Par. 2. Section 1.337(d)–5 is added to read as follows:

§ 1.337(d)–5 Tax on C assets becoming RIC or REIT assets.

[The text of proposed § 1.337(d)–5 of this section is the same as the text of § 1.337(d)–5T published elsewhere in this issue of the **Federal Register**.]

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

[FR Doc. 00–1895 Filed 2–4–00; 8:45 am]

BILLING CODE 4830–01–U

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[REG–100276–97; REG–122450–98]

RIN 1545–AV59; RIN 1545–AW98

Financial Asset Securitization Investment Trusts; Real Estate Mortgage Investment Conduits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to financial asset securitization investment trusts (FASITs). This action is necessary because of changes to the applicable tax law made by the Small Business Job Protection Act of 1996. The proposed regulations affect FASITs and their investors. This document also contains proposed regulations relating to real estate mortgage investment conduits (REMICs). This document provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by May 8, 2000. Outlines of topics to be discussed at the public hearing scheduled for May 15, 2000 at 10 a.m., must be received by April 24, 2000.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–100276–97 and REG–122450–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–100276–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments via the Internet by selecting the ''Tax Regs'' option of the IRS Home Page or by submitting them directly to the IRS Internet site at http://www.irs.gov/tax__regs/regslist.html. The public hearing will be held in Room 2615, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations other than issues relating specifically to cross border transactions, David L. Meyer at (202) 622–3960 (not a toll-free number) and for issues relating specifically to cross border transactions, Rebecca Rosenberg or Milton Cahn at (202) 622–3870 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor at (202) 622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by April 7, 2000.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the collection will have a practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information is in § 1.860H–1(b)(2) and § 1.860H–6(e). This information is required to permit qualified entities to elect to become a Financial Asset Securitization Investment Trust and to ensure the holder of the ownership interest in a FASIT properly reports the FASIT's items of income, gain, deduction, loss, and credit. This information will be used to properly administer the provisions of part V of subchapter M of the Code. The collection of information is mandatory. The likely respondents are business or other for-profit institutions.

Estimated total annual reporting and/or record keeping burden: 750 hours.

Estimated average annual burden hours per respondent and/or record-keeper: 5 hours.

Estimated number of respondents and/or record-keepers: 150.

Estimated annual frequency of responses: one annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1621(a) of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1755 (August 20, 1996) (the Act) amended the Internal Revenue Code (Code) by adding part V (sections 860H through 860L) (the FASIT provisions) to subchapter M of chapter 1. Part V, which is effective September 1, 1997, authorizes a securitization vehicle called a Financial Asset Securitization Investment Trust (FASIT). FASITs are meant to facilitate the securitization of debt instruments, including non-mortgage and mortgage debt instruments.

A solicitation for comments was published in the **Federal Register** for November 4, 1996 (61 FR 56647). The comments received both raised and helped resolve significant issues. The IRS and Treasury request comments on these proposed regulations generally, and specifically request suggestions on how they may be revised to be more easily understood.

Explanation of Provisions

In General

A FASIT is a qualified arrangement that elects FASIT treatment and meets certain requirements concerning the

composition of its assets and the interests it issues to investors. A qualified arrangement can be a corporation (other than a regulated investment company (RIC) as defined in section 851(a)), partnership, trust, or segregated pool of assets.

A FASIT may issue one or more classes of regular interests, which are treated as debt for all purposes of the Code. In addition, each FASIT must have a single ownership interest, which must be held entirely by a non-exempt domestic C corporation (other than a RIC, real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), or subchapter T cooperative).

A FASIT is not subject to income tax. Instead, the tax items of the FASIT are included in the taxable income of the holder of the ownership interest (the Owner). The Owner, (and in some circumstances a person related to the Owner) must recognize gain (if any) when property is either transferred to the FASIT or supports the regular interests.

Congress enacted the FASIT provisions to facilitate the securitization of revolving, non-mortgage debt obligations. An anti-abuse rule incorporated in these proposed regulations is designed to ensure that FASITs are used in a manner that is consistent with this intent and not to create opportunities for tax planning that would not exist but for the enactment of the FASIT provisions and these proposed regulations.

Rules Applicable to the FASIT

Administrative Provisions

1. Background

The administrative provisions have three objectives: (1) ensuring accurate and timely reporting of the FASIT's tax items, (2) ensuring compliance by the FASIT with the operating and qualification rules, and (3) reducing administrative burdens on FASIT interest holders and the IRS.

2. FASIT Election

The proposed regulations provide that a FASIT election is made by attaching a statement to the Owner's Federal income tax return for the taxable year that includes the startup day. No particular form is presently required, but the statement must be specified as a FASIT election, and must identify the arrangement for which the election is made. The IRS and Treasury want to ensure that the persons most affected by a FASIT election have agreed to make the election. Therefore, if the electing arrangement is an entity, the election statement must be signed by the person who would sign the entity's return in the absence of the FASIT election. If the electing arrangement is a segregated pool of assets, the election statement must be signed by each person that owns the assets in the pool for Federal income tax purposes immediately before the startup day.

3. Treatment of FASIT Under Subtitle F

None of the FASIT provisions addresses how a FASIT is treated under subtitle F (Procedure and Administration), which governs matters such as returns, penalties, tax payments, and assessments. One rule considered was to make a FASIT's subtitle F treatment depend on the classification of the electing arrangement. Thus, for example, if a partnership makes a FASIT election, the FASIT is a partnership for purposes of subtitle F. Rather than adopt this approach, which leads to several different administrative regimes for FASITs, the proposed regulations treat each FASIT as a branch or division of its Owner for purposes of subtitle F. Because an Owner must always be a domestic C corporation, this solution results in uniform treatment.

The proposed regulations also make the Owner responsible for reporting interest income with respect to the regular interests which are treated for reporting purposes as collateralized debt obligations (CDOs).

Relationship of a FASIT to the Owner

The FASIT provisions do not provide a general rule defining the relationship between a FASIT and its Owner for non-FASIT Federal income tax purposes. The nature of this relationship may be relevant in determining the Federal income tax consequences of a number of transactions entered into with a FASIT. For example, it is necessary to know the extent to which transactions with a FASIT are treated as transactions with the Owner in determining how the portfolio interest exception applies and whether a change in the Owner of the FASIT results in a realization event for holders of the FASIT regular interests.

The IRS and Treasury considered proposing a general rule to characterize the FASIT's relationship to its Owner for all non-FASIT Federal income tax purposes. Among the alternatives evaluated were (1) treating the FASIT as an entity separate from the Owner; (2) treating the FASIT as a branch of the Owner; and (3) treating the FASIT as an entity for some purposes and as a branch for others.

Each alternative has some underpinning in the statutory scheme. For example, in determining the Owner's taxable income, the FASIT provisions treat a FASIT's assets, liabilities, and tax items as the assets, liabilities, and tax items of the Owner. This supports treating a FASIT as a branch of the Owner. However, the restrictions on what kind of assets may be held and what type of investor interests may be issued apply to the FASIT alone and favor treating a FASIT as a separate entity.

The IRS and Treasury have decided it is better to resolve the nature of the FASIT's relationship with the Owner on an issue-by-issue basis rather than by adopting a single general rule. A few situations (for example, the treatment of a FASIT under subtitle F and the treatment of a FASIT under the portfolio interest rules) are addressed in these proposed regulations. The IRS and Treasury welcome additional comments on whether and how additional rules should detail the FASIT's relationship with the Owner for non-FASIT Federal income tax purposes.

Assets That May Be Held by a FASIT (Permitted Assets)

1. Background

Except during a brief formation period, substantially all of a FASIT's assets must consist of permitted assets. Permitted assets include cash and cash equivalents, debt instruments (and rights to acquire debt instruments), foreclosure property, interest and currency hedges (and rights to acquire interest and currency hedges), guarantees (and rights to acquire guarantees), regular interests in other FASITs, and regular interests in REMICs. The FASIT provisions generally do not allow a FASIT to hold debt instruments issued by the Owner (or a related person).

Several commentators requested guidance on whether certain assets qualified as permitted assets. Other comments focused on the prohibition on Owner debt. In particular, the commentators requested guidance on the extent to which an Owner may guarantee assets or enter into a permitted hedge with the FASIT without violating the prohibition on Owner debt.

2. ''Substantially All''

The FASIT provisions *require substantially all* of a FASIT's assets to be permitted assets. Under the proposed regulations, a FASIT meets this test if the aggregate adjusted basis of its assets other than permitted assets is less than one percent of the aggregate adjusted basis of all its assets.

The proposed rule is patterned after a safe harbor rule applicable to REMICs.

The proposed regulations do not incorporate a provision in the REMIC safe harbor that allows a qualified entity that fails the REMIC safe harbor to otherwise demonstrate that it does not own more than a de minimis amount of non-qualified assets. This provision does not appear necessary because a FASIT, unlike a REMIC, can acquire additional permitted assets if it is in danger of failing the *substantially all* test.

3. Cash and Cash Equivalents

The FASIT provisions treat *cash and cash equivalents* as permitted assets. The proposed regulations generally define the phrase *cash and cash equivalents* to mean functional currency. Investment quality debt instruments that are close to maturity are also cash and cash equivalents because of their perceived liquidity.

In response to some commentators, the proposed regulations provide that cash and cash equivalents include shares in U.S.-dollar-denominated money market mutual funds. Although such shares are technically stock, money market mutual funds are practical investments for cash balances pending either distribution to regular interest holders or reinvestment in new debt instruments. The IRS and Treasury, therefore, believe it is appropriate to allow FASITs to hold these investments.

4. Debt Instruments in General

Under the FASIT provisions, a debt instrument must satisfy two criteria to be a permitted asset. First, it has to be a *debt instrument* as defined in section 1275(a)(1) of the Code, which means it has to be a bond, debenture, note or certificate, or other evidence of indebtedness. Second, interest payments (if any) must be made in the manner prescribed for REMIC regular interests. Interest payments on REMIC regular interests must be based on a fixed or variable rate (as allowed in regulations), or must consist of a specified portion of the interest payments on the underlying mortgages held by the REMIC. This means that under the FASIT provisions, interest payments on a debt instrument held by a FASIT must also be payable at a fixed or variable rate, or consist of a specified portion of the interest payments on some underlying debt instrument.

The proposed regulations enumerate the types of debt instruments that meet this standard and therefore qualify as permitted assets. In general, a FASIT may hold fixed-rate debt instruments, specified floating-rate debt instruments, inflation-indexed debt instruments, and credit card receivables. In response to comments received, the proposed regulations also clarify that a FASIT may generally hold beneficial interests in, or coupon and principal strips created from, these instruments.

One commentator requested that the proposed regulations specifically allow FASITs to hold debt instruments that provide for prepayment penalties. The commentator's concern was that prepayment penalties might be viewed as contingent payments that are not fixed or variable interest payments within the meaning of the FASIT provisions. The proposed regulations accommodate this concern by including in the list of permitted debt instruments, debt instruments to which § 1.1272–1(c) (relating to debt instruments that provide for alternate payment schedules) applies. These rules generally accommodate prepayment penalties.

To prevent a FASIT from indirectly holding equity-like or other non-debt interests, the proposed regulations disqualify any debt instrument that can be converted into, or the value of which is based on, anything other than a permitted debt instrument. Impermissible debt instruments include, for example, a debt instrument convertible into stock and a debt instrument the interest payments on which vary based on the spot price of oil. The proposed regulations also do not permit a FASIT to hold debt instruments that, when acquired by the FASIT, are in default due to any payment delinquency unless the Owner reasonably expects the obligor to cure the default (including the payment of any interest and penalties) within 90 days of the date the instrument is acquired by the FASIT. The concern is that a distressed debt instrument may take on the characteristics of equity because the FASIT (and in turn the regular interest holders): (1) may have to look to the obligor's general assets for payment of the instrument, (2) may not receive full payment of the instrument, and (3) may not receive any payment until the satisfaction of claims held by the obligor's other creditors.

5. Participation Interests

One commentator requested guidance on whether a participation interest in a pool of revolving loans would be considered a permitted asset. The commentator pointed out that a participation interest can be based either on a fixed percentage of assets in the pool or on a fixed dollar amount of assets in the pool.

The proposed regulations do not specifically address participation interests. It does not appear that guidance is needed concerning participation interests that are based on a fixed percentage of assets. If a FASIT owns a fixed-percentage participation interest, as the outstanding principal balance of the pool rises and falls, the FASIT may be required to pay additional amounts or entitled to receive distributions to maintain its fixed percentage ownership in the pool. As long as the distributions are paid in cash (or in the form of an otherwise permitted asset), the FASIT's fixed-percentage interest should be considered a fixed-percentage interest in each of the debt instruments in the pool. Thus, the FASIT's fixed-percentage participation interest should qualify as a permitted debt instrument to the extent the underlying debt instruments are themselves permitted assets.

The result under the FASIT provisions is less clear in cases where the participation interest is based on a fixed dollar amount of assets in a pool. In this case, each change in the outstanding balance of the pool would trigger a corresponding change in the FASIT's percentage ownership of the pool. When the size of the pool increases, the FASIT could be viewed as exchanging an interest in each asset in the old pool for a lower percentage interest in each asset in the new pool. This exchange might constitute an impermissible asset disposition. In some cases, this disposition could result in the imposition of the prohibited transaction tax.

While the problem with fixed-dollar participation interests might be resolved by treating a pool as a single asset, a rule specifically allowing a FASIT to hold participation interests may be used as a means of inappropriately avoiding other rules. The IRS and Treasury welcome additional comments on whether and how the need for a FASIT to hold fixed-dollar amount participation interests can be accommodated.

6. Debt Instruments Issued by the Owner

To ensure that the holders of the regular interests are looking primarily to the FASIT, and not the Owner, for payment, the FASIT provisions generally prohibit a FASIT from holding debt instruments issued either by the Owner or a person related to the Owner (collectively, Owner debt). An exception is made for cash equivalents and other instruments specified by regulation.

Under the proposed regulations, Owner debt means more than just debt instruments issued by the Owner. It includes an obligation of the Owner embedded in another instrument, a third party debt instrument the

performance of which is contingent on the performance of Owner debt, and any partial interest in Owner debt such as a principal or coupon strip. Similarly, a debt instrument guaranteed by an Owner is treated as Owner debt, if at the time the FASIT acquires the debt instrument, the Owner is in substance the primary obligor of the debt instrument. See Rev. Rul. 97–3 (1997–1 C.B. 9).

Cash equivalents of the Owner, which are permitted under the FASIT provisions, are limited by the proposed regulations to short-term investment quality debt instruments that are acquired to temporarily invest cash pending either distribution to the FASIT interest holders or re-investment in other permitted assets.

One commentator noted that under the FASIT provisions, it is unclear whether the Owner of two or more FASITs may use regular interests from one FASIT to fund another of its FASITs. If regular interests are considered debt of the Owner, then, technically, the regular interests held by the second FASIT would be impermissible Owner debt. The commentator noted that this form of tiering arrangement is commonly used in REMICs and should be available for use with FASITs. In response to this comment, the proposed regulations allow this type of tiering arrangement. As discussed below, however, tiered FASITs may not be used to achieve benefits that could not be obtained without the FASIT provisions.

7. Foreclosure Property

The FASIT provisions allow a FASIT to hold an asset (foreclosure property) acquired upon the default or imminent default of a permitted debt instrument. The FASIT provisions generally allow a FASIT to retain foreclosure property for a designated grace period of approximately three to four years. After the grace period, a 100-percent tax is imposed on any net income derived from the foreclosure property, including income from its operation or disposition.

In some cases, the property acquired upon foreclosure may independently qualify as another type of permitted asset. Under the proposed regulations, the FASIT may retain this type of foreclosure property beyond the grace period. If the FASIT retains the property beyond the grace period, the property loses its status as foreclosure property at the end of the grace period.

At this point, the proposed regulations require the Owner to recognize gain, if any, on the property as if it had been contributed to the FASIT at the close of the grace period. In addition, after the grace period, the property can no longer qualify for the foreclosure exception to the prohibited transaction rules.

8. Contracts or Agreements in the Nature of a Line of Credit

A FASIT may generally hold as a permitted asset a contract or agreement in the nature of a line of credit as long as the FASIT does not originate the contract or agreement.

9. Guarantees and Hedges

Under the FASIT provisions, a contract may qualify as a permitted asset if it is a permitted hedge or guarantee. The FASIT provisions impose two requirements on permitted hedges and guarantees. First, the contract must be an interest rate or foreign currency notional principal contract, letter of credit, insurance, guarantee against defaults, or other similar instrument. Second, the contract must be reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor on the interests that the FASIT has issued. Several commentators asked for guidance on the scope of this rule.

The proposed regulations provide guidance as to what constitutes a permitted hedge or guarantee. Rather than focus on the type of contract, the proposed regulations focus on its intended function. Under the proposed regulations, a contract is a permitted hedge or guarantee if the contract is reasonably required to offset differences that specified risk factors may cause between the amount or timing of the cash flows on a FASIT's assets and the amount or timing of the cash flows on the FASIT's regular interests. The specified risk factors are (1) fluctuations in market interest rates, (2) fluctuations in currency exchange rates, (3) the credit quality of the FASIT's assets and regular interests, and (4) the receipt of payments on the FASIT's assets earlier or later than originally anticipated.

Several commentators requested that the proposed regulations list specific types of hedges and guarantees that qualify as permitted assets. Because the proposed regulations define permitted assets and guarantees in terms of their function, the proposed regulations do not include this type of list. Out of a concern that hedges could be used to effect the economic equivalent of a transfer of non-permitted assets to the FASIT, the proposed regulations prohibit a hedge or guarantee from referencing certain assets and indices. In particular, a hedge is not a permitted hedge if it references an asset other than a permitted asset or if it references an index, economic indicator or financial average that is not widely disseminated and designed to correlate closely with changes in one or more of the four specified risk factors.

One commentator requested that the proposed regulations permit the incidental hedging of assets allocable to ownership interests. The commentator suggested that, as a practical matter, an Owner may desire to hedge all of the FASIT's assets inside the FASIT even though the FASIT securitizes less than all of the assets. The proposed regulations accommodate this concern by allowing the FASIT to hedge assets held (or to be held) and liabilities issued (or to be issued). Thus, under the proposed regulations, an Owner can hedge assets inside a FASIT that currently relate to the ownership interest if the assets are being held inside the FASIT because the Owner intends for them to support FASIT regular interests in the future.

The proposed regulations provide special rules for hedges and guarantees entered into with the Owner or a related party. These rules generally allow a FASIT to enter into a hedge (other than a credit hedge) with the Owner (or a related party) if two conditions are met. First, the Owner (or related party) must be a dealer with respect to that type of hedging contract. Second, the Owner must maintain records establishing that the hedge contract was entered into at arm's length. In addition, the special rules provide that an Owner (or a related party) may issue a guarantee to a FASIT if the Owner can demonstrate that, immediately after the guarantee is issued, less than three percent of the value of the FASIT's assets are attributable to Owner guarantees.

Finally, the usefulness of a hedge is diminished if the tax character of the hedge (as an ordinary or capital asset) does not match the tax character of the hedged item. Absent a special rule, disposing of a FASIT hedge could generate capital loss even though the associated assets and liabilities of the FASIT generate ordinary income and deductions. To alleviate this character mismatch, the proposed regulations treat a permitted hedge as an ordinary asset.

Prohibited Transactions

1. Background

The FASIT provisions restrict the types of transactions in which a FASIT may engage through the imposition of a prohibited transactions tax. The tax is equal to 100 percent of the income a FASIT realizes from a prohibited

transaction. The four categories of prohibited transactions set out in the FASIT provisions include the receipt of any income from a loan originated by the FASIT and the receipt of gains from the FASIT's disposition of its assets.

2. Loan Origination

Commentators expressed considerable concern over the lack of statutory guidance on determining whether a debt instrument held by a FASIT has been originated by the FASIT. Commentators noted that debt instruments originated through the Owner's business activities might be deemed to be originated by the FASIT thereby exposing the FASIT to liability for the prohibited transactions tax on any income realized on the instrument.

The proposed regulations contain five safe harbors to limit the scope of the prohibited transaction rules as they relate to loan origination. Under the first safe harbor, a FASIT is not considered to have originated a loan if the FASIT acquires the loan from an established securities market.

Under the second safe harbor, a FASIT is not considered to have originated a loan if the FASIT acquires the loan more than a year after the loan was created.

Under the third safe harbor, a FASIT is not considered to have originated a loan if the FASIT acquires the loan from a person that regularly originates similar loans in the ordinary course of its trade or business. Importantly, this third safe harbor extends to transactions entered into with the Owner (or a related party). As a result, a FASIT that acquires credit card receivables from its Owner (or a related party), or creates new receivables from issuances made on accounts held by the FASIT will not be considered to have originated the receivables to the extent the Owner (or related party) originates similar loans in the ordinary course of its business.

The fourth safe harbor provides that the FASIT will not be treated as originating any new loan it may receive from the same obligor in exchange for the obligor's original loan in the context of a workout.

Finally, a FASIT will not be treated as having originated a debt instrument when it makes a loan pursuant to a contract or agreement in the nature of a line of credit the FASIT is permitted to hold.

3. Substitution or Distribution of Debt Instruments

The FASIT provisions generally impose a prohibited transaction tax on the distribution of debt instruments to the Owner. An exception to this rule exists for distributions to the Owner so long as the principal purpose of the distribution is not the recognition of gain that is due to changes in market conditions while the FASIT held the debt instrument. This rule effectively allows an Owner to reduce over-collateralization so long as the reduction is not designed to obtain a character advantage. Absent this rule, in times of falling market interest rates, an Owner could inappropriately generate capital gain and economically offsetting ordinary loss by disposing of distributed appreciated debt instruments while having the FASIT dispose of related hedges. To clarify the application of the distribution rule, the proposed regulations deem a distribution of a debt instrument to be carried out principally to recognize gain if the Owner (or a related person) sells the substituted or distributed debt instrument at a gain within 180 days of the substitution or distribution. In this case, the distribution will be a prohibited transaction subject to the 100-percent tax.

Consequences of FASIT Cessation

Under the FASIT provisions, the Commissioner may consent to the intended cessation of a FASIT and may grant conditional relief in the case of an inadvertent cessation. There are, however, no comprehensive rules describing the consequences of a cessation. The proposed regulations, therefore, detail how a cessation affects the FASIT, the underlying arrangement that made the FASIT election, the Owner, and the regular interest holders. These rules apply unless a cessation is carried out with the Commissioner's consent, in which case the consent document controls.

Under the proposed regulations the Owner is treated as disposing of the FASIT's assets for their fair market value in a prohibited transaction. Gain, if any, on this deemed distribution is subject to the prohibited transactions tax. Any loss is disallowed. The Owner is also treated as satisfying the regular interests for an amount equal to the lesser of the adjusted issue price or fair market value of the regular interests. This deemed satisfaction will result in cancellation of indebtedness income in cases where the aggregate fair market value of the assets is less than the aggregate adjusted issue price of the regular interests. The underlying arrangement is no longer treated as a FASIT and generally is prohibited from making a new FASIT election. In addition, the underlying arrangement is treated as holding the assets of the terminated FASIT and is classified (for example, as a corporation or partnership) under general tax principles. Finally, the regular interest holders are treated as exchanging their FASIT regular interests for new interests in the underlying arrangement. These new interests are classified under general tax principles, and the deemed exchange of the regular interests for the new interests may require the regular interest holders to recognize gain or loss.

Rules Applicable to Owner

Under the FASIT provisions, an Owner generally determines its taxable income by including the gains, losses, income and deductions of the FASIT and by treating the assets and liabilities of the FASIT as its own. In addition, the Owner must also follow special rules concerning the FASIT's tax-exempt income, prohibited transactions and method of accounting for debt instruments. Few comments were received concerning these provisions.

Under the special rule concerning the method of accounting for debt instruments, a FASIT must use the constant yield method in determining all interest, acquisition discount, original issue discount (OID), market discount, and premium deductions or adjustments. To ensure that the Owner uses a constant yield method for all interest and interest-like items, the proposed regulations require the Owner to compute the amount of interest income and premium offset accruing on debt instruments held in a FASIT under the methodology described in § 1.1272–3(c).

One commentator noted that the FASIT provisions speak in terms of determining the Owner's *taxable income,* and that taxable income, which the Code defines as gross income minus deductions, makes no reference to credits. The proposed regulations, therefore, clarify the extent to which an Owner, in determining its tax, may claim the FASIT's credits. In general, the Owner may claim a credit for taxes paid or deemed paid by the FASIT in the same manner and to the same extent as if the FASIT were an unincorporated branch of the Owner. As discussed below, the allowance of a foreign tax credit is subject to the anti-abuse provisions of this regulation, and other relevant authorities including case law and the potential application of IRS Notice 98–5 (1998–3 I.R.B. 49).

Because the Owner includes the FASIT's tax items in determining its credits and taxable income, the proposed regulations make the Owner (rather than the FASIT) responsible for reporting those items on its Federal

income tax return. The Owner is required to attach a separate statement to its income tax return detailing these items. No specific form is required.

Gain Recognition on Property Transferred to a FASIT

1. Background

The FASIT provisions require Owners (or, in some cases, related persons) to include in income gain (but not loss) realized on the transfer of assets to a FASIT. In general, the amount of gain (if any) that must be included is equal to the value of the transferred asset over its adjusted basis in the transferor's hands. In addition, the FASIT provisions require gain (if any) to be recognized on assets the Owner holds outside of the FASIT but which nonetheless support FASIT regular interests. Significant comments were received regarding the gain recognition rule. In particular, comments were received on the method of valuing property, the scope of the support rule, and the need for a gain deferral rule.

2. Related-Person Gain Recognition Rule

The IRS and Treasury have determined that the gain recognition rule of the FASIT provisions could be circumvented when a related person transfers property to a FASIT. Because the FASIT provisions do not require that the related person be a taxable C corporation (or even that the related person be subject to U.S. tax), the intended corporate-level tax on gain could be avoided by having non-corporate or foreign related persons make asset transfers. In this case, the FASIT provisions could be interpreted as allocating gain to the related person and the economically offsetting losses (usually in the form of premium offset) to the Owner. This misallocation of gain, if allowed, would frustrate the purpose of the gain recognition rule.

The IRS and Treasury considered two ways to address this issue in developing these proposed regulations. One approach would have required any contribution from a related party to the FASIT to be taxed as if it were a deemed sale to the Owner followed by a contribution to the FASIT. This rule would conform the treatment of related person contributions with the treatment of contributions from unrelated persons under section 860I(a)(2). This rule would also ensure that gain upon contribution would be allocated to the taxpayer entitled to the subsequently occurring offsetting economic loss, namely, the Owner. A second approach was to develop regulations that would limit related person treatment to taxable, domestic C corporations and ensure that the misallocation of gain (in the related person) and associated loss (in the Owner) would not produce unwarranted tax benefits.

The proposed regulations adopt the first approach. Under the proposed regulations, transactions between a related person and the FASIT are treated as transactions between the related person and the Owner followed by transactions between the Owner and the FASIT. This rule, however, does not apply in all cases. Transfers of publicly traded property by related persons are unlikely to be abusive. The rule in the proposed regulations, therefore, only applies if the related person transfers property not traded on an established securities market. Thus, for example, the rule applies to a transfer of consumer receivables, but not to a transfer of Treasury bills.

3. Determination of Value for Gain Recognition Purposes

a. *In general.* To determine value for purposes of applying the gain recognition rules, the FASIT provisions divide property into two categories: (1) debt instruments not traded on an established securities market, and (2) all other property. The value of debt instruments not traded on an established securities market is determined by a special statutory rule. The value of all other property (which includes debt instruments that *are* traded on an established securities market) is fair market value.

Under the special rule, the value of a debt instrument not traded on an established securities market is the sum of the reasonably expected cash flows on the instrument, discounted using semiannual compounding at a rate equal to 120 percent of the applicable federal rate (AFR).

The intent behind the special valuation rule is uncertain. The legislative history of the FASIT provisions indicates the rule was meant to be a simple and mechanical formula that, by its nature, would not produce accurate results in every case. Specifically, the legislative history states that the value of an asset is determined by the special valuation rule even if a different value would be determined by applying a willing buyer/willing seller standard. See H.R. Rept.104–737, 104th Cong. 2d Sess., 327 (1996). At the same time, by applying a fair market value standard to all other assets (including market-traded debt), Congress showed a clear preference for using actual fair market value whenever it can be determined with reasonable accuracy.

Several commentators made suggestions on how to interpret the legislative intent behind the special valuation rule. In general, the commentators were concerned that implementing the rule without modification would in many cases generate tax gains far in excess of economic gains. Because the commentators viewed this overvaluation as a substantial impediment to the use of FASITs, they asked that the proposed regulations narrow as much as possible the debt instruments subject to the special valuation rule.

The proposed regulations attempt to reconcile the legislative intent and the commentators' concerns in a consistent and principled manner. The policy justification for the special valuation rule is strongest where it is difficult, if not impossible, to separate the value of a debt instrument from the value of the Owner's business relationship with the debtor. For example, the value of credit card receivables may be inferred if the receivables are placed in trust and used to create new debt instruments that are sold to the public at a disclosed price. In this case, however, the implied price necessarily includes both the value of the receivables and the value of the transferor's implicit or explicit promise to replace the receivables as they mature. Because there is no objective, easily administrable method for allocating the portion of the price allocable to the receivable (as opposed to the portion allocable to the transferor's ongoing business), the special valuation rule seems appropriate in this context.

By contrast, the policy justification for the special valuation rule is weakest in cases where the fair market value of the debt instrument can be easily established. For example, if a FASIT purchases a pool of non-market-traded securities for cash in a transaction where the FASIT maintains no continuing relationship with the seller, there appears to be no reason to distrust the value as determined by an actual arm's length bargaining.

Consistent with this understanding of the purpose behind the special valuation rule, the proposed regulations take a broad view of what constitutes an established securities market. In addition, the regulations clearly delineate whether property is subject to the special rule and provide a number of exceptions from the special rule.

b. *Traded on an established securities market.* The proposed regulations define the term *traded on an established securities market* by reference to § 1.1273–2(f)(2) through (4) of the OID

regulations. The proposed regulations also give the Commissioner the power to determine that debt instruments not meeting the standards of the OID regulations are nevertheless traded on an established securities market. Under the cross-reference to the OID regulations, debt is considered traded on an established securities market if (1) it is listed on certain specified securities exchanges or on certain interdealer quotation systems, (2) it is traded on a board of trade or interbank market, or (3) it appears on a quotation medium that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions.

The proposed regulations do not cross-reference § 1.1273–2(f)(5) of the OID regulations. Consequently, debt is not considered *traded on an established securities market* if it is merely readily quotable within the meaning of § 1.1273–2(f)(5). The IRS and Treasury do not expect this omission to have a significant impact because, under a special exception (the spot purchase rule, discussed below) the proposed regulations value non-publicly traded debt instruments at their cost if a FASIT acquires them in (or soon after) an arm's length cash purchase.

According to one commentator, bank loans and private placement loans, which are typically made to small and medium sized businesses, are readily quotable within the meaning of § 1.1273–5(f)(5) but would not otherwise be considered as traded on an established securities market. The commentator stated there would be commercial interest in securitizing these loans through FASITs but for application of the special valuation rule. Although the proposed regulations do not adopt the readily quotable standard, the IRS and Treasury believe bank and private placement loans will be securitized in transactions qualifying for the spot purchase exception. Nevertheless, comments are requested on whether the readily quotable standard is still necessary.

c. *Exceptions for debt not traded on an established securities market.* The proposed regulations except from the special valuation rule certain beneficial and stripped interests. Under this exception, a certificate representing beneficial ownership of debt instruments constitutes beneficial ownership of debt instruments traded on an established securities market if either the certificate or all of the underlying debt instruments are traded on an established securities market. Similarly, a stripped bond or stripped coupon represents debt traded on an established securities market, if either the strip or the underlying debt instrument is traded on an established securities market. Because fair market value is easily determined in these circumstances, there appears to be little reason to apply the special valuation rule.

Finally, the proposed regulations provide an exception for certain debt instruments that are contemporaneously purchased and transferred to the FASIT (the spot purchase rule). Under this provision, the value of a debt instrument is its cost to the Owner if four conditions are met: (1) the debt instrument is purchased from an unrelated person in an arm's length transaction, (2) the debt instrument is acquired for cash, (3) the price of the debt instrument is fixed no more than 15 days before the date of the purchase, and (4) the debt instrument is transferred to the FASIT no more than 15 days after the date of the purchase.

d. *Debt instruments not traded on an established securities market.* As discussed above, the special valuation rule values a debt instrument by discounting the reasonably expected cash flows on the instrument. The proposed regulations require that the determination of reasonably expected cash flows be commercially reasonable. The proposed regulations also permit reasonable assumptions concerning credit risk, early repayments, and loan servicing costs to be taken into account. Additional rules discourage the use of assumptions known to be inaccurate.

One safeguard is a consistency test. Even though a debt instrument may not be traded on an established securities market, a person securitizing the debt instrument may make certain public representations about the debt instrument, such as in a prospectus or an offering memorandum. The consistency test prevents the use of one set of assumptions for tax purposes and the use of another set for different purposes. Specifically, all assumptions used in determining reasonably expected cash flows (for purposes of the FASIT valuation rule) must be no less favorable than the assumptions underlying the representations made to any of the following groups in the prescribed order: investors, rating agencies, or governmental agencies. For example, if one default rate is assumed to value debt instruments in a prospectus, a higher default rate cannot be assumed to value the debt instruments for purposes of the gain recognition provisions. Even if no representations concerning value are made to investors, rating agencies, or governmental agencies, the assumptions made for purposes of the gain recognition provisions must still be consistent with any applicable industry customs and standards. To encourage adherence to the consistency test, the Commissioner may determine reasonably expected cash flows without making any adjustment if the assumption made with respect to that adjustment (for example, assumed credit risks) fails the consistency test or is otherwise unreasonable.

In addition to the consistency test, the proposed regulations place a ceiling on projected loan servicing costs. Specifically, the amount of loan servicing costs projected may not exceed the lesser of (1) the amount the FASIT agrees to pay the Owner (or a related person) for servicing all, or a portion, of the loans held by the FASIT, or (2) the amount a third party would reasonably pay for the servicing of identical loans.

e. *Special valuation rule for guarantees.* Because a guarantee usually is not a debt instrument, any gain recognized on transferring a guarantee to a FASIT would be determined using the guarantee's fair market value absent a special rule. Nevertheless, if a guarantee relates solely to non-traded debt instruments, the proposed regulations allow taxpayers to value the guarantee and the debt instruments together. Under this rule, the reasonably expected payments on the guarantee are treated as part of the reasonably expected payments on the debt instruments to which the guarantee relates.

4. Property Held Outside a FASIT Supporting FASIT Regular Interests

An Owner (or a person related to the Owner) must recognize gain on any property the Owner or related person holds outside the FASIT that supports the regular interests. In addition, property held by the Owner or related person that supports regular interests is treated as held by the FASIT for all purposes of the FASIT provisions. By treating support property as transferred to and held by a FASIT, the support rules discourage taxpayers from trying to avoid the gain-on-transfer rules and ensure that FASIT income includes the income from all FASIT property.

Commentators asked for a clear and narrow definition of support property. They suggested limiting the support rule to situations in which the arrangement with the regular interest holders indicates that assets held outside the FASIT would have been transferred to the FASIT but for the gain recognition rules. Under this view, support property

includes: (1) subordinated interests in debt instruments contributed to the FASIT, (2) property securing an Owner's guarantee, and (3) contribution agreements that allow the FASIT to purchase a debt instrument for an amount significantly below its fair market value. Several commentators argued that unless a narrow view of support is adopted, the support rule threatens to subject to the gain recognition rule all property held by an Owner whenever the Owner guarantees a regular interest or has any kind of continuing relationship with the FASIT.

Consistent with the comments received, the proposed regulations narrowly define support property. Under the proposed regulations, property generally is *support property* if the Owner (or a related person): (1) Identifies the property as providing security for a regular interest, (2) sets aside the property for transfer to the FASIT under a contribution agreement, or (3) holds an interest in the property that is subordinate to the FASIT's interest in the property. This last situation can arise, for example, if the Owner holds the junior interests in a pool of debt instruments while the FASIT holds the senior interests.

5. Deferral of Gain Recognition

Although gain must ordinarily be recognized as soon as property is transferred, the FASIT provisions authorize regulations under which gain on transferred property is deferred until the transferred property supports regular interests. Several commentators specifically requested a gain deferral system and one explained in detail how a gain deferral system could be applied to a constantly revolving pool of assets.

The proposed regulations do not provide a general gain deferral system. After carefully considering the issues involved, the IRS and Treasury have determined that gain deferral rules must build on rules for accounting for pooled debt instruments. The IRS and Treasury anticipate providing rules for pooled debt instrument in future guidance, and at that time expect to revisit the FASIT gain deferral rules.

Although the proposed regulations do not provide rules for gain deferral generally, rules permitting gain deferral for pre-effective date FASITs have been developed consistent with the requirements of the Act. The IRS and the Treasury request comments on whether and how the gain deferral system for pre-effective date FASITs may be modified to accommodate a general gain deferral system.

Ownership Interests and Consolidated Groups

By statute, to qualify as a FASIT, an arrangement must have one (and only one) ownership interest, and that ownership interest must be held by one (and only one) eligible corporation. Congress, however, anticipated that Treasury would ''issue guidance on how the ownership rule would apply to cases in which the entity that owns the FASIT joins in the filing of a consolidated return with other members of the group that wish to hold an ownership interest in the FASIT.'' See H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 329 (1996).

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. Therefore, the proposed regulations do not provide rules permitting members of a consolidated group to jointly hold ownership interests in a FASIT. The IRS and Treasury invite the submission of additional comments that would address these concerns.

Transfers of Ownership Interests

The proposed regulations ignore the transfer of an ownership interest if the transfer is accomplished to impede the assessment or collection of tax. A transfer is accomplished to impede the assessment or collection of tax if the transferor knows, or should know, that the transferee would be unwilling or unable to pay some or all of the tax arising from holding the ownership interest. A safe harbor, incorporated through a cross-reference to comparable rules regarding transfers of REMIC residual interests, is available to Owner-transferors who conduct a reasonable investigation of the transferee's financial condition. As explained under the caption PROPOSED AMENDMENT TO REMIC REGULATIONS in this preamble, the REMIC safe harbor incorporated by the FASIT rules has been modified.

Rules Applicable to Regular Interest Holders

The FASIT provisions treat a regular interest as a debt instrument for all purposes of the Code and require the holder to account for gross income with respect to the regular interest under an accrual method.

Few comments were made with respect to FASIT regular interests. One commentator suggested a rule that would prevent the holder of a debt instrument from recognizing a loss on, or changing the tax consequences of, the debt instrument by transferring it to a FASIT in exchange for an identical or similar FASIT regular interest. No such rule is adopted by the proposed regulations because the IRS and Treasury believe this type of transaction is adequately addressed by the wash sales rules of the Code and the FASIT anti-abuse rule described later. Similarly, the proposed regulations have adopted no special rules concerning the consequences of modifying regular interests, because the IRS and Treasury believe these issues are adequately addressed under existing principles of Federal tax law.

Special Rules

Anti-Abuse Rule

The proposed regulations contain an anti-abuse rule patterned after the anti-abuse rule in the partnership regulations issued under subchapter K. The FASIT anti-abuse rule evaluates transactions against the underlying purpose of the FASIT provisions, which is to promote the spreading of credit risk on debt instruments by facilitating the securitization of debt instruments. If a FASIT is formed or used to achieve a tax result inconsistent with this purpose, the Commissioner may take remedial action, including disregarding the FASIT election, reallocating items of income, deductions and credits, recharacterizing regular interests, and redesignating the holder of the ownership interest. Whether a FASIT is formed or used to achieve a tax result that is inconsistent with the FASIT provisions is a question of fact. In addition to applying the specific anti-abuse rule included in these proposed regulations, the IRS and Treasury will also continue to apply other statutory, administrative, and judicial anti-abuse provisions, such as the judicial

doctrines of economic substance and substance over form, to transactions and structures involving FASITs. For example, see the principles of Notice 98–5 (1998–3 I.R.B. 49), regarding foreign tax credits.

Although regular interests in a FASIT may be held in a tiered FASIT structure and treated by each FASIT as permitted assets, the tiering of FASITs may not be used for double or multiple counting of the FASIT gross income or gross assets for other purposes of the Code in a manner that would be inconsistent with the intent of the FASIT provisions. In this regard, the IRS and Treasury consider the recognition of interest expense paid and the corresponding interest income received by the same Owner to be inconsistent with the intent of the provisions. Accordingly, such Owner-created attributes must be disregarded because a taxpayer may not enter into a transaction with itself. For example, the gross income and gross assets from the tiering of FASITs may not be taken into account more than once for purposes of testing whether an Owner is an 80/20 company under section 861, or for purposes of determining the relative domestic and foreign source gross assets of the Owner or the Owner's affiliated group in applying the interest expense allocation rules proposed here under section 864(e).

International Provisions

Prohibition of Foreign FASITS and Segregated Pools Subject to Foreign Tax

It appears that taxpayers may attempt to exploit differences in the characterization of a FASIT or the interests in a FASIT under U.S. law and relevant foreign law to produce inappropriate tax avoidance (including by producing a non-economic allocation of foreign taxes to the holder of the FASIT ownership interest). To minimize this possibility, the proposed regulations provide that a foreign entity (including but not limited to a foreign corporation or a foreign partnership) may not be a qualified arrangement. In addition, a qualified arrangement may not be a domestic entity or a segregated pool of identified assets any of the income of which is subject to tax on a net basis by a foreign country. The IRS and Treasury intend that the imposition of foreign tax on a net basis with respect to the assets and liabilities of a FASIT will disqualify a FASIT election without regard to whether the segregated pool of assets is actually held through a U.S. or foreign office or fixed place of business. In addition, a preexisting qualified FASIT may cease to be a FASIT prospectively by being subjected to foreign net taxation for the first time in a later year as a result of newly conducted foreign activities. It is not necessary that actual foreign tax be imposed for an arrangement to be considered subject to foreign net taxation.

The IRS and Treasury request comments regarding whether there may be circumstances in which legitimate (non-tax) business reasons justify allowing a FASIT election to be made by a foreign entity, or an entity the income of which is subject to net foreign taxation, or on behalf of a segregated pool which may be subject to net foreign taxation.

Prohibition on Foreign FASITs and Segregated Pools Subject to Foreign Tax

The IRS and Treasury are also concerned that taxpayers may attempt to use FASITs to produce non-economic allocations of foreign withholding taxes to the holder of the FASIT ownership interest. The IRS and Treasury believe that such transactions may be facilitated by the ease with which an Owner can acquire publicly-traded debt that is subject to foreign withholding tax. In addition, prohibiting a FASIT from holding publicly-traded debt subject to a foreign withholding tax should not unduly interfere with legitimate securitizations of debt held by an Owner. Accordingly, the proposed regulations provide that the definition of permitted debt instruments does not include debt instruments traded on an established securities market if such debt instruments are subject to foreign withholding tax. The IRS and Treasury request comments concerning whether the scope of this rule is adequate to address potentially abusive transactions and whether legitimate (non-tax) business reasons may justify the use of a FASIT to hold foreign debt that is traded on an established securities market and is subject to a foreign withholding tax.

Avoidance of U.S. Withholding Tax

The IRS and Treasury are also concerned that FASITs may be used by foreign resident taxpayers to avoid U.S. withholding taxes that would otherwise be imposed on direct cross-border financing to a foreign person's U.S. subsidiary. In particular, the IRS and Treasury are aware that foreign taxpayers may attempt to use FASITs to convert interest that would be disqualified from the portfolio interest exemption under sections 871(h)(3), 881(c)(3)(B), and 881(c)(3)(C) (concerning interest paid to a 10 percent shareholder and interest paid to a controlled foreign corporation from a related person) into interest that qualifies as portfolio interest. To prevent such avoidance, the proposed regulations provide that interest paid or accrued to a foreign holder of a FASIT regular interest will not qualify as portfolio interest under sections 871(h)(3) and 881(c)(3) to the extent that the FASIT receives or accrues interest from an obligor who is a U.S. resident taxpayer (the related obligor) if (1) the foreign holder is a 10 percent shareholder (within the meaning of Section 871(h)(3)) of the related obligor or (2) the foreign holder is a controlled foreign corporation and the related obligor is a *related person* (within the meaning of section 864(d)(4)) with respect to the foreign holder. For these purposes, the related obligor is defined as a *conduit debtor* who is treated as paying interest directly to the 10 percent shareholder or the controlled foreign corporation for purposes of sections 871, 881, 1441 and 1442. This rule characterizes all interest of the foreign regular interest holder as non-portfolio interest if the FASIT receives or accrues an equal or greater amount of interest from the related obligor.

Further, the IRS and Treasury request comments concerning whether FASIT regular interests, REMIC regular interests, and pass through certificates should be treated in a consistent manner for purposes of applying U.S. withholding tax rules.

The IRS and Treasury intend to issue regulations that will provide that the FASIT and its Owner are withholding agents in respect of payments made to foreign regular interest holders.

The IRS and Treasury solicit comments with respect to circumstances in which the FASIT and its Owner may be unaware of a possible relationship between foreign regular interest holders and the related obligors of the debt instruments held by the FASIT or other circumstances under which it would be inappropriate to treat payments to a regular interest holder as payments directly from a conduit debtor. It is anticipated that these regulations will provide that the FASIT and its Owner will not be responsible for withholding amounts paid to the foreign regular interest holders in the above circumstances unless the FASIT or its Owner knows, or has reason to know, that the foreign regular interest holder is a 10 percent shareholder of the related obligor or is a controlled foreign corporation considered to be receiving interest from a related person. It is expected that these regulations will further provide that the FASIT and its Owner shall be presumed to know that

these circumstances exist if the foreign regular interest holder owns 10 percent or more of the total value of the FASIT's regular interests and the debt of the related obligor accounts for 10 percent or more of the total value of the FASIT's assets.

Earnings Stripping and Original Issue Discount

The IRS and Treasury are also aware that regular interests in FASITs may be used by foreign residents to avoid other consequences that might apply to cross-border related-party payments. The IRS and Treasury are concerned that taxpayers may attempt to use FASITs to avoid the deferrals on deductibility imposed by sections 163(e)(3) on OID owing to related foreign persons and 163(j) on net interest expense that is otherwise treated as disqualified under the earnings stripping rules.

Similar to the rules adopted for portfolio indebtedness purposes, the proposed regulations treat a U.S. resident taxpayer who is an obligor to a FASIT as a conduit debtor to the extent a related person (within the meaning of section 267(b) or 707(b)(1)) who would not be subject to tax on a direct payment by the U.S. obligor receives interest with respect to a regular interest in the FASIT. In such circumstances, the earnings stripping provisions will apply to treat interest paid by a U.S. corporation or a U.S. trade or business of a foreign corporation on an obligation held by a FASIT as disqualified interest for purposes of section 163(j). Similarly, the conduit debtor rule also operates to treat OID accrued to a FASIT by a domestic party as deferred to the extent a related foreign person (as defined in section 163(e)(3)(B)) receives interest with respect to a regular interest of the FASIT. These rules apply to payments and accruals made during the same period the regular interest in the FASIT is held by the 10 percent shareholder or foreign related party.

No Correlative Adjustments to FASIT

The FASIT and its Owner are not entitled to any correlative adjustments for amounts that are treated as directly paid by a conduit debtor and treated as directly received by or accrued to a related party. Accordingly, all interest paid or accrued by the conduit debtor to the FASIT must be taken into account by the Owner in determining its own taxable income. This treatment is consistent with Treasury's general approach, already adopted in conduit financing regulations, to preventing withholding tax avoidance. TD 8611, 1995–2 C.B. 286, 293.

Interest Expense Allocation

For purposes of applying the interest expense allocation rules to the Owner under section 864(e) and the regulations thereunder, new proposed regulations provide that all interest expense from all FASITs that is treated as incurred by any Owner or by any other Owner that is a member of the same affiliated group of which the Owner is a member is directly allocated solely to all income from all FASITs of such Owners. The directly allocated interest expense is treated as directly related to all activities and assets of all the Owner's FASITs and is apportioned between domestic and foreign source FASIT gross income by applying the general asset method to the FASIT's assets. The proposed interest allocation rules also extend the existing asset adjustment rules under the asset method in § 1.861–9T(g), which reduce assets to reflect the principal amount of indebtedness outstanding relating to the interest which is directly allocated. The rules of § 1.861–10T(d)(2) are also made applicable. In addition, the new proposed interest allocation rules are the exclusive method for the direct allocation of FASIT interest expense. The IRS and Treasury are not aware of any situations in which the direct allocation rules of the existing temporary regulations would apply to any items of FASIT income and interest expense. Comments are solicited in this regard.

The rules apply to interest expense with respect to any FASIT as of that FASIT's startup day and throughout the entire period that the arrangement continues to qualify as a FASIT. The rules provide the Commissioner with discretion to continue to directly allocate interest expense with respect to a ceased FASIT to FASIT income if the Commissioner determines that a principle purpose for terminating the FASIT was to affect the interest allocation.

The IRS and Treasury believe that directly allocating FASIT interest expense solely to FASIT gross income is an administrable and appropriate way to limit distortions (favorable or unfavorable as the case may be) to a taxpayer's overall allocation of interest expense for foreign tax credit purposes. It is recognized, however, that the new proposed direct allocation rules may enable certain interest expense allocation planning that may create distortions that would not occur under existing interest allocation rules. To address these concerns, the IRS and Treasury are considering whether to adopt rules in final regulations that limit the extent to which the direct allocation rules may apply, including rules regarding the amount of variance between the direct allocation and combined asset allocation rules that is appropriate. Comments are solicited on this issue.

Pre-Effective Date FASITs

Section 1691(e) of the Small Business Job Protection Act of 1996 (the Act) provides special transition rules for securitization entities in existence on August 31, 1997. Under these rules, the Owner of a pre-effective date FASIT may defer the recognition of FASIT gain on assets attributable to pre-FASIT interests. For purposes of this rule, a *pre-effective date FASIT* is a FASIT the underlying arrangement of which was in existence on August 31, 1997. A *pre-FASIT interest* is an interest in the underlying arrangement that was outstanding on the FASIT startup date and that is considered debt under general tax principles.

The proposed regulations provide a safe-harbor method of accounting that allows the separation of FASIT gain attributable to pre-FASIT interests, and other FASIT gain. Basically, the safe-harbor method has three steps. Under the first step, the Owner groups the assets of the FASIT into pools. To ensure that each pool can be marked to market using a valuation methodology appropriate for its constituent assets, the proposed regulations provide that no pool may contain assets of more than one of the following three types: (1) assets that are valued under the special valuation rule and that have FASIT gain on the first day they are held by the FASIT, (2) assets that are valued under general fair market value principles and that have FASIT gain on the first day they are held by the FASIT, and (3) assets that do not have FASIT gain on the first day they are held by the FASIT.

Under the second step, the Owner periodically computes for each pool the difference between the income determined under a mark-to-market system (using the appropriate FASIT valuation methodology) and the income determined under an accrual system. This difference is referred to as FASIT gain (or loss) and is essentially a measure of the gain (or loss) from the pool that is attributable to the operation of the FASIT gain recognition rules. These rules require gain to be determined at the pool level when assets are contributed to a FASIT, and implicitly allow this gain to be reversed out (as deductions in the nature of premium offset) as the assets in the pool mature. In periods in which net contributions are made to the pool, the

calculation generally will produce FASIT gain. In periods in which the pool decreases in size or duration, the calculation generally will produce FASIT loss. This FASIT loss is, in effect, a recapture of previously determined FASIT gain. Over the entire life of a pool, the aggregate FASIT gain (or loss) will be zero; the FASIT valuation rules do not create lifetime net income.

Under the third step, the Owner determines the proper amount of FASIT gain (or loss) to recognize during the current period. To determine this amount, the Owner first calculates the total amount of FASIT gain as of the last day of the current period. The Owner then reduces this amount to exclude the percentage of the FASIT gain that is attributable to pre-FASIT interests outstanding on the last day of the period. This reduced amount represents the cumulative amount of FASIT gain the Owner should recognize by the end of the current period. Finally, to adjust for amounts recognized in previous periods, the Owner subtracts from this amount the cumulative amount of FASIT gain that the Owner had recognized at the end of the previous period. The difference is the amount of FASIT gain (or loss) to be recognized in the current period.

Owners of pre-effective date FASITs that presently use a gain deferral methodology that differs from the safe harbor method described above may adopt the safe-harbor method. The IRS and Treasury request comments on whether guidance is needed on how this change of method may be accomplished.

Proposed Amendment to REMIC Regulations

Final regulations governing REMICs, issued in 1992, contain rules governing the transfer of noneconomic REMIC residual interests. In general, a transfer of a noneconomic residual interest is disregarded for all tax purposes if a significant purpose of the transfer is to enable the transferor to impede the assessment or collection of tax. A purpose to impede the assessment or collection of tax (a wrongful purpose) exists if the transferor, at the time of the transfer, either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the REMIC's taxable income.

Under a safe harbor, the transferor of a REMIC residual interest is presumed not to have a wrongful purpose if two requirements are satisfied. First, the transferor must conduct a reasonable investigation of the transferee's financial condition. Second, the transferor must secure a representation from the transferee to the effect that the transferee understands the tax obligations associated with holding a residual interest and intends to pay those taxes.

The IRS and Treasury are concerned that some transferors of residual interests claim they satisfy the safe harbor even in situations where the economics of the transfer clearly indicate the transferee is unwilling or unable to pay the tax associated with holding the interest. The proposed regulations, therefore, would clarify the safe harbor. The proposal explains that the safe harbor is unavailable unless the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of: (1) the present value of any consideration given to the transferee to acquire the interest; (2) the present value of the expected future distributions on the interest; and (3) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses. No inference is intended regarding whether any existing transactions satisfy the substantive requirements of this safe harbor before the clarification made by this amendment.

Proposed Effective Date

In general, the proposed regulations including the proposed amendments to the interest expense allocation regulations are proposed to apply on the date final regulations are filed with the **Federal Register**. The portion of the proposed regulations containing the anti-abuse rule and the portion of the proposed regulations allowing the deferral of gain on assets held by a pre-effective date FASIT are proposed to apply on February 4, 2000. The proposed amendment to the REMIC regulations is proposed to apply to all transfers occurring after the date final regulations concerning the amendment are published in the **Federal Register**.

Special Analyses

It is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that it is unlikely that a substantial number of small entities will hold FASIT ownership interests. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 15, 2000, beginning at 10 a.m. in Room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble. The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 24, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is David L. Meyer, Office of Assistant Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and record keeping requirements.

26 CFR Part 602

Reporting and record keeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for 1.861–10(e) and adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.860H–1 also issued under 26 U.S.C. 860L(h).

Section 1.860H–2 also issued under 26 U.S.C. 860L(h).

Section 1.860H–3 also issued under 26 U.S.C. 860L(h) and 860L(f).

Section 1.860H–4 also issued under 26 U.S.C. 860L(h).

Section 1.860H–5 also issued under 26 U.S.C. 860L(h) and 7701(l).

Section 1.860I–1 also issued under 26 U.S.C. 860L(h) and 860I(c).

Section 1.860I–2 also issued under 26 U.S.C. 860L(h).

Section 1.860J–1 also issued under 26 U.S.C. 860L(h).

Section 1.860K–1 also issued under 26 U.S.C. 860L(h).

Section 1.860L–1 also issued under 26 U.S.C. 860L(h).

Section 1.860L–2 also issued under 26 U.S.C. 860L(h).

Section 1.860L–3 also issued under 26 U.S.C. 860L(h).

Section 1.860L–4 also issued under 26 U.S.C. 860L(h). * * *

Section 1.861–9 also issued under 26 U.S.C. 864(e)(7).

Section 1.861–10 also issued under 26 U.S.C 863(a), 26 U.S.C. 864(e)(7), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). * * *

Par. 2. Section 1.860E–1 is amended by:

1. Revising paragraph (c)(4).

2. Adding paragraphs (c)(5) and (c)(6).

The addition and revision read as follows:

§ 1.860E–1 Treatment of taxable income of a residual interest holder in excess of daily accruals.

* * * * *

(c) * * *

(4) *Safe harbor for establishing lack of improper knowledge.* A transferor is presumed not to have improper knowledge if—

(i) The transferor conducted, at the time of the transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future;

(ii) The transferee represents to the transferor that it understands that, as the holder of the noneconomic residual interest, the transferee may incur tax liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding residual interest as they become due; and

(iii) The present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of—

(A) The present value of any consideration given to the transferee to acquire the interest;

(B) The present value of the expected future distributions on the interest; and

(C) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(5) *Computational assumptions.* The following rules apply for purposes of paragraph (c)(4)(iii) of this section:

(i) The transferee is assumed to pay tax at a rate equal to the highest rate of tax specified in section 11(b)(1); and

(ii) Present values are computed using a discount rate equal to the applicable Federal rate prescribed by section 1274(d) compounded semiannually (a lower discount rate may be used if the transferee can demonstrate that it regularly borrows, in the course of its trade or business, substantial funds at such lower rate from unrelated third parties).

(6) *Effective date.* Paragraphs (c)(4) and (5) of this section are applicable on February 4, 2000.

Par. 3. Sections 1.860H–0 through 1.860L–4 are added to read as follows:

§ 1.860H–0 Table of contents.

This section lists captions that appear in §§ 1.860H–1 through 1.860L–4.

§ 1.860H–1 FASIT defined, FASIT election, other definitions.

(a) *FASIT defined*—(1) A *FASIT* is a qualified arrangement (as defined in paragraph (a)(2) of this section) that meets the requirements of section 860L(a)(1) and the FASIT regulations (as defined in paragraph (c) of this section). A qualified arrangement fails to meet the requirements of section 860L(a)(1) unless it has one and only one ownership interest and that ownership interest is held by one and only one eligible corporation (as defined in section 860L(a)(2)).

(2) Except as provided in paragraph (a)(3) of this section, a qualified arrangement is an arrangement that is either—

(i) An entity (other than a regulated investment company as defined in section 851(a)); or

(ii) A segregated pool of assets if—

(A) The initial assets of the pool are clearly identified, such as through an indenture; and

(B) Changes in the assets of the pool are clearly identified, such as through instruments of conveyance or release.

(3) Notwithstanding paragraph (a)(2) of this section, a qualified arrangement does not include—

(i) An entity created or organized under the law of a foreign country or a possession of the United States;

(ii) An entity any of the income of which is or ever has been subject to net tax by a foreign country or a possession of the United States; or

(iii) A segregated pool of assets any of the income of which at any time is subject to net tax by a foreign country or a possession of the United States.

(b) *FASIT election*—(1) *Person that makes the election.* For a qualified arrangement to be a FASIT an eligible corporation (as defined in section 860L(a)(2)) must make the election required under section 860L(a)(1)(A).

(i) If the qualified arrangement is an entity described in paragraph (a)(2)(i) of this section, the eligible corporation making the election must hold one or more interests in the entity, and one of those interests must be the interest designated as the FASIT's ownership interest.

(ii) If the qualified arrangement is a segregated pool of assets described in paragraph (a)(2)(ii) of this section, the eligible corporation making the election must be the first taxpayer to be treated as the Owner of the resulting FASIT.

(2) *Form of election.* Unless the Commissioner prescribes otherwise, a FASIT election is made by means of a statement attached to the Federal income tax return of the eligible corporation making the election.

(3) *Time for filing election.* The statement referred to in paragraph (b)(2) of this section must be attached to a timely filed (including extensions) original Federal income tax return for the eligible corporation's taxable year in which the FASIT's startup day occurs. An election may not be made on an amended return.

(4) *Contents of election.* The statement referred to in paragraph (b)(2) of this section must include—

(i) For other than a segregated pool of assets, the name, address, and taxpayer identification number of the arrangement (if one was issued prior to the making of the election);

(ii) For a segregated pool of assets, the following information—

(A) The name, address, and taxpayer identification number of the person or persons holding legal title to the pool of assets;

(B) The name, address, and taxpayer identification number of the person or persons that, immediately before the startup day, are considered to own the pool for Federal income tax purposes; and

(C) Information describing the origin of the pool (including the caption and date of execution of any instruments of indenture or similar documents that govern the pool);

(iii) The startup day; and

(iv) The name and title of all persons signing the statement.

(5) *Required signatures.* The statement referred to in paragraph (b)(2) of this section must be signed by the authorized person, described in this paragraph (b)(5).

(i) For other than a segregated pool of assets, the authorized person is any person authorized to sign the qualified arrangement's Federal income tax return in the absence of a FASIT election. For example, if a qualified arrangement is a corporation or trust under applicable state law, an authorized person is a corporate officer or trustee, respectively.

(ii) For a segregated pool of assets, the authorized person is each person who, for Federal income tax purposes, owns the assets of the pool immediately before the earlier of the date on which—

(A) An outstanding interest in the pool is designated as a regular or ownership interest in a FASIT; or

(B) The pool issues an interest designated at the time of issuance as a regular or ownership interest in a FASIT.

(6) *Special rule regarding startup day.* The startup day must be a day on which the eligible corporation making the election is described in paragraph (b)(1)(i) or (ii) of this section.

(c) *General definitions.* For purposes of the regulations issued under part V of subchapter M of chapter 1 of subtitle A of the Internal Revenue Code (the FASIT regulations)—

(1) *Owner* means the eligible corporation that holds the interest described in section 860L(b)(2);

(2) *Transfer* includes a sale, contribution, endorsement, or other conveyance of a legal or beneficial interest in property.

§ 1.860H–2 Assets permitted to be held by a FASIT.

(a) *Substantially all.* For purposes of section 860L(a)(1)(D), substantially all of the assets held by a FASIT consist of

permitted assets if the total adjusted bases of the permitted assets is more than 99 percent of the total adjusted bases of all the assets held by the FASIT, including those assets deemed to be held under section 860I(b)(2).

(b) *Permitted debt instrument*—(1) *In general.* Except as otherwise provided, a debt instrument is described in section 860L(c)(1)(B) only if it is a permitted debt instrument. For purposes of the FASIT regulations, a permitted debt instrument is—

(i) A fixed rate debt instrument, including a debt instrument having more than one payment schedule for which a single yield can be determined under § 1.1272–1(c) or (d);

(ii) A variable rate debt instrument within the meaning of § 1.1275–5 if the debt instrument provides for interest at a qualified floating rate within the meaning of § 1.1275–5(b);

(iii) A REMIC regular interest;

(iv) A FASIT regular interest (including a FASIT regular interest issued by anotherFASIT in which the Owner (or a related person) holds an ownership interest);

(v) An inflation-indexed debt instrument as defined in § 1.1275–7;

(vi) Any receivable generated through an extension of credit under a revolving credit agreement (such as a credit card account);

(vii) A stripped bond or stripped coupon (as defined in section 1286(e)(2) and (3)), if the debt instrument from which the stripped bond or stripped coupon is created is described in paragraphs (b)(1)(i) through (vi) of this section; and

(viii) A certificate of trust representing a beneficial ownership interest in a debt instrument described in paragraphs (b)(1)(i) through (vii) of this section.

(2) *Special rules for short-term debt instruments issued by the Owner or related person.* Notwithstanding section 860L(c)(2) and paragraph (b)(3)(iii) of this section, a debt instrument issued by the Owner (or a related person) is a permitted debt instrument if it—

(i) Is described in paragraph (b)(1)(i) or (ii) of this section;

(ii) Has an original stated maturity of 270 days or less;

(iii) Is rated at least investment quality by a nationally recognized statistical rating organization that is not a related person of the issuer; and (

iv) Is acquired to temporarily invest cash awaiting either reinvestment in permitted assets not described in this paragraph (b)(2), or distribution to the Owner or holders of one or more FASIT regular interests.

(3) *Exceptions.* Notwithstanding paragraph (b)(1) of this section, the following debt instruments are not permitted assets.

(i) *Equity-linked debt instrument.* A debt instrument is not a permitted asset if the debt instrument contains a provision that permits the instrument to be converted into, or exchanged for, any legal or beneficial ownership interest in any asset other than a permitted debt instrument (such as a debt instrument that is exchangeable for an interest in a partnership). Similarly, a debt instrument is not a permitted asset if the debt instrument contains a provision under which one or more payments on the instrument are determined by reference to, or are contingent upon, the value of any asset other than a permitted debt instrument (such as a debt instrument containing a provision under which one or more payments on the instrument are determined by reference to, or are contingent upon, the value of stock).

(ii) *Defaulted debt instrument.* A debt instrument is not a permitted asset if, on the date the debt instrument is acquired by the FASIT, the debt instrument is in default due to the debtor's failure to have timely made one or more of the payments owed on the debt instrument and the Owner has no reasonable expectation that all delinquent payments on the debt instrument, including any interest and penalties thereon, will be fully paid on or before the date that is 90 days after the date the instrument is first held by the FASIT.

(iii) *Owner debt.* A debt instrument is not a permitted asset if the debt instrument is issued by the Owner (or a related person) and the debt instrument does not qualify as a permitted debt instrument under paragraphs (b)(1)(iv) or (2) of this section.

(iv) *Certain Owner-guaranteed debt.* A debt instrument is not a permitted asset if the debt instrument is guaranteed by the Owner (or a related person) and, based on all of the facts and circumstances existing at the time the guarantee is given, or at the time the FASIT acquires the guaranteed debt instrument the Owner (or a related person) is, in substance, the primary obligor on the debt instrument. For this purpose, a guarantee includes any promise to pay in the case of the default or imminent default of any debt instrument.

(v) *Debt instrument linked to the Owner's credit.* A debt instrument that is issued by a person other than the Owner (or a related person) is not a permitted asset if the timing or amount of payments on the instrument are determined by reference to, or are contingent on, the timing or amount of payments made on a debt instrument issued by the Owner (or a related person).

(vi) *Partial interests in non-permitted debt instruments.* A debt instrument is not a permitted asset if the debt instrument is a partial interest such a stripped bond or stripped coupon (as defined in section 1286(e)) in a debt instrument described in paragraphs (b)(3)(i) through (v) of this section.

(vii) *Certain Foreign Debt Subject to Withholding Tax.* A debt instrument is not a permitted asset if the debt instrument is traded on an established securities market (within the meaning of § 1.860I–2) and interest on the debt instrument is subject to any tax determined on a gross basis (such as a withholding tax) other than a tax which is in the nature of a prepayment of a tax imposed on a net basis.

(c) *Cash and cash equivalents.* For purposes of section 860L(c)(1)(A) and the FASIT regulations, the term *cash and cash equivalents* means—

(1) The United States dollar;

(2) A currency other than the United States dollar if the currency is received as payment on a permitted asset described in § 1.860H–2, or the currency is required by the FASIT to make a payment on a regular interest issued by the FASIT according to the terms of the regular interest;

(3) A debt instrument if it—

(i) Is described—

(A) In paragraphs (b)(1)(i), (ii), or (v) of this section, or

(B) In paragraph (b)(vii) of this section if it is created from an instrument described in paragraphs (b)(1)(i), (ii), or (v) of this section;

(ii) Has a remaining maturity of 270 days or less; and

(iii) Is rated at least investment quality by a nationally recognized statistical rating organization that is not a related person to the issuer; and

(4) Shares in a U.S.-dollar-denominated money market fund (as defined in 17 CFR 270.2a–7).

(d) *Hedges and guarantees*—(1) *In general.* Subject to the rules in paragraphs (d)(2) through (4) of this section, a hedge or guarantee contract is described in section 860L(c)(1)(D) (a *permitted hedge*) only if the hedge or guarantee contract is reasonably required to offset any differences that any risk factor may cause between the amount or timing of the receipts on assets the FASIT holds (or expects to hold) and the amount or timing of the payments on the regular interests the FASIT has issued (or expects to issue). For purposes of this paragraph (d), the risk factors are—

(i) Fluctuations in market interest rates;

(ii) Fluctuations in currency exchange rates;

(iii) The credit quality of, or default on, the FASIT's assets or debt instruments underlying the FASIT's assets; and

(iv) The receipt of payments on the FASIT's assets earlier or later than originally anticipated.

(2) *Referencing other than permitted assets.* A hedge or guarantee contract is not a permitted hedge if it references an asset other than a permitted asset or if it references an index, economic indicator, or financial average, that is not both widely disseminated and designed to correlate closely with changes in one or more of the risk factors described in paragraphs (d)(1)(i) through (iv) of this section.

(3) *Association with particular assets or regular interests.* A hedge or guarantee contract need not be associated with any of the FASIT's assets or regular interests, or any group of its assets or regular interests, if the hedge or guarantee contract offsets the differences described in paragraph (d)(1) of this section.

(4) *Creating an investment prohibited.* A hedge or guarantee contract is not a permitted hedge if at the time the hedge or guarantee is entered into, it in substance creates an investment in the FASIT.

(e) *Hedges and guarantees issued by Owner (or related person*)—(1) *Hedges.* A hedge contract issued by the Owner (or a related person) is a permitted asset only if—

(i) The contract is a permitted hedge other than a guarantee contract;

(ii) The Owner (or the related person) regularly provides, offers, or sells substantially similar contracts in the ordinary course of its trade or business;

(iii) On the date the contract is acquired by the FASIT (and on any later date that it is substantially modified) its terms are consistent with the terms that would apply in the case of an arm's length transaction between unrelated parties; and

(iv) The Owner maintains records that—

(A) Show the terms of the contract are consistent with the terms that would apply in the case of an arm's length transaction between unrelated parties; and

(B) Explain how the Owner (or related person) determined the consideration for the contract.

(2) *Guarantees.* A guarantee contract issued by the Owner (or a related person) is a permitted asset only if—

(i) The contract is a permitted hedge and satisfies paragraphs (e)(1)(iii) and (iv) of this section;

(ii) The contract is a credit enhancement contract under § 1.860G–2(c); and

(iii) Immediately after the contract is acquired by the FASIT (and on any later date that it is substantially modified), the value (determined under section 860I and § 1.860I–2) of all the FASIT's guarantee contracts issued by the Owner (and related persons) is less than 3 percent of the value (determined under section 860I and § 1.860I–2) of all the FASIT's assets.

(f) *Foreclosure property.* Property acquired in connection with the default or imminent default of a debt instrument held by a FASIT may qualify both as foreclosure property under section 860L(c)(1)(C) and as another type of permitted asset under section 860L(c)(1). If foreclosure property qualifies as another type of permitted asset, the FASIT may hold the property beyond the grace period prescribed for foreclosure property under section 860L(c)(3). In this case, immediately after the grace period ends, the taxpayer must recognize gain, if any, as if the property had been contributed by the Owner to the FASIT on that date. See § 1.860I–1(a)(1)(iii). In addition, after the close of the grace period, disposition of the property is subject to the prohibited transactions tax imposed under section 860L(e) without the benefit of the exception for foreclosure property.

(g) *Special rule for contracts or agreements in the nature of a line of credit.* For purposes of section 860L(c)(1), the term *permitted asset* includes a lender's position in a contract or agreement in the nature of a line of credit (other than a contract or agreement that is originated by the FASIT). Such a contract or agreement is not subject to the rules of section 860I(a) at the time the contract or agreement is transferred to the FASIT. Extensions of credit under the contract or agreement are subject to the rules of section 860I(a) at the time the extension is made. See section 860I(d)(2). To determine whether a contract or agreement is originated by a FASIT, see § 1.860L–1.

(h) *Contracts to acquire hedges or debt instruments.* A contract is not described in section 860L(c)(1)(E) if it is an agreement under which the Owner (or a related person) agrees to transfer permitted hedges or permitted debt instruments to a FASIT for less than —

(1) Fair market value, in the case of hedges or debt instruments traded on an established securities market (as defined in § 1.860I–2); or

(2) Ninety percent of their value, as determined under section 860I(d)(1)(A) and the FASIT regulations, in the case of debt instruments not traded on an established securities market.

§ 1.860H–3 Cessation of a FASIT.

(a) *In general.* An arrangement ceases to be a FASIT if it revokes its election with the consent of the Commissioner or if it fails to qualify as a FASIT and the Commissioner does not determine the failure to be inadvertent.

(b) *Time of cessation.* An arrangement ceases to be a FASIT at the close of the day designated by the Commissioner in the consent to revoke, or if there is no consent to revoke or determination of inadvertence, at the close of the day on which the arrangement initially fails to qualify as a FASIT.

(c) *Consequences of cessation.* Except as otherwise determined by the Commissioner, the consequences of cessation are as follows:

(1) *The FASIT and the underlying arrangement.* The arrangement that made the FASIT election (the underlying arrangement) is no longer a FASIT and cannot re-elect FASIT treatment without the Commissioner's approval. Immediately after the cessation, the arrangement's classification (for example, as a partnership or corporation) is determined under general principles of Federal income tax law. Immediately after the cessation, the arrangement holds the FASIT's assets with a fair market value basis. Any election the Owner made (other than the FASIT election), and any method of accounting the Owner adopted with respect to those assets, binds the underlying arrangement as if the underlying arrangement itself had made the election or adopted the method of accounting. If the underlying arrangement is a segregated pool of assets, the person holding legal title to the pool is responsible for complying with any tax filing or reporting requirements arising from the pool's operation.

(2) *The Owner.* (i) The Owner is treated as exchanging the assets of the FASIT for an amount equal to their value (as determined under § 1.860I–2). Gain realized on the exchange is treated as gain from a prohibited transaction and the Owner is subject to the tax imposed by 860L without exception. Loss, if any, is disallowed. The determination of gain or loss on assets for purposes of this paragraph is made on an asset-by-asset basis.

(ii) The Owner must recognize cancellation of indebtedness income in an amount equal to the adjusted issue

price of the regular interests outstanding immediately before the cessation over the fair market value of those interests immediately before the cessation. This determination is made on a regular interest by regular interest basis. The Owner cannot take any deduction for acquisition premium.

(iii) If, after the cessation, the Owner has a continuing economic interest in the assets, the characterization of this economic interest (for example, as stock or a partnership interest) is determined under general principles of Federal income tax law. If the Owner has a continuing economic interest in the assets immediately after cessation, the Owner holds the interest with a fair market value basis.

(3) *The regular interest holders.* Holders of the regular interests are treated as exchanging their regular interests for interests in the underlying arrangement. Interests in the underlying arrangement are classified (for example, as debt or equity) under general principles of Federal income tax law. Gain must be recognized if a regular interest is exchanged either for an interest not classified as debt or for an interest classified as debt that differs materially either in kind or extent. No loss may be recognized on the exchange. The basis of an interest in the underlying arrangement equals the basis in the regular interest exchanged for it, increased by any gain recognized on the exchange under this paragraph (c)(3).

(d) *Disregarding inadvertent failures to remain qualified*—(1) If a qualified arrangement that ceases to be a FASIT meets the requirements of paragraph (d)(2) of this section, then the Commissioner may either—

(i) Deem the qualified arrangement as continuing to be a FASIT notwithstanding the cessation; or

(ii) Allow the qualified arrangement to re-elect FASIT status after cessation notwithstanding the prohibition in section 860L(a)(4) .

(2) The requirements of this paragraph are satisfied if —

(i) The Commissioner determines that the cessation was inadvertent;

(ii) No later than a reasonable time after the discovery of the event resulting in the cessation, steps are taken so that all of the requirements for a FASIT are satisfied; and

(iii) The qualified arrangement and each person holding an interest in the qualified arrangement at any time during the period the qualified arrangement failed to qualify as a FASIT agree to make such adjustments (consistent with the treatment of the qualified arrangement as a FASIT or the treatment of the Owner as a C corporation) as the Commissioner may require with respect to such period.

§ 1.860H–4 Regular interests in general.

(a) *Issue price of regular interests*—(1) *Regular interests not issued for property.* The issue price of a FASIT regular interest not issued for property is determined under section 1273(b).

(2) *Regular interests issued for property.* Notwithstanding sections 1273 and 1274 and the regulations thereunder, the issue price of a FASIT regular interest issued for property is the fair market value of the regular interest determined as of the issue date.

(b) *Special rules for high-yield regular interests*—(1) *High-yield interests held by a securities dealer*—(i) *Due date of tax imposed on securities dealer under section 860K(d).* The excise tax imposed under section 860K(d) (treatment of high-yield interest held by a securities dealer that is not an eligible corporation) must be paid on or before the due date of the securities dealer's Federal income tax return for the earlier of the taxable year in which the securities dealer—

(A) Ceases to be a dealer in securities; or

(B) Commences holding the high-yield interest for investment.

(ii) [Reserved]

(2) *High-yield interests held by a pass-thru*—(i) *Nature and due date of tax imposed under section 860K(e).* The tax imposed under section 860K(e) (treatment of high-yield interest held by a pass-thru entity) is an excise tax which must be paid on or before the due date of the pass-thru entity's Federal income tax return for the taxable year in which the pass-thru entity issues the debt or equity interest described in section 860K(e).

(ii) *Pass-thru entity includes REMIC.* For purposes of section 860K(e), a pass-thru entity includes a real estate mortgage investment conduit (REMIC) as defined in section 860D.

§ 1.860H–5 Foreign resident holders of regular interests.

(a) *Look-through to underlying FASIT debt.* If, during the same period, a foreign resident holds (either directly or through a vehicle which itself is not subject to the Federal income tax such as a partnership or trust) a regular interest in a FASIT and a conduit debtor (as defined in paragraph (b) of this section) pays or accrues interest on a debt instrument held by the FASIT, then any interest received or accrued by the foreign resident with respect to the regular interest during that period is treated as received or accrued from the conduit debtor. This rule applies to both the foreign resident holder of the FASIT regular interest and the conduit debtor for all purposes of subtitle A and the regulations thereunder.

(b) *Conduit debtor.* A debtor is a conduit debtor if the debtor is a U.S. resident taxpayer or a foreign resident taxpayer to which interest expense paid or accrued with respect to the debt held by the FASIT is treated as paid or accrued by a U.S. trade or business of the foreign taxpayer under section 884(f)(1)(A), and the foreign resident holder described in paragraph (a) of this section—

(1) Is a 10-percent shareholder of the debtor (within the meaning of section 871(h)(3)(B));

(2) Is a controlled foreign corporation, but only if the debtor is a related person (within the meaning of section 864(d)(4)) with respect to the controlled foreign corporation; or

(3) Is related to the debtor (within the meaning of section 267(b) or 707(b)(1)).

(c) *Limitation.* The amount of income treated under paragraph (a) of this section as received from a conduit debtor is the lesser of—

(1) The income received or accrued by the foreign resident holder with respect to the FASIT regular interest; or

(2) The amount paid or accrued by the conduit debtor with respect to the debt instrument held by the FASIT.

(d) *Cross references.* For the treatment of related-party interest accrued to foreign related persons, see sections 163(e)(3), 163(j), 871(h)(3), 881(c)(3)(B), and 881(c)(3)(C).

§ 1.860H–6 Taxation of Owner, Owner's reporting requirements, transfers of ownership interest.

(a) *In general.* For purposes of determining an Owner's credits and taxable income, all assets, liabilities, and items of income, gain, deduction, loss, and credit of the FASIT are treated as assets, liabilities, and such items of the Owner.

(b) *Constant yield method to apply.* The income from each debt instrument a FASIT holds is determined by applying the constant yield method (including the rules of section 1272(a)(6)) described in § 1.1272–3(c).

(c) *Method of accounting for, and character of, hedges.* The method of accounting used for a permitted hedge (as described in § 1.860H–2(e)) must clearly reflect income and otherwise comply with the rules of § 1.446–4 (whether or not the permitted hedge instrument is part of a hedging transaction as defined in § 1.1221–2(b)). The character of any gain or loss realized on a permitted hedge (as described in § 1.860H–2(e)) is ordinary.

(d) *Coordination with mark-to market provisions*—(1) *No mark to market accounting.* Mark to market accounting does not apply to any asset (other than a non-permitted asset) while it is held, or deemed held, by a FASIT.

(2) *Transfer of a mark to market asset to a FASIT.* If an Owner transfers a permitted asset to a FASIT and the asset would have been marked to market if the taxable year had ended immediately before the transfer (for example, an asset accounted for under section 475(a)), then immediately before the transfer, the Owner must mark the asset to market and take gain or loss into account as if the taxable year had ended at that point. See § 1.475(b)–1(b)(4). If the asset is a debt instrument that is valued under the special valuation rule of § 1.860I–2(a), then immediately after the asset is marked to market under this paragraph (d)(2), the asset is also valued under § 1.860I–2(a), and any additional gain is taken into account under section 860I. The latter gain, but not any mark to market gain, is subject to section 860J.

(e) *Owner's annual reporting requirements.* Unless the Commissioner otherwise prescribes, specified information regarding the FASIT must be reported by means of a separate statement, attached by the Owner to its income tax return for the taxable year that includes the reporting period. The reporting period is the period in the Owner's taxable year during which the Owner holds the ownership interest in the FASIT. Unless the Commissioner otherwise requires, the statement must set forth—

(1) The name, address, and taxpayer identification number (if any) of the FASIT and any other information necessary to establish the identity of the FASIT for which the statement is being filed;

(2) If the ownership interest was acquired from another person during the Owner's taxable year, the date on which it was acquired, and the name and address of the person from which it was acquired;

(3) If the ownership interest was transferred by the Owner during the Owner's taxable year, the date on which it was transferred, the name and address of the person to which it was transferred, and whether such person is described in section 860L(a)(2);

(4) If any regular interests are issued during the reporting period, a description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6) and any regulations thereunder, including a statement supporting the selection of the prepayment assumption;

(5) The FASIT's items (taken into account during the reporting period) of income, gain, loss, deduction and credit from permitted transactions, and separately stated, the FASIT's items (taken into account during the reporting period) of income, gain, loss, deduction and credit from prohibited transactions;

(6) Information detailing the extent to which the items described in paragraph (f)(5) of this section consist of interest accrued that, but for section 860H(b)(4), is exempt from the taxes imposed under subtitle A of 26 U.S.C.; and

(7) If a qualified arrangement ceases to be a FASIT during a reporting period (including at the close of a reporting period), information disclosing—

(i) The effective date of the cessation;

(ii) A description of how the cessation occurred; and

(iii) A statement regarding whether the arrangement will continue after cessation and, if so, the continuing arrangement's name, address, and taxpayer identification number.

(f) *Treatment of FASIT under subtitle F of Title 26 U.S.C.* For purposes of subtitle F (Procedure and Administration)—

(1) A FASIT is treated as a branch or division of the Owner;

(2) The Owner is treated as the issuer of the regular interests; and

(3) The regular interests are treated as collateralized debt obligations as defined in §1.6049–7(d)(2).

(g) *Transfer of ownership interest*—(1) *In general.* If, at the time of any transfer of the ownership interest, the Owner knew or should have known that the transferee would be unwilling or unable to pay some or all of the tax arising from the application of section 860H(b), then the transfer is disregarded for all Federal tax purposes.

(2) *Safe harbor for establishing lack of improper knowledge.* A transfer will not be disregarded under paragraph (g)(1) of this section if the rules of § 1.860E–1(c)(4) (safe harbor for establishing lack of improper knowledge on the transfer of a non-economic REMIC residual interest) are satisfied with respect to the FASIT ownership interest.

§ 1.860I–1 Gain recognition on property transferred to FASIT or supporting FASIT regular interests.

(a) *In general*—(1) Except as provided in paragraphs (a)(2) and (d) of this section, the Owner of a FASIT (or a related person) must recognize gain (if any) on—

(i) Property the Owner (or the related person) transfers either to the FASIT or its regular interest holders;

(ii) Support property; and

(iii) Property acquired by the FASIT as foreclosure property and held beyond the grace period allowed for foreclosure property.

(2) An Owner (or a related person) does not have to recognize gain under section 860I or paragraph (a)(1) of this section on a transfer or pledge of property to a regular interest holder, if the Owner (or the related person) makes the transfer or pledge in a capacity other than as Owner (or related person), and the regular interest holder receives the transfer or pledge in a capacity other than regular interest holder.

(b) *Support property defined.* Property is *support property* if the Owner (or a related person)—

(1) Pledges the property, directly or indirectly, to pay a FASIT regular interest, or otherwise identifies the property as providing security for the payment of a FASIT regular interest;

(2) Sets aside the property for transfer to a FASIT under any agreement or understanding; or

(3) Holds an interest in the property that is subordinate to the FASIT's interest in the property (for example, the Owner holds subordinate interests in a pool of mortgages and the FASIT holds senior interests in the same pool).

(c) *Timing of gain determination and recognition.* Gain is determined and recognized under paragraph (a)(1) of this section immediately before the property is transferred to the FASIT or becomes support property, or in the case of foreclosure property, on the day immediately following the termination of the grace period allowed for foreclosure property.

(d) *Gain deferral election.* [Reserved]

(e) *Amount of gain.* Except as provided in paragraph (f) of this section, the amount of gain recognized under paragraph (a)(1) of this section is the same as if the Owner (or the related person) had sold the property for its value as determined under § 1.860I–2.

(f) *Recordkeeping requirements.* The Owner is required to maintain such books and records as may be necessary or appropriate to demonstrate that the requirements of this section are satisfied.

(g) *Special rule applicable to property of related persons.* Except in the case of property traded on an established securities market (as defined in § 1.860I–2(b)), if a related person holds property that becomes support property, or if a related person transfers property to a FASIT or its regular interest holders, then for purposes of applying the gain recognition provisions of this section—

(1) The related person is treated as transferring the property to the Owner for the property's fair market value as

determined under general tax principles; and

(2) The Owner is treated as transferring the property to the FASIT for the property's value as determined under § 1.860I–2.

§ 1.860I–2 Value of property.

(a) *Special valuation rule.* For purposes of section 860I(d)(1)(A), except as provided in paragraph (c) of this section, the value of a debt instrument not traded on an established securities market is the present value of the reasonably expected payments on the instrument determined—

(1) As of the date the instrument is to be valued (as described in § 1.860I–1(c)); and

(2) By using a discount rate equal to 120 percent of the applicable federal rate, compounded semi-annually, for instruments having the same term as the weighted average maturity of the reasonably expected payments on the instrument. For this purpose, the applicable federal rate is the rate prescribed under section 1274(d) for the period that includes the date the instrument is valued (as described in § 1.860I–1(c)).

(b) *Traded on an established securities market.* For purposes of section 860I(d)(1)(A), a debt instrument is traded on an established securities market if it is traded on a market described in § 1.1273–2(f) (2), (3), or (4).

(c) *Reasonably expected payments*—(1) *In general.* Reasonably expected payments on an instrument must be determined in a commercially reasonable manner and, except as otherwise provided in this section (c), may take into account reasonable assumptions concerning early repayments, late payments, non-payments, and loan servicing costs. No other assumptions may be considered.

(2) *Consistency requirements.* Except as provided in paragraph (c)(3) of this section, any assumption used in determining the reasonably expected payments on an instrument must be consistent with (and no less favorable than) the first of the following categories that applies—

(i) Representations made in connection with the offering of a regular interest in the FASIT;

(ii) Representations made to any nationally recognized statistical rating organizations;

(iii) Representations made in any filings or registrations with any governmental agency with respect to the FASIT; and

(iv) Industry customs or standards (as defined in paragraph (e) of this section).

(3) *Servicing costs.* Notwithstanding paragraph (c)(2) of this section, the amount of loan servicing costs assumed may not exceed the lesser of—

(i) The amount the FASIT agrees to pay the Owner for servicing the loans held by the FASIT if the Owner is providing the servicing; or

(ii) The amount a third party would reasonably pay for servicing identical loans.

(4) *Nonconforming or unreasonable assumptions.* If a taxpayer, in determining the expected payments on an instrument, takes into account an assumption that either fails to meet the requirements of paragraph (c)(2) or (3) of this section or is unreasonable, the Commissioner may determine the reasonably expected payments on the instrument without the assumption. Thus, for example, if a taxpayer makes an unreasonable assumption concerning non-payments, the Commissioner may compute expected payments without any adjustment for non-payments.

(d) *Special rules*—(1) *Beneficial ownership interests.* A certificate representing beneficial ownership of a debt instrument, is deemed to represent beneficial ownership of a debt instrument traded on an established securities market, if either —

(i) The certificate is traded on an established securities market; or

(ii) The certificate represents ownership in a pool of assets composed solely of debt instruments all of which are traded on established securities markets.

(2) *Stripped interests.* A stripped bond or stripped coupon (as defined in section 1286(e)) not otherwise traded on an established securities market is considered as being traded on an established securities market, if—

(i) The underlying bond (the bond from which the stripped bond or stripped coupon is created) is traded on an established securities market; and

(ii) The stripped bond or stripped coupon is valued using a commercially reasonable method based on the market value of the underlying bond.

(3) *Contemporaneous purchase and transfer of debt instruments*—(i) Notwithstanding paragraph (a) of this section, the value of a debt instrument not traded on an established securities market is its cost to the Owner (or a related person) if—

(A) The debt instrument is purchased from an unrelated person in an arm's length transaction in which no other property is transferred or services provided;

(B) The debt instrument is acquired solely for cash;

(C) The price of the debt instrument is fixed no more than 15 days before the date of purchase; and

(D) The debt instrument is transferred to the FASIT no more than 15 days after the date of purchase.

(ii) For purposes of paragraph (d)(3)(i) of this section, the date of purchase is the earliest date on which the burdens and benefits of ownership of the debt instrument irrevocably pass to the Owner (or a related person).

(4) *Guarantees.* Notwithstanding paragraph (c)(1) of this section, if a guarantee qualifying as a permitted hedge under this paragraph (d) relates solely to a debt instrument not traded on an established securities market and the taxpayer determines the reasonably expected payments on the debt instrument by including the reasonably expected payments on the guarantee, then the guarantee and the property need not be valued separately.

(e) *Definitions.* For purposes of § 1.860I–2—

(1) An *industry custom* is any long-standing practice in use by entities that engage in asset securitization as part of their ordinary business activities; and

(2) An *industry standard* is any standard that is both—

(i) Commonly used in evaluating the expected payments on securitized debt instruments (or debt instruments pending securitization) in similar transactions; and

(ii) Disseminated through written or electronic means by any independent, nationally recognized trade association or other authority that is recognized as competent to issue the standard.

§ 1.860J–1 Non-FASIT losses not to offset certain FASIT inclusions.

(a) *In general.* For purposes of applying section 860J(a)(1), an Owner's taxable income from a FASIT includes any gains recognized by the Owner under § 1.860I–1(a).

(b) *Special rule for holders of multiple ownership interests.* For purposes of applying section 860J and the rules of § 1.860J–1, a person may aggregate the net income (or loss) from all FASITs in which the person holds the ownership interest.

(c) *Related persons*—(1) *Taxable income.* The taxable income of a related person for any taxable year is no less than the sum of—

(i) The amounts specified in section 860J(a); plus

(ii) Any gains recognized under § 1.860I–1(a).

(2) *Effect on net operating loss.* Any increase in a related person's taxable income attributable to paragraph (c)(1) of this section is disregarded—

(i) In determining under section 172 the amount of the related person's net operating loss for the taxable year; and

(ii) In determining the related person's taxable income for such taxable year for purposes of the second sentence of section 172(b)(2).

(3) *Coordination with minimum tax.* For purposes of part VI of subchapter A of chapter 1 of subtitle A of Title 26 U.S.C., the alternative minimum taxable income of any related person is in no event less than the related person's taxable income as computed under paragraph (c)(1) of this section.

§ 1.860L–1 Prohibited transactions.

(a) *Loan origination*—(1) *In general.* Section 860L(e) imposes a prohibited transactions tax on the receipt of any income derived from any loan originated by a FASIT. Except as provided in paragraphs (a)(2) and (3) of this section, whether a FASIT originates a loan for purposes of section 860L(e) depends on all the facts and circumstances.

(2) *Acquisitions presumed not to be loan origination.* Except as provided in paragraph (a)(3) of this section, a FASIT is considered not to have originated a loan if the FASIT acquires the loan—

(i) From an established securities market described in § 1.1273–2(f)(2), (3), or (4);

(ii) On a date more than 12 months after the loan was issued; or

(iii) From a person (including the Owner or a related person) that regularly originates similar loans (such as through a standardized contract) in the ordinary course of its business.

(3) *Activities presumed to be loan origination.* (i) Notwithstanding paragraph (a)(2) of this section, a FASIT is considered to originate a loan if the FASIT either engages in or facilitates (other than through a person from whom the FASIT acquires the loan and who is described in paragraph (a)(2)(iii) of this section)—

(A) Soliciting the loan, including advertising to solicit borrowers, accepting the loan application, or generally making any offer to lend funds to any person;

(B) Evaluating an applicant's financial condition;

(C) Negotiating or establishing any terms of the loan;

(D) Preparing or processing any document related to negotiating or entering into the loan; or

(E) Closing the loan transaction.

(ii) For purposes of paragraph (a)(3)(i) of this section, if a FASIT enters into a contract to engage in purchases described in paragraph (a)(2)(iii) of this section, the FASIT is not treated as originating the loans it acquires solely because it was a party to the contract.

(4) *Loan workouts.* If a FASIT holds a loan, the FASIT is not treated as originating a new loan that it receives from the same obligor in exchange for the old loan in the context of a workout.

(b) *Origination of a contract or agreement in the nature of a line of credit*—(1) *In general.* A FASIT is presumed not to have originated a contract or agreement in the nature of a line of credit if the FASIT acquires the contract or agreement from a person (including the Owner or a related person) that regularly originates similar contracts or agreements in the ordinary course of its business.

(2) *Activities presumed to be origination.* If a FASIT assumes the role of a lender under a contract or agreement in the nature of a line of credit from a person that does not regularly originate similar contracts or agreements in the ordinary course of its business, the FASIT is considered to originate the contract or agreement if, with respect to the contract or agreement, the FASIT engages in any of the activities described in paragraphs (A) through (E) of § 1.860L-1(a)(3)(i) of this section.

(3) *Debt instruments issued under contracts or agreements in the nature of a line of credit.* If a FASIT acquires a debt instrument as a result of the FASIT's position as a lender under a contract or agreement in the nature of a line of credit, the FASIT is presumed to have originated the debt instrument if and only if the FASIT originated the related contract or agreement.

(c) *Disposition of debt instruments.* Notwithstanding sections 860L(e)(3)(B)(i) and (ii) (certain exceptions from the prohibited transactions tax), the distribution to the Owner of a debt instrument contributed by the Owner, and the transfer to the Owner of one debt instrument in exchange for another, are prohibited transactions, if within 180 days of receiving the debt instrument the Owner realizes a gain on the disposition of the instrument to any person, regardless of whether the realized gain is recognized.

(d) *Exclusion of prohibited transactions tax to dispositions of hedges.* The rules of section 860L(e) and paragraph (b) of this section do not apply to the disposition of any asset described in section 860L(c)(1)(D).

§ 1.860L–2 Anti-abuse rule.

(a) *Intent of FASIT provisions.* Part V of subchapter M of the Internal Revenue Code (the FASIT provisions) is intended to promote the spreading of credit risk on debt instruments by facilitating the securitization of those debt instruments. Implicit in the intent of the FASIT provisions are the following requirements—

(1) Assets to be securitized through a FASIT consist primarily of permitted debt instruments;

(2) The source of principal and interest payments on a FASIT's regular interests is primarily the principal and interest payments on permitted debt instruments held by the FASIT (as opposed to receipts on other assets or deposits of cash); and

(3) No FASIT provision may be used to achieve a Federal tax result that cannot be achieved without the provision unless the provision clearly contemplates that result.

(b) *Application of FASIT provisions.* The FASIT provisions and the FASIT regulations must be applied in a manner consistent with the intent of the FASIT provisions as set forth in paragraph (a) of this section. Therefore, if a principal purpose of forming or using a FASIT is to achieve results inconsistent with the intent of the FASIT provisions and the FASIT regulations, the Commissioner may make any appropriate adjustments with regard to the FASIT and any arrangement or transaction (or series of transactions) involving the FASIT. The Commissioner's authority includes—

(1) Disregarding a FASIT election;

(2) Treating one or more assets of a FASIT as held by a person or persons other than the Owner;

(3) Allocating FASIT income, loss, deductions and credits to a person or persons other than the Owner;

(4) Disallowing any item of FASIT income, loss, deduction, or credit;

(5) Treating the ownership interest in a FASIT as held by a person other than the nominal holder;

(6) Treating a FASIT regular interest as other than a debt instrument; and

(7) Treating a regular interest held by any person as having the same tax characteristics as one or more of the assets held by the FASIT.

(c) *Facts and circumstances analysis.* Whether a FASIT is created or used for a principal purpose of achieving a result inconsistent with the intent of the FASIT provisions is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction.

(d) *Effective date.* This section is applicable on February 4, 2000.

§ 1.860L–3 Transition rule for pre-effective date FASITs.

(a) *Scope.* This section applies if a pre-effective date FASIT has one or

more pre-FASIT interests outstanding on the startup day of the FASIT.

(1) *Pre-effective date FASIT defined.* A *pre-effective date FASIT* is a FASIT whose underlying qualifying arrangement was in existence on August 31, 1997.

(2) *Pre-FASIT interest defined.* A *pre-FASIT interest* is an interest in a pre-effective date FASIT that—

(i) Was issued before February 4, 2000;

(ii) Was outstanding on the date the FASIT election for the underlying qualifying arrangement goes into effect; and

(iii) Is considered debt of the Owner under general principles of Federal income tax law.

(3) *FASIT gain defined.* For purposes of this section, the term FASIT gain means any gain that the Owner of a pre-effective date FASIT must recognize under the rules of this section.

(b) *Election to defer gain.* The Owner of a pre-effective date FASIT may elect to defer the recognition of FASIT gain on assets that are held by the FASIT but that are allocable to pre-FASIT interests. An Owner that elects under this section must establish a method of accounting for its FASIT gain. To clearly reflect income, this method must periodically determine the aggregate amount of FASIT gain on all of the assets in the FASIT and exclude the portion of the FASIT gain attributable to the pre-FASIT interests.

(c) *Safe-harbor method.* This paragraph (c) provides a safe-harbor method for determining the amount of FASIT gain that can be deferred under this section. The method has the following steps:

(1) *Step one: Establish pools*—(i) *Group assets into pools.* The Owner must group the assets of the FASIT into one or more pools. No pool may contain assets of more than one of the following three types—

(A) Assets that are valued under the special valuation rule of § 1.860I–2(a) and that have FASIT gain on the first day held by the FASIT;

(B) Assets that are valued for FASIT gain purposes under a standard other than the special valuation rule of § 1.860I–2(a) and that have FASIT gain on the first day held by the FASIT; and

(C) Assets that do not have FASIT gain on the first day held by the FASIT.

(ii) *Treatment of pools.* If a pool contains assets described in paragraph (c)(1)(i)(A) or (B) of this section, the Owner must apply paragraphs (c)(2) through (5) of this section to the pool. If a pool contains assets described in paragraph (c)(1)(i)(C) of this section, the pool is ignored for FASIT gain purposes.

(2) *Step two: Determine the FASIT gain (or loss) at the pool level*—(i) *In general.* For each taxable year, the FASIT gain (or loss) at the pool level is equal to the net increase (or decrease) in the value of the pool minus the income that is included with respect to the pool under general income tax principles (without regard to the FASIT rules). For purposes of the preceding sentence, the net increase (or decrease) in the value of the pool is equal to—

(A) The sum of the value of the pool (as determined under § 1.860I–2) at the end of the taxable year and the amount of any cash distributed (even if reinvested) from the pool during the taxable year; minus

(B) The sum of the value of the pool (as determined under § 1.860I–2) at the end of the previous taxable year and the Owner's adjusted basis in the assets contributed to the pool during the taxable year.

(ii) *Limitation.* This paragraph applies if the calculation in paragraph (c)(2)(i) of this section produces a loss for the taxable year and the amount of the loss exceeds the net amount of the FASIT gain from the pool in all prior years. In this case, the amount of the loss for the current year is limited to the amount of net FASIT gain for all previous years.

(3) *Step three: Determine the percentage of total FASIT gain that must be recognized by the end of the current taxable year.* The percentage of FASIT gain that must be recognized by the end of the current taxable year is equal to 100 percent minus the percentage of FASIT gain that may be deferred at the end of the current taxable year. The percentage of FASIT gain that may be deferred at the end of the taxable year is equal to the lesser of 100 percent and the ratio of—

(i) The product of 107 percent and aggregate adjusted issue prices of all pre-FASIT interests outstanding on the last day of the taxable year; over

(ii) The total value of all assets held by the FASIT on the last day of the taxable year.

(4) *Step four: Determine the total amount of FASIT gain that is not attributed to pre-effective date FASIT interests.* The total amount of FASIT gain that is not attributed to pre-effective date FASIT interests is equal to the product of—

(i) The sum of the amount of FASIT gain (as determined under paragraph (c)(2) of this section) for the current taxable year and all previous taxable years; and

(ii) The percentage of FASIT gain that must be recognized in the current taxable year (as determined under paragraph (c)(3) of this section).

(5) *Step five: Determine the amount of FASIT gain (or loss) to be recognized in the taxable year.* For the taxable year that includes the startup date, the amount of FASIT gain to be recognized is equal to the total amount of FASIT gain not attributable to pre-effective date FASIT interests (as determined under paragraph (c)(4) of this section). Thereafter, the amount of FASIT gain (or loss) to be recognized in a given taxable year is equal to the total amount of FASIT gain not attributable to pre-effective date FASIT interests for that taxable year (as determined under paragraph (c)(4) of this section) less the amount of FASIT gain not attributable to pre-effective date FASIT interests for the immediately preceding taxable year (as determined under paragraph (c)(4) of this section).

(d) *Example.* The rules of this section are illustrated by the following example:

Example. (i) *Facts. O* is an eligible corporation within the meaning of section 860(a)(2) that uses the calendar year as its taxable year. On July 1, 1996, *O* forms *TR,* a trust. Shortly thereafter, *O* contributes credit card receivables to *TR* and *TR* issues certificates that, for Federal income tax purposes, are characterized as debt of *O.* Effective March 31, 1999, *O* elects FASIT status for *TR.* On March 31, 1999, *TR* holds credit card receivables that have an outstanding principal balance of $20,000,000 and *TR* has outstanding certificates (that are characterized for Federal income tax purposes as debt of *O*) that have an aggregate adjusted issue price of $10,000,000.

(ii) *Status as a pre-effective date FASIT. TR* is a pre-effective date FASIT because *TR* was a trust that was in existence on August 31, 1997. The certificates outstanding on March 1, 1999, are pre-FASIT interests because they were outstanding on March 31, 1999, and they were considered debt of *O* under general principles of Federal income tax law.

(iii) *Facts: 1999.* From April 1, 1999, through December 31, 1999, the credit card receivables held by *TR* generated $800,000 of taxable income and $4,000,000 of total cash flow. *TR* distributed $2,500,000 of the cash flow to *O* in exchange for new receivables having an outstanding principal balance of $2,500,000. *TR* used the remaining $1,500,000 of cash flow to make payments on its outstanding debt instruments. On December 31, 1999, *TR* contributed additional credit card receivables with an outstanding principal balance of $10,700,000 and an aggregate adjusted basis of $10,700,000. On December 31, 1999, *TR* held credit card receivables that had an outstanding principal balance of $30,000,000, an aggregate adjusted basis of $30,000,000, and a value (as determined under § 1.860I–2(a)) of $30,300,000. In addition, on December 31, 1999, the outstanding adjusted issue price of the pre-FASIT interests was $9,000,000.

(iv) *FASIT gain recognition for 1999*—(A) *Establish pools. TR* elects to defer gain recognition under the safe harbor method.

Consistent with paragraph (c)(1) of this section, *TR* groups the assets of the FASIT into a single pool because all of the assets of the FASIT are credit card receivables subject to the special valuation rule of § 1.860I–1(a) and the assets have FASIT gain on the date they are acquired by the FASIT.

(B) *Determination of FASIT gain for 1999.* The sum of the value of the pool at the end of 1999 ($30,300,000) and the cash distributed during 1999 ($4,000,000) is $34,300,000. There are three contributions of assets by *O* during 1999: one of $20,000,000 on March 31, 1999; one of $2,500,000 over the course of 1999; and an additional contribution of $10,700,000 on December 31, 1999. Thus, *O*'s basis in assets contributed to the pool during 1999 is $33,200,000. The net increase in the value of the pool is $1,100,000 ($34,300,000 minus $33,200,000). Under paragraph (c)(2) of this section, the FASIT gain for 1999 is $300,000 ($1,100,000 net increase in value minus $800,000 taxable income).

(C) *Determination of percentage of total FASIT gain that must be recognized by the end of 1999.* Under paragraph (c)(3) of this section, the percentage of FASIT gain that may be deferred for the taxable year is 31.78 percent (107 percent × $9,000,000 adjusted issue price of pre-FASIT interests divided by $30,300,000 value of the assets). The percentage of the FASIT gain that must be recognized is for the taxable year, therefore, 68.22 percent (1—31.78 percent).

(D) *Determination of total amount of FASIT gain not attributed to pre-effective date FASIT interests in 1999.* Under paragraph (c)(4) of this section, the total amount of FASIT gain not attributed to pre-effective date FASIT interests in 1999 is $204,660 ($300,000 FASIT gain × 68.22 percent).

(E) *Determine the amount of FASIT gain to be recognized in 1999.* Under paragraph (c)(5) of this section, because 1999 includes the startup date, *TR* must include in income the entire $204,660 of FASIT gain not attributed to pre-effective date FASIT interests.

(v) *Facts: 2000.* In 2000, the credit card receivables held by *TR* generated $1,500,000 of taxable income and $5,000,000 of cash flow. *TR* distributed $4,000,000 of the cash flow to *O* in exchange for new receivables having an outstanding principal balance of $4,000,000. *TR* used the remaining $1,000,000 of cash flow to make payments on its outstanding debt instruments. On December 31, 2000, *TR* contributed additional credit card receivables with an outstanding principal balance of $9,500,000 and an aggregate adjusted basis of $9,500,000. On December 31, 2000, *TR* held credit card receivables that had an outstanding principal balance of $40,000,000, an aggregate adjusted basis of $40,000,000, and a value (as determined under § 1.860I–2(a)) of $40,800,000. In addition, on December 31, 2000, the outstanding adjusted issue price of the pre-FASIT interests was $8,500,000.

(vi) *FASIT gain recognition for 2000*—(A) *Determination of FASIT gain for 2000.* The sum of the value of the pool on December 31, 2000 ($40,800,000) and the cash distributed during 2000 ($5,000,000) is $45,800,000. The value of the pool on December 31, 1999, was $30,300,000. During 2000, *O* contributed receivables in which *O* had a basis of $13,500,000 ($4,000,000 over the course of the year and $9,500,000 on December 31, 2000). The net increase in the value of the pool during 2000 is $2,000,000 ($45,800,000 minus $43,800,000). Under paragraph (c)(2), the FASIT gain for 2000 is $500,000 ($2,000,000 net increase in value minus $1,500,000 taxable income).

(B) *Determination of percentage of total FASIT gain that must be recognized by the end of 2000.* Under paragraph (c)(3), the percentage of FASIT gain that may be deferred for the taxable year is 22.29 percent (107 percent times $8,500,000 adjusted issue price of pre-FASIT interests divided by $40,800,000 value of the assets). The percentage of the FASIT gain that must be recognized is, therefore, 77.71 percent (1—22.29 percent).

(C) *Determination of total amount of FASIT gain not attributed to pre-effective date FASIT interests in 2000.* Under paragraph (c)(4) of this section, the total amount of FASIT gain not attributed to pre-effective date FASIT interests in 2000 is $388,500 ($500,000 FASIT gain multiplied by 77.71 percent).

(D) *Determine the amount of FASIT gain to be recognized in 2000.* Under paragraph (c)(5) of this section, the FASIT gain to be recognized for 2000 is equal to the FASIT gain that not attributable to pre-effective date FASIT interests in 2000 ($388,500) minus the FASIT gain not attributable to pre-effective date FASIT interests in 1999 ($204,660). Thus, in 2000, *TR* must include $183,840.

(e) *Election to apply gain deferral retroactively.* The Owner of a pre-effective date FASIT, including a pre-effective date FASIT having a startup date before February 4, 2000, may apply the rules of paragraph (a) of this section for the period beginning on the startup date by making an election in the manner prescribed by the Commissioner.

(f) *Effective date.* This section is applicable on February 4, 2000.

§ 1.860L–4 Effective date.

Except as otherwise provided in § 1.860L–2(e) (relating to the rules on anti-abuse) and § 1.860L–3(f) (relating to the rules governing transition entities) this section is applicable on the date final regulations are filed with the **Federal Register**.

Par. 4. Section 1.861–9T is amended by redesignating the text of paragraph (g)(2)(iii) as paragraph (g)(2)(iii)(A) and adding a heading to new paragraph (g)(2)(iii)(A), and adding paragraph (g)(2)(iii)(B):

§ 1.861–9T Allocation and apportionment of interest expense (temporary regulations).

* * * * *

(g) * * *

(2) * * *

(iii) *Adjustment for directly allocated interest*—(A) *Nonrecourse indebtedness and integrated financial transactions.* * * *

(B) *FASIT Interest Expense.* The rules of paragraph (g)(2)(iii)(A) of this section shall also apply to all assets to which FASIT interest expense is directly allocated during the current taxable year under the rules of § 1.861–10T(f). This paragraph (g)(2)(iii)(B) applies on the date final regulations are filed with the **Federal Register**.

Par. 5. Section 1.861–10T is amended by—

1. Revising paragraph (a); and
2. Adding paragraph (f).

§ 1.861–10T Special allocations of interest expense (temporary regulations).

(a) *In general.* This section applies to all taxpayers and provides four exceptions to the rules of § 1.861–9T that require the allocation and apportionment of interest expense on the basis of all assets of all members of the affiliated group. Paragraph (b) of this section describes the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Paragraph (c) of this section describes the direct allocation of interest expense to income generated by certain assets that are acquired in integrated financial transactions. Paragraph (d) of this section provides special rules that are applicable to all transactions described in paragraphs (b) and (c) of this section. Paragraph (e) of this section requires the direct allocation of third party interest of an affiliated group to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). Paragraph (f) of this section provides rules for the direct allocation and apportionment of all FASIT interest expense to all FASIT gross income, on the basis of all FASIT assets. See also § 1.861–9T(b)(5), which requires direct allocation of amortizable bond premium.

* * * * *

(f) *FASIT Interest Expense*—(1) *In general.* All FASIT interest expense of the taxpayer's affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group) shall be directly allocated solely to the FASIT gross income of the affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group).

(2) *Asset method.* Interest expense that is directly allocated under this paragraph (f) shall be treated as directly related to all the activities and assets of all FASITs in which the taxpayer or any

member of the taxpayer's affiliated group holds the ownership interest. The directly allocated interest expense shall be apportioned among all of the FASIT gross income of the affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group) under the asset method described in § 1.861–9T(g).

(3) *FASIT period.* After a FASIT's startup day (as defined in section 860L(d)(1)), the taxpayer must allocate the interest expense of the FASIT according to the rules of this paragraph (f) during the entire period that the arrangement continues to be a FASIT. If an arrangement ceases to be a FASIT, interest expense with respect to the ceased FASIT arrangement shall no longer be allocated and apportioned under the rules of this paragraph (f) as of the time the arrangement is treated as having ceased in accordance with § 1.860H–3(b). The Commissioner may continue to allocate interest expense with respect to a ceased FASIT arrangement under this paragraph (f) if the Commissioner determines that the principal purpose of ending the arrangement's qualification as a FASIT was to affect the taxpayer's interest expense allocation.

(4) *Application of special rules.* In applying this paragraph (f), the rules of paragraph (d)(2)of this section shall apply.

(5) *Definitions.* For purposes of this paragraph (f):

(i) *FASIT defined.* FASIT has the meaning given such term in § 1.860H–1(a).

(ii) *FASIT interest expense defined.* (A) In general. FASIT interest expense means any amount paid or accrued by or on behalf of a FASIT to a holder of a regular interest in such FASIT, if such amount is—

(*1*) treated as incurred by the taxpayer or any member of the taxpayer's affiliated group by reason of § 1.860H–6(a), because the taxpayer or such member holds the ownership interest in a FASIT; and

(*2*) treated as interest by reason of section 860H(c).

(B) *Interest equivalents.* FASIT interest expense includes any expense or loss from a hedge that is a permitted asset (as described in § 1.860H–2 (d) and (e)), but only to the extent such expense or loss is an interest equivalent as described in § 1.861–9T(b).

(iii) *FASIT gross income defined.* FASIT gross income means gross income of the taxpayer's affiliated group (or the taxpayer, if the taxpayer is not a member of an affiliated group) treated as received or accrued by the taxpayer, or any member of the taxpayer's affiliated group, by reason of § 1.860H–6(a).

(iv) *Affiliated group defined.* Affiliated group has the meaning given such term by § 1.861–11T(d).

(6) *Coordination with other provisions.* If any FASIT interest expense is directly allocable under both this paragraph (f) and paragraph (b) or (c) (determined without regard to this paragraph (f)(6)), only the rules of this paragraph (f) shall apply.

(7) *Effective date.* The rules of this section apply for taxable years beginning after December 31, 1986. However, paragraphs (a) and (f) apply as of the date final regulations are filed with the **Federal Register**, and paragraph (e) applies to all taxable years beginning after December 31, 1991.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

[FR Doc. 00–1896 Filed 2–4–00; 8:45 am]

BILLING CODE 4830–01–U

DEPARTMENT OF THE TREASURY

Bureau of Alcohol, Tobacco and Firearms

27 CFR Part 9

[Notice No. 891]

RIN 1512–AA07

Expansion of Lodi Viticultural Area (98R–109P)

AGENCY: Bureau of Alcohol, Tobacco and Firearms, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Bureau of Alcohol, Tobacco and Firearms (ATF) has received a petition for expansion of the Lodi Viticultural Area. The proposed additions to the Lodi Viticultural Area are located in San Joaquin County, California, in the northern San Joaquin Valley. The additions are situated contiguous to the western and southern boundaries of the current viticultural area. The proposed western addition encompasses approximately 14,500 acres, of which 3,640 acres are planted to vineyards. Situated contiguous to the southern boundary of the viticultural area, the proposed southern addition encompasses approximately 66,600 acres, of which 5,600 acres are planted to vineyards. Attorney Christopher Lee, on behalf of nine (9) growers who own vineyards within the proposed expansion area, submitted the petition. According to the petitioner, the importance of Lodi as a viticultural area demands that particular care be taken in extending the viticultural area boundaries, in order to safeguard the region's identity, integrity, and reputation. The petitioner states that this petition adds only that land which meets all the historical and geographical criteria that distinguish the Lodi viticultural area.

DATES: Written comments must be received by April 7, 2000.

ADDRESSES: Send written comments to: Chief, Regulations Division, Bureau of Alcohol, Tobacco and Firearms, P.O. Box 50221, Washington, DC 20091–0221 (Attn: Notice No. 891). Copies of the petition, the proposed regulations, the appropriate maps, and any written comments received will be available for public inspection during normal business hours at the ATF Reading Room, Office of Public Liaison and Information, Room 6480, 650 Massachusetts Avenue, NW., Washington, DC 20226.

FOR FURTHER INFORMATION CONTACT: Joyce Drake, Regulations Division, Bureau of Alcohol, Tobacco and Firearms, 650 Massachusetts Avenue, NW., Washington, DC 20226 (202) 927–8210.

SUPPLEMENTARY INFORMATION:

Background

On August 23, 1978, ATF published Treasury Decision ATF–53 (43 FR 37672–54624), which revised regulations in 27 CFR part 4 to allow the establishment of definitive viticultural areas. The regulations allow the name of an approved viticultural area to be used as an appellation of origin on wine labels and in wine advertisements. On October 2, 1979, ATF published Treasury Decision ATF–60 (44 FR 56692) which added a new part 9 to 27 CFR, for the listing of approved American viticultural areas, the names of which may be used as appellations of origin.

Section 4.25a(e)(1), Title 27, CFR, defines an American viticultural area as a delimited grape-growing region distinguishable by geographic features, the boundaries of which are delineated in subpart C of part 9.

Section 4.25a(e)(2), outlines the procedure for proposing an American viticultural area. Any interested person may petition ATF to establish a grape-growing region as a viticultural area.

The petition to expand a current viticultural area should include:

(a) Historical or current evidence that the boundaries of the viticultural area to be expanded are as specified in the petition;

(b) Evidence relating to the geographical characteristics (climate,