposes difficult. The secondary problem is that the originator wants to securitize "efficiently," i.e., produce as much current cash as possible from the assets, but this may expose the SPV to entity-level tax. The tension between these objectives drives the search for better ways to securitize and is behind the effort to create statutory regimes that relieve the stress.

The following discussion is intended to provide an overview of the tax treatment of securitizations so that the reader can better understand the context of the FASIT rules. Rather than giving a full analysis of the legal basis for the tax characterization of various securitization transactions, or even a full description of the transactions, this section is intended to give an overview of the general categories of securitization transactions and sketch the different effects each transaction has on the income tax treatment of their participants. To that extent I have taken some liberties to simplify the discussion and have not described many of the variations that occur in securitizations.

There have been a number of significant changes in both the tax law and other rules that apply to securitization transactions since the FASIT provisions were enacted. It is not my purpose to explore these changes in detail. Instead I wish to alert the reader to the changes to provide perspective on the changed environment for FASITs. The first part of this section discusses securitization transactions that are not subject to a statutory regime. The end of the section discusses the REMIC vehicle.

In general, non-REMIC securitization transactions fall into two categories for tax purposes: transactions where a separate entity is created to hold the securitized assets and to issue equity and debt, and transactions in which no entity separate from the originator is intended to be created. In the former structure, the SPV is usually intended to qualify as a grantor trust or partnership and therefore not as an entity subject to tax on its income. The transfer of assets to the SPV is a contribution or sale for tax purposes, and securities represent either undivided ownership interests in the securitized assets or partnership interests. Thus, income passes through to the holders of the securities and is not taxed at the SPV.
level. In contrast, in the latter structure the securities represent secured debt and the SPV is merely a device for holding the securitized assets as collateral. The originator does not sell or dispose of the assets for tax purposes. The originator claims interest deductions on the debt that shelter income on the assets from any corporate-level tax.

A. **Pass-Through Transactions**

In many securitization transactions the SPV is organized as a state-law trust. A trust is an entity not subject to tax if it qualifies as an investment trust and its interest holders qualify as grantors. An investment trust exists if there is no power under the trust agreement to vary the investment of the interest holders. To meet this test, a trust must generally be a passive investor—it must exist to hold investments on behalf of its interest holders and cannot engage in business. Accordingly, the permissible activities of an investment trust are quite circumscribed. For example, the trust can sell assets, but generally must promptly distribute the sales proceeds. It generally cannot reinvest those proceeds or otherwise acquire new assets without jeopardizing its tax status. The originator in a securitization qualifies as a grantor, as do investors who subsequently purchase trust securities.

Because no income tax is imposed at the entity level in this structure, income and other tax items flow through to the holders of the trust securities. A grantor is treated as owner of the portion of the trust over which it has control, and as deriving the tax items (income, deduction, gain, loss, and credits) attributable to that portion directly. Thus, each investor is in effect an owner of a proportionate undivided interest in the assets held by the trust and obligor on a proportionate share of the liabilities to which the entity is subject. Income, deductions, gain, and loss on the trust’s assets and liabilities pass through to each investor as if each

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70. These entities may also issue debt. This is described later in this discussion. See infra text accompanying note 112.
71. Treas. Reg. § 301.7701-4(c) (as amended in 1996).
72. See Peaslee & Nirenberg, supra note 15, at 177-79 (discussing permissible investment trust activities).
76. Grantors are owners and obligors for tax purposes, but may not be for other purposes. Peaslee and Nirenberg say “the trust is ignored (collapsed into a co-ownership arrangement) for almost all substantive tax purposes. While the language of section 671 is not entirely clear on the point, the Service has issued a number of rulings and other pronouncements disregarding grantor trusts.” Peaslee & Nirenberg, supra note 15, at 281 (footnote omitted). One interesting result is that each grantor of a fixed investment trust can have distinct holding periods, basis, bond premia and market discounts for its interest in the underlying property. This can occur, for example, if investors purchase securities at different times. In addition, holders can use different accounting methods to determine annual income or deductions.
investor was the direct owner or obligor. Consequently, the tax items passed through to the investors retain their character in the investors' hands. Tax is imposed only at the investor level, and distributions of funds from the trust are not themselves subject to tax.

The prohibition on reinvestment imposes a significant obstacle to the use of the pass-through structure other than to securitize relatively long-lived assets such as real estate mortgage loans. Another constraint is that grantor trusts generally may not have multiple classes of ownership interests. Under the so-called Sears regulations, promulgated in the mid-1980s, a trust that has multiple classes of ownership interests is classified for tax purposes as a partnership or corporation unless the multiple classes are "incidental" to the purpose of facilitating "direct investment in the assets of the trust." These regulations prevent grantor trusts from issuing securities that have different maturities or that otherwise represent economically different interests in the trust's assets, unless they meet the "incidental" test of the regulations or are classified as debt.

If the securitization structure qualifies as a grantor trust, the originator realizes no gain or loss on the exchange of assets for interest in the trust. However, any sale of the trust interests to others is treated as a sale of the underlying assets, and so the originator must recognize gain or loss as if a portion of those assets were sold directly.

If the SPV does not qualify as a grantor trust it still may be able to avoid entity-level tax. An entity that is not a trust is either a partnership or a corporation for income tax purposes. If it is characterized as a

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78. Treas. Reg. § 301.7701-4(c) (as amended in 1996). For example, an owner of an interest in a trust that held only tax-exempt bonds would receive tax-exempt interest. If the trust held real estate mortgages, the interest holder would be treated as holding real estate assets (which would be relevant, for example, to whether the holder can qualify as a real estate investment trust under I.R.C. § 856(c)(2)-(4) (2002)).


81. Treas. Reg. § 301.7701-4(c)(1) (as amended in 1996). See also Peaslee & Nirenberg, supra note 15, at 19; James M. Peaslee, Investment Trusts in the Age of Financial Derivatives, 49 Tax L. Rev. 419, 450 (1994). The regulations provide two very limited examples of arrangements that meet the "incidental" test: one in which one class is subordinated to the other in a manner that provides a limited guarantee of payment from the originator of the loans held by the trust to the other holders of trust interests; and one in which the interests merely allow stripping of interest coupons from bonds held by the trusts. Treas. Reg. § 301.7701-4(c)(2) exs. 2, 4 (as amended in 1996).

82. Treas. Reg. § 301.7701-4(c)(2) exs. 2, 4 (as amended in 1996). As used herein, the term "corporation" usually is intended to mean a domestic corporation subject to tax at the entity level under Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code (a "C corporation").

83. This statement assumes there is more than one holder of an equity interest in the SPV. If there is only one owner, the transaction is not really a securitization unless the entity also issues debt, as described below. A business entity that is not characterized for tax purposes as a corporation and that has only one owner is ignored for tax purposes.
partnership, its income flows through and is taxed to its partners. Under current law, it is relatively easy for a trust or other domestic, non-corporate entity to qualify as a partnership. Under the “check-the-box” entity classification rules adopted in 1996, a trust that fails to qualify as a grantor trust is treated as a partnership unless it elects otherwise.84

Partnership characterization is available to an entity that has a multiple class ownership structure or that actively manages its assets and liabilities. For example, an SPV that relies on partnership classification can acquire new assets or reinvest proceeds from the sale or payoff of receivables. Thus, securitizations can be structured to qualify for partnership status, and many transactions in which the SPV is intended to qualify as a grantor trust use partnership characterization as a fallback position.85

However, the partnership structure is also of limited utility for securitizing assets. A publicly traded partnership is subject to tax as a corporation unless it qualifies for an exception.86 This presents a problem in securitization transactions because they are often utilized to create marketable securities.87 If, however, 90% of a partnership’s gross income is passive income such as dividends, interest, rents and royalties, the publicly traded partnership rules do not apply.88 It is thought that most securitization transactions meet this requirement.89 Interest arising from a financial business, however, is not qualifying income.90 Since the border between a financial business and other activities is unclear, structures that are intended to rely on partnership status to avoid entity-level tax

Treas. Reg. § 301.7701-3(b)(1)(ii) (as amended in 2001); Rev. Rul. 99-5, 1999-1 C.B. 434. It is a “tax nothing,” to use a common phrase. If this tax nothing also issues debt the transaction is much like a pay-through securitization discussed infra at notes 112-15.

84. Generally speaking, a state-law trust is not a per se corporation under the Treasury Regulation, and thus would be characterized as a partnership unless it elected otherwise. Treas. Reg. § 301.7701-2 (as amended in 2002); Treas. Reg. § 301.7701-3 (as amended in 2001). See Peaslee & Nirenberg, supra note 15, at 155-56 (discussing Treas. Reg. §§ 301.7701-2(b) (as amended in 2002), 301.7701-3(a) (as amended in 2001)).


86. I.R.C. § 7704(a) (2002).

87. As discussed below, when the entity also issues instruments treated as debt for tax purposes, it may not be necessary for the equity of the entity to be traded. An instrument classified as debt for tax purposes is not taken into account for purposes of determining whether the partnership is publicly traded. Treas. Reg. § 301.7704-1(a)(2)(ii) (as amended in 1995). In that case, organizing documents or other agreements may have provisions intended to prevent the entity from being treated as publicly traded, such as limitations on numbers of partners or on transfers of the partnership interests. See Schwarcz, supra note 27, § 5:2.3 at 5-18. For a detailed discussion of the rules for determining whether a partnership is publicly traded, see Peaslee & Nirenberg, supra note 15, at 247-52.

88. Technically, 90% of the partnership’s income must be “qualifying income” for the taxable year and all prior taxable years in which the partnership was a publicly traded partnership. I.R.C. § 7704(c) (2002). For a detailed discussion of this issue, see Peaslee & Nirenberg, supra note 15, at 252-73.

89. Peaslee & Nirenberg, supra note 15, at 245 ("Most securitization vehicles holding largely fixed pools of debt instruments (including hedges) escape section 7704 by meeting the passive income test.").

tend to limit the activities in which the SPV can engage.91

There are other disadvantages of utilizing the partnership structure. The tax law that applies to partnerships is complex and difficult for investors to understand. Investors are generally thought not to like receiving partnership tax information returns, and there is said to be a general investor disdain for partnership interests.92 In addition, some investors are not permitted to hold partnership interests.93

Before 1996, partnership status was much less useful in a securitization. At that time it was less certain that a failed grantor trust could qualify as a partnership, and purposefully meeting the qualifications could be burdensome.94 The regulations in effect until the early 1990s characterized entities as corporations or partnerships based on certain substantive characteristics.95 This made it much less clear that an SPV could rely on partnership status as a fallback if it failed to qualify as a grantor trust.

SPVs that issued multiple classes of interests generally issued those instruments as debt and were often structured so that a residual equity class would be characterized as partnership interests under the regulations.96 Organizers imposed restrictions on these SPVs so that they would lack centralized management and freely transferable interests, and required that they have at least one partner with a substantial ownership interest who was liable for the entity’s expenses.97 These strictures had several effects. First, to avoid centralized management the SPV was generally subject to substantially the same restrictions on its activities as a grantor trust.98 Second, to avoid having freely transferable interests, the SPV’s

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91. This issue arises most often in securitizations of credit card receivables, which is usually accomplished through the collateralized debt structure, discussed later in this section. See infra text accompanying notes 119-32.
94. Id.
95. To qualify as a partnership, the entity could not have more than two of the following four characteristics: (i) centralized management, (ii) limited liability, (iii) freely transferable interests, and (iv) continuity of life. Treas. Reg. § 301.7701-2 (as amended by T.D. 7889, 48 Fed. Reg. 18,805 (Apr. 26, 1983)). For a brief but pithy discussion of the origin of these regulations and their relationship to FASITs, REMICs and other special purpose entities, see generally Willard B. Taylor, Beyond Check-the-Box—Neglected Issues, TAXES, Dec. 1, 1997, at 671.
96. Proposal to Expand REMIC Provisions, supra note 28, at 317. Sometimes these entities were structured as taxable corporations when they would be part of a consolidated group for tax purposes, which would result in no additional corporate-level tax to the SPV. Id. at 316 & n.54, 317.
97. Id. at 311 & n.57, 317. See also Gergen, supra note 85, at 39 (“While it was possible . . . to structure an intermediary to avoid corporate classification without sacrificing the crucial features of public trading, limited liability, and centralized management, doing so required some contortions and left tax planners feeling exposed (even a little uncertainty regarding an important issue such as partnership classification can kill a public offering of a security).”).
organizational documents prevented the transfer of interests except in limited circumstances.\textsuperscript{99} The result was that there was no active market for equity interests in these SPVs.\textsuperscript{100} In addition, the equity cushion needed to ensure that the debt issued by the SPV would be respected as such reduced the efficiency of the structure relative to a grantor trust.\textsuperscript{101}

When an SPV qualifies as a partnership (and is not taxed as a corporation), its income is not taxed at the entity level, but flows through to its partners.\textsuperscript{102} This is similar, but not identical to the treatment of the grantor trust, because unlike a grantor trust, a partnership is an entity for some tax purposes. Many differences in treatment may be observed.\textsuperscript{103} For example, the partnership may use a different tax accounting method than the partners do,\textsuperscript{104} while a grantor trust has no accounting method. Unlike a grantor trust, the partnership has a basis in its assets that is distinct from the basis its partners have in their interests. The partnership's basis in its assets may be different than the partners' aggregate basis, and it is the partnership's basis that is used in calculating the income of the partnership.\textsuperscript{105} While a partnership's cash distributions, like a grantor trust's, are not generally included in a partner's gross income, they are (in general) taxable to the extent the distributions, in the aggregate, exceed the partner's tax basis.\textsuperscript{106} More importantly, the allocation of income between interests representing different economic claims is more complicated under the partnership structure simply because no analog exists under the grantor trust structure.\textsuperscript{107}

\begin{itemize}
  \item \textsuperscript{99} Id. at 317 n.61.
  \item \textsuperscript{100} Id. at 317 & n.63.
  \item \textsuperscript{101} Willard Taylor points out that implicit in the enactment of the REMIC and FASIT legislation is an assumption that partnerships were "not viable alternatives to a statutory pass-through vehicle." Taylor, \textit{supra} note 95, at 673.
  \item \textsuperscript{102} I.R.C. § 701 (2002).
  \item \textsuperscript{103} For a catalogue of differences, see \textit{Peaslee & Nirenberg}, \textit{supra} note 15, at 322-25.
  \item \textsuperscript{104} I.R.C. §§ 703, 448 (2002) (requiring partnerships to use the accrual method of accounting if any of its partners is a C corporation). \textit{See} \textit{Peaslee & Nirenberg}, \textit{supra} note 15, at 294.
  \item \textsuperscript{105} A partnership can elect to adjust the basis in its assets when a partnership interest is purchased. I.R.C. § 754 (2002). This helps reduce the difference between the inside basis of a partnership in its assets and the outside basis of partners in their interests. \textit{See} \textit{Peaslee & Nirenberg}, \textit{supra} note 15, at 301. Before 1997, there would be limited differences between inside and outside basis for a partnership that had publicly traded interests (but was not classified as a publicly traded partnership). If more than 50\% of its interests were sold or exchanged by partners to non-partners within a 12-month period, the partnership would be terminated and all of its assets would be treated as distributed to partners (thereby obtaining the same basis as the partners' interests under I.R.C. § 732(b) (1997)) and recontributed to the partnership (retaining their new basis) under I.R.C. § 722 (1997). \textit{Peaslee & Nirenberg}, \textit{supra} note 15, at 300 & n.77. This result was changed by Treas. Reg. § 1.704-1(b)(2)(iv)(1) (as amended by T.D. 8717, 1997-1 C.B. 125). \textit{Peaslee & Nirenberg}, \textit{supra} note 15, at 300-01, 301 & n.78.
  \item \textsuperscript{106} I.R.C. §§ 731(a)(1) (2002) (treating cash received as income only to the extent it exceeds the partner's basis), 733 (2002) (reducing the partner's basis by cash distributions and basis of property distributed).
  \item \textsuperscript{107} For a description of problems in allocating partnership income in a securitization, \textit{see} \textit{Peaslee & Nirenberg}, \textit{supra} note 15, at 302-12. For a discussion of allocating income
The overall tax ramifications of the formation of a securitization partnership are similar to those for a grantor trust. When a single originator transfers receivables to an SPV that is a partnership in exchange for interests, and the originator promptly sells the interests, the transaction is treated as a transfer of the assets by the originator to the investors and contribution of the assets by the investors to the SPV. Thus, the originator must recognize gain or loss on the sale of the securitized assets to the extent of the interest in those assets represented by the partnership interests it sells. The other investors recognize no gain or loss on the deemed contribution of assets to the SPV. The originator recognizes no gain or loss to the extent of the interest it retains in the SPV.

As mentioned earlier, SPVs can issue debt instruments as well as equity interests. The debt securities are commonly called collateralized debt obligations or collateralized mortgage obligations, and are often issued by owner trusts. These securities are much like pass-through certificates: the interest and principal on the debt is generally paid from securitized assets’ cash flows. Yet these securities take the form of debt and are intended to be respected as debt for tax purposes. Thus, an investor who holds the debt does not have an ownership interest in the underlying assets. The investor receives interest from the SPV, not income from the assets. An originator may choose to issue debt through an SPV because, unlike ownership interests in a grantor trust, the debt can be issued in multiple classes with different maturities, seniorities, in-

and other tax items among grantors with different economic interests in a grantor trust, see Peaslee, supra note 81, at 450-65.

108. Until more than one person owns an interest in the SPV, it is disregarded as an entity and its owner is treated as directly owning the assets. See supra note 83. Different concerns arise when the SPV is formed by two or more partners who contribute assets. In that case it is possible for the investment company rules to apply and cause the contributors to recognize gain on the contribution. I.R.C § 721(a)-(b) (2002). Peaslee & Nirenberg, supra note 15, at 887-89.

109. There are numerous caveats to this statement, but in general the taxpayer will recognize gain or loss equal to the amount realized on the sale minus the basis allocable to the portion of the assets disposed of. I.R.C. § 1001(a) (2002). The amount realized would include any indebtedness incurred by the SPV and allocable to the interests of the purchasers of the securities. Treas. Reg. § 1.1001-2 (1980).

110. I.R.C. § 721(a) (2002). Any indebtedness to which the SPV’s assets are subject should generally have no effect on the tax treatment of the purchasers’ deemed contribution to the SPV unless the SPV has more than one class of equity interests. Peaslee & Nirenberg, supra note 15, at 891 & n.39 (discussing I.R.C. § 752 (2002)).


112. To obtain this treatment there generally must be a difference between the payments received on the underlying assets and the payments made on the debt. For example, there may be significant lags between the time payments are collected on the assets and payments are made on the receivables. This factor, which requires reinvestment by the SPV, makes it difficult for an SPV that issues debt to qualify as a grantor trust. In addition, there must be a sufficient equity cushion to prevent the debt from being recharacterized as equity for tax purposes (and thereby depriving the SPV of an interest deduction). See Peaslee & Nirenberg, supra note 15, at 31, 103-18.

113. This can be significant when tax rules require an entity to receive income from certain sources or hold a certain percentage of its assets in a specified type of investment. Real estate mortgage investment conduits, which must hold and derive income from real estate assets, are one example of such a taxpayer. See I.R.C. § 856(c)(2)-(4) (2002).
terest rates (including rates unrelated to those on the underlying assets), and other features. However, this structure may not be as advantageous from a financial accounting perspective as a pass-through structure because the originator often needs to dispose of a greater percentage of its interest in the securitized assets when the SPV issues debt to obtain off-balance sheet treatment.

The SPV realizes no gain or loss upon receiving the proceeds from issuing debt, and interest accruals on the debt are generally deductible against the income generated by the securitized assets. Thus, in some cases, a securitization that includes debt securities may be as advantageous, or even more advantageous from a tax perspective, than a pure pass-through structure. A securitization transaction that involves debt, however, can generate significant mismatches of annual income and deduction at the entity level without corresponding mismatches in cash flow. For example, if an SPV holds long-term debt instruments that it fully securitizes by issuing classes of debt with different maturities (but with the same weighted average maturity as the assets), the SPV will have more interest income than expense in the early years, and more expense than income in the later years. This can result in radically different patterns of annual income and loss to equity owners compared to patterns of annual income in a securitization when no debt is issued.

The most significant tax issue for this type of arrangement is the substantial equity interest in the securitized assets that must exist for debt

114. A trust that issued multiple classes of interests with these features could be characterized as a corporation, and all its interests as equity interests. Thus, it could be subject to entity-level tax on all its income from the securitized assets. Interests treated as debt reduce the amount of taxable income at the entity level by providing interest deductions. This structure was invented before the 1996 change in the check-the-box entity classification rules, which makes it more likely that a trust that fails to qualify as a grantor trust will be treated as a partnership for tax purposes. See supra notes 83-84 and accompanying text.

115. When FASIT legislation was enacted, accounting rules required an originator to dispose of at least 50% of the equity of the SPV to avoid financial statement consolidation with the SPV. See Peaslee & Nirenberg, supra note 15, at 33-35; Schwarcz, supra note 27, § 5:2.3 at 5-13. This imposed a significant burden on structures that utilized securities issued in the form of debt. Current accounting rules may make it easier for some originators to accomplish this result while holding a larger equity interest in the SPV. See Marty Rosenblatt et al., Securitization Accounting Under FASB 140: The Standard Formerly Known as FASB 125, Deloitte & Touche (2d ed. 2002) (on file with the SMU Law Review). This allows the publicly traded interests in SPVs to take the form of debt, making it less likely that the partnership interests in the entity would be treated as publicly traded. See also Peaslee & Nirenberg, supra note 15, at 34-35; Peaslee & Nirenberg, It’s Time to Bag the FASIT Rules and Start Over, supra note 18, n.7; Schwarcz, supra note 27, § 7:4 at 7-11.

116. Typically, if long-term cash flow assets support debt classes that are similar to stripped coupons and principal, income at the entity level will be accelerated, in some cases causing the entity to have high net income in early years and net losses in later years. This effect can be reversed if long-term debt is supported by a series of payments on cash flow assets with different maturities. The difference in income on the asset and the income at the entity level is often referred to as “phantom income.” For a full exploration of this issue, see Kirk Van Brunt, Tax Aspects of REMIC Residual Interests, 2 FLA. TAX REV. 149, 211-15 (1994). See also infra note 146. The problem of phantom income was probably one of the motivating factors behind the adoption of the Sears regulations. See Peaslee, supra note 81, at 456-57.
characterization to be respected. This makes the securitization structure less efficient than one that requires no equity cushion, such as the grantor trust structure. In addition, the level of equity necessary depends on several factors. The most significant consideration is the riskiness of the securitized assets. The more uncertain the payments on the securitized assets, the greater the equity cushion needed to assure timely payment on the debt.\textsuperscript{117} Reducing or eliminating the need for an equity cushion by issuing debt with terms that link payments to actual receipts on the underlying assets risks recharacterization of the structure as a conduit and the debt as equity interests. In that case the arrangement is a partnership or a corporation, and the proceeds from the issuance of the recharacterized debt are treated as amounts received from the sale of the securitized assets.\textsuperscript{118}

B. PASS-THROUGH INTERESTS AS COLLATERALIZED DEBT

In some cases the parties to a securitization transaction intend for it to be treated for tax purposes as a financing rather than a sale, and for the SPV to be treated as a mechanism for holding collateral, rather than as an entity that owns the securitized assets. In this structure the SPV's securities take the form of beneficial interests in a trust holding cash-flow assets. This form is driven by accounting rule considerations.\textsuperscript{119} But for tax purposes the securities are meant to qualify as debt instruments secured by the assets.\textsuperscript{120} Payments on these securities typically reflect the payments on the underlying assets and the assets are generally expected to be the primary or sole source of payments on the securities.\textsuperscript{121} Accruals of interest deductions on the securities offset income from the securitized assets.

This structure allows much greater flexibility than the grantor trust or partnership structures. Tax considerations do not prevent the originator from freely transferring new assets to the trust or substituting one asset for another: this activity is even helpful in sustaining the characterization of the transaction as a secured borrowing because it reinforces the posi-

\textsuperscript{117} One factor that contributes to the debt characterization is a relatively low risk, evidenced by a relatively low yield on an instrument. If the risk on "debt" issued by an SPV was comparable to the risk on underlying assets, there is a likelihood that the instrument would be recharacterized as equity for tax purposes, which may defeat the purpose of the structure.

\textsuperscript{118} If the entity is classified as a corporation, the transaction might be treated as a contribution of assets to the corporation and a sale of stock. This would be particularly disadvantageous if the assets had built-in gain: the gain from the sale of the stock would be subject to tax but would not provide amortizable bond premium deductions under I.R.C. § 171 (2002) to offset the income on the entity's assets. The structure with recharacterized debt could not qualify as a grantor trust because of the multiple classes of interests and the potential for reinvestment of proceeds from the assets. While the entity would retain its partnership classification under the check-the-box rules, it is uncertain whether such partnership would nonetheless be treated as a taxable corporation due to public trading in its interests. I.R.C. § 7704(c) (2002).

\textsuperscript{119} See supra note 115 and accompanying text.

\textsuperscript{120} See Peaslee & Nirenberg, supra note 15, at 38.

\textsuperscript{121} Id. at 38-39.
tion that the originator, rather than the SPV or security holders, controls the securitized assets. The assets can support multiple classes of securities, and new tranches can be issued over time as new assets are added to the SPV. In addition, the sponsor can call assets or classes of securities to take advantage of market changes without disrupting the tax characterization of the transaction.\(^\text{122}\)

Credit card and other short-term consumer debt is commonly securitized this way. These assets tend to have short maturities, but the securitization allows them to be financed with longer-term obligations. In general, principal payments the originator or the servicer collects on behalf of the SPV are reinvested in new receivables, rather than being distributed to security holders, for some period. Accordingly, the assets that provide for payments on the trust securities change, perhaps many times over the life of the securities.\(^\text{123}\)

Credit card securitizations tend to follow a specific transactional form.\(^\text{124}\) An originator (usually referred to as the sponsor) typically transfers outstanding draws on credit card accounts to a trust and agrees that subsequent draws on those accounts will also go to the trust. The trust issues certificates to investors, and the sponsor also retains an interest. The sponsor's interest is generally not subordinated to the other interests. The investors' interests usually provide that they will receive their proportionate share of interest, but no principal, from the credit card receivables during a “revolving” period. During the revolving period, principal payments on the receivables are distributed to the sponsor and new draws are credited to the sponsor’s interest, with the result that the sponsor's percentage interest in the trust fluctuates over time. After the revolving period, the sponsor and other interest holders share in principal payments on a pro rata basis. This is called the amortization period. The sponsor also usually undertakes to transfer receivables on other accounts to prevent its interest from dropping below a certain point during the revolving period. If its interest drops too low, the amortization period is triggered prematurely.

Credit card securitizations have several other common features. It is not unusual for a sponsor to transfer receivables (especially those representing draws on new accounts) to a trust some time before the trust is to

\(^{122}\) Id. Some of these activities might, however, be limited by accounting considerations. Id. at 66-67.

\(^{123}\) See id. at 39, 130-31.

issue certificates representing interests in the receivables. This allows the accounts to age and develop a performance history that is valuable in the securitization process. Secondly, the trusts are often a funding facility that is used by several members of an affiliated group. These members combine their securitizations under one roof, so to speak. This kind of arrangement is commonly called a master trust.

Several aspects of these transactions are significant for concluding the SPV should be treated as holding collateral on behalf of the originator. The originator usually retains power to place receivables in the SPV or, to a limited extent, remove them. In addition, because the securitized receivables tend to bear interest at rates much higher than the SPV’s securities, the originator retains a relatively high and variable spread. The securities are generally significantly over-collateralized, and the amounts that are not required to make payments on the securities are returned to the originator. These factors are consistent with the originator retaining the benefits and burdens of ownership on the receivables.\(^\text{125}\)

However, because the securities take the form of beneficial interests rather than debt, tax advisors tend to be quite conservative about rendering opinions that they are properly characterized as such for tax purposes.\(^\text{126}\) The practice is to require the securities to carry a high credit rating, indicating a low level of risk of default or delinquency, to insure debt treatment. Historically, a security issued in a credit card securitization must carry one of the top three investment grade ratings to obtain a clean opinion that the instrument is debt for tax purposes.\(^\text{127}\) This, in effect, limits the extent to which credit card receivables can be monetized: instruments with these ratings have low risk and low interest rates. The excess cash flow on the receivables over that needed to pay interest and principal on the securities is retained by the originator and cannot be securitized.

Though the limitation on the extent to which receivables can be monetized using this structure may be a negative, the transaction is advantageous in that the originator recognizes no gain on the receipt of cash from the sale of the securities. Since the transaction is a financing rather than a sale, the proceeds from the securities are borrowings and are not included in the originator’s gross income. Conversely, the originator is not entitled to any deduction for repayment of principal to the security holders.

\(^{125}\) For a complete discussion of recharacterizing equity interests as debt, see Peaslee & Nirenberg, \textit{supra} note 15, at 130-48.

\(^{126}\) See, e.g., Peaslee & Nirenberg, \textit{It's Time to Bag the FASIT Rules and Start Over}, \textit{supra} note 18.

\(^{127}\) See Peaslee & Nirenberg, \textit{supra} note 15, at 122 n.148 (describing pass-through certificates treated as debt). Thus, a longer-term security generally must be rated A or better by Standard & Poor's Rating Group or Moody's Investors' Service, Inc. to obtain a clean opinion. \textit{Id. See also} Donald B. Susswein, \textit{Attorney Testifies in Support of FASIT Bill on Behalf of Coalition for Asset Backed Securities}, 95 \textit{TAX NOTES TODAY} 186-37 (1995) (requiring issuers to be able to point to "strong proof" that the security is in substance debt, including high credit rating); Proposal to Expand REMIC Provisions, \textit{supra} note 28, at 321.
Assuming that the securities are respected as debt for tax purposes, the holders of the securities are treated as holders of debt rather than owners of the securitized receivables. Accordingly, they calculate their income, gains, deductions, and losses using the normal rules that apply to debt instruments.

A transaction that fails to qualify as a secured financing is likely to be treated as a sale of the receivables to the SPV. As discussed earlier, before the 1996 change in the entity classification regulations it was unclear in such a case whether the SPV would be characterized as a partnership or corporation. Under the new regulations there is much less chance that the SPV would be classified as a corporation. Even when the entity is a partnership under the general entity classification rules, however, there is a risk that it would be treated as a corporation for tax purposes. If the SPV securities are treated as partnership interests, and any class of those securities is publicly traded, the entity could be a publicly traded partnership, and thus potentially taxable as a corporation. Although the entity might qualify for the passive income exception to the publicly traded partnership rules, there is a risk that its activities relating to the receivables might cause it to be treated as engaged in an active finance business. If the entity’s activities do not qualify for the exception, the entity would be taxable as a corporation.

C. REMICs

Much of the foregoing discussion is a background for the REMIC provisions as well as the FASIT legislation. But before FASITs can be understood, a picture of the antecedent statutory securitization vehicle must be developed. The following description of the REMIC rules and their background is necessarily brief: the rules are tremendously detailed and the scheme is quite complex. Nonetheless, they demonstrate a particular strategy for dealing with the problem of asset securitizations that carried through to the FASIT regime. They also help show how the FASIT rules went wrong.

The REMIC vehicle was created by the Tax Reform Act of 1986. In light of the increasing pace of secondary market transactions in mort-

128. See supra notes 94-95 and accompanying text.
129. See supra notes 83-84 and accompanying text.
131. Id. § 7704(c); see supra notes 81-91 and accompanying text.
132. The almost constant reinvestment needed to accommodate the quick payoff of assets held by the SPV and the likelihood that new receivables would come from charges made on the same accounts as the prior receivables makes it conceivable that the credit card users could be considered customers of the SPV and thus the SPV would be engaged in the financial services business of originating loans to customers. See, e.g., Michael L. Schler, Comments on Prop. Reg. Section 1.7704-1, reprinted in Schler Says Proposed PTP Regs. are Potentially Disastrous for Asset-Backed Securitizations, 95 Tax Notes Today 166-12 (1995); Peaslee & Nirenberg, supra note 15, at 245-46, 271-73.
gages occurring at the time, Congress intended to clarify the tax rules that would apply to the transactions and provide "some relief" from the corporate-level tax. But the statute and the legislative history also demonstrate an understanding that the regime would be susceptible to abuse. Without safeguards the REMIC structure could be exploited to shift income to tax-exempt entities and offsetting losses to taxable entities. Thus, the legislation was an attempt to balance the interests of simplicity and clarity for securitizations of real estate mortgages against concerns that the legislation might poke a hole in the fiscal bucket through which significant amounts of revenue could leak.

As discussed earlier in this piece, the problem for mortgage securitizations in the period before the Tax Reform Act of 1986 was that grantor trusts could not issue multiple classes of ownership interests, and the availability of partnership status was uncertain. The Sears Regulations prevented the grantor trust structure from being employed to slice different economic shares out of the underlying assets. This problem could have been avoided if grantor trusts could issue instruments that qualified as debt for tax purposes, but it was not entirely certain a trust could do so without jeopardizing its grantor trust status. In addition, because it is advantageous for some investors to hold interests in real estate mortgage loans, debt would be less desirable than pass-through interests. While partnership status offered another possible escape from entity-level tax, it was unclear at the time whether a trust structured to securitize mortgage loans could meet the tests for this status. These hurdles made it more costly to securitize mortgages, and as a consequence limited the quantity of mortgages that could be repackaged and sold in advantageous ways to the capital markets.

The creators of the REMIC regime took a logical approach to eliminating, or at least lowering these hurdles: they attempted to describe in legislation the features of the paradigm transaction and then solve some of its

135. Id. at 411-12 (expressing concern that the REMIC could lead to "certain systematic opportunities to avoid taxation on a portion of income derived from the pool of mortgages through the use of tax-exempt entities, foreign persons, and taxpayers with net operating loss carryovers").
136. It is interesting to note, however, that the legislation did not attempt to retain the revenue status quo. It was recognized that income would escape the corporate tax because of the rules. The provision was scored as losing a modest amount of revenue—$196 million over five years. Id. at 1365 tbl.A-2.
137. See supra notes 80-82 and 86-95 and accompanying text.
138. There is a small risk that such a trust would violate the Sears Regulations prohibition on multiple class grantor trusts. In addition, depending on the terms of the debt, there is a risk that the borrowing could cause the trust to have the power to vary the investments of its certificate holders and thus be classified as a partnership or corporation under Treas. Reg. § 301.7701-4(c) (1996). See Peaslee, supra note 81, at 444-45. If the instruments were classified as equity the entity would certainly violate the prohibition on multiple class grantor trusts. If the instruments were issued in the form of debt to shore up their tax status the transaction would simply be trading off a tax problem for an accounting problem. See supra note 115 and accompanying text.
problems. Thus, for example, the legislation’s limits on a REMIC’s activities approximate the restrictions that apply to grantor trusts. In some ways a REMIC is subject to even tighter restrictions than a grantor trust. A REMIC is permitted do little else but hold assets, and the only substantial assets it is permitted to hold are debt instruments secured by interests in real estate.\textsuperscript{139} These assets must be acquired shortly after a REMIC commences activities,\textsuperscript{140} and the REMIC may not dispose of them except in unusual circumstances.\textsuperscript{141}

The legislation solved the problem of allocating income among multiple classes of trust interests by treating a REMIC as issuing debt. REMIC regular interests are debt instruments regardless of whether they would otherwise qualify,\textsuperscript{142} but are subject to limitations that make accruals of income on the instruments relatively predictable.\textsuperscript{143} Naturally, the REMIC is explicitly permitted to issue as regular interests the fast-pay/slow-pay securities that are proscribed under the Sears regulations.\textsuperscript{144}

The REMIC rules depart from the grantor trust model by making the REMIC income calculation similar to that of a simple partnership. A REMIC calculates its net taxable income or net loss by deducting the interest accruals on the regular interests. Its net income or net loss flows through to the owners of its single class of equity interests, called residual interests.\textsuperscript{145} This supplies the mechanism for calculating and allocating

\textsuperscript{139} I.R.C. §§ 860D(a)(4), 860G(a)(3)-(7) (2002). A REMIC is permitted to invest cash flow temporarily in other assets. It may also hold a regular interest in another REMIC, a reserve fund, or foreclosure property. Id. § 860G(a)(3). REMICs are also allowed under regulations to hold credit enhancement contracts. Treas. Reg. § 1.860G-2(c) (as amended in 1993).

\textsuperscript{140} I.R.C. § 860G(a)(3)(A) (2002) (defining qualified mortgages). A mortgage that replaces a mortgage held by the REMIC within three months of the start-up date, or that replaces a defective mortgage within two years of the start-up date is also a qualified mortgage. Id. § 860G(a)(4).

\textsuperscript{141} In general, income from dispositions of REMIC assets is subject to a 100\% penalty tax unless specified exceptions apply. Id. § 860F(a). A REMIC may dispose of an asset incident to (1) foreclosure, default or imminent default of a loan; (2) its bankruptcy or insolvency; (3) its liquidation; (4) to avoid default on a regular interest due to a default on an asset it holds; or (5) to facilitate the redemption of a class of interests which has a small remaining balance. Id. § 860F(a)(2)(A), (a)(5).

\textsuperscript{142} I.R.C. § 860D(a)(2) (2002); see 1986 Blue Book, supra note 134, at 415 (“The Congress intended that regular interest in REMICs may be issued in the form of debt, stock, partnership interests, interests in a trust, or any other form.”).

\textsuperscript{143} A regular interest is required to provide unconditionally for principal payments or something akin to principal payments. If it provides for interest payments, those payments must be based on a fixed rate or certain variable rates, or must represent interest stripped from the underlying mortgages. I.R.C. § 860G(a)(1) (2002). Accruals on REMIC regular interests are unpredictable primarily due to variations in the speed at which the interests mature because of prepayments on the underlying assets. An assumption of prepayment rate is required to be made for purposes of determining accruals, and special methods to take into account actual payment rates are also mandated. See id. § 1272(a)(6).

\textsuperscript{144} Id. § 860G(a)(1); Treas. Reg. § 1.860G-1(b)(3)(i) (as amended in 1995); Id. § 301.7701-4(c)(2), ex. 1 (as amended in 1996) (giving an example of a prohibited multi-class trust with fast-pay and slow-pay interests).

\textsuperscript{145} A REMIC must have one and only one class of residual interests. I.R.C. § 860D(a)(3) (2002). An interest is a residual interest if it is issued on the REMIC’s start-up day and is designated as a residual interest. Id. § 860G(a)(2) (2002). There are no other
phantom income.

Phantom income and loss arise in a REMIC when the portion of incoming cash flows that represents interest income is different than the portion of outgoing cash flows that represents interest expense. Even if cash flows on mortgages and regular interests are identical, and there is no net economic income to the REMIC, the REMIC will have phantom income in early years and phantom loss in later years if the REMIC finances mortgages with instruments that have shorter maturities. Over time these amounts will exactly offset each other, but in any particular year interest income will not match expense. This phenomenon results from an interaction of a tax convention with economic reality. The convention is that interest accrues at a single constant rate over the life of an instrument. The economic reality is that interest does not accrue at a constant rate, but (assuming a positive yield curve) at higher rates for later payments. Thus, a single long-term instrument will accrue interest at a rate different from the rate at which its constituent pieces would accrue interest.

Phantom income in a REMIC flows through to the residual interest holders. The REMIC “excess inclusion” rules provide a mechanism for approximating phantom income and imposing tax regardless of whether the residual interest holder would otherwise pay tax. This is intended to prevent taxpayers from engaging in a strategy to shift phantom income to non-taxpaying entities.

The excess inclusion rules are backstopped by procedural rules intended to discourage transfers of residual interests to those who are beyond U.S. taxing jurisdiction. Further supporting the excess inclusion requirements except that distributions on the residual interests must be pro rata. Technically the REMIC must calculate its taxable income or net loss using the accrual method and as if it were an individual, with certain exceptions. A residual interest holder takes into account its daily portion of the REMIC’s taxable income or net loss for the quarter.

146. See Gergen, supra note 85, at 60. To borrow a lucid example of this phenomenon from Professor Gergen, imagine a REMIC holds one mortgage providing 8% interest and paying interest and principal in three equal annual installments. The REMIC issues three classes of regular interests, one with a one-year maturity and a 7.7% yield, one with a two-year maturity and an 8% yield, and one with a three-year maturity and an 8.2% yield, each entitled to one of the annual installments on the mortgage. Even though the cash flows will match, the income and expense will not. The REMIC’s interest income will be greater than its interest expense in the first year (because the average rate on the regular interests is less than 8%), and less than the interest expense in the last two years. Id. at 60 n.99. See also Van Brunt, supra note 116, at 212-14 (providing more elaborate, better-developed illustrations of the phantom income phenomenon).

147. A holder of a residual interest can never have income in a taxable year that is less than its portion of “excess inclusion income.” I.R.C. § 860E(a) (2002). For a full discussion of the issues associated with the excess inclusion rules, see Peaslee & Nirenberg, supra note 15, at 647-80; Van Brunt, supra note 116, at 210-25.

148. A REMIC is required to have reasonable arrangements to prevent persons who cannot be subject to tax from holding its ownership interests. I.R.C. §§ 860D(a)(6)(A), 860E(e)(5) (2002). In addition, an excise tax is imposed on a transfer of a residual interest to such a person, and the REMIC must maintain and make available information that allows for the application of the excise tax. Id. §§ 860D(a)(6)(B), 860E(e).
rules is a provision that attempts to make REMICs the exclusive method of issuing multiple classes of interests backed by real estate mortgage loans.\textsuperscript{149} This makes many of the transactions described in the previous sections less useful for securitizing mortgages than they were before enactment of the REMIC rules in 1986.

Transfers of assets to REMICs are subject to rules modeled on the way contributions to grantor trusts or partnerships are taxed, but follow neither precisely. As in the case of a transfer to a grantor trust or partnership, a transfer of assets to a REMIC in exchange for REMIC interests does not trigger gain or loss. Instead, the transferor takes a substituted basis in the REMIC interests.\textsuperscript{150} Accordingly, the transferor recognizes gain or loss when interests are sold. The REMIC takes contributed assets with a fair market value basis.\textsuperscript{151} To reconcile the difference between the transferor’s outside basis in REMIC interests and the REMIC’s new basis in the assets, the transferor is required to accrue built-in gain or loss much as it would market discount or premium\textsuperscript{152} when it retains an interest.\textsuperscript{153} This parallels the results of an exchange of property for grantor trust or partnership interests and subsequent sale of the interests. The REMIC rules, however, result in different inside and outside bases, but eliminate the complexity of treating each interest holder as owning a direct, undivided interest in the trust’s assets.\textsuperscript{154}

In effect, a REMIC is taxed much like a partnership that issues multiple classes of debt that cannot be recharacterized as equity. This holds true regardless of the form of the REMIC securities and even when the entity is thinly capitalized.\textsuperscript{155} The one exception to this generalization is the excess inclusion rules.

\textsuperscript{149} The taxable mortgage pool rules, contained in I.R.C. § 7701(i) (2002), treat as a separate taxable corporation any entity or portion of an entity that holds real estate mortgages and issues multiple classes of debt obligations if payments on the debt obligations bear a relationship to the payments on the mortgages.

\textsuperscript{150} Id. § 860F(b)(1)(A)-(B).

\textsuperscript{151} Id. § 860E(b)(2). The REMIC’s fair market value basis can cause it to accrue a different amount of income on the assets than the transferor would have because of the application of the market discount and amortizable bond premium rules.

\textsuperscript{152} Market discount, which arises when a debt instrument is acquired for less than its adjusted issue price, is accrued as additional interest income on the instrument. Amortizable bond premium, which arises when an amount greater than adjusted issue price is paid for a debt instrument, is treated as an offset to interest income on the instrument. Id. §§ 171(e), 1276.

\textsuperscript{153} Id. § 860F(b)(1)(C)-(D). Gain or loss attributable to a residual interest is accrued ratably over the period in which the REMIC is expected to be in existence. Gain or loss attributable to an interest is determined by the difference between the interest’s basis and its issue price.

\textsuperscript{154} The result of the grantor trust rules is that each piece of property held by the trust will have many bases associated with the different owners. If all of the interests in a grantor trust are sold at once, however, the basis in the assets held by the grantor trust will be, at that time, equal to their fair market values.

\textsuperscript{155} Peaslee & Nirenberg, supra note 15, at 37.
IV. FASITS

In the lead-up to the Tax Reform Act of 1986, Congressmen introduced a number of bills intended to facilitate secondary market sales of real estate mortgages. At least one of those bills would have applied to a broader class of assets than the ultimate legislation.\textsuperscript{156} It is not entirely clear why the REMIC legislation took such a narrow approach, and there does not seem to be a pure tax policy explanation for it.\textsuperscript{157} Not surprisingly, shortly after the REMIC provisions were enacted interest groups began work on designing an expanded statutory securitization regime. Ultimately, concrete proposals to ease restrictions on securitizing non-mortgage receivables and short-term mortgage loans emerged. The first proposals would have expanded the preexisting REMIC regime to accommodate these assets.\textsuperscript{158} This would have necessitated making numerous statutory changes to the types of assets REMICs could hold, the activities they could engage in, and the mechanisms for taxing their interest holders.

While at its inception, the idea was simply to modify the REMIC sections of the tax code to accommodate a broader class of securitizations,\textsuperscript{159} the FASIT evolved over time into its own special purpose vehicle. As it evolved, it seemed to have become less modeled on the REMIC provisions and their foundation in grantor trust and partnership treatment, and more modeled on the collateralized debt structure used in securitizing credit card receivables. This is hardly illogical since credit card receiv-


\textsuperscript{157} The Treasury Department may have been worried about jumping the gun. The mortgage-backed securities market was sufficiently well established that tax staffers probably felt they could grasp its workings. Securitization of other kinds of assets was nascent and probably not well understood except by a small number of experts. In that situation it seems wise to wait to see how the market shakes out before stepping in with legislation. Cf. Proposal to Expand REMIC Provisions, supra note 28, at 308. Moreover, there was undoubtedly greater pressure to do something for mortgage securitizations. See Peaslee & Nirenberg, supra note 15, at 36. The Treasury Department and Congress might also have wanted to gain experience with the REMIC structure before expanding it to other assets and transactions. Proposal to Expand REMIC Provisions, supra note 28, at 309 n.33 (citing Dep't of Treasury, Review of Tax Treatment of Mortgage-Related Securities and Environmental Zone Legislation: Hearings on S. 1839, S. 1959, and S. 1978 Before the Subcomm. on Tax'n and Debt Mgmt. of the S. Fin. Comm., 99th Cong., 2d Sess. 61, 77 (1986) (Statement of Dennis E. Ross, Acting Tax Legislative Counsel), reprinted in 86 TAX NOTES TODAY 24-4 (1986); Dep't of Treasury, Statement Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means of the U.S. House of Representatives on H.R. 4448, 99th Cong., 2d Sess. 38 (1986), reprinted in 86 TAX NOTES TODAY 116-8 (1986); 131 CONG. REC. S17,767 (1985) (Statement of Senator Chafee on S. 1959)).

\textsuperscript{158} See generally Proposal to Expand REMIC Provisions, supra note 28; Susswein, supra note 127, at 4.

\textsuperscript{159} See generally Proposal to Expand REMIC Provisions, supra note 28. The proposal contained in this letter was an explicit amendment to the REMIC provisions contained in I.R.C. §§ 860A-860G (1990). By the time it was introduced in Congress in 1993 the proposed legislation was no longer in that form. See infra text accompanying note 198.
ables constitute the largest portion of non-mortgage securitized assets.\footnote{At the end of the second quarter of 2002, credit card receivables backed 27.7\% of all outstanding asset-backed securities. Home equity loans (16.5\%) and automobile loans (14.4\%) are the next largest categories. The Bond Market Ass’n, Asset Backed Securities Outstanding, available at http://www.bondmarkets.com/Research/absos.shtml (last visited on Oct. 26, 2002).} Thus, the final legislation was a mix of the REMIC rules and other non-statutory models.

As under the REMIC rules, FASIT status is elective, and the electing entity must meet a number of complex qualifications. Each set of rules impose restrictions on the kinds of assets the vehicle can hold, the activities it can engage in, the interests it can issue, and the investors who can hold those interests. As one would expect, however, the FASIT’s restrictions are generally looser than the REMIC’s. But they are also less generous in important ways.

A FASIT, unlike a REMIC, may hold virtually any asset that qualifies as a debt instrument under the tax law and that bears interest at a fixed or variable (but not contingent) rate.\footnote{These debt instruments, along with certain other assets, such as cash (which includes deposit accounts) and foreclosure property, are “permitted assets” for a FASIT. I.R.C. § 860L(c)(1) (2002). There are, however, a number of exceptions. For example, a debt instrument issued by the holder of the ownership interest in a FASIT or any related person generally is not a permitted asset. Id. § 860L(c)(2).} On one hand this gives the FASIT the flexibility to securitize a large variety of instruments, including trade receivables, car loans, home equity loans, and credit card receivables. Plus, a FASIT has a greater ability than a REMIC to enter into contracts or hold assets that hedge its risks.\footnote{The FASIT must be hedging its risks of issuing “regular interests,” described below. See infra note 167 and accompanying text. These hedging contracts or assets may include interest rate or currency swaps or assets that provide credit support, such as guarantees, sureties or letters of credit. I.R.C. § 860L(c)(1)(D) (2002).} On the other hand, a REMIC may hold contingent payment debt instruments, which would be a prohibited transaction for a FASIT. On balance, however, the FASIT structure allows securitization of many more asset types than the REMIC structure does.

The FASIT regime also provides much more flexibility to add or remove assets. A FASIT may receive or acquire assets at any time during its existence.\footnote{The FASIT rules require no specific time period for including assets in the FASIT, nor do they define the receipt of a permitted asset as a prohibited transaction.} Similarly, while neither a FASIT nor a REMIC can sell assets to take advantage of price changes, the circumstances in which a FASIT may dispose of assets are much broader than those in which a REMIC can do so. A FASIT can dispose of assets without engaging in a prohibited transaction in all the same circumstances as a REMIC.\footnote{In general, income a FASIT earns from dispositions of assets is subject to a 100\% penalty tax unless an exception applies. I.R.C. § 860L(e)(1) (2002). The circumstances under which a REMIC can dispose of assets is discussed supra note 141.} Plus, it can substitute one debt instrument for another, distribute a debt instrument to reduce over-collateralization, dispose of assets to liquidate a class of regular interests, and dispose of former hedges that no longer fulfill...
that purpose. 165

The securities that FASITs and REMICs are permitted to issue have logical similarities and differences. Both FASITs and REMICs must have a designated equity interest, which is an "ownership interest" in the case of a FASIT. 166 All other FASIT securities, the regular interests, must have specific debt-like characteristics. 167 Unlike REMICs, FASITs have a special class of regular interests, called high-yield interests, that are subject to fewer restrictions on their terms than the other regular interests, 168 but are subject to other limitations, discussed later. As in the case of REMICs, the FASIT regular interests are debt instruments for federal income tax purposes: holders of the regular interests accrue interest income, and the FASIT owner accrues interest expense. 169 Unlike REMICs, however, FASITs may issue securities at any time and can liquidate classes of regular interests without penalty. 170 Thus, while a REMIC is a fixed pool of assets and has a limited life span, a FASIT can continue indefinitely, much like a revolving credit facility secured by a changing pool of assets.

The different securitization structures on which the two regimes were modeled also explain the different ways income from the arrangements is taken into account. While a REMIC makes entity-level calculations of income and loss, a FASIT does not. Instead, the holder of the ownership interest accounts for the income, deductions, and other tax items of the FASIT directly, as if the FASIT's assets were owned, and its regular interests were issued, directly by the holder. 171 Thus, a FASIT is not even a pass-through for this purpose—it is a non-entity. This is another example of the way in which the FASIT rules appear to be modeled on the collateralized debt securitization structure.

The link between the collateralized debt securitization structure and the FASIT rules also illuminates one of the significant differences be-

166. Id. § 860L(a)(1).
167. The regular interests must resemble plain-vanilla debt: they must have a fixed term, be designated as a regular interest in a FASIT; unconditionally entitle the holder to a specified principal amount, provide for interest (if any) at fixed or certain qualified variable rates, have a stated maturity of 30 years or less, have an issue price not exceeding 125% of the principal amount, and have a yield to maturity of less than 500 basis points above the applicable federal rate for the month in which the interest is issued. Id. § 860L(b)(1)(A).
168. The high-yield interests are not subject to the stated principal amount requirement or the yield and issue price limitations that apply to other regular interests, and may provide for payments determined by reference to a specific and constant portion of interest received on the FASIT's assets. Id. § 860L(b)(1)(B).
169. Id. § 860H(b)-(c).
170. There are no restrictions under the FASIT rules on the issuance of regular interests after a specified time. I.R.C. § 860L(e)(2)(D) provides that a disposition of a FASIT's assets to liquidate a class of regular interests, for whatever reason, is not a prohibited transaction. A prohibited transaction is subject to a tax of 100% of the net income from the transaction. Id. § 860L(e)(1). A REMIC, on the other hand, may only dispose of assets in order to redeem class of interests if there is a small remaining balance of the interests. See supra note 141.
between the FASIT and REMIC regimes. The FASIT rules require high-
yield regular interests and FASIT ownership interests to be held by taxa-
table corporations.\textsuperscript{172} Moreover, the holder's taxable income cannot be less
than the income on its FASIT interest.\textsuperscript{173} The REMIC provisions, by
contrast, have rules that only help ensure tax will be collected on excess
inclusion income.\textsuperscript{174} The consequence of the FASIT rule is that a signifi-
cant portion of a FASIT's income may be subject to corporate-level tax.

The origin of this rule is easy to understand. In a collateralized debt
securitization only a portion of the yield from a pool of receivables can be
paid as interest to security holders. Because of the limit in practice on the
securities' yields, which is a function of the high credit rating needed to
obtain a tax opinion, a portion of the return from the receivables remains
in the originators' hands and can be subject to a corporate-level tax.\textsuperscript{175}
Using this transaction as the starting point, the FASIT legislation allows a
greater percentage of assets in a pool to be securitized, but retains the
corporate-level tax, imposing it explicitly on holders of the high-yield and
ownership interests.

The effect of this rule, however, can be significantly harsher than sim-
ply including FASIT income in a corporate taxpayer's gross income. In a
collateralized debt securitization, the borrower may not actually pay tax
on the difference between the income on the assets and the interest on
the debt if, for example, it otherwise has losses. But an originator who
retains an ownership interest in a FASIT cannot reduce the income from
the interest the same way. This creates a strong disincentive for some
taxpayers against using the FASIT structure to securitize assets.

Moreover, the policy basis for imposing the corporate tax is not self-
evident. Although one might argue it is appropriate because high-yield
and ownership interests have "equity-like" returns, this statement cannot
withstand critical examination. An investment is not subject to entity-
level tax simply because it is risky.\textsuperscript{176} A return is said to be "equity-like"
because the holder bears the risks of an owner rather than a creditor, not
because he or she owns the equivalent of equity in a corporation. An
individual can own a junk bond or speculate in real estate, which can be a

\begin{itemize}
\item \textsuperscript{172} \textit{Id.} §§ 860K, 860L(a)(1)(C), (a)(2). The rules attempt to limit ownership of owner-
ship interest and high-yield debt instruments to "eligible corporations." \textit{Id.}
§ 860L(a)(1)(C). The ownership interest must be held by a single, eligible corporation or
the FASIT will be disqualified. \textit{Id.} An eligible corporation is a domestic corporation sub-
ject to tax under Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code.
In addition, it cannot be a pass-through entity such as a regulated investment company, a
real estate mortgage investment conduit or an S corporation. \textit{Id.} § 860L(a)(2). A high-
yield interest may also be held by another FASIT. A transfer of a high-yield interest to any
person who is ineligible to hold it is ignored for tax purposes and the transferor is subject
to tax as if it continued to hold the interest. \textit{Id.} § 860K.
\item \textsuperscript{173} \textit{Id.} § 860J(a).
\item \textsuperscript{174} See supra text accompanying notes 146-47.
\item \textsuperscript{175} See supra text accompanying note 127.
\item \textsuperscript{176} Cf. Gergen, supra note 85, at 51 (making a similar argument about equating risk
with an active business for purposes of defining an active financing business under the
publicly traded partnership rules).
\end{itemize}
very risky investment and can pay a very high return, without being treated as owning corporate stock or being subject to the corporate tax on the income.177

But if corporate tax were not imposed on the income from the high-yield and ownership interests, the returns on assets securitized in a FASIT would be removed from the corporate tax base. Could this create allocative inefficiencies by increasing the after-tax returns to investments in these assets relative to the returns on other investments? It might, but it is worth observing that diversified investments in many other types of assets can be made through publicly traded vehicles that are not subject to entity-level tax. For example, notes and bonds and other financial contracts can be owned through mutual funds, long-term debt can be owned through grantor trusts, and real estate assets can be owned through real estate investment trusts and REMICs. The holder of a FASIT high-yield or ownership interest is making an essentially passive investment: at most these investors provide credit support for the regular interest class.178 Equality of treatment would seem to argue against imposing the corporate tax on income from these investments.179

The absence of a compelling policy justification for the rule imposing corporate tax on FASIT income is clearer when it is compared to the REMIC excess inclusion rule.180 If there were no excess inclusion rule, taxpayers could more easily utilize a strategy of allocating taxable income to an exempt person without also allocating the corresponding economic income. This strategy would remove the net present value of the phantom income, or more,181 from the tax base even if the related economic

177. An issuer of an interest bearing a high yield, however, may lose the interest deduction under the high yield debt obligation rules of I.R.C. § 163(e)(5) (2002).

178. Some worry that failing to impose the corporate level tax on at least some portion of a FASIT's income would allow financial institutions to escape corporate level tax by siphoning off income to a related FASIT. See, e.g., Lee A. Sheppard, Bank Deregulation Through the Back Door, 95 TAX NOTES TODAY 178-6 (1995). This concern is not without merit, but it seems that limiting FASIT assets to debt instruments with fixed (or certain variable) rates of interest should control this potential. Merely running what would otherwise be debt through a “funnel” should not convert some portion of that debt into equity. PEASLEE & NIRENBERG, supra note 15, at 119. Nonetheless, a financial institution might work around this requirement by allowing the FASIT to retain the institution's fee income, the interest rate spread it enjoys, so that the institution's equity interests could be converted into debt instruments and its corporate level tax could be wiped out. Alternatively, an originator operating as a partnership might use the FASIT regime as a method of avoiding publicly traded partnership status under I.R.C. § 7704 (2002) by using what are essentially equity investments in the FASIT to finance its activities. To fully respond to these concerns one must address the policy justifications for a corporate level tax and whether the FASIT or REMIC regime might be an acceptable means of corporate tax integration. That discussion is beyond the scope of this article.

179. Cf. Letter from Donald B. Susswein, of Thatcher, Profit, and Wood, to Mr. Davenport, Editor, Tax Notes (Sept. 13, 1995), reprinted in FASIT Lawyer Takes Sheppard To School, 95 TAX NOTES TODAY 185-111 (1995) (“The principal group of loans excluded from . . . passthrough treatment are short-term or revolving loans whose duration is too short (or too uncertain) for a 'static' pass-through structure.”).


181. The result is even worse if phantom losses can be allocated to taxpayers who can use them against other income. Losses on REMIC ownership interests are only deductible
income had been earned by a taxable entity. The REMIC excess inclusion rules attempt to limit the tax savings obtained through this strategy. The same purpose cannot be ascribed, however, to the imposition of corporate tax on all income accruing on high-yield and ownership interests in a FASIT.

The REMIC rules do not subject any portion of the income from mortgages held by a REMIC to a corporate-level tax. Furthermore, they do not explicitly impose corporate tax on the returns to any REMIC securities, even though the REMIC securities that represent interest strips can be very risky and may bear high interest rates. The inconsistency between the REMIC rules and the FASIT provisions looks suspiciously like a historical accident rather than a policy choice; the accident being that the secondary market for mortgages developed earlier and more completely than did secondary markets for other cash-flow assets. By the time the REMIC rules were enacted the returns on mortgages had already exited the corporate tax base. The REMIC rules just help them exit more efficiently.

These criticisms may be answered by arguing that the imposition of the corporate tax under the FASIT rules is appropriate because the FASIT legislation was not really intended to reduce the tax costs of securitizing assets, but to reduce transaction costs by providing certainty of tax treatment. This argument seems hollow. But even if accepted at face value, the additional rules necessary to insure collection of the corporate-level tax on the high-yield debt and ownership interests, together with the rule that terminates FASIT status if the ownership interest is not held by a taxable corporation would seem to undo a good deal of whatever cer-

to the extent of the holder's basis. \textit{Id.} § 860C(e)(2). Presumably a taxpayer can use phantom losses to defer income by purchasing an ownership interest that has economic value right at the time the REMIC starts to generate losses, or by engaging in a transaction that increases his basis in the REMIC residual interest.

182. \textit{Peaslee & Nirenberg, supra note 15, at 454-55} Peaslee and Nirenberg believe the specified fixed portion of interest payments rule was added to the REMIC provisions in 1988 because policymakers thought it would not allow a REMIC to accomplish anything that could not be done through a grantor trust. A FASIT, however, would probably not be able to achieve the effect in another form.

183. The especially favorable treatment of mortgage securitizations could also be attributable to the importance of mortgage lending in this country. \textit{Cf. id.} at 36 (postulating that the REMIC legislation went forward in such a narrow form because home loans "have traditionally benefited from Congressional largesse").

184. For an excellent description of the development of the asset-backed security market, see \textit{Proposal to Expand REMIC Provisions, supra note 28, at 302-07}.

185. Although the mortgages could not be securitized in a multi-class structure without a potential corporate-level tax after the promulgation of the Sears regulations and before the enactment of the REMIC rules, see supra notes 80-82, an originator who used a simpler structure could sell its entire interest in the mortgages in the secondary market.


187. \textit{I.R.C. §§ 860K, 860L(a)(1)(B) (2002).} The FASIT analogue to the REMIC excess inclusion provision of \textit{I.R.C.} § 860E (2002) is somewhat simpler because it does not require a calculation of the excess inclusion amount. It provides that the taxable income of a
tainty otherwise flows from the FASIT rules.\textsuperscript{188}

While imposing corporate tax on income from FASIT high-yield and ownership interests is understandable because of its consistency with the transactional blueprint for the FASIT legislation, the rules that govern transfers of securitized assets to a FASIT are a clear break from that model. The rules require the holder of the ownership interest to recognize gain (but not loss) on contributions of property to the FASIT.\textsuperscript{189} The rules are entirely inconsistent with the collateralized debt securitization paradigm, which allows all proceeds from the transaction to be received without recognition of gain or loss. Moreover, they are substantially more burdensome than the REMIC rules, which require recognition of gain or loss on contributed assets only when interests representing those assets are sold.\textsuperscript{190} A taxpayer that originates receivables and transfers them to a FASIT recognizes gain immediately, even if the taxpayer sells none of the FASIT interests.

An early report states that the FASIT legislation was intended “to strike the same ‘bargain’ between the Treasury and the securitization industry that the REMIC legislation struck, namely the waiver . . . of debt/equity testing on securitization in exchange for immediate recognition of gain” and the current taxation of phantom income.\textsuperscript{191} But the industry seems to have come out on the short end of that bargain. The FASIT gain recognition rules effectively accelerate income much more than the REMIC rules do. Not only that, they use a special valuation rule for debt instruments that are not traded on an established securities market that causes an overly high fair market value to be ascribed to the assets transferred to a FASIT.\textsuperscript{192} Finally, to prevent taxpayers from trying to avoid gain recognition by keeping assets out of the FASIT, the rules require the holder of an ownership interest to recognize gains on any assets not held by the FASIT that “support” payments on FASIT regular interests.\textsuperscript{193}

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\textsuperscript{188} One could rightly ask why the legislation did not simply impose tax on the FASIT itself. If an SPV is subject to significant potential for liability it may not obtain a desirable level of “bankruptcy remoteness” and thus would not be able to obtain the high credit rating that is the purpose, or one of the main purposes of engaging in the transaction in the first place. If another party bears primary liability for tax on the income of the entity this issue does not arise.

\textsuperscript{189} \textit{Id.} § 860J(a).

\textsuperscript{190} \textit{Id.} § 8601(a).

\textsuperscript{191} \textit{Id.} § 860F(b). \textit{See supra} notes 150-54 and accompanying text.

\textsuperscript{192} Letter from N. Jerold Cohen, Chair, Section of Tax’n, Am. Bar Ass’n, to Kenneth Kies, Chief of Staff, J. Comm. on Tax’n (Aug. 12, 1995), reprinted in \textit{ABA Tax Section Members Offer Mixed Support on ‘FASIT’ Bill, 95 TAX NOTES TODAY} 167-14 (1995).

\textsuperscript{193} I.R.C. § 8601(d) (2002). The value of such an asset is the present value of its reasonably expected payments, using a discount rate equal to 120\% of the Applicable Federal Rate, defined in I.R.C. § 1274 (2002), unless regulations provide otherwise. Proposed Regulations issued under this section to date have provided no meaningful exceptions to this rule, but do provide other discount rates. \textit{See Prop. Treas. Reg.} § 1.8601-2, 65 Fed. Reg. 5807 (Feb. 7, 2000).

\textsuperscript{192} I.R.C. § 8601(b) (2002).
There are three principal factors that make immediate gain recognition problematic. First, originators often contribute assets to an SPV some time before the SPV’s interests are sold to other investors. Thus, the FASIT gain recognition rule substantially accelerates income relative to simply holding the assets. Second, originators in non-mortgage loan securitizations, and especially originators of securitized credit card receivables, often retain relatively large interests in the receivables. In credit card securitizations in particular, the originator must provide a cushion so investors’ interests do not amortize prematurely. Again, the gain recognition rule marks contributed assets to the higher of basis or market, even though, in a sense, the originator retains the portion of the assets measured by its percentage interest in the pool. Finally, the mandated discount rate for valuation is too low in many cases, and results not only in inclusion of previously accrued economic gain, but also artificial gain. These problems translate into a significant disincentive for many originators to use the FASIT structure at all.

The gain recognition requirement and its associated rules may be an appropriate way to undo some of the vagaries of our realization system. It may also be a response to legitimate concerns about income shifting. Even so, technical budgetary concerns played a critical role in the development of the FASIT legislation and the adoption of the gain recognition requirement and associated rules. Representative Clay Shaw, sponsor of the 1995 FASIT legislation, touted its ability to raise revenue through requiring gain recognition. According to his statement accompanying introduction of the bill, the FASIT legislation would raise $87 million over five years and $92 million over ten by replacing amounts lost to the cor-

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194. A sponsor often transfers all of the receivables of a certain type that it originates over time to a master trust. This is done to avoid accounting complexities and to allow the accounts associated with receivables to establish a performance history. See Letter from Richard L. Reinhold, Chair, Section of Tax’n, N.Y. State Bar Ass’n, to Hon. Donald C. Lubick, Acting Assistant Sec’y, Dep’t of Treasury, and Margaret M. Richardson, Comm’r, IRS (Feb. 7, 1997), reprinted in NY Bar Suggests FASIT Rules, 97 TAX NOTES TODAY 28-27 (1997) [hereinafter Letter from Richard L. Reinhold].

195. Whether or not mortgage loans are transferred in advance to a REMIC is of little consequence, since a transferor of assets to a REMIC in exchange for REMIC interests recognizes income or loss only upon the disposition of the assets. See supra text accompanying notes 150-54.

196. See supra text accompanying note 125.

197. See, e.g., Letter from James M. Peaslee to Paul Crispino, Treasury Dep’t (July 29, 1998), reprinted in Peaslee Follows up on FASIT Regs’ Meeting, 98 TAX NOTES TODAY 205-15 (1998) (“[T]he 120% of AFR rule can significantly distort the value of debt instruments in a way that makes the FASIT rules unusable where it applies, particularly in the case of medium or long-term debt obligations.”); Letter from Richard L. Reinhold, supra note 194; Letter from George P. Miller, Bond Market Association, to the IRS (May 19, 2000), reprinted in Bond Association Suggests Changes to Proposed FASIT Regs., 2000 TAX NOTES TODAY 116-44 (2000).

198. H.R. 1967, 104th Cong. (1995). This bill did not contain the same gain on transfer rule applied under I.R.C. § 8601(d) (2002). Rather, it would have accelerated income only to the extent a person who transferred assets to a FASIT sold some or all of the securities received in exchange at a gain.
porate tax basis with gain recognition. But he also said that the bill would not increase taxes, which seems at odds with the revenue estimate. Both of these statements can be true, however, if the revenue generated by accelerated gain is temporary. Thus, when the creation of FASITs and issuance of FASIT interests stabilized, revenue generated by the accelerated income would be offset by deductions for bond premiums. The relatively small amount of revenue the legislation would have raised in years five-through-ten ($87 million in the first five years, $5 million in the second) supports this hypothesis.

Nonetheless, gain acceleration allowed the legislation to be scored as a revenue raiser, which in turn made it much more likely to be enacted. Under recently expired congressional budget rules, a provision that loses revenue generally must be accompanied by a proposal that provides a revenue offset. Whether a tax provision raises or loses revenue over the relevant period is determined by revenue estimates performed by economists at the Joint Committee on Taxation. This stage of the journey to enactment is so critical that many proposals are crafted specifically with the revenue estimate in mind. When groups advocate new tax provisions that will reduce revenues, they not only have the burden of justifying the revenue reduction on policy grounds, but often must also supply an acceptable method to raise the offsetting revenue. The dilemma is that proponents of other costly proposals are also on the lookout for "pay-fors" and will compete viciously for those that appear to be politically acceptable.

The original FASIT gain recognition rule was intended to ease passage of the legislation by making it a desirable source of revenue for other proposals. This strategy, however, backfired by rendering it untenable for FASIT legislation to go forward on any basis other than as a revenue-raising provision. As it became clearer that the FASIT rules would provide opportunities to shift income, the legislation became increasingly complex to foreclose the opportunities and protect the revenue to be raised. This complexity ultimately collapsed on itself and resulted in the

200. Id. at E1369.
202. For example, phase-in and transition rules are often adopted to help achieve a certain revenue goal.
203. It is not uncommon for proponents of one legislative proposal to steal a revenue raising provision identified by advocates of a different legislative proposal. Among Congressional staffers this is called being "Guarined" after former House Ways and Means Committee member Frank J. Guarini of New Jersey. See, e.g., Ryan J. Donmoyer, Houdini Bests Guarini As Pay-For Disappears, 99 TAX NOTES TODAY 162-1 (1999).
final legislation. This can be seen by tracing the development of the FASIT legislation.

The American Bar Association made the first formal and well-developed proposal to expand statutory securitization vehicles after 1986.\textsuperscript{204} The group called its vehicle an asset securitization investment conduit ("ASIC"). The ASIC proposal retained almost all the REMIC rules, but extended them so that non-mortgage assets could be securitized and that revolving or short-term assets could move into the vehicle and revolving assets could move out more freely. As under the REMIC provisions, a person transferring assets in exchange for ASIC interests would recognize no gain or loss on the exchange, and its basis in the ASIC interests would be the same as its basis in the property contributed. To ensure the contributor would have the same income from a continuing interest in the ASIC as it would have had if it had retained the assets, the ASIC rules, like the REMIC rules, would have required the transferor to accrue unrecognized gain or loss as if they were market discount or amortizable bond premium on the retained ASIC interests.\textsuperscript{205} In addition, since the basis of the ASIC interests would be the same as the transferor's aggregate basis in the assets transferred in exchange, the transferor would recognize gain or loss as the interests were sold.

This approach would have worked fairly well for a static pool of assets, but was not fully formed when it came to revolving securitizations. For example, it left open the opportunity for the originator to recognize loss on receivables simply by selling them to the ASIC. Similarly, an originator could have recognized or deferred gain or loss by rearranging the order in which the ASIC received assets and issued interests: an originator who wanted to recognize losses could exchange receivables with built-in loss for interests that it would sell, and only later transfer assets with built-in gain to the ASIC. Contributing assets at different times for different consideration also could allow transferors to obtain significant income deferral if the assets supported ASIC interests having significantly longer maturities, as they would, for example, in a credit card securitization. The proposal would also have allowed multiple holders of ownership interests to shift income among themselves by contributing assets with different basis-to-value ratios.\textsuperscript{206} Thus, the proposal created significant opportunities for taxpayers to accelerate losses, defer gains, and shift income.

\textsuperscript{204} See generally Proposal to Expand REMIC Provisions, supra note 28.

\textsuperscript{205} This is the same rule that applies to transferors of assets to REMIC. See supra note 152. Thus, the discount and premium rules would cause an ASIC's income on assets with built-in gain to be lower than it would have been in the transferor's hands, and its income on assets with built-in loss to be higher. The special accrual rule for the transferor's unrecognized gains and losses was an attempt to undo this result when the transferor retains an interest in the assets by holding ASIC securities.

When the first legislation was introduced in 1993, the bill was significantly different than the original proposal. Instead of piggybacking on the existing REMIC rules, H.R. 2065 created an entirely new vehicle and called it a FASIT. But in many respects the legislation still closely tracked the REMIC provisions. It provided that gain or loss would be recognized upon the transfer of assets to a FASIT, that the basis in a FASIT interest received by a transferor would be equal to its fair market value at the time of transfer, and that the FASIT would have a basis in the received assets equal to their fair market value. Gain or loss recognized on the transfer would be deferred, however, to the extent interests were retained, and would be taken into account as if the gains were market discount and the losses were bond premium on the transferred assets (rather than on the received interests). Since the transferor received the interests with a fair market value basis, no gain or loss would be recognized on their immediate sale. However, the bill contained a special rule that required the transferor to treat any sale proceeds as pro-rata payments on the principal of the outstanding assets held by the FASIT. This would accelerate the recognition of a pro-rata portion of the notional market discount income or bond premium deduction to the transferor.

Although this regime was more sophisticated than the ASIC proposal, it still left gaping holes. Again, it failed to prevent taxpayers from electing between deferral and recognition simply by choosing the form of the transaction in which assets are transferred to the FASIT. While in theory it did a better job of ensuring a transferor that had a continuing interest in the FASIT would recognize gain or loss in a manner approximating the income or deductions it would have had if it had retained the assets, it also set up a mechanism that required taxpayers or the IRS to track specific assets contributed to the FASIT by the transferor. Using this mechanism would have been unworkable for revolving trusts that could hold millions or billions of dollars worth of receivables.

The Securitization Enhancement Act of 1995 was even more complex in its efforts to prevent loss acceleration, income deferral, and income shifting. Under this proposal, no gain or loss would be recognized on contribution of assets if the transferor held an ownership


209. An even more complicated set of rules had been proposed at the end of 1993. See NYSBA Reports on Proposed “FASIT” Legislation, supra note 10. The proposal was much like its successor, H.R. 1967, but more complex. For example, it had an elaborate scheme requiring holders of ownership interests to reallocate basis among various FASIT securities before a sale to prevent loss cherry-picking. The proposal also required a holder of an ownership interest to take into account as income or deduction its share of the difference between its outside basis in the FASIT interests and the FASIT’s aggregate basis in its assets, and to recognize gain to the extent that its interest in the FASIT’s assets declined by reason of the issuance of FASIT regular interests.
interest in the FASIT after the transfer. The transferor would take a substituted basis in its FASIT ownership interests, and the FASIT would have a carryover basis in contributed assets. The proposal required the holder of an ownership interest to treat all receipts of cash from the FASIT as distributions on the interest rather than as payment for assets transferred to the FASIT. Thus, the transferor could not use the FASIT to trigger loss recognition without disposing of a significant amount of FASIT securities. The bill also would have required the holder of an ownership interest to recognize gain to the extent of any decline in its proportionate share of the built-in gain on FASIT assets, taking into account the extent to which the FASIT was leveraged by regular interests. The legislation also contained rules against adding assets to manipulate recognized income, and generally would have followed a partnership model to track income and loss allocations to transferors who contributed assets with different built-in gains and losses.

These rules did a much better job of policing the problems identified with the early FASIT proposal. But they also required frequent valuations of FASIT assets, which would have been administratively burdensome and potentially unreliable.

Finally, in late 1995 Congress abandoned the effort to provide deferral of gain or loss on assets transferred to a FASIT, and provided for immediate gain recognition in all events. The legislation also provided a valuation rule, a rule requiring gain recognition on supporting assets, and the requirement that a FASIT's ownership interest be held by a single taxable

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210. The legislation would, however, have applied the partnership disguised sale rules of I.R.C. §§ 707(a)(2)(B), 737 (2002) to transfers to and distributions from a FASIT.

211. The receipt of a FASIT regular interest by a holder of an ownership interest would be treated as an issuance of the interest for cash and a distribution of the cash to the holder of the ownership interest. This could give rise to immediate gain recognition if the transferor's basis in its ownership interest was less than the fair market value of the FASIT regular interests distributed in the exchange.

212. Since distributions of cash from the FASIT would have been treated as a recovery of basis in the FASIT ownership interest, no loss could be recognized and gain might be recognized upon receipt of a cash distribution.

213. This would have been determined by multiplying the unrealized gain on assets held by the FASIT by the FASIT's leverage ratio. Thus, as a FASIT increased its leverage, the holder would recognize gain. Similarly, if leverage remained the same, but assets appreciated, the holder would recognize gain. A corresponding deduction would have been allowed for reductions in the leverage ratio or decreases in the built-in appreciation in the FASIT's assets.

214. The legislation referenced the rules that apply to partners under I.R.C. § 704(c) (2002) to police allocation between owners. It also would have subjected contributions to the investment partnership rules of I.R.C. § 721 (2002).

corporation. This legislation was very similar in these regards to the FASIT legislation that was eventually enacted.

The statute contemplated that regulations would allow gain deferral, reduce discrepancies between the FASIT valuation and fair market value of contributed assets, and permit more than one member of an affiliated group of corporations to hold a FASIT’s ownership interests. But Congress sent a profoundly mixed message to the bureaucrats responsible for crafting those regulations. On the one hand, legislative history suggests that securitization should be encouraged by simplifying the tax rules that apply to securitizations and to make those rules more clear and their application more certain. But when faced with a conflict between clear, simple rules that would encourage securitizations but cost revenue, on the one hand, and clear, simple rules that would allow the FASIT legislation to retain its status as a revenue raiser, on the other, Congress chose the latter path.

In light of this, regulators have no good choices. They could design taxpayer-friendly rules to allow gain deferral, multiple owners, and more lenient valuation of transferred assets, but doing so would likely reduce revenue collections, which Congress indicated should not be sacrificed for simplicity’s sake. Alternatively, they could design highly complex rules to protect revenues, but at the risk of doing little or nothing that would make the FASIT structure more useful. Finally, regulators might choose to do nothing, on the one hand protecting revenue and on the other doing little to reduce tax impediments to securitization. Since the two latter options have essentially the same effect, why would anyone choose to invest resources in drafting essentially useless, complex rules? Congress so effectively communicated the revenue considerations that regulators so far have tried to avoid adopting rules that have any risk of reducing revenues.


217. For example, the preamble to the 2000 proposed FASIT regulations say:

Commentators urged the IRS and Treasury to issue guidance that would change the statutory rule and permit members of a consolidated group to jointly hold a FASIT ownership interest. In studying the issue, however, the IRS and Treasury became concerned about how such guidance would continue to satisfy those general principles of the consolidated return regulations that preclude the shifting of stock basis, income, or loss. The IRS and Treasury considered different models that would permit members of a consolidated group to jointly hold (or enjoy the benefits of jointly holding) a FASIT ownership interest, but none of these were found to adequately address the government’s concerns without adding administrative complexity for both the IRS and taxpayers. Moreover, the IRS and Treasury are not convinced the level of potential attribute shifting should be disregarded or addressed through an anti-abuse rule or would be so minor that disregarding it would be appropriate.

Preamble to Proposed Regulations on Financial Asset Securitization Trusts, supra note 17, at 5814.
In retrospect, promoting the FASIT legislation as a revenue raiser was a strategic mistake. On the other hand, it seems unlikely Congress would have enacted the provisions if they had appeared to lose revenue within the budget window. The more important question is whether, in the absence of budget constraints, they nonetheless should have been enacted.

The arguments that securitization is an improvement over other methods of raising capital, and so improves capital market efficiency, are somewhat persuasive, even if not supported by significant empirical evidence. To the extent securitization allows risk to be segmented and spread, creates a market for otherwise illiquid assets, allows investors to better tailor their own risk exposures, and reduces agency costs associated with corporate borrowing, it is an economically beneficial activity. Thus, in theory securitization should not be structurally disadvantaged versus other methods of raising capital.

The costs of providing a workable regime for non-mortgage securitizations, however, may be high, both in revenue and in complexity, especially considering that non-statutory structures are relatively well developed and accepted. On the other hand, the other statutory vehicles for pooling financial assets are highly successful. This suggests that these vehicles create significant efficiencies.

The toll charges an originator incurs when creating a FASIT must be reduced if FASITs are to become a viable securitization vehicle. The necessity of this step is self-evident: Virtually no securitizations are currently being structured as FASITs. Reducing the toll charges would have two elements: easing the rules that mandate payment corporate-level tax on income from ownership and high-yield regular interests, and mitigating the effect of immediate gain recognition on the transferor of assets to a FASIT.

As a matter of policy, there is no obvious reason to impose a corporate-level tax on FASIT income. This element of the legislation was clearly motivated by revenue considerations. It is also clearly the easiest flaw in the FASIT provisions to solve. Presumably, however, the rules that impose corporate tax on income from ownership and high-yield regular interests would need to be replaced with a provision analogous to the REMIC excess inclusion rules to insure that phantom income could not be allocated to an accommodation party.218 While the REMIC excess inclusion rules allow long-term mortgages to be stripped into interests with various maturities, most of which are shorter than the maturities of the mortgages. This back-loads income to the regular interest holders relative to the obligors on the underlying mortgages. Without the excess inclusion rules, a portion of interest that is deductible to the borrowers under the mortgages would not be included income by any taxpayer. See supra notes 146-47 and accompanying text. If, on the other hand, the debt instruments securitized through a FASIT have shorter maturities than do the instruments used to monetize them, the interest accrued on the instruments will be front-loaded compared to the interest on the securitized debt. The tax deductibility of home mortgage interest may have also been a motivating factor behind the excess inclusion rules. One cannot make a generalization about the deductibility of interest on debt instruments that could be held by a

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218. It is not clear that rules identical to those contained in the REMIC rules would be necessary. The REMIC structure allows long-term mortgages to be stripped into interests with various maturities, most of which are shorter than the maturities of the mortgages. This back-loads income to the regular interest holders relative to the obligors on the underlying mortgages. Without the excess inclusion rules, a portion of interest that is deductible to the borrowers under the mortgages would not be included income by any taxpayer. See supra notes 146-47 and accompanying text. If, on the other hand, the debt instruments securitized through a FASIT have shorter maturities than do the instruments used to monetize them, the interest accrued on the instruments will be front-loaded compared to the interest on the securitized debt. The tax deductibility of home mortgage interest may have also been a motivating factor behind the excess inclusion rules. One cannot make a generalization about the deductibility of interest on debt instruments that could be held by a
inclusion provisions are complex and controversial themselves, they apparently prove less of an impediment to the formation of REMICs than the imposition of a corporate-level tax on a portion of a FASIT's income.

The other significant element of the toll charge, the recognition of income on transfer of assets to a FASIT, is a thornier problem. Taking a realization-based income tax as the given, there are no necessarily correct policy answers and no adequate ways to assure tax neutrality between a FASIT and other economically similar transactions. If the appropriate analogy for a FASIT is a secured borrowing, then gain or loss on securitized receivables should be recognized only as the originator accrues income from the receivables and deductions from the FASIT interests. Alternatively, if the appropriate model is the REMIC structure, an originator of receivables should recognize gain or loss as interests in the cash flows from the receivables are “sold” to other investors. Neither of these approaches seems more theoretically correct in the abstract.

From a more practical perspective, however, a REMIC-like approach creates problems the other might not. The income or loss an originator recognizes on the sale of a REMIC interest is roughly equivalent to the income or loss the originator would have recognized had it sold a proportionate share of the assets contributed to the REMIC.219 The equivalence does not hold if a pool of securitized assets can change or the securitization vehicle can issue new interests. A rule that required an originator to recognize gain on the sale of FASIT interests would fail to account for gains and losses on assets subsequently transferred to the FASIT to replace matured assets, and would allow originators to manage their gains and losses by making strategic contributions of assets and causing the FASIT to issue new interests.220 Measuring gain or loss for each asset each time the originator sold FASIT interests or the FASIT issued interests would require elaborate, costly, and perhaps manipulable accounting. In addition, either of these methods require an ancillary set of rules for calculating the income the originator should accrue on the ownership interest—i.e., the income on the “unsold” portion of the receivables.221

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219. This is because REMIC assets and interests are static: Generally speaking, a REMIC may not acquire new assets once it commences activities, nor may it issue new interests.
220. See supra text preceding note 206.
221. The REMIC rules provide that the REMIC has a fair market value basis in the assets it receives from the holder of an ownership interest. Thus, for example, if an originator transfers appreciated assets to a REMIC, the REMIC will accrue less income than the originator would have because the assets have a higher basis in the REMIC's hands. This is only a problem to the extent that the originator has not recognized income upon disposing of interests in the REMIC. To address this problem the REMIC rules require the originator to accrue as income the excess the value of the REMIC interests the originator holds over the originator's basis in those interests. I.R.C. § 860F(b)(1)(C) (2002). This accounts for the difference between the income the originator would have accrued on the portion of the assets that have not been “sold” and the income the REMIC accrues on
None of these problems arise, however, under a secured financing model because the originator continues to accrue income on securitized assets as if nothing had changed. This requires no special rule for measuring gain or loss on the sale of FASIT interests (the proceeds would generally be treated as borrowed funds), and no adjustment in the accruals on the FASIT’s assets to account for the recognized gain or loss.

An immediate gain recognition requirement is appealing not because it replicates the treatment of an analogous transaction, but because it helps prevent taxpayers from deferring pre-contribution built-in gains. The effect of such a rule, however, is to preclude many from using the structure at all.

The fact that a revolving pool of assets presents different problems than a static pool of assets suggests that perhaps each requires a different approach. One option would be to expand the REMIC provisions beyond real estate mortgage loans to cover securitization of other long-term debt. A collateralized debt securitization model (i.e., with no gain recognition on creation or sale of regular interests) could be reserved for receivables that could not be usefully securitized through a static pool.

The problem with this approach, however, is that it seems unlikely originators would use the REMIC model if the alternative did not require the originator to recognize gain on the sale of interests. Although the result would be a deferral of gain recognition relative to the current rules, it is not clear why this is necessarily an unacceptable result.

The effect of such a regime would be to create a form of safe-harbor debt for securitizations. Under either the REMIC or collateralized debt regimes instruments with certain features would qualify as debt for tax purposes regardless of their form. If the collateralized debt model were applicable to those assets. This method, tracking the difference between the value and basis of the interests retained by the originator, would not work well if the interests represented a constantly changing pool of assets, and could allow the originator to defer income relative to simply retaining the assets. See supra text preceding note 206. The alternative of tracking the difference at the FASIT asset level, rather than at the FASIT interest level, would probably be unworkable. The other alternative, giving the FASIT a carryover basis in the assets it receives as contributions would create the opposite problem: it would overstate the income to the holder of the ownership interests to the extent the originator recognized gain on the sale of FASIT interests. Efforts to adjust FASIT net income to take these gains into account would suffer the same infirmities as regimes to adjust understated income.

222. Securitizations are sometimes analogized to factoring, although there are many distinctions between the transactions. See SCHWARZ, supra note 27, § 1:4 at 1-12 to 1-15. An originator would recognize gain in a factoring transaction (i.e., a sale of receivables to a factor), but would also recognize losses. It is, however, understandable that the FASIT rules do not permit immediate recognition of loss—that would allow an originator to elect to recognize losses simply by creating an FASIT and contributing assets to it.

223. It also help prevent income shifting between transferors of assets to a FASIT.

224. Both the FASIT rules and the REMIC rules restrict the terms of instruments that qualify for debt treatment: regular interests must entitle the holder to a specified principal or similar amount and bear only certain types of interest. I.R.C. §§ 860G(a)(1), 860L(b)(1)(A) (2002). The FASIT rules contain a second restriction: To avoid being classified as a high-yield regular interest, an instrument must have a yield below a certain level and be restricted in other ways. Id. § 860L(b)(1)(B). These restrictions would be less relevant if FASIT income were not subject to a corporate-level tax.
followed, the entity holding the securities would be ignored for tax purposes and the holder of a residual interest would be treated as the owner of the assets. If REMIC model were followed the entity holding the securities would be treated more like a partnership.225

There undoubtedly would be many complexities attendant on this approach taxing securitization transactions. For example, when would tax policy concerns necessitate the existence of an ownership or residual interest in the securitized assets and what would determine the line between a regular interest and an ownership or residual interest? Could there be more than one holder of an ownership or residual interest? What would be the tax consequences of a transfer or sale of such an interest? Should the treatment only apply to securitizations of debt, or should it apply more broadly?226 Should it somehow be made the exclusive tax vehicle available for securitizations?227

The significant benefit of a safe-harbor debt approach is that it would be flexible. It would not be limited to a historical transactional model but would be able to accommodate innovative structures. It would also reduce the number of special purpose vehicles in the tax code. This would reduce the complexity of the tax code itself. More importantly, however, such an approach would reduce the tax complexity associated with securitizing assets by providing a relatively simple and consistent template for structuring transactions.

As a preliminary matter it seems clear that a single safe-harbor debt regime would be superior to the combination of the REMIC and FASIT rules. Like any other meaningful simplification, however, adopting a useful safe-harbor debt approach to securitization would probably be scored as losing significant revenue because it would increase corporate interest deductions. More importantly for our purposes, however, the transition from the current rules, particularly in the REMIC area, to a new regime would be complex and costly.

One might also ask if enacting a safe-harbor debt regime would be substantially better than simply repealing the FASIT rules and letting taxpayers rely on other methods of securitizing debt. In practice it may not be.

225. The partnership structure has the benefit of allowing multiple holders of ownership interests, but also creates opportunities for income shifting between them. Many authors have commented on the use of partnerships to shift income between partners. For a small sample, see, e.g., Gergen, supra note 85, at 53-60; Mark P. Gergen, Reforming Subchapter K: Contributions and Distributions, 47 Tax L. Rev. 173 (1991); Laura E. Cunningham & Noel B. Cunningham, Simplifying Subchapter K: The Deferred Sale Method, 51 SMU L. Rev. 1, 2 (1997); George K. Yin, The Future Taxation of Private Business Firms, 4 FLA. Tax Rev. 141, 142 (1999). This was a concern in the formulation of the FASIT legislation and the subsequent promulgation of regulations. See, e.g., supra note 217.

226. The safe harbor debt treatment might apply more broadly but be limited to non-recourse arrangements. How non-recourse arrangements might be defined for this purpose is another difficult question.

227. The taxable mortgage pool rules limit structures other than the REMIC that can be used to securitize mortgages, I.R.C. § 7701(i) (2002), presumably to protect the taxation of REMIC excess inclusion income. The FASIT provisions contain no similar exclusivity rule.
Over time new securitization structures become entrenched and the costs of uncertainty decline as lawyers and investors become more familiar and comfortable with the structure. In addition, the discontinuities between different areas of the law and between law and accounting rules begin to erode so that costly impediments to an efficient structure are reduced. Thus, the difficulties that first motivated the FASIT proposals have declined, perhaps to the point that few interested parties would desire a new statutory regime for securitizations.

On balance, it would be sensible to rationalize the tax treatment of securitizations by adopting a unified set of rules for all structures. On the other hand, such a regime would have had much more utility at the time the FASIT regime was first proposed than it would have now. It is unfortunate that many resources were wasted on a failed approach. Accordingly, while substituting a safe-harbor debt regime for the REMIC and FASIT rules has great appeal, the repeal of the FASIT provisions would be an acceptable second-best solution.

V. CONCLUSION

In this piece I argued that the FASIT regime is a failed piece of legislation that should be replaced or repealed. A taxpayer must incur toll charges to obtain the tax treatment provided by the regime for asset securitization transactions. The present value of the toll charge appears to exceed the value of the benefits bestowed by the FASIT rules, especially if one takes into account the complexity of the rules, the uncertainty of their application and the additional burdens they place on the securitization.

Although it has not yet been authoritatively proven, it appears that asset securitization may reduce transaction costs and help complete markets. Thus, the activity seems to be economically beneficial. Yet the tax rules applicable to securitizations have tended to be more complex and restrictive than economically comparable transactions, such as secured financing. This is the insight that motivated the enactment of the REMIC provisions, which now govern most securitizations of real estate mortgage loans. It also provoked the attempt to extend the REMIC rules to securitizations of other assets.

To ensure passage, the advocates for extending the REMIC regime positioned the new legislation as raising revenue. Over time however, it became clear that protecting the revenue meant adopting unacceptably complex rules. Ultimately some of the conflict was resolved by adopting rules that were simple, and protected revenue, but imposed high costs on those utilizing the regime. Although Congress appeared to delegate responsibility for reducing those costs to the Treasury Department, it made doing so in a manner consistent with legislative intent virtually impossible. Thus, few taxpayers have utilized the regime even though significant

228. For an example of this, see *supra* notes 115, 124.
resources were devoted to crafting the statute and developing regulations interpreting it.

If a proposal to simplify and rationalize the tax rules for securitizations could have proceeded without revenue considerations, undoubtedly the end result would not have looked like the FASIT regime. Unfortunately, the need for revenue combined with the FASIT proponents' strategy drove a process that destroyed the FASIT as useful tax vehicle.

A more sensible approach would have been to enact a single set of rules applying to a broad range of securitization transactions. A simple regime that treated securitizations as secured borrowings and provided uniform safe-harbor debt classification of interests in securitized assets would have been a much better way to reduce complexity and improve the tax treatment of securitizations.

Is it too late now to follow that path? It may well be, and not just because congressional staff would likely attribute large revenue losses to such an approach. Those who finance through securitizations have had years to work around the problems the FASIT regime was supposed to address. Shifting to a new regime now would impose costs it would not have imposed in 1995 when the FASIT rules were passed. Those costs might outweigh the benefits taxpayers could expect to receive from a new regime, so that there would be no taxpayer constituency for such a change. Thus, a viable alternative to improving the FASIT rules would be to simply repeal them and prevent the waste of additional resources on a failed project.

Ultimately, the FASIT debacle calls into question the role of special purpose vehicles in the tax law. Examples of this approach include REMICs, real estate investment trusts and regulated investment companies. Using a special purpose vehicle to reduce tax costs for economically desirable transactions glosses over difficult tax policy issues, such as whether two levels of tax should be imposed on corporate income and whether income to capital should be subject to tax at all. Resorting to special purpose vehicles imposes complexity and other costs, hides the tax policy problems from taxpayers' view, and allows Congress and the Executive Branch to avoid taking on the problems more broadly.