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March 25, 2015

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Systems for Holding Consumer and Privately Negotiated Loans in Registered Form to Qualify for the Portfolio Interest Exemption

Dear Messrs. Mazur, Koskinen and Wilkins:

Under current law, the portfolio interest exemption applies only to debt in registered form. Certain important categories of debt, including home mortgages and other consumer debt and privately negotiated loans, are not required to be in registered form and often are not. A longstanding regulation, Treasury Regulation section 1.163-5T(d), allows investors to meet the registration requirement for these categories of debt by holding them through an entity that issues "pass-through certificates" in registered form. Unfortunately, the regulations are ambiguous in one important respect and thus somewhat uncertain in scope. This letter asks the IRS and Treasury to issue guidance resolving the ambiguity.[1]

The requested guidance would be consistent with a recent private letter ruling, 201504004 (October 3, 2014) ("2014 PLR"), but, unlike the ruling, would be in a form that can be relied upon by taxpayers. We believe the issue resolved in the ruling is one that is faced by many taxpayers and is thus commercially significant. Issuing guidance that can be relied on by taxpayers will limit the need for other taxpayers to seek similar private letter rulings, using up scarce IRS and taxpayer resources.

A similar recommendation for clarifying the definition of pass-through certificate was made by the Tax Section in 2002 in a report proposing a number of law changes and clarifications relating to securitizations.[2]

This letter also proposes that an alternative mechanism be adopted that would allow consumer and privately negotiated loans (more precisely, debt instruments that are not registration-required obligations) to be treated as obligations in registered form for periods in which they are held through a book entry system, regardless of whether that system is set up by investors, third parties, or the issuer or its agents.

Background. Since the enactment of TEFRA in 1982, the Code has effectively required that certain debt instruments (defined in section 163(f)(2) as "registration-required obligations") be issued in registered form. The purpose of registration was to establish a record of ownership to promote tax compliance. A failure to register when required can result in various tax penalties, including the imposition of an excise tax on the debt issuer.[3] There is a technical definition of "registered form" described below. Debt that does not meet the definition is said to be in bearer form, even though often it may in fact be assignable only by a transfer document executed by the assignor and not by the mere delivery of a piece of paper.[4]

Under section 163(f)(2)(A) as enacted in 1982, debt was not a registration-required obligation (and thus could continue to be issued in bearer form) if it was issued by natural persons, not of a type offered to the public, short-term, or targeted to foreign investors upon issuance. The foreign targeting exception (found in section 163(f)(2)(B)) was sometimes

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1 The principal drafter of this letter was James M. Peaslee. It also reflects comments from S. Douglas Borisky, Peter J. Connors, Michael S. Farber, Erika W. Nijenhuis, David S. Miller, and David R. Sicular.

2 "Report on Securitization Reform Measures," December 20, 2002 ("2002 Report"). The 2002 Report was reprinted as a special supplement to the February 10, 2003 issue of *Tax Notes*. For convenience, the part of the 2002 Report dealing with pass-through certificates and the portfolio interest exemption is attached to this letter.

3 The sanctions include denying interest deductions (section 163(f)(1)), denying loss deductions (section 165(j)(1)), converting capital gains into ordinary income (section 1287), and the imposition of an excise tax on issuers (section 4701).

4 For example, debt that is payable to the order of a named lender would be in bearer form for TEFRA purposes even if a transfer between holders would ordinarily be accomplished by having the lender execute a transfer document without requiring, for the transfer to be legally effective, that notice be given to the borrower or its agent.

referred to as the "Eurobond Exception." Under the first two of these exceptions, home mortgages and other consumer debt, and privately negotiated loans, could continue to be issued after TEFRA in bearer form (meaning again, not in registered form under the TEFRA definition).[5] The definition of registration-required obligation is the same today, except that the Eurobond Exception was repealed in 2010.

In 1984, the portfolio interest exemption was added to the Code to provide a broad statutory exemption for debt held by foreign investors unrelated to the debtor from the 30 percent withholding tax that generally applies to domestic-source interest paid to foreign investors. The portfolio interest exemption applied to interest on debt in registered form only if, generally, the beneficial owner of the interest certified its identity to the withholding agent or an intermediary with reporting obligations to the IRS, typically on some version of IRS Form W-8.[6] Such certification was not required, however, for bearer-form debt issued under the Eurobond Exception. The Eurobond Exception was repealed in 2010. Accordingly, under current law, the portfolio interest exemption is limited to debt in registered form for which certifications of beneficial ownership are obtained.

The registration requirement for interest to qualify as portfolio interest poses a problem for foreign investors investing in home mortgages, other consumer loans or privately negotiated loans of U.S. borrowers. Even though the debt is not required to be issued in registered form under TEFRA and therefore often is not in registered form, the portfolio interest exemption applies only if it is in registered form. The lack of registration may not be an issue for the first holder of the debt, particularly if it is a U.S. person, but becomes an issue upon a secondary market sale to foreign investors (or partnerships with foreign partners). The problem could in theory be solved by going back to the borrower and negotiating amendments that would convert the debt to registered form, but often negotiating such changes is impractical or even virtually impossible. For example, an investor who buys a pool of 100 home mortgages could not practically change the loan form on which the mortgages were written. A purchaser of privately negotiated loans (and particularly a partial interest in such a loan) may have no leverage to get a borrower to agree to an amendment.

Under current law, as discussed below, Treasury Regulation section 1.163-5T(d) provides that if debt that is not in registered form is held by a trust that issues "pass-through certificates" representing interests in the trust, and the certificates are in registered form, then interest on the debt paid through on the certificates is considered paid on obligations in registered form so that the portfolio interest exemption can apply. The 2014 PLR, following earlier private letter rulings, resolves an ambiguity in the language of the regulations by allowing pass-through certificates to be issued in an arrangement that does not qualify for tax purposes as a grantor trust.

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5 In this letter, obligations that are not of a type offered to the public are sometimes referred to as "privately negotiated loans".

6 See sections 871(h)(2)(B)(ii) and (h)(5).

The balance of this letter will describe the definition of registered-form debt and rules for pass-through certificates, the 2014 PLR, issues to consider in issuing further guidance, and our recommendations.

Registered Form Definition. The Code does not generally define the term "registered form" although it does specifically allow registration to be effected through a book entry system.[7]

Under Treasury Regulation section 5f.103-1(c)(1), an obligation is considered to be in registered form if it meets certain procedures; specifically, if the obligation may be transferred only (1) by surrender of the old obligation and its reissuance to a new holder, or (2) through a book entry system that provides a record of ownership, or (3) a combination of these two methods. The regulations refer to a "holder" and "ownership" but not to a "beneficial owner" or "beneficial ownership". The regulations generally require that the issuer of the obligation or its agent maintain the bond register or book entry system, and that an obligation not be capable of being converted at any time over its life from registered to bearer form.[8]

In recognition of the practice of securitizing home mortgages and other consumer receivables by combining them in fixed pools, having those pools be held by a trust, and then having the trust issue transferable certificates representing partial interests in the trust assets, Treasury Regulation section 1.163-5T(d) has long had a rule that effectively treats "pass-through certificates" representing interests in pools of loans as if the certificates were themselves interest bearing debt obligations to which the TEFRA registration rules apply.[9] Thus, a pass-through certificate is considered to be a registration-required obligation if, standing alone, it meets the definition of that term in section 163(f)(2)(A) (meaning generally that it would be registration required if it were of a type offered to the public).[10] Following that same theme, regulations under section 871 treat interest paid on "pass-through certificates" as interest paid on obligations in registered form for purposes of applying the portfolio interest exemption as long as the certificates are in registered form (even if the underlying obligations are not).[11] As a result, interest paid on pass-through certificates issued by a trust holding mortgages or other loans in bearer form can qualify for the portfolio interest exemption (assuming the other requirements of the exemption are met).

7 See section 163(f)(3), which relies in part on a cross-reference to section 149(a)(3).

8 As discussed below, Notice 2012-20 modifies this definition in some respects.

9 The use of pass-through certificates to securitize home mortgages and other debt instruments is described in the 2002 Report.

10 See Treasury Regulation section 1.163-5T(d)(1). Trust interests could not, of course, fall within the exception to the definition of registration-required obligation for obligations of natural persons. Treasury Regulation section 1.163-5T(d)(6) has an example involving mortgage pass-through certificates that are sold by a bank in a public offering. Not surprisingly, the example states that the certificates are of a type offered to the public and registration-required obligations (without regard to the fact that the underling obligations are home mortgages).

11 Treasury Regulation section 1.871-14(d)(1).

A pass-through certificate is defined in Treasury Regulation section 1.163-5T(d)(1) as a "pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under Subpart E of Subchapter J of the Code [i.e., the grantor trust rules of section 671-679] is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust)." The same definition should apply for purposes of the regulations under section 871.[12]

As pointed out in the 2002 Report, the definition of pass-through certificate is ambiguous. Specifically, in the phrase "similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust", there is some doubt whether "treated as a grantor trust" was intended to modify "similar pooled fund" in addition to "pooled trust". The language could plausibly be read to require that the issuer of a pass-through certificate always be classified as a trust that is taxed as a grantor trust, but the language is not a model of clarity.[13]

Under Treasury Regulation section 301.7701-4(c), an investment trust (which would include any trust holding debt instruments to benefit investors who invested their own funds in the trust) is classified as a trust only if there are no management powers (under the regulations, no "power to vary" the investment of certificate holders) and the trust does not have multiple classes (with some limited exceptions).

The 2002 Report recommended that the definition of pass-through certificate in the section 163 regulations be changed to delete the requirement that a similar pooled fund or trust be a grantor trust. The rationale for the change was that as long as obligations were held through an arrangement meeting the section 5f.103-1(c)(1) procedures, it should not matter as a policy matter if the arrangement was classified as a grantor trust or a business entity. The 2002 Report also recommended that the regulations under section 871 be amended to confirm expressly that the section 163 definition of pass-through certificate was controlling in applying the portfolio interest exemption. These recommended changes in the regulations have not been made.

The excise tax imposed by section 4701 applies to issuers of registration-required obligations that are issued in bearer form. The pass-through certificate regulations under section 163 have special rules treating a sponsor receiving the proceeds of issuance of pass-through certificates as the issuer to which the excise tax would apply if certificates that are registration required are sold in bearer form, and otherwise grant to the IRS the power to recharacterize arrangements involving trusts in accordance with their substance so as to carry out the purposes

[12] Although Treasury Regulation section 1.871-14(d)(1) uses the term "pass-through certificate" without defining it, almost certainly the definition in the section 163 regulations was intended to be controlling. See the 2002 Report, footnote 49. See also section 871(h)(7), which states that the term "registered form" as used in section 871(h) has the same meaning as under section 163(f). Treasury Regulation section 1.871-14(d)(1) refers in one place to payments to the holder of a pass-through certificate from "the trustee of the pass-through trust", which could indicate an understanding that the issuer of pass-through certificates must be a trust, but the regulation also refers to a "fund" as a potential issuer of pass-through certificates.

[13] The reference to "pass-through or participation certificates" is a further source of uncertainty, because loan participations are typically treated as co-ownership arrangements, not trusts.

of the TEFRA rules.[14] Thus, it is clear that a pass-through certificate that is of a type offered to the public cannot be issued in bearer form and comply with TEFRA.

Since 2002, there have been three changes in the Code that are worth noting, all occurring in 2010. First, the Eurobond Exception was repealed. Under that exception, investors were not required to provide IRS Form W-8s, or otherwise to identify themselves, to receive payments free of withholding tax (including backup withholding tax). Accordingly, under current law, benefitting from the portfolio interest exemption on an obligation always requires tax-related certifications as to beneficial ownership of the obligation.

Second, the rule treating debt as being in registered form if it is held through a book entry system was expanded to include not only a book entry system as defined in section 149(a)(3) (prior law) but also "a dematerialized book entry system or other book entry system specified by the Secretary".[15] A notice partly implementing this change is discussed further below.

Finally, FATCA was adopted. The requirement that debt be issued in registered form represented an attempt to curb tax avoidance by U.S. taxpayers by requiring that there be some record of ownership. FATCA, to put it mildly, is a far more potent mechanism to prevent U.S. taxpayers from avoiding tax by receiving income anonymously through foreign accounts and entities.

In March 2012, the IRS issued Notice 2012-20 interpreting, at least in part, the "dematerialized book entry system or other book entry system" language added in 2010. The Notice addresses debt instruments that are registration required (so not obligations of individuals or privately negotiated loans). The Notice broadens the circumstances in which debt held through a clearing organization may be treated as in registered form, by providing that an obligation will be considered to be in registered form if it is issued (1) without a physical instrument through a "dematerialized book entry system" in which beneficial interests are transferable only through a book entry system maintained by a clearing organization (or its agent) or (2) with a physical instrument that is "effectively immobilized" in a clearing system. The Notice cross-references only a portion of the definition of "book entry system" described above, indicating that the book entry system referred to in the Notice is *not* required to be maintained by the issuer or its agent. An obligation is treated as effectively immobilized if (1) it is represented by a global security that is issued to and held by a clearing organization (or its agent), for the benefit of purchasers of interests in the obligation, under arrangements that prohibit the transfer of the global securities except to a successor clearing organization; and (2) beneficial interests in the underlying obligation are transferable only through the clearing organization's book entry system. Physical securities in bearer form can be issuable in narrow circumstances (termination of the clearing organization's business without a successor, issuer

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14 Treasury Regulation sections 1.163-5T(d)(3) and (4).

15 Section 163(f)(3). The Tax Section submitted a report on the new book entry definition in December 2011, "Report on Registered Debt Following the HIRE Act," December 15, 2011, reproduced at 2011 Tax Notes Today 242-23 (December 15, 2011).

default, or issuer request upon a change in tax law that would be adverse to the issuer but for the issuance of physical bearer securities) without adversely affecting the treatment of the global security as a registered form obligation. Thus, the Notice creates at least some exceptions to both the rule requiring that a book entry system be maintained by the issuer or its agent and the rule treating debt as being in bearer form if it may at any time in the future be converted into bearer form.

2014 PLR. The facts of the 2014 PLR involve a conventional investment fund structure with a manager and domestic and foreign investors. A "Master Fund" organized as a state-law limited partnership is managed by a general partner, and receives equity contributions from a domestic partnership U.S. feeder fund and a foreign feeder fund (organized as a foreign corporation), as well as from the general partner. Master Fund wishes to invest in "scratch & dent" commercial mortgage loans ("S&D Loans") which are *not* in registered form within the meaning of section 5f.103-1(c). S&D Loans suffer from various "incurable" defects such as higher loan-to-value ratios or debt service coverage or missed payments. In other words, they have a low credit quality. The taxpayer represented that Master Fund and the foreign feeder would be operated so as to not be engaged in a U.S. trade or business.

Taxpayer represented that interests in Master Fund would be transferable pursuant to the procedures described in section 5f.103-1(c)(1), so that those interests would be in registered form if they were debt. Taxpayer also represented that Master Fund has no trustees, will be managed by the general partner, and has a profit-making activity as one of its purposes.

Master Fund will acquire beneficial interests in S&D Loans and contribute them to a domestic statutory trust ("Trust"). Trust will hire independent parties to service the loans, and the servicers will be expected to negotiate changes in payment terms that will be significant modifications (deemed exchanges under section 1001). Also, Trust may acquire new loans over time (through reinvestments of Trust assets as well as contributions). As a result, taxpayer represented that Trust would have a power to vary its investments, and would therefore not be classified as a trust. Instead it would be a disregarded entity owned by Master Fund.[16]

The 2014 PLR refers to the rule treating pass-through certificates as obligations in registered form if the certificates are in registered form even if the underlying obligations are not. It states that neither Trust nor Master Fund is a grantor trust, but section 1.163-5T(d)(1) does not specify what type of arrangements may qualify as similar pooled funds. The ruling concludes that the interests in Trust and Master Fund "each are similar evidences of interest in a similar pooled fund with the meaning of section 1.163-5T(d)(1), and that if the requirements of section 5f.103-1(c)(1) are satisfied, the interests in Trust and Master Fund will be considered obligations in registered form."

[16] The 2014 PLR does not state expressly that all interests in Trust will be owned by Master Fund, but describes Trust as a disregarded entity.

The ruling cautions that no opinion is expressed or implied regarding whether any payment of interest on the interests in Trust and Master Fund will qualify as portfolio interest. [17] Likely, however, the taxpayer got the ruling to ensure that the registered form requirement of the portfolio interest definition would be met.

Discussion and Recommendations. The 2014 PLR clearly reads "treated as a grantor trust" in the phrase "similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust" to modify "pooled trust" and not "similar pooled fund". As indicated in the 2002 Report, we agree with that reading as a policy matter, but is it certainly not compelled by the language of the regulation. Accordingly, a taxpayer relying on the reasoning and holding of the 2014 PLR is taking a risk that the IRS will change its mind. The stakes are very high, namely the potential imposition of a 30 percent withholding tax on interest paid to foreign investors.

We have two recommendations. Our first, and narrower, recommendation is that the IRS and Treasury issue some form of guidance consistent with the 2014 PLR in a form that can be relied upon by taxpayers. Our second, more ambitious suggestion is that the government use its power to define a book entry system to give investors an alternative means to hold obligations that are not registration-required in registered form.

The first recommendation could be implemented by modifying the regulations defining pass-through certificates along the lines described in the 2002 Report. Alternatively the guidance could be provided through a revenue ruling or notice.

In implementing the narrow recommendation, it would be helpful to clarify one somewhat confusing feature of the 2014 PLR, which is the fact that interests in Master Fund were in registered form. It is not clear how much weight was given to the registered status of those interests.[18] The rules for pass-through certificates (and more generally the regulations determining when debt is in registered form) address principally transfers of direct interests in certificates and obligations and not indirect transfers. It does not seem to us to make much sense to impose such a requirement unless it is extended up through all ownership chains to the ultimate foreign taxpayer, and we note that there has never been such a requirement for an obligation to be in registered form.[19] For that reason, the requirement of registration, while

[17] The cautionary statement may have been required to uphold the principle that the Associate Chief Counsel (International) will not "ordinarily" rule on whether a payment constitutes portfolio interest under section 871(h) or whether an obligation qualifies for any of the components of portfolio interest such as being in registered form. See section 4.01(5) of Revenue Procedure 2015-7, 2015-1 I.R.B. 231.

[18] While speculative, perhaps the Master Fund interests were in registered form to address the argument that because the Trust was generally a "disregarded entity", the pass-through certificates were properly considered issued only at the level of the Master Fund. Of course grantor trusts are also disregarded for substantive tax purposes, so this may not be a good reason to apply the registration requirements to Master Fund interests as well as Trust interests.

[19] For example, one common arrangement for holding publicly traded debt is for the issuer to deliver a global certificate in registered form to a custodian, which then maintains a book entry system for recording interests in

better than nothing, is, and has always been, a highly imperfect way of identifying the tax owners of debt instruments.

The concern over indirect transfers may also be addressed, at least in abuse cases, by the excise tax in section 4701.[20] Any guidance could refer to the excise tax and leave that as the policeman.

Our broader recommendation is that the Service and Treasury create a more straightforward mechanism that would allow investors owning debt instruments in bearer form that are not registration-required obligations to treat the instruments as being in registered form. For example, a rule could provide that such a debt instrument is owned through a qualifying book entry system and accordingly is considered in registered form for any period in which it is held through a system that maintains a record of direct ownership and ensures that Form W-8s or W-9s are collected from owners of interests in the instrument, whether or not the debt instrument is part of a pool that is similar to a pool of mortgages.[21]

Under our recommendation, it would not be necessary to establish that the underlying debt is locked up in the arrangement over its life. In that way, the mechanism would differ from the current definition of registered form in Treasury Regulation section 5f.103-1(c)(1). However, importantly, it would only be available for debt obligations that are not registration required. We believe the authority to define a book entry system would be broad enough to encompass the mechanism we propose.[22] Interest on an obligation would qualify for the portfolio interest exemption only for periods in which it is held through the proposed book entry system. If an obligation were removed from the system, it would return to the state it was in before being held through the system. Thus, the portfolio interest exemption would no longer apply and the instrument could continue to be held in bearer form without tax sanctions.

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the debt. The registration requirement is met because the physical certificate is in registered form, not because of the book entry system, which is not maintained by the issuer or its agent. (Under Notice 2012-20, described in the text above, the registration requirement also will be met in some circumstances even if the physical certificate is in bearer form.) The parties who own debt through the book entry system are likely to be financial institutions which hold securities in customer accounts. The way information in those accounts gets back to the issuer or withholding agent has nothing to do with the mechanism for creating registered form debt.

[20] See the rule discussed at footnote 14, above, treating the sponsor of pass-through certificates as the issuer for purposes of the excise tax. While section 4701 does not apply to the underlying assets in this case, because they are not registration-required, it would apply to the pass-through certificates if they were of a type offered to the public.

[21] The recommendation would not treat interests in the debt instrument created through the book entry system as separate obligations (akin to pass-through certificates) but would instead allow the debt to be treated as being in registered form for purposes of TEFRA and the portfolio interest exemption for the period in which the book entry system exists. We do not think a special definition of registered form could be adopted just for purposes of the portfolio interest exemption in light of section 871(h)(7).

[22] Section 163(f)(3) treats as a qualifying book entry system that meets the registration requirement "a dematerialized book entry system or other book entry system specified by the Secretary." Thus the grant of authority is very broad.

We are not in this letter addressing whether Congress (or for that matter the IRS) has drawn the right line in defining what types of debt instruments should be registration required. However, once that line has been drawn, there is no apparent policy reason why the TEFRA rules should apply differently to a debt instrument because interest thereon has for a period qualified for the portfolio interest exemption (and was tracked for that period through the delivery of ownership certificates as required by the exemption).

The proposed mechanism would apply to a single loan. The IRS has issued a private letter ruling that applied the definition of pass-through certificate to a participation interest in a single loan (where the participation interest is in registered form).[23] From a policy perspective, we agree with that conclusion, but it is a result that is very difficult to reach under a literal reading of the current definition of pass-through certificate, which refers to an interest in a pool of mortgage loans held through a grantor trust or a similar pooled fund or trust. Taxpayers should have an ability to hold single debt instruments that are not registration required in a manner that will allow the portfolio interest exemption to apply without going back to the issuer and amending the underlying loan documents.

It can be argued that the requirement of a pooled fund or pooled trust in the current pass-through certificate rules is appropriate to ensure that there is a qualitative difference between the pass-through certificates and ownership of the underlying loans. However, the definition of pass-through certificate simply does not impose that requirement.[24] For example, the definition does not require that pass-through certificates be guaranteed by a third party or have multiple owners. If a single person owns all of the interests in a trust holding debt instruments (which are the facts of the 2014 PLR), the existence of the trust may not materially change the character of the underlying obligations. Further, the existence of a pool would not seem to have anything to do with the goal of maintaining a record of ownership. The mechanism for creating a record does or does not work just as effectively for one loan as for a pool.

The Code clearly requires that a debt instrument be in registered form in order for it to qualify as portfolio interest, so absent a statutory change, the test must be met. That said, allowing taxpayers the flexibility we propose to treat consumer and private placement loans as being in registered form would not frustrate the purposes of the registration requirement.

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[23] P.L.R. 9548018 (June 30 1995), which includes the following: “The regulations do not specify what type of arrangements may qualify as similar pooled funds other than pooled trusts, nor do they indicate whether an arrangement may qualify that consists of a single loan pool. Based on all of the Taxpayer's circumstances and representations, it is held that section 35a.9999-5 Q and A 21 will not fail to apply to Taxpayer's participations because the participations are not trust certificates or because the participations evidence interests in pools consisting of a single loan.”

[24] As indicated above, an example showing how the TEFRA rules apply to pass-through certificates involves a trust issuing certificates that are publicly offered. See Treasury Regulation section 1.163-5T(d)(6). However, this example may be simply illustrating the principle that pass-through certificates that are publicly offered are registration required (of a type offered to the public), without saying that all pass-through certificates must be of that type.

The goal of establishing a record of ownership to limit tax avoidance is an important one. The goal is effectively served under current law by the need for certifications as to beneficial ownership to qualify for the portfolio interest exemption and by FATCA. By contrast, the ownership records kept in a bond registry or book entry system add very little to the certification and FATCA regimes. Typically at least for traded debt, there are intermediaries between the issuer or its agent maintaining the ownership records and the beneficial owners. Also, the records that serve to meet the registration requirement are not made available routinely to the IRS, and as indicated above, are not needed given other information gathering tools. Further, designing a system to allow debt to be held in registered form to meet the requirements of the portfolio interest exemption raises different policy issues under TEFRA where the debt is consumer debt and privately placed loans—debt that is not registration required—than where the debt is publicly traded or sold in a publicly traded form and required under TEFRA to be in registered form. Specifically, the need for an airtight system to ensure that debt is locked up in registered form over its entire life rather than for the period in which the portfolio interest exemption is claimed is surely less where the debt is not registration required and is privately held.

We appreciate your consideration of our recommendations.

Respectfully submitted,

David R. Sicular
Chair

Attachment (Excerpt from 2002 Securitization Reform Report)

CCs:

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SPECIAL REPORT

TAX ANALYSTS

SECURITIZATION REFORM MEASURES

By the New York State Bar Association Tax Section

This report was prepared by the New York State Bar Association Tax Section's Committee on Securitizations and Structured Finance, which is a new standing committee of the Tax Section. James M. Peaslee was the principal author and editor. Charles Adelman, Colman Burke, Ayano Kato, Bruce Kayle, Robert Kreitman, Tom Lyden, David C. Miller, David Z. Nirenberg, Peter Ritter, and Paul Wysocki contributed to the report. Comments were received from Linda M. Beale, Kimberly S. Blanchard, Micah Bloomfield, Samuel J. Dimon, Maxim Kulikov, Michael L. Schler, Janine Shissler, and Willard Taylor.

The report recommends that the IRS and Treasury issue rulings or regulations in a number of tax law areas as an alternative to further implementing the FASIT rules (sections 860H through 860L) and with a view to an eventual repeal of the FASIT sections.

The specific recommendations (16 in all) are summarized in Part III of the report. The recommendations fall into the following areas: withholding tax rules for interest income and swap payments under sections 871, 881, 1441, and 1442; the definition of a financial business in section 7704(d)(2); the definition of a trade or business under section 864 (specifically relating to the securities trading safe harbor in section 864(b)(2)(A)(ii)); the status of certificates issued by a credit card securitization trust as debt or equity; and the REMIC and taxable mortgage pool (TMP) regulations. The report also includes recommendations on tax reporting by fixed investment trusts that are foreign trusts (which is relevant to pending proposed regulations under section 671 on reporting by widely held fixed investment trusts).

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D. Portfolio Interest and Partnerships

1. Consumer receivables. Generally, interest paid to foreign persons is exempt from U.S. withholding tax if the interest is portfolio interest.[45] To qualify for the exemption, among other requirements, the interest must be "paid on an obligation" that (1) is in "registered form" as defined in Treasury regulation section 5f.103-1(c), or (2) is not in registered form but meets the "foreign targeting" requirements of section 163(f)(2)(B).[46]

Most consumer loans and receivables are not in registered form and do not meet the foreign targeting requirements.[47] Accordingly, interest on these obligations generally would not qualify as portfolio interest. Where the obligation is held by a grantor trust, however, the portfolio interest exemption may nonetheless be available under Treasury regulation section 1.871-14(d). This regulation provides in effect that interest paid on a passthrough certificate qualifies as portfolio interest if the certificate itself meets the registration or foreign targeting requirements regardless of whether any obligation held by the related fund or trust meets those requirements. Treasury regulation section 1.871-14(d) does not define the term "passthrough certificate," but it likely has the same meaning as in temporary Treasury regulation section 1.163-5T(d). This regulation applies the TEFRA registration requirements to passthrough certificates rather than to the underlying trust assets.[48] A passthrough certificate is defined for this purpose as a "passthrough or participation certificate evidencing an interest in a pool of mortgage loans [taxed as a grantor trust] (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust)."[49]

[45]*See* sections 871(h)(1) and 881(c)(1).

[46]*See* sections 871(h)(2) and 881(c)(2).

[47]Consumer loans are not "registration required obligations" subject to the TEFRA requirements because they are either issued by a natural person or not of a type offered to the public. *See* section 162(f)(2)(A).

[48]The regulation was likely inspired by a statement in the legislative history of the Tax Reform Act of 1984. The Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), page 396, footnote 19, states that, "in determining whether an interest in certain intermediate investment entities, such as mortgage passthrough trusts, is registration-required under TEFRA, it is the nature of the interest itself that is relevant; if the interest is liquid and actively traded, it would pose compliance problems were it not registration-required."

[49]Treasury regulation section 1.871-14 is effective January 1, 2001. The prior version of the portfolio interest regulations included an explicit cross-reference to the definition of passthrough certificate in the section 163 regulations. *See* Treasury regulation section 35a.9999-5(e), Q&A 21 (in effect before January 1, 2001). Although this cross-reference is not included in the current version of the portfolio interest regulations, the preamble to those regulations indicates that they were not intended to differ substantively from the prior version. *See* Treasury Decision 8734, 1997-2 C.B. 109, 111.

It is not always clear what types of arrangements may qualify as passthrough certificates.[50] However, under a literal reading of the quoted definition, if a certificate issuer were classified as a partnership rather than a grantor trust, interest payments on consumer obligations passed through to its partners may not qualify as portfolio interest.[51]

As a policy matter, we see no reason why a sharp distinction should be drawn between interest paid on a pool of receivables held by a partnership and one held through a grantor trust. In either case, interest allocated to an owner should be able to qualify for the portfolio interest exemption if the interest is allocated to an owner whose equity interest is in registered form or foreign targeted.[52] Indeed, partnership interests are subject to more extensive reporting than debt obligations, including a requirement under temporary Treasury regulation section 1.6031(c)-1T that nominees holding partnership interests on behalf of a beneficial owner identify the owner to the partnership.

To conform the treatment of partnerships to grantor trusts, we recommend that the definition of

[50]In LTR 9548018, *95 TNT 235-40* (December 1, 1995), the Service held that interests in a pool of loans that were identified and segregated on the books of the taxpayer (but not placed in a separate trust) could qualify as passthrough certificates for purposes of the portfolio interest rules. The loans were grouped together to create a pool and participants could purchase participations in each pool. The interest and principal payments were essentially passed through based on each participant's participation percentage in the pool. The participation interests were without recourse to the taxpayer. The taxpayer continued as the owner of record and servicer of the loans and was responsible for monitoring the borrower's compliance and effecting available remedies (at the taxpayer's discretion) where there was an event of default. This fact pattern illustrates an arrangement that is a "similar pooled fund," but provides no guidance generally about what arrangements may qualify.

[51]The reference to "similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust" is ambiguous in that it is not clear if "treated as a grantor trust" modifies "pooled fund" as well as "pooled trust."

[52]Our proposal would apply the rule where partnership interests are either in registered form or in bearer form but foreign targeted. It is, of course, highly unusual to issue conventional partnership interests in bearer form, but the fact pattern could arise in a securitization setting where a class of securities that are intended to be debt and are foreign targeted are recharacterized as equity. To keep the proposal in context, it would apply only to partnerships consisting of pools of debt instruments and then would be relevant only in applying the TEFRA registration rules and the portfolio interest exemption. It would not otherwise affect partnership reporting obligations. The portfolio interest exemption would be relevant only to partnerships that were earning interest income and were not engaged in a U.S. trade or business (so that the income was not ECI subject to withholding under section 1446). While we believe it would be appropriate for the portfolio interest exemption to apply to income allocated to partnership interests that are foreign targeted and in bearer form as well as to those in registered form, if the IRS disagrees, a rule that applies only to partnership interests in registered form would still be desirable.

passthrough certificate in temporary Treasury regulation section 1.163-5T(d) be amended to read as follows:

> A passthrough or participation certificate evidencing an interest in a pool of mortgage loans which under Subpart E of Subchapter J of the code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar fund or trust holding a pool of mortgage loans or other secured or unsecured debt obligations and related assets, whether or not the composition of the pool may change over time) is considered a 'registration-required obligation' [rest of sentence as in original].

This definition differs from the original by deleting the requirement that the similar pooled fund or trust be a grantor trust and clarifying that a trust or pool may have a revolving feature and still be considered similar. The definition also states explicitly that the rule extends to pools of debt obligations other than mortgage loans (a conclusion we believe is implicit in the existing regulation). We also recommend that Treasury regulation section 1.871-14 be amended to include a cross reference to the temporary regulation under section 163 (or a successor) for the definition of passthrough certificate. Alternatively, the definition could be inserted directly into Treasury regulation section 1.871-14.

2. Partnership guaranteed payments. Some questions exist regarding the application of the portfolio interest exemption for "guaranteed payments" paid by a partnership to a foreign partner. Guaranteed payments are payments to a partner for services or the use of capital, if those payments are not dependent on the partnership's income.[53] Payments of income on a class of securities issued by a securitization vehicle may be guaranteed payments because, while they are very likely to be paid out of interest income or swap income, there may be no explicit limitation based on the net income of the issuer. This result is particularly likely for a class of securities that is intended to be debt but is recharacterized as equity for tax purposes.

Some question exists regarding the application of the portfolio interest exemption for 'guaranteed payments' paid by a partnership to a foreign partner.

Logically, guaranteed payments made to non-U.S. persons for the use of capital could be treated in one of three ways: as interest paid by the partnership,[54] as a distributive share of partnership ordinary income, or as an item of ordinary income that is neither interest nor a distributive share of partnership income.[55] The treatment of a payment as a distributive share of income would necessarily be limited to a payment that does not exceed the partnership income available to be allocated to it. A guaranteed payment treated as interest paid by the partnership would be eligible for the portfolio interest exemption so long as the partnership interest was in registered form or was foreign targeted and otherwise met the requirements of the exemption. A distributive share of income would be eligible for the portfolio interest exemption to the extent that the underlying income would qualify.[56] Undifferentiated ordinary income could be characterized as U.S.-source fixed or determinable annual or periodical (FDAP) income that would be subject to the 30 percent withholding tax.[57]

The difficulty in characterizing guaranteed payments stems from the statute itself. Section 707(c) states that a guaranteed payment is considered as made to one who is not a member of the partnership, "but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)." This language implies a guaranteed payment could be treated as a distributive share of partnership income except to the extent doing so is inconsistent with treatment of the payment as an item of ordinary income. Regulations under section 707(c) generally confirm this view. They state that guaranteed payments are considered made to a nonpartner for purposes of sections 61 and 162. The regulations state that the reference to section 162 does not affect the deductibility of guaranteed payments made to a retiring partner under section 736(a)(2) and such payments are not a profit share for purposes of various subchapter K provisions. "For the purposes of other provisions of the internal revenue laws," the regulations continue, "guaranteed payments are regarded as a partner's distributive share of ordinary income."

Some authorities relating to guaranteed payments for the use of capital support a look-through approach.[58] On the other hand, the *Miller* case[59] applies an entity theory (characterizing a payment as if made to an nonpartner) in determining the source of a guaranteed payment made to a law firm partner for

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[53] Section 707(c).

[54] *See* GCM 36702 (April 12, 1976) (guaranteed payments made by a partnership to a real estate investment trust were characterized as interest income).

[55] *See* Sheldon I. Banoff, "Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K," 70 *Taxes* 820 (December 1992) (discusses all three possibilities).

[56] *See* the discussion in Part IV.D.1, above, regarding TEFRA registration requirements.

[57] Treasury regulation section 1.1441-2(b) treats all income as FDAP with carveouts not relevant here.

[58] *See* LTR 8728033 (April 13, 1987) (guaranteed payments made by a partnership to a real estate investment trust retained the character of the partnership's underlying income and were therefore rental income in the hands of the recipient) and LTR 8639035 (June 27, 1986) (same); GCM 34141 (June 25, 1969) (guaranteed payments from royalty income eligible for percentage depletion).

[59] *Andrew O. Miller v. Comm'r*, 52 T.C. 752 (1969). *See also* *Carey v. United States*, 427 F.2d 763 (Ct. Cl. 1970).

purposes of applying the foreign-source earned income exclusion in section 911. The case indicates that the choice between entity treatment and an aggregate approach (looking through to the character of underlying items) may depend on the purpose of the substantive tax provision under consideration. The court examines the purposes of section 911 (promoting foreign trade by removing tax barriers to U.S. citizens working abroad) and concludes that those purposes would be best carried out by applying the exemption to a guaranteed payment made to a partner in the same manner as if he were receiving compensation as an employee.

We believe that look-through treatment is appropriate in applying withholding tax rules to a securitization vehicle that is classified as a partnership. Such a vehicle is largely passive and it does not seem appropriate to impose a withholding tax on payments made to non-U.S. investors where the source of those payments is a type of gross income that is not subject to withholding tax (interest eligible for the portfolio interest exemption and swap income). Recently adopted regulations under section 1441 appear to adopt a look-through approach for withholding taxes, but the language is not clear.[60]

A harder case is one in which a guaranteed payment for any tax year exceeds the ordinary income for that year allocable to the payment. That excess amount must be considered made from partnership capital (including any capital gains allocable to other partners). We believe that in the setting of a securitization vehicle, income from capital that is not paid out of partnership earnings and is effectively guaranteed by the other partners is closely analogous to interest and should be regarded as interest for withholding tax purposes. Adding this second rule would avoid the need to consider closely how ordinary income is allocated among various classes of partnership interests. If, however, the IRS is not willing to take this step, we recommend at least that the status of guaranteed payments be clarified to the extent they are payable out of ordinary income. To implement these proposals, we suggest that a regulation be adopted as follows:

> For purposes of applying sections 871, 881, 1441, and 1442 to a passthrough certificate as defined in section 1.163-5T(d),[61] a payment described in section 707(c) made to a partner for the use of capital shall be treated as a distributive share of partnership ordinary income to the extent the guaranteed payment is deductible from the partnership ordinary income allocable to other partners, and otherwise shall be treated as interest paid by the partnership.

Any amount treated as interest payable by the partnership would qualify for the portfolio interest exemption only if paid to a person that is not considered to own a 10 percent or greater interest in the partnership's capital or profits.[62]

3. Interest received by a 10 percent shareholder. Sections 871(h)(3)(A) and 881(c)(3)(B) both provide that the portfolio interest exemption does not apply to interest "received" by any "person" who is a "10 percent shareholder." In the case of an obligation issued by a corporation, a 10 percent shareholder is any person who owns 10 percent or more of the total combined voting power of all classes of voting stock of such corporation.[63] With limited exceptions (not relevant to this discussion), the attribution rules of section 318 apply for purposes of determining who is a 10 percent shareholder. Those rules include section 318(a)(3)(A), which attributes stock held by a partner to a partnership.

Withholding for interest paid to a partnership is generally determined by applying the aggregate approach.[64] This is consistent with the literal language of sections 871 and 881, which on their face do not apply to a partnership that receives U.S.-source income. Arguably then a partnership should also be treated as an aggregate and not as an entity for purposes of determining which "person" has "received" interest on obligations held by the partnership. However, there appears to be no guidance on point. An entity approach can produce very harsh results where one partner is a 10 percent shareholder outside of the partnership. Consider the following examples.

> *Example 1.* T is a fixed investment trust (taxable as a grantor trust) that has outstanding a single class of passthrough certificates. T owns a portfolio of corporate debt instruments including a bond of a domestic corporation (X). One percent of the passthrough certificates are owned by F, a foreign investor. F does not own outside of the trust any interest in X. LB, a leveraged buyout

[60]When a domestic partnership has foreign partners, the partnership acts as the withholding agent with respect to income it receives that is subject to withholding tax and is allocable to foreign partners. Treasury regulation section 1.1441-5 lumps together for this purpose guaranteed payments and other distributions of partnership income. In each case, withholding is required to the extent the payments are attributable to partnership items subject to withholding.

> A U.S. partnership is required to withhold under section 1.1441-1 as a withholding agent on an amount subject to withholding . . . that is includible in the gross income of a partner that is a foreign person. Subject to paragraph (b)(2)(v) of this section [withholding not required on distribution if tax was previously withheld], a U.S. partnership shall withhold when any distributions that include amounts subject to withholding (including guaranteed payments made by a U.S. partnership) are made.

[61]As discussed in Part IV.D.1, above, the passthrough certificate definition is used in determining when an interest in a pool of debt instruments is treated as a registration required obligation for purposes of the TEFRA registration rules. The cross-reference assumes that this definition has been amended as proposed herein to apply to interests in pools of debt instruments and related assets that are classified as partnerships.

[62]*See* sections 871(h)(3) and 881(c)(3)(B).

[63]Section 871(h)(3)(B)(i). Similar rules apply to obligations issued by a partnership. *See* section 871(h)(3)(B)(ii).

[64]*See* Treasury regulation sections 1.1441-5(b) and (c).

fund, owns 10 percent of the voting stock of X and also owns 1 percent of T. The status of F as a 10 percent shareholder is tested at the F level because, under the grantor trust rules, T is effectively ignored for substantive purposes. F is not a 10 percent shareholder of X and (assuming all other requirements are met) can qualify for the portfolio interest exemption with respect to its share of interest received from X.

Example 2. Same facts as Example 1, except that T has a power to vary its investments and accordingly is classified as a partnership rather than a trust. If the 10 percent shareholder definition is still applied at the F level, then the result would be the same as in Example 1. On the other hand, if the test is applied at the T level, then interest allocated to F would be considered to be received by a 10 percent shareholder because the X shares owned by LB would be attributed to T under section 318(a)(3)(A).

Whether or not an aggregate approach to partnerships is taken generally in applying the 10 percent shareholder definition, we believe that attributing stock owned by one partner to the partnership and applying the 10 percent test at that level conflicts with the principles of section 318(a)(5)(C). This provision states that an entity shall not be considered to own stock attributed to it from an owner for purposes of reattributing that stock to another owner. Something akin to reattribution of stock ownership to F is required to impose withholding tax because the tax depends on F's status as a foreign investor.

Moreover, it appears, based on the legislative history of the portfolio interest exemption, that the congressional purpose in enacting the 10 percent shareholder limitation was to prevent a borrower from being able to take a deduction for interest that is kept within the borrower's group and not taxed in the hands of the payee.[65] Allowing F the portfolio interest exemption in Example 2 would not frustrate this purpose given that F does not have any economic interest, directly or indirectly, in the X stock.

Accordingly, we ask the IRS to provide guidance (which could be a ruling) clarifying that under the principles of section 318(a)(5)(C) a partnership's constructive ownership of stock from one partner will not be taken into account in determining if the partnership is a 10 percent shareholder for purposes of applying the portfolio interest exemption to another partner.[66]

E. Source of Payments on Swaps

A securitization vehicle often holds, in addition to receivables, interest rate swaps that are used to better match interest receipts with payments due to investors.[67] In the event a foreign investor is considered to hold equity in a securitization vehicle that is classified as a domestic partnership, a question arises as to the source of swap payments allocated to the investor.

Payments on notional principal contracts are considered to be FDAP income (the type subject to withholding tax), but are generally sourced based on the residence of the payee as determined under section 988(a)(3)(B)(i).[68] Accordingly, payments made to a non-U.S. resident are not subject to U.S. withholding tax.[69]

The analysis becomes somewhat more complex where a non-U.S. person is a partner in a domestic partnership. Under section 988(a)(3)(B)(i), the residence of a domestic partnership is generally the United States, except that to the extent provided in regulations, the determination of residence may be made at the partner level. Aside from an antiabuse rule, the only regulation under this grant of authority is Treasury regulation section 1.988-4(d)(3), which states that the determination of residence shall be made at the partner level "in the case of partners in a partnership that are not engaged in a U.S. trade or business by reason of section 864(b)(2)." Section 864(b)(2) provides a safe harbor rule under which a foreign person who is not a dealer will not be considered engaged in a U.S. trade or business because it trades in stocks, securities (broadly any debt instrument) or commodities for its own account or through an independent agent.

To recapitulate, a foreign partner in a domestic partnership that owns receivables and receives swap payments would be considered to derive foreign-source income (not subject to withholding tax) from the swap if residence can be tested at the partner level. Residence is tested at the partner level in the case of a partner who is not engaged in a U.S. trade or business by reason of the securities trading safe harbor rules. A foreign partner in an investment partnership would not benefit from this rule if it were read literally because such a partner does not need the protection of the safe harbor to avoid a U.S. business activity. It would be illogical, however, for a wholly passive investment vehicle to be less transparent than a slightly more active vehicle that trades. We believe the regulation should be construed to apply to any partnership holding stocks, securities or commodities and engaging in related activities so long as it is not considered to be engaged in a trade or business within the United

[65]Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 393-394.

[66]We are not arguing that an aggregate approach should always be used in applying the 10 percent shareholder test to partnerships. For example, suppose F owns a 1 percent interest in a partnership that owns X bonds. The partnership also owns, alternatively, 10 percent or 100 percent of the voting stock of X. In either case, F would own on an aggregate basis less than 10 percent of the X stock. However, the argument for not treating F as a 10 percent shareholder is less sympathetic on these facts than in a case where F and the partnership own no economic interest in the stock of X.

[67]The discussion in this section would apply equally to foreign currency hedges.

[68]*See* Treasury regulation section 1.863-7. This regulation provides that income from a notional principal contract that arises from the conduct of a U.S. trade or business is sourced in the U.S. and considered effectively connected to the trade or business. In such a case, however, the income would be subject to a net income tax and not a withholding tax.

[69]*See* Treasury regulation section 1.1441-4(a)(3).