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# Subchapter K and Passive Financial Intermediation

Mark P. Gergen

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# SUBCHAPTER K AND PASSIVE FINANCIAL INTERMEDIATION

Mark P. Gergen\*

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## I. INTRODUCTION

**I**N the commentary on the ramifications of the "check the box" regulations, there is no mention of what I believe will turn out to be one of the thornier sets of issues in partnership tax in the coming years. These issues will be raised by the use of entities that are taxed as partnerships and, thus, as passive financial intermediaries. Loosely speaking, financial intermediaries are in the business of investing other people's money. Banks, insurance companies, and mutual funds all serve as financial intermediaries. *Passive* financial intermediaries do little more than

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hold financial contracts and distribute their returns among their stakeholders. A passive financial intermediary does not "originate" the contracts it holds (distinguishing it from a bank) and it does not actively trade investments (distinguishing it from an investment company). The most familiar type of passive financial intermediary is used to create mortgage-backed securities and other forms of asset-backed securities,<sup>1</sup> which has been one of the most important areas of development in financial markets in the last generation.<sup>2</sup> Passive financial intermediaries are used for purposes other than securitization. Some of the more interesting financial transactions in recent years place a passive intermediary between an issuer of a security and investors to yield tax, regulatory, or accounting advantages.<sup>3</sup>

The lack of attention paid to the use of entities that are taxed as partnerships as passive financial intermediaries is not surprising. Right now these issues germinate mostly beneath the surface. While tax planners who create asset-backed securities use intermediaries that are taxed as partnerships<sup>4</sup> out of necessity when there is no more secure way to avoid a corporate level tax on a securitization vehicle,<sup>5</sup> they are circumspect in

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1. Any asset that has regular and fairly predictable cash flows is ripe for securitization. Short-lived assets, such as credit card receivables, have been securitized using revolving pools. Public entities have securitized rights to tax receipts. Even predicted cash flows from as-yet-unmade contracts, such as anticipated royalties from the sale of David Bowie's future recordings, have been securitized. See Aaron Elstein, *If It Moves, David Pullman Might Securitize It*, AM. BANKER, Feb. 28, 1997, at 7.

2. Securitization is attractive to firms holding cash-generating assets because it can lower their cost of financing and improve their financial appearance by moving liabilities off book. The development of mortgage pools has had profound effects on the structure of the mortgage industry and on financial markets. Once, banks were in the business of both making and investing in mortgages; today those functions are often separate. Out of mortgage pools have been carved an array of securities with peculiar payoff and risks and oddly poetic names, including Z-bonds, PACS, TACS, jump Zs, IO and PO strips, floaters and inverse floaters, and super-floaters and super-inverse floaters. See Joseph G. Haubrich, *Derivative Mechanisms: The CMO*, ECON. COMMENTARY, Sept. 1, 1995, at 1. This process of slicing cash flows and risks has been described as "financial alchemy." The sum of the parts is worth more than the whole because different investors will pay a premium for a security with risks and cash flows that is tailored to their specific wants. See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142-43 (1994).

3. A passive intermediary was used as an integral element in a plan to spawn a new class of securities known by the tax-delectable oxymoron "tax-deductible preferred stock." Basically, a corporation sold its long-term debt to a specially created partnership that raised the funds to purchase the debt by issuing preferred interests. The end result was a form of financing that was treated as equity for accounting purposes and as debt for tax purposes. See Mark P. Gergen & Paula Schmitz, *The Dynamics of Securities Innovation and Tax Law in the United States*, TAX L. REV. (forthcoming).

4. These include state law trusts that are taxable as partnerships, LLCs, limited partnerships, and partnerships. For the sake of brevity, I will use the term "partnership" to refer to this entire class of entities.

5. Historically, tax planners utilized grantor trusts that were structured to qualify as partnerships if they failed to qualify as a grantor trust. See William A. Schmalzl et al., *Tax Issues, in SECURITIZATION OF FINANCIAL ASSETS* § 10.02B[e] (1997). The authors cite five post-1993 offerings that use an "owner trust" that is structured to qualify as a partnership. See *id.* § 10.02B[f][iv] n.73. Recent offerings using LLCs include MassMutual High Yield Partners LLC (collateralized loan obligations), Triad Park LLC (real estate), and Nellie Mae Education Funding LLC (student loans). See *Smith-Barney Prices Nellie Mae Deal*

doing so, and do not seek tax advantages other than avoiding an entity level tax on the intermediary. The use of partnerships as financial intermediaries involves sophisticated transactions and occurs at the nexus of several complex bodies of tax rules, including the publicly traded partnership rules,<sup>6</sup> the REMIC<sup>7</sup> and FASIT<sup>8</sup> rules (these are the two tax regimes created for entities issuing asset-backed securities), the variable rate debt instrument<sup>9</sup> and contingent payment debt instruments rules,<sup>10</sup> and, as this Article will address, several anti-abuse and anti-arbitrage rules located both inside and outside of Subchapter K.

The "check the box" regulation,<sup>11</sup> the most celebrated recent development in partnership tax, and the subject of this symposium, is relevant to this story, for it eliminates one impediment to the use of partnerships as passive financial intermediaries. While it was possible even before the regulation<sup>12</sup> to structure an intermediary to avoid corporate classification without sacrificing the crucial features of public trading, limited liability, and centralized management, doing so required some contortions and left tax planners feeling exposed (even a little uncertainty regarding an important issue such as partnership classification can kill a public offering of a security). The "check the box" regulation eliminates uncertainty on classification. Other impediments to the use of partnerships as financial intermediaries remain. One of these is uncertainty regarding key elements of the publicly traded partnership rules. This impediment is likely to be short-lived, for the Treasury has promised to issue regulations clarifying these rules. There are other impediments to using partnerships, including: the complexity of partnership tax law; restrictions on the purchase by some institutional investors of equity securities including partnership interests;<sup>13</sup> dislike by individual investors of the partnership return;<sup>14</sup> and a "marketing taint" carried by partnerships.<sup>15</sup> These imped-

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*Featuring An LCC-Based Structure*, THE BOND BUYER, July 10, 1996, at 2. Municipal bonds are often held through entities that are taxed as partnerships. See George G. Wolf et al., *Certain Legal Aspects of Secondary Market Municipal Derivative Products*, 49 BUS. LAW. 1629, 1672-74 (1994). The Statistics of Income Division of the Internal Revenue Service has reported to the author that in the 1994 return year (the most recent year for which information was available), 506 partnership returns checked line 7, indicating they were publicly traded, with 161 of these being general partnerships, 277 being limited partnerships, and 68 being LLCs.

6. See I.R.C. § 7704 (1994). For a good introduction to § 7704, see Schmalzl et al., *supra* note 5, § 10.02[B][1][e] and [f][iv].

7. See I.R.C. §§ 860A-860G (West Supp. 1997).

8. See I.R.C. §§ 860H-860L (West Supp. 1997).

9. See Treas. Reg. § 1.1275-5 (as amended in 1996).

10. See Treas. Reg. § 1.1275-4 (1996).

11. See Treas. Reg. § 301.7701-2 (as amended in 1996).

12. See Schmalzl et al., *supra* note 5.

13. See Arthur M. Miller, *Statement to Accompany Proposed TEMIC Legislation*, TAX NOTES TODAY, Jan. 6, 1994, at 35.

14. Merrill Lynch created TOPRS (Trust Originated Preferred Securities) that used a trust as intermediary in MIPS structure rather than a partnership so that investors would receive a Form 1099 rather than a K-1.

15. See Thomas Humphreys, *Current Developments in Taxation Law*, AM. BANKER, Aug. 25, 1992, at 8A. "As LLCs become more accepted, I think you'll see more asset

iments melt away if the tax or other benefits to using partnerships as passive financial intermediaries are substantial enough.

My major goal in this Article is to revisit an argument I made several years ago that partnerships should not be allowed to make special allocations.<sup>16</sup> Part II addresses some preliminary issues regarding the scope of the “passive-type” income exception to the publicly traded partnership rules. Part III takes a first cut at the problem of tax alchemy through special allocations by comparing how well the special allocation rules and the REMIC and FASIT rules do in preventing the creation of securities that predictably bear deferred income out of a pool of debt instruments. The comparison is apt, for a partnership that could not make special allocations would look something like a REMIC and a FASIT because these entities can have only one class of “pass-through” equity. They may have multiple classes of debt. This comparison is not only of academic interest, for as the law now stands, tax planners may elect between the FASIT rules and Subchapter K in securitizing non-mortgage debt. The REMIC and FASIT rules afford planners enormous flexibility in allocating risks and cash flows in an entity while making it very difficult to structure securities to predictably bear deferred income.<sup>17</sup> If one takes the partnership special allocation rules at face value, it is fairly easy to structure partnership-holding debt instruments so that some securities issued by the partnership will predictably bear deferred income. The caveat is important because it is clear that the rules in Subchapter K cannot be taken at face value in this area. The government has shown a willingness to

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securitization being done in the LLC format. . . . [T]he LLC is not a partnership, which has a bad marketing taint. That’s the reason we use trusts all the time.” *Id.*

16. See Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990).

17. In this Article, I do not try to justify the proposition that the creation of interests that predictably bear tax-deferred income is a bad thing. This is a form of something I describe as tax alchemy, by which I mean the carving up of interests in a pool of securities in a way that increases the aggregate value of the pool because of the tax attributes of the interests. Sometimes this increase in value is captured by the issuer since the securities command a higher price. Sometimes it is captured by the investor. Often tax alchemy occurs because different tax clienteles place a premium value on interests with different characteristics, though, as you will see, tax alchemy can occur without the existence of different tax clienteles.

The argument for why tax alchemy is a bad thing is fairly straightforward on the surface. To the extent the issuer captures this value, tax law may have a non-neutral effect on intermediation decisions, including both decisions about what assets to hold through intermediaries and decisions about how to structure an intermediary. An issuer may also reap a windfall at the expense of the Treasury (i.e., the American people) to the extent it reaps a tax-driven premium price on a securities offering without sacrificing other things it values. To the extent an investor captures this value, then tax law may have a non-neutral effect on the investor’s portfolio choices regarding the timing of cash flows and risks, or, to the extent an investor can hold an interest with a premium after-tax return without sacrificing other things she values, she reaps a windfall at the expense of the Treasury. There are, in addition, the inevitable dead weight losses in the form of resources committed to planning and squabbling with the government over tax-saving strategies. If we dig beneath the surface, then the policy issue often turns out to be more difficult than just stated because tax-saving strategies may diminish the effect of non-neutral tax rules. This and other policy issues are addressed in Gergen & Schmitz, *supra* note 3.

stretch the law—perhaps beyond the breaking point—to rein in exotic uses of partnerships.

Part IV pushes the analysis a little deeper by considering how a FASIT-like tax regime and Subchapter K function if debt-like assets that yield tax preference income are held through a passive intermediary. The particular examples I use are preferred stock and tax-exempt bonds. The FASIT model does not work for such assets because it has the effect of stripping away the tax preference from the income flowing through the intermediary. Use of a partnership with no debt in its capital structure avoids this problem, but it leads to another set of problems from the Treasury's perspective, for the special allocation rules (again, if taken at face value) enable tax planners to use partnerships as intermediaries to circumvent rules on dividend-stripping and other provisions of tax law.

Part V takes up where the analysis in Parts III and IV leave off. After explaining in general terms why passing the substantiality test ought to be a necessary, but not a sufficient condition for taxing an arrangement on a "pass-through" basis, I turn to other anti-abuse rules. In particular, I examine the section 701 regulations and recent rulings under section 7701(l) on "conduit financing arrangements." I argue that anti-abuse law could and should be stretched to cover the use of partnerships to circumvent other provisions in tax law, and that recent rulings under section 7701(l) have begun to tighten up anti-abuse law by formulating "middle-range" principles that cover reasonably well defined categories of cases. This tightening strengthens anti-abuse law, but it also limits its potential reach, thus establishing that there are some issues that cannot be addressed through anti-abuse law. Thus, my ultimate conclusion is that Subchapter K is not a suitable framework for taxing passive financial intermediaries.

## II. OVERVIEW OF TAX LAW GOVERNING PASSIVE FINANCIAL INTERMEDIARIES

Tax law governing financial intermediaries can be visualized as sets of sometimes overlapping rule systems. The basic choices are between the rule systems governing corporations,<sup>18</sup> partnerships,<sup>19</sup> investment trusts,<sup>20</sup> and a number of special rule systems that apply to particular types of financial intermediaries, including the Regulated Investment Company (RIC) rules, designed with mutual funds in mind,<sup>21</sup> the Real Estate Investment Trust (REIT) rules,<sup>22</sup> the Real Estate Mortgage Investment Conduit (REMIC) rules, designed for mortgage pools,<sup>23</sup> and the Financial Asset Securitization Investment Trust (FASIT) rules, designed gener-

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18. These are primarily found in Subchapter C. See I.R.C. §§ 301-368 (West Supp. 1997).

19. See Subchapter K, I.R.C. §§ 701-761 (West Supp. 1997).

20. See Subchapter J, I.R.C. §§ 641-692 (West Supp. 1997).

21. See I.R.C. §§ 851-855 (West Supp. 1997).

22. See I.R.C. §§ 856-860 (West Supp. 1997).

23. See I.R.C. §§ 860A-860G (West Supp. 1997).

ally for pools of debt-backed securities.<sup>24</sup> In addition, there are special rules that apply to insurance companies,<sup>25</sup> banks,<sup>26</sup> and securities broker-dealers.<sup>27</sup> Which rule system (or systems) covers an entity depends upon the character of the assets it holds, what activities it performs, its capital structure, and whether interests in it are publicly traded.

This Article focuses on entities with publicly traded interests and "multi-class" capital structures that passively hold investment assets. Generally, an entity is considered to be "publicly traded" if its equity interests are traded on an established exchange or are readily tradable on a secondary market.<sup>28</sup> An entity is considered to have a multi-class capital structure if it has more than one class of equity interest. A "single-class" entity may issue multiple classes of debt interests. Tax planners tend to be ultra-cautious in dealing with classification issues, so if they plan to use an entity that by law may have only a single-class of equity, such as an investment trust, they will not create debt interests that arguably could be classified as equity under general tax principles.<sup>29</sup> These restrictions allow us to put aside the rules on investment trusts, for an investment trust generally cannot have more than one class of equity interest.<sup>30</sup> And we can put to the side the rules on RICs (i.e., mutual funds),<sup>31</sup> insurance companies, banks, and securities broker-dealers, for these rules apply to different types of *active* financial intermediaries.

This narrowing of focus brings to the fore the rules on publicly traded partnerships,<sup>32</sup> which tax partnerships with publicly traded interests as corporations. More to the point, it brings to the fore an exception in those rules for partnerships with "passive-type" income,<sup>33</sup> because a publicly traded partnership will come within Subchapter K if it comes within this exception.<sup>34</sup> The REMIC and FASIT rules remain very much in the

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24. See I.R.C. §§ 860H-860L (West Supp. 1997).

25. See Subchapter L, I.R.C. §§ 801-848 (West Supp. 1997).

26. See Subchapter H, I.R.C. §§ 581-597 (West Supp. 1997).

27. See, e.g., I.R.C. § 475 (West Supp. 1997) (requiring securities dealers to use market-on securities not held for investment and debt securities not held for sale).

28. Regulations issued under the publicly traded partnership rules amplify this definition. See Treas. Reg. § 1.7704-1 (1997).

29. Reportedly, tax counsel will opine in a public offering that a security that is formally denominated as equity will be treated as debt for tax purposes only if it has a high investment grade rating of "A" or better. It has been argued that this standard effectively precludes the creation of trust structures in securitizations of commercial receivables that have large subordinated interests that bear significant default risk. See Statement of Donald B. Susswein to House Ways and Means Committee on the FASIT legislation, July 27, 1995, reprinted in *Coalition Counsel's Testimony in Support of FASIT Bill*, TAX NOTES TODAY, Oct. 2, 1995, at 106.

30. See Treas. Reg. § 301.7701-4(c) (as amended in 1996).

31. RICs are also restricted in their ability to have multiple classes of interests. See Rev. Rul. 89-81, 1989-1 C.B. 226 (requiring that tax-exempt income be allocated *pro rata* among dividends paid on different RIC classes).

32. See I.R.C. § 7704 (1994).

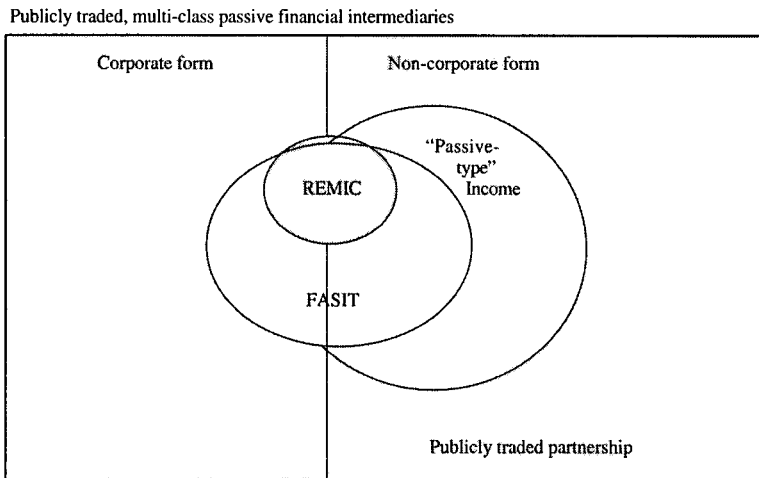
33. See I.R.C. § 7704(c) (1994).

34. A partnership must clear two bars to come within the "passive-type" income exception to the publicly traded partnership rules. First, 90% of the gross income of the partnership must be "passive-type" income, or, in further Code-speak, it must be "qualify-

picture. These rules apply to passive financial intermediaries that hold particular types of assets, respectively, mortgages and debt instruments (including receivables). While REMICs and FASITs literally may have only one class of equity interests (indeed, the equity interest in a FASIT may be owned by only one person), these rules belong in this picture because they have safe harbors that treat as debt instruments securities issued by an entity that might arguably be classified as equity under general tax principles.

Diagram I depicts the rough relationship among these rule sets.

DIAGRAM I



ing income." I.R.C. § 7704(c)(2) (1994). The Treasury is presently considering the questions of what is qualifying income. See Treas. Regs. §§ 1.7704-1, -2 (1997).

The definition of qualifying income includes ordinary income and capital gain from most forms of investment assets, specifically debt instruments (so long as interest is not contingent on any person's gross income or profits); preferred and common stock; foreign currency; many forms of derivatives on debt, stock, and foreign currency, including at least options, futures, and forward contracts; interests in REMICs and FASITs (both regular interests and residual interests); and real estate so long as it is not held for sale in the ordinary course of business and it is not leased out on a basis where the rent is contingent on any person's gross income or profits. See I.R.C. § 7704(d) (1994).

Second, the partnership cannot be a regulated investment company, which means that it must be exempt from regulation under the Investment Company Act of 1940. More precisely, the exception does not apply "to any partnership which would be described in section 851(a) [of the Internal Revenue Code] if such partnership were a domestic corporation." I.R.C. § 7704(c)(3) (1994). Section 851(a) applies to "any domestic corporation" that "is registered under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 to 80b-2, as a management company or unit investment trust." I.R.C. § 851(a)(1)(A) (1994). Section 851(a) also covers two classes of companies that are exempt under the 1940 Act. Neither of these provisions is relevant here.

The Treasury has the power to extend the qualifying income exception to investment companies that trade in commodities and some forms of commodity derivatives by regulation. It has not done so yet. Such regulations may include "any partnership a principal activity of which is the buying and selling of commodities (not described in section 1221(f)), or options, futures, or forwards with respect to commodities." I.R.C. § 7704(c)(3) (1994).



As Diagram I shows, the class of entities covered by the REMIC rules is almost entirely a subset of the class of entities covered by the FASIT rules,<sup>35</sup> which itself is almost entirely a subset of the class of entities that qualify for the "passive-type" income exception to the publicly traded partnership rules when the partnership form is used.<sup>36</sup> In other words, most partnerships that qualify as a FASIT will also come within the "passive-type" income exception, which covers many types of investment assets,<sup>37</sup> but many partnerships that come within the "passive-type" income

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35. The overlap is not perfect. A REMIC may hold a contingent payment debt instrument that is secured by real property. See I.R.C. § 860G(a)(3)(A) (1994). A FASIT may not hold a CPDI. See *infra* notes 38, 67, 68.

36. The "passive-type" income domain is not coextensive with the FASIT domain along two lines. One difference involves derivative income. While it is clear that a FASIT may enter into derivative contracts to hedge against its risk as obligor on the interests it issues, it is unclear what derivative income will qualify under § 7704(d)(4). See *infra* note 43. A second difference involves income from the foreclosure of personal property, such as automobiles. A FASIT is permitted to earn incidental income from foreclosure property. Income from the sale or lease of personal property is not qualifying income. A publicly traded partnership with such income will still come within the exception so long as it and other forms of nonqualifying income are less than ten percent of the partnership's gross income.

37. The rules defining "qualifying income" generally are drawn to distinguish income derived in the conduct of an active trade or business from investment income. Thus, the definition of qualifying income omits the most common forms of business income: service income and income from the sale of inventory. See H.R. REP. NO. 100-391 (II), at 714 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-378. "The purpose of distinguishing between passive-type income and other income is to distinguish those partnerships that are engaged in activities commonly considered as essentially no more than investments, and those activities more typically conducted in corporate form that are in the nature of active business activities." *Id.* at 714. The additional bar for investment companies was included because Congress wanted to retain the RIC rules as the exclusive pass-through tax regime for investment companies. See *id.* at 713-16. ("It is not intended to alter the requirements for conduit tax treatment set forth in the present law applicable to regulated investment companies.").

There is an important exception: income from the exploration, development, processing, transportation, and marketing of mineral and natural resources is defined as qualifying income under a special rule. See I.R.C. § 7704(d)(1)(E) (1994). This provision has been held to cover aluminum smelting, Priv. Ltr. Rul. 95-38-016 (Sept. 22, 1995); saw milling, Priv. Ltr. Rul. 94-50-029 (Dec. 16, 1994), Priv. Ltr. Rul. 91-05-015 (Nov. 1, 1990); growing and harvesting timber, Priv. Ltr. Rul. 93-38-028 (Nov. 24, 1989), Priv. Ltr. Rul. 91-05-015 (Nov. 24, 1990); the production of pulp for paper, Priv. Ltr. Rul. 90-08-035 (Oct. 1, 1993); and the production of fertilizer, Priv. Ltr. Rul. 93-39-014 (June 28, 1993).

This provision is remarkable from a tax policy perspective because it opens the door for the elimination of the corporate income tax on major sectors of the United States economy, including not just the oil industry and the timber industry, but also industries that process natural resources into primary products, such as aluminum, steel, and power. In 1988, Congress closed the door it opened in 1987 somewhat by amending the statute to limit the provision to depletable resources. See I.R.C. § 7704(d)(1) (1994) (especially the last clause, which was added by TAMRA). Thus, the generation of electricity from coal is covered but not hydro and solar generation. Further, there was a statement in the legislative history that the exception was never meant to apply to retail sales to end users. See Technical and Miscellaneous Revenue Act of 1988, S. REP. NO. 100-455 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515.

If requests for private letter rulings are indicative of developments, then the major oil companies are beginning to take advantage of this opportunity by spinning off some of their operations into limited partnerships. See Priv. Ltr. Rul. 97-12-024 (Mar. 21, 1997) (responding to request for private letter ruling by "a major integrated [oil production] and marketing business" with domestic and international operations that wanted to spinoff por-

exception will not qualify under the FASIT rules, which cover only entities that hold "debt instruments."<sup>38</sup> The REMIC domain is shaded because it is exclusive. A multi-class entity with substantial holdings in mortgages is taxed as a corporation if it does not come under the REMIC or FASIT rules. The FASIT rules are not exclusive. The noncorporate area outside the "passive-type" income exception and the corporate area are shaded to denote that an entity level tax applies.

Where an entity appears on this diagram is primarily a function of the type of assets it holds. Diagram II shows the location of publicly traded partnerships that hold four types of assets: debt-instruments other than mortgages,<sup>39</sup> preferred stock,<sup>40</sup> common stock,<sup>41</sup> and insurance contracts.

tions of its operations handling sales to governmental entities as a limited partnership with publicly traded interests); Priv. Ltr. Rul. 96-39-011 (Sept. 27, 1996) (responding to request regarding spinoff of pipeline operations into limited partnership); Priv. Ltr. Rul. 94-52-013 (Dec. 30, 1994) (responding to request regarding spinoff of storage business into limited partnership).

Why the movement in this direction has not been more aggressive is an interesting question about which I can only speculate. Companies that could eliminate the corporate income tax by spinning off operations into partnerships or LLCs (or converting into LLCs when they have no retail components) may be disinclined to do so for several reasons: they may pay little corporate tax in any event; they may face a hefty "toll-charge" on the change because they own a substantial amount of appreciated assets; they may face substantial nontax costs from fragmenting their operations; or perhaps it is just inertia.

38. See I.R.C. § 860L(c)(1)(B) (West Supp. 1997). A FASIT may not hold debt instruments that pay contingent interest. See *id.* (incorporating the limitation of I.R.C. § 860G(a)(1)(B)(i)). A FASIT may hold certain assets that are incidental to its debt holdings, including cash and cash equivalents, foreclosure property, and contracts used to guarantee or hedge against risks borne by regular interest holders.

39. Interest is qualifying income. See I.R.C. § 7704(d)(1)(A) (West 1989 & Supp. 1997). And so too is gain from the sale of an instrument held for the production of interest income. See I.R.C. § 7704(d)(1)(F) (West Supp. 1997). Interest cannot be contingent on any person's gross income or profits. Section 7704(d)(2)(B) excludes interest that "would be excluded from the term 'interest' under section 856(f)." I.R.C. § 7704(d)(2)(B) (West Supp. 1997). Section 856(f) excludes from the definition of interest for purposes of the REIT rules any amount that "depends in whole or in part on the income or profits of any person." I.R.C. §§ 856(f) (West Supp. 1997). An entity that holds debt instruments is likely to come under the exception to the 1940 Act for issuers of asset-backed securities and so clear that bar to the "passive-type" income exception.

40. Dividends are qualifying income. See I.R.C. § 7704(d)(1)(B) (West 1989 & Supp. 1997). And so too is gain from the sale of an instrument held for the production of dividends. See I.R.C. § 7704(d)(1)(F) (West Supp. 1997).

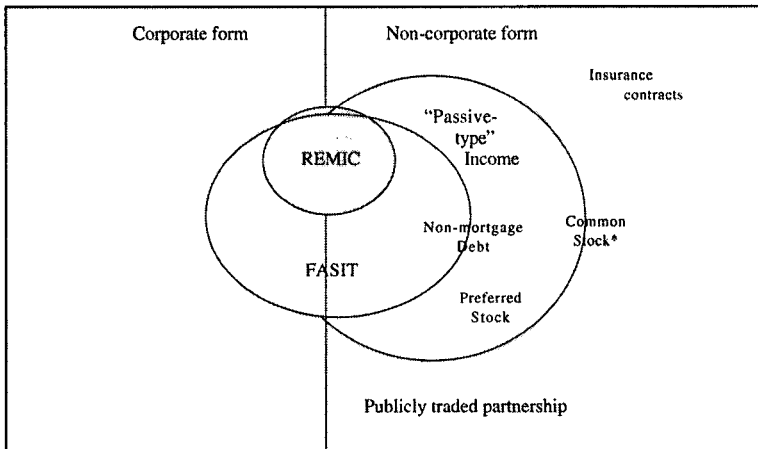
41. Income from common stock, along with income from many other assets, is defined as qualifying income by I.R.C. § 7704(d)(4) (West Supp. 1997), which covers "any income which would qualify under section 851(b)(2) or 856(c)(2)." The reference is to the RIC and REIT rules. Qualifying income for a RIC is

dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities . . . or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies.

I.R.C. § 851(b)(2) (West Supp. 1997). The definition of "security" in the RIC rules is expansive. It is coextensive with the definition of security in the Investment Company Act of 1940. See Treas. Reg. § 1.851-3 (1997).

As securities law now stands, a widely-held entity that holds common stock will not come within the "passive-type" income exception because it will trip over the bar for investment companies. The entity will not come under Rule 3a-7, the exception for asset-backed securities, for that exception applies only to entities that hold "financial assets . . .

DIAGRAM II



Non-mortgage debt straddles the FASIT and “passive-type” income domains because it may be held through an entity in either domain. Common stock straddles the “passive-type” income border and is starred because the question of whether it may be held through an entity that comes within the “passive-type” exception, and so is therefore taxed as a partnership, is in the hands of the SEC.<sup>42</sup> I will return to this point shortly.

#### A. THE FINANCIAL BUSINESS EXCLUSION

An important legal question mark hangs over the use of partnerships as financial intermediaries generally.<sup>43</sup> The publicly traded partnership

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that by their terms convert into cash within a finite time period . . .” 17 C.F.R. § 270.3a-7(b)(i) (1997).

42. Perpetual preferred stock is in the same category as common stock for this purpose because by its terms it does not convert into cash within a finite time period. *See* 17 C.F.R. § 270.3a-7(b)(1) (1997).

43. Another important unresolved question concerns when income from derivatives is qualifying income. *See Guidance Sought on Definition of Qualifying Income in Partnership Regs.*, TAX NOTES TODAY, July 27, 1995, at 116-40 (requesting clarification of whether income from swaps and other exotic derivatives was qualifying income). Section 7704(d)(4) defines as qualifying income “any income which would qualify under section 851(b)(2) or 856(c)(2).” I.R.C. § 7704(d)(4) (West Supp. 1997). Section 851(b)(2) lists, among other things, “income (including but not limited to gains from options, futures, or forward contracts) derived with respect to [the entity’s] business of investing in such stock, securities, or currencies.” I.R.C. § 851(b)(2). Under section 851(b)(2), an entity may hold equity, interest rate, and currency derivatives, but only as an adjunct to its principal holdings in equity, debt instruments, and currency. There is a somewhat analogous restriction on the ability of FASITs to take positions in derivatives. A FASIT may enter into derivatives to hedge against its risks as obligor on interests that it issues. *See* I.R.C. § 860L(c)(1)(D)(ii). Looking at the FASIT rule for guidance, it seems uncontroversial that a partnership that issues debt can enter into derivative contracts to hedge against the risk that fluctuations in the returns on its principal assets will impair its ability to service the debt. *See* I.R.C. § 860K. The principle underlying the FASIT rule seems to be that derivatives are properly used to hedge against the risk that the entity will be unable to meet its

rules exclude interest “derived in the conduct of a financial or insurance business”<sup>44</sup> from the definition of “passive-type” income.<sup>45</sup> The legislative history provides little help in defining the scope of this exclusion. It states in full:

interest income from the conduct of a banking business is not treated as passive-type income, as deriving interest is an integral part of the conduct of the business. Similarly, it is not intended that dividend income derived in the ordinary conduct of a business in which dividend income is an integral part (e.g., a securities broker/dealer) be treated as passive-type income.<sup>46</sup>

This statement explains that the exclusion is not limited to interest income (which is what the statute literally says), but that it applies as well to dividend income and, presumably, other forms of income “derived in the conduct of a financial business or insurance business.”<sup>47</sup> However, the legislative history tells us little about what constitutes the conduct of a “financial business.” It does explain that interest income earned by a bank is not “passive-type” income, but it does not address the real question posed by securitization, which is what specific functions performed by a bank are part of the “financial business.” The process of securitization enables banks and other firms that provide financial services to spin off some of their functions by securitizing the assets associated with the performance of that function. Accordingly, banks have spun off the function of financing credit card debt by securitizing credit card receivables.

Looking to other parts of the legislative history reveals two criteria that may be used in defining “non-passive type” activities in general and the scope of the “financial business” exclusion in particular. One criterion is tradition: the legislative history indicates that Congress thought it relevant whether a function traditionally performed by an entity was subject to corporate income tax.<sup>48</sup> The other criterion is risk: Congress thought

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commitments on the debt-like interests it issues. Applying this principle in the partnership context, it should permit the use of derivatives to hedge the risk of servicing “preferred” equity interests in partnerships. A slightly broader principle underlies section 851(b)(2). It permits a RIC to use derivatives to hedge against a risk of loss on its principal assets. See STAFF OF JOINT COMM. ON FINANCE, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99th Cong. 381 (1987). The difference in the two principles is that a RIC need not justify the hedge as necessary to meet commitments it has made on interests it has issued; it is sufficient that the hedge be against a risk of loss.

44. I.R.C. § 7704(d)(2)(A) (West Supp. 1997).

45. See Michael L. Schler, *Schler Says Proposed PTP Regs. Are Potentially disastrous Asset-Backed Securities*, TAX NOTES TODAY, Aug. 24, 1995, at 166 (seeking guidance that trust that holds a revolving pool of assets is not engaged in the financial business); see also Joe Crouse, *American Bankers Association Wants Guidance On Publicly Traded Partnerships*, TAX NOTES TODAY, Sept. 24, 1996, at 208 (seeking guidance that pool of credit card receivables is not in the financial business).

46. H.R. REP. NO. 100-391, at 1068-69 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-684.

47. *Id.*

48. The House Report justifies distinguishing between passive-type income and other income on the ground that “purchasers of such partnership interests could in most cases independently acquire such investments.” *Id.* at 750. It goes on to justify the inclusion of some forms of non-passive income in the definition of qualifying income with the state-

it appropriate that some risky enterprises bore the corporate income tax.<sup>49</sup> The problem with these criteria is that they do not fit very well with the lines actually drawn by the statute in defining “passive type” investments, nor do they make much sense. When the publicly traded partnership rules were enacted the securitization revolution was already under way: assets that had traditionally been held by financial institutions, such as credit card receivables, were spun off into vehicles that were taxable as trusts or as partnerships. There is no reason to think that Congress meant to halt this process of innovation. Risk is no better as a criterion. Risk is difficult to square with the statute because some forms of “passive type” investments are quite risky, real estate in particular (though the treatment of real estate could be explained on grounds of tradition), and also other instruments such as debt and high-yield bonds.<sup>50</sup> Nor is there any apparent policy reason to treat high risk enterprises differently from low risk enterprises. Risk is relevant in tax law to the characterization of an interest in an enterprise as debt or equity,<sup>51</sup> but the issue here is classification of the enterprise. Non-risky enterprises can be carved up in ways that create very risky interests. The exotic interests carved out of mortgage pools are a case in point, and risky enterprises can be carved up in ways that create some non-risky interests.

Despite the lack of useful guidance from the statute and the legislative history, it is possible to sketch what are likely to be the broad contours of the “financial business” exclusion. The Treasury would be on very weak legal ground if it took the position that bearing interest rate risk, default

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ment “the rationale relates to the traditional conduct of such activities in partnership form, and the consequent reluctance to impose entity-level tax in such circumstances.” *Id.*

49. The House Report justifies the exception for interest or rent that is contingent on profits on the ground that it “involves a greater degree of risk, and also a greater potential for gain, than fixed (or even a market-indexed) rate of interest or rent, and thus is more properly regarded as from an underlying active business activity.” *Id.* at 751. In justifying risk as a criteria, one may draw an analogy to the FASIT rules on “high-yield interests.” A FASIT may issue a high-yield interest, but it is taxed in a manner similar to an ownership interest, i.e., such an interest may only be held by a Subchapter C corporation and net operating losses cannot be used to offset its income. See I.R.C. §§ 860J(a), 860K (West Supp. 1997). A high yield interest is defined as an interest either that makes principal contingent on a risk other than default, or that has a maturity greater than 30 years, or that bears excessive interest, which is defined either as having a yield to maturity that exceeds the applicable federal rate by more than five percent or as having an issue price that exceeds the stated principal amount by more than 125%. See I.R.C. § 860L(b)(1)(B)(i)(I) (West Supp. 1997). The legislative report for the Small Business Job Protection Act of 1996 states that the purpose of the rule is to preserve the “corporate tax on returns that approach returns on equity.” See S. REP. NO., 104-281, at 126 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1944, 1600.

50. An argument for treating interest and rents differently from dividends and other payments received on stock, which may be just as risky, is that the former are deductible by the payor, while the latter are not. Profits from an active business passed from a corporation through a publicly traded partnership in the form of dividends or other distributions bear an entity-level tax. If they pass through the partnership tax free, interest and rent paid by a corporation would never bear an entity-level tax.

51. None of the standard justifications for the corporate income tax turn on the riskiness of corporate enterprise. For a good review of these justifications, see Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World*, 39 CASE W. RES. L. REV. 965, 1066-1099 (1988-89).

risk, or other forms of investment risk on loans constitutes the “conduct of a financial business” for this interpretation of the exclusion consumes the rule that interest income is “passive-type” income. By similar logic, the incidental monitoring and enforcement of loans should not constitute the conduct of a financial business.<sup>52</sup> More generally, the performance of labor incidental to holding an investment asset should not necessarily take an entity outside the “passive-type” income exception. The performance of labor in conjunction with the holding of rental real estate is expressly permitted under the publicly traded partnership rules,<sup>53</sup> and, by analogy to the REMIC and FASIT rules, an entity that holds mortgages or loans secured by property should be able to foreclose, operate, and sell property when a loan is in default without being considered to engage a financial business.<sup>54</sup> On the other hand, the origination of loans does constitute the “conduct of a financial business.”<sup>55</sup> In addition, active trading of investments is also likely to be deemed the conduct of a financial business,<sup>56</sup> though such a rule would be redundant. A publicly traded partnership that actively trades investments will be considered an investment company and so will not qualify for the “passive-type” income exception under a separate rule.<sup>57</sup>

The implicit policy choice seems to preserve the corporate tax on servicing functions performed through publicly traded entities in the financial sector while foregoing the corporate tax on risk-bearing and capital-providing functions. It is not obvious that the line should be drawn there. If we were to draw a similar line through the business of insurance (the point is hypothetical because insurance premiums are not within the defi-

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52. See *supra* notes 43-51 and accompanying text.

53. The statute incorporates the REIT definition of real property rents, § 7704(d)(3), where allowance is expressly made for “charges for services customarily furnished or rendered in connection with the rental of real property.” See I.R.C. § 856(d)(1)(B) (West Supp. 1997).

54. In the absence of guidance, the tax bar has been cautious about pressing service functions into securitization vehicles. Typically, a securitization vehicle will have no employees; services are contracted out. Presumably, intensive monitoring and enforcement activities will disqualify an entity; the income of a collection agency is not passive. A case that may fall near the line is the securitization of large commercial loans as they can involve considerable effort in monitoring and enforcement.

Yet another question is whether actions taken to replenish loans in a revolving pool of contracts constitute the conduct of a “financial business.” See Schler, *supra* note 45. Given the enactment of the FASIT rules, which were intended to facilitate securitizations using revolving pools, it would be very surprising if Treasury took a position that disqualified revolving pools under the publicly traded partnership rules.

55. See Priv. Ltr. Rul. 97-01-006 (Jan. 3, 1997) (holding that income from holding mortgages is qualifying income where the partnership performs only incidental origination functions).

56. The statement in the legislative history that a “securities broker/dealer” is engaged in a financial business points in this direction. See H.R. REP. NO. 100-391, at 751 (1987).

57. Securities Rule 3a-7 prohibits speculative trading through three rules: an entity can buy and sell assets only in accordance with the terms by which it is established; asset purchases or sales cannot result in a downgrading of its fixed-income securities; and an entity cannot buy and sell assets “for the primary purpose of recognizing gains and decreasing losses resulting from market value changes.” 17 C.F.R. § 270.3a-7(a)(3)(iii) (1997).

dition of qualifying income), then the origination of insurance policies and processing of claims would remain subject to the corporate income tax, but the bearing of insurance risk—and in particular, the business of reinsurance—could be spun off to entities that are not subject to the corporate income tax.

There are no compelling policy arguments for drawing the line in any particular place. Perhaps the major policy concern in this regard is the potential revenue loss from the erosion of the corporate tax base. This revenue loss is difficult to estimate because it depends on such variables as the degree to which corporate spin-offs of certain financial assets into non-corporate vehicles takes the place of debt-financing, as well as the effective tax rate on these assets when they are held within a corporation.<sup>58</sup> The matter of revenue loss to the side, it is not clear whether inducing corporations to spin off assets and related functions is socially harmful. Some changes in corporate capital structure induced by the rule will be of only formal significance. For example, a corporation might move assets off its books without meaningfully altering the claims of creditors shareholders, or the incentives of corporate agents. In instances where these changes in corporate capital structure have substantive effects, it is not clear whether they are positive or negative from a social perspective. In the long run, these developments are likely to lead to finer divisions of claims to cash flows (and risks) generated by firms, and to the creation of new forms of securities, effects that entail both benefits and costs.<sup>59</sup>

## B. THE SEC'S ROLE AS GATEKEEPER TO SUBCHAPTER K

One of the key moments in the history of the development of tax law on financial intermediaries came in 1986 when the Treasury ruled that an investment trust with more than one class of equity interest was taxable as a business association.<sup>60</sup> This ruling was hurriedly issued in response to publicity about plans to use trusts to slice interests in common stock into two securities: a right to dividends and a right to the sale price of the

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58. It is not clear what the effective tax rates on the insurance and banking industries are today. Data prior to the 1986 reforms can be found in Tax Analysts, *Effective Corporate Tax Rates 1985*, 86 TAX NOTES TODAY 141-43, *microformed on* 86 TAX NOTES DOC. 86-7410 (1986) (estimating 16.49% effective tax rate on U.S. income of national banks, 15.39% rate on U.S. income of states banks, 7.78% rate on U.S. income of mutuals, and 19.41% rate on U.S. income of insurance industry). Tax Analysts, *Quantifying the Impact of the Tax Reform Act of 1986 on Effective Corporate Tax Rates*, 86 TAX NOTES TODAY 2413, *microformed on* 86 TAX NOTES DOC. 86-7412 (1986), predicted that these rates would be changed little by the 1986 Act. The most recent published data from corporate tax returns shows that in the aggregate firms in the financial, insurance, and real estate business paid \$38,723,220,000 in corporate income tax in 1993. See Michael G. Seiders, *Corporation Income Tax Returns, 1993*, 16 STAT. OF INCOME BULL. 36, 48 (1996).

59. The case has been made that spinning off high-grade assets from firms with low credit ratings yields informational benefits to investors and lenders. See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1086 (1996).

60. T.D. 8080, 1986-1 C.B. 371 (amending Treas. Reg. § 301.7701-4(c)). This story is told in Douglas H. Walter & Paula A. Strasen, *Innovative Transactions—The Americus Trust "Prime" and "Score" Units*, 65 TAXES 59 (1987).

stock. The Treasury was justly worried about stock slicing; different tax clienteles will pay a premium for different slices of common stock.<sup>61</sup> Given this history, one might be surprised to learn that today the Securities Exchange Commission (SEC) has the power to decide whether partnerships that are used to hold common stock come under Subchapter K.

This odd state of affairs is due to the two requirements that a partnership must meet to come within the "passive-type" income exception to the publicly traded partnership rules: the income of the partnership must be "qualifying income," which income from common stock is, and the entity cannot be within the definition of an "investment company" under the Investment Company Act of 1940 (the 1940 Act).<sup>62</sup> Congress included the latter provision to preserve the exclusivity of the RIC regime for mutual funds.<sup>63</sup> The definition of an "investment company" is quite broad: it covers any issuer of a security<sup>64</sup> that is primarily engaged "in the business of investing, reinvesting, or trading in securities."<sup>65</sup> This definition encompasses most publicly traded entities that have "passive-type" income. While the overlap is not complete, however, it is substantial. An entity that invests in real estate has qualifying income but is not an investment company. The investment company bar does not swallow the "passive-type" income exception because of exceptions within securities law to the definition of an investment company. The most important of these exceptions in the securitization area is Rule 3a-7, which was issued by the SEC in 1992 and provides that an issuer of asset-backed securities is not an investment company.<sup>66</sup> This rule was written in expansive terms to allow for innovation.<sup>67</sup>

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61. Tax-paying corporations might pay a premium for the right to the dividend stream. Tax-paying persons might pay a premium for the right to appreciation because of income deferral. And, there is a huge potential tax payoff if a slice can be created that is similar to a zero-coupon bond but is not subject to the OID rules.

62. 15 U.S.C. § 80a-1 to -3 (1994).

63. It is not intended to alter the requirements for conduit tax treatment set forth in the present law applicable to regulated investment companies. Thus, the success of a securitization transaction depends on the vehicle not being classified as an investment company. See Robert F. Hugi et al., *Registration Under the Investment Company Act of 1940*, in *SECURITIZATION OF FINANCIAL ASSETS* (1997).

64. The term "securities" includes notes, stocks, options, and debt instruments. See 15 U.S.C. § 80a-2(a)(36) (1994).

65. 15 U.S.C. § 80a-3(a)(1)(A). The definition also includes a company that owns "investment securities" with a value exceeding 40% of the total value of its assets. See 15 U.S.C. § 80a-3(a)(3) (1994).

66. See *Exclusion from the Definition of Investment Company for Structured Financings*, 57 Fed. Reg. 56,248 (1992) (codified at 17 C.F.R. § 270.3a-7 (1997)). Securitization transactions prior to Rule 3a-7 proceeded under other exceptions, particularly those for companies that purchase mortgages or financing instruments, 15 U.S.C. §§ 80a-3(c)(5), which permitted securitizations of mortgages, credit card receivables, and trade receivables, and an exception for "private investment companies," which covers non-public offerings to fewer than 100 persons. See 15 U.S.C. § 80a-3(c)(5) (1994).

67. The proposed version of Rule 3a-7 had a laundry list of eligible assets. See *Exclusion from the Definition of Investment Company for Structured Financing*, 57 Fed. Reg. 23,980, 23,985 (1992) (codified at 17 C.F.R. § 270.3a-7 (1997)). The final rule defines "eligible assets" broadly as "financial assets . . . that by their terms convert into cash within a finite time period." 17 C.F.R. § 270.3a-7(b)(1) (1997). Rule 3a-7 also broadly defines per-



In effect, the SEC serves as a gatekeeper to Subchapter K for partnerships that serve as passive financial intermediaries because of the agency's power to define what is a regulated investment company.<sup>68</sup> Some restrictions imposed by the SEC have a great bearing on tax policy. Because Rule 3a-7 covers only "financial assets . . . that by their terms convert into cash within a finite time period,"<sup>69</sup> it is difficult to hold common stock through a widely traded partnership (other exceptions may come into play if a partnership is not widely traded). Additionally, Rule 3a-7 requires that to come within the exception for asset-backed securities, interests sold by an intermediary to the general public must be high-grade, fixed-income, or pay-through securities, which limits the ability of tax planners to create publicly marketable interests that bear contingent deferred income.<sup>70</sup> If the SEC relaxed these restrictions, which is in its power, then it would become possible to hold common stock through a publicly traded partnership, and to create interests with back-end loaded returns.

It is worrisome to have decisions with important tax policy ramifications made by the SEC because the agency has different regulatory objectives than the Treasury. The SEC's objective is to protect investors; the Treasury must protect the fisc. Inter-agency consultation might alleviate this problem, but that seems not to have been the practice in the past. The Treasury did not comment on Rule 3a-7, and there are no mechanisms in place to ensure inter-Agency consultation in the future.

### III. SECURITIZATION OF DEBT: WHY THE FASIT AND REMIC RULES ARE SUPERIOR TO SUBCHAPTER K

A passive financial intermediary that holds debt (other than mortgages) may elect to operate either under the FASIT rules, now that those rules are in effect, or under Subchapter K. This election is not available to intermediaries that hold mortgages because Congress made the REMIC and FASIT rules the exclusive regimes for securitizing mortgages. Congress did this through the rule on Taxable Mortgage Pools, which taxes a multi-class entity that primarily holds mortgages as a corporation if it does not come under the REMIC or FASIT rules.<sup>71</sup>

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missible interests as nonredeemable, 17 C.F.R. § 270.3a-7(a), "fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets." 17 C.F.R. § 270.3a-7(a)(1) (1997).

68. Securities law imposes significant substantive restrictions on investment companies, including limitations on the ability of an entity to have multiple classes of interests. Thus, for non-tax reasons, even more so than for tax reasons, the success of a securitization transaction depends on the vehicle not being classified as an investment company. See Hugi et al., *supra* note 63.

69. 17 C.F.R. § 270.3a-7(b)(1) (1997).

70. See 17 C.F.R. § 270.3a-7(a)(1)-(2) (1997).

71. More precisely, the rules tax as a corporation any entity other than a REMIC or a FASIT if "substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein)," and "such entity is the obligor under debt obligations with 2 or more maturities," and payments on the debt obligations issued by the

How do the FASIT rules stack up against Subchapter K as a tax regime for securitizing debt? One difference between the two regimes that is often significant in tax planning has little bearing on the typical debt securitization. Under the FASIT rules, gain (but not loss) is recognized on a transfer of debt to the entity;<sup>72</sup> under Subchapter K, neither gain nor loss is recognized on a transfer of assets to a partnership if the transferor retains an interest in the partnership.<sup>73</sup> This difference has little bearing on a typical debt securitization because a transfer to a vehicle is likely to be structured as a sale for accounting and legal reasons even in cases where the transferor retains an ownership interest in the vehicle. Also, typically the transferor will receive the proceeds from the public offering upon the transfer of debt to the vehicle, which would bring into play the rule on disguised sales to partnerships,<sup>74</sup> as well as other rules that apply to “abnormal” partnership distributions,<sup>75</sup> even were a transfer structured as a contribution rather than a sale.<sup>76</sup>

A more significant difference between the two regimes lies in the different possibilities under the two for creating interests that predictably bear deferred income. The most obvious way to do this is to strip interest from the principal on a debt instrument. The goal is to create a security—a “principal only,” or “PO,” interest—that is equivalent to a zero coupon bond but that does not accrue interest under the OID rules. The interest income attributable to the principal does not disappear; it is shifted to the holders of the “interest only,” or “IO,” interest. There is a potential for gain in income shifting because the IO interest can be sold to foreigners or tax-exempt entities who are indifferent to the extra taxable income.

The interest strip is an extreme example of income shifting. A similar effect can be achieved by creating interests with inversely stepped interest

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entity “bear a relationship” to payments on debt obligations held by the entity. I.R.C. 7701(i)(2)(A) (West Supp. 1997).

72. See I.R.C. § 860I(a)(1) (West Supp. 1997). Publicly traded partnerships might be used for debt securitizations to get around two recognition provisions in the FASIT rules. First, if the holder of an ownership interest in a FASIT pledges property to secure payments on a regular interest, then the FASIT rules require that the holder recognize gain on that pledged property as soon as it “supports any regular interest in such FASIT.” See I.R.C. § 860I(b) (West Supp. 1997). Second, the FASIT rules require that non-publicly traded debt be valued for purposes of computing gain by discounting “reasonably expected payments” by 120% of the AFR. See I.R.C. § 860I(d)(1) (West Supp. 1997).

73. See I.R.C. § 721(a) (1994).

74. See I.R.C. § 707(a)(2)(B) (1994).

75. These include § 751, which treats a distribution that alters partners’ relative interest in ordinary income assets as a deemed sale, and § 737, which recognizes “precontribution gain” to the extent the value of assets distributed exceeds a partner’s basis in its interest. See I.R.C. §§ 751(b)(1), 737(a)(1) (1994).

76. Under § 721(b), gain also will be recognized on a transfer of property to a partnership if the partnership would come within the definition of an investment company under § 351 were it a corporation. See I.R.C. § 721(b) (1994). A transfer is considered to be to an investment company if the transfer results in diversification of the transferor’s interests and “more than 80 percent of the value of [the corporation’s] assets (excluding cash and nonconvertible debt obligations) are held for investment and are readily marketable stocks or securities, . . . .” Treas. Reg. § 1.351-1(c)(1)(ii) (as amended in 1996).

rates or claims on interest paid through the pool. One class (Class A) would first pay an above-market interest rate<sup>77</sup> and later pay a below-market rate. The other class (Class B) would initially pay a below-market interest rate and later pay an above-market rate. The stepped rates could be fixed or variable (e.g., Class A first pays LIBOR plus two percent and later pays LIBOR minus four percent). The two classes could be structured with the same pre-tax expected yield on the date of issue. Were the interest income to each class based on the stated interest, then this structure would temporarily shift taxable income to Class A from Class B. The shift in taxable income to Class A is not matched by a corresponding economic shift in the value of the interests because the below-market interest rate in the later years suppresses the gain of Class A.

This sort of tax alchemy is impossible under the FASIT and REMIC rules. A FASIT or REMIC must have two classes of interests: regular interests, which must take the form of debt instruments; and an ownership or residual interest, of which in a REMIC there can only be one class<sup>78</sup> and in a FASIT there can be only one owner.<sup>79</sup> Obviously, income shifting is not possible within the ownership interest class.

In theory, income shifting might be possible within the regular interest class, or across the regular and ownership interest classes, but two different types of rules make it impossible. First, there are restrictions on the form that regular interests may take; specifically, a regular interest may not bear a stepped fixed or variable interest rate.<sup>80</sup> Second, because regular interests are taxed as debt instruments, several bodies of rules that are designed to tax debt instruments on their expected yield come into play to ensure that a regular interest cannot predictably bear deferred income. For example, the REMIC regulations permit a pool to have interest-only and principal-only classes.<sup>81</sup> For example, they permit interest stripping, but the rules on bond premium and OID ensure that each class of interest is taxed on its expected yield.<sup>82</sup> And even if a FASIT or

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77. The market rate of interest for a given year is the forward interest for the year at the date of issue.

78. See I.R.C. § 860D(a)(3) (West Supp. 1997).

79. See I.R.C. § 860L(a)(1)(c) (West Supp. 1997).

80. Stepped fixed rates run afoul of a statutory requirement that interest on a regular interest must be payable "on a fixed rate" (note the singular) or a variable rate. See I.R.C. § 860G(a)(1)(B)(i) (West Supp. 1997). Stepped variable rates run afoul of a regulatory requirement that additions or subtractions to a variable rate must be constant over the life of the instrument. See Treas. Reg. § 1.860G-1(a)(3)(iii)(B) (as amended in 1995).

81. See Treas. Reg. § 1.860G-1(a)(2)(C)(iv) (as amended in 1995).

82. Bond premium exists when the acquisition cost of a bond exceeds its principal amount, which is true in spades of an IO security since the principal amount is zero. The holder amortizes this premium over the life of the bond, reducing his interest income. See I.R.C. § 171(E) (1994). This calculation can be made for a mortgage-backed security along the same lines as the calculation of original issue discount. See DAVID GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ch. 16.6 (3d ed. 1994). The issuer of an IO security will treat the amount it pays on the security correspondingly as interest and principal. A holder of a PO security will calculate interest under the OID rules because the stated principal amount of the security exceeds the issue price. Special OID rules apply to REMICs that produce a result that in certain respects is closer to a mark-to-market method than to a pure expected-yield method. See I.R.C. § 1272(a)(6) (1994). Under an

REMIC could have classes of regular interests with stepped rates (again they cannot) the rules on Variable Rate Debt Instruments and Contingent Rate Debt Instruments would come into play to ensure that each class would be taxed on its expected yield.<sup>83</sup> The possibility remains that an ownership interest could predictably bear deferred income since it is taxed on a flow-through basis and not an expected-yield basis. However, for a reason that will be explained shortly, ownership interests usually have the opposite characteristic—they predictably bear taxable income in excess of economic income.

If one took the rules in Subchapter K at face value, then it would be fairly easy to create interests in a pool of debt instruments that predictably bear deferred income. Subchapter K imposes no restrictions on the capital structure of a partnership other than a requirement that income or loss allocated to a partner be reflected in the partner's capital account and that balances in capital accounts be respected on liquidation.<sup>84</sup> This rule does not prevent income shifting because offsetting allocations can be made over time. To take a simple example, consistent with the application of this rule, interest income could be allocated to Class A interests

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expected-yield method, income is imputed on an investment based on the expected yield when the investment is made without regard to the actual yield. Assume a five-year \$1,000 zero-coupon bond that pays \$1,000 multiplied by one plus the rate of increase in the price of gold in five years. The expected yield on the bond is a function of the five-year forward price of gold when the bond is acquired. Interest accrued on the bond will not fluctuate with the forward price of gold. Under a special rule that applies to regular interests in REMICs and other debt instruments subject to prepayment risk, OID is calculated for each period by determining the present value of the remaining payments at the end of the period, adding payments of principal during the period, and subtracting the issue price at the beginning of the period. The effect is that variations as the mortgage prepayment rate will be accounted for in income as they occur. This can have a dramatic effect on the interest calculation on an IO security since unexpected principal prepayments can devastate its present value. The method does not produce a result equivalent to mark-to-market. Events other than prepayment are not taken into account (though the statute enables the Treasury to cover other events accelerating payment). See I.R.C. § 1272(a)(6)(C) (1994). And, the present value of the instrument is calculated using its original yield to maturity. See I.R.C. § 1272(a)(6)(B)(i) (1994).

83. These rules require recalculation of interest in line with the true expected yield on a debt instrument. For example, the Class B interest with stepped fixed rates would be determined to bear original issue discount, with the consequence that interest would be accrued on a constant yield method. This occurs because the step in the interest rate does not come within the definition of "qualified stated interest." See Treas. Reg. § 1.1273-1(c) (as amended in 1996) (requiring that QSI be paid "at a single fixed rate"). Thus, interest is included in the stated redemption price at maturity for purposes of calculation of OID. See Treas. Reg. § 1.1273-1(c)(4) (as amended in 1996). Arguably, the Class B interest with stepped variable rates would be taxed as a Variable Rate Debt Instrument (VRDI). See Treas. Reg. § 1.1275-5(a)(3)(i)(A) (as amended in 1996) (covering debt instruments with "one or more qualified floating rates"). Accordingly, Treas. Reg. § 1.1275-5(e)(3), which covers VRDIs that have more than a single variable rate, would come into play to impute interest using a constant yield method. Alternatively, the instrument might not qualify to be taxed as a VRDI because it violates a requirement that additions or subtractions to a variable rate must be constant over the life of the instrument. See Treas. Reg. § 1.1275-5(b) (as amended in 1996) (defining a "qualified floating rate"); Treas. Reg. § 1275-5(d), ex. 2. In this case, the rules on Contingent Interest Debt Instruments will apply, which means that interest will be imputed using a constant yield method.

84. Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1994).

until the capital account attributable to an interest equals the amount due the interest holder at maturity; thereafter, interest income would be allocated to Class B interests.<sup>85</sup> This is called the "interest flip."

Until a few years ago, I would have thought that the principal test that this arrangement would have to pass is the rule in the § 704(b) regulations, which states that special allocations must have a "substantial" economic effect.<sup>86</sup> The principle of substantiality should suffice to deal with the interest flip in a partnership that holds high-grade debt instruments. However, it is a far weaker check than the principle that underlies the FASIT and REMIC rules, which is that an interest should bear tax on its expected yield whatever the pattern of cash flows or risks. The strongest form of the substantiality test is met if there is a "strong likelihood that the after-tax economic consequences" of any partner will "in present value terms" be "substantially diminished" by an allocation.<sup>87</sup> While allocations that merely vary the timing of fairly certain cash flows to achieve some tax advantage without altering the expected yield on interests should not pass muster under this test, allocations that vary the timing of cash flows *and* the risks borne by partners should pass muster even though there is a tax benefit in the allocation.

Let me give you one example of a capital structure that I believe would pass muster under the § 704-1(b) regulations where the partnership rules yield very different tax results than the FASIT rules. The partnership holds a portfolio of long-term debt instruments that pay a higher than-market rate of interest but which are purchased at a significant discount because of a significant risk of default. Notes of companies in distress would do the trick. To keep it simple, assume the partnership has two classes of interests (multiple tranches would work even better). Class A is initially allocated all of the interest paid on the notes, which is distrib-

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85. This arrangement mimics a similar arrangement using a REIT that the Treasury condemned in I.R.S. Notice 97-21, 1997-11. I.R.B. 9. I am told that the REIT structure was used because it was thought that this arrangement would not pass muster under § 704(b).

86. See Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1995).

87. Treas. Reg. § 1.704-1(b)(2)(iii)(a). This test is poorly drafted as a technical matter; there is a crucial ambiguity. Is the test satisfied if there is substantial chance that the after-tax payoff on an interest will be less than it would have been without the allocation on an outcome or set of outcomes that have a meaningful chance of occurring? Or does the test require that the after-tax expected yield on an interest be less than it would have been without the allocation? I interpret the test in the first way because it says "strong likelihood," which is outcome oriented, but the regulation is not entirely clear on this crucial point for it also dictates that outcomes be assessed in "present value terms," which is forward looking and might be stretched to cover discounting for risk. See Treas. Reg. § 1.704-1(b)(2)(iii)(a). Thus, a pattern of allocations that has a positive after-tax expected yield to all classes will pass muster so long as there is a sufficient chance that the actual yield to one class will be substantially less than it would have been without the allocation. There is no guidance on how probable a loss outcome must be.

There are other technical problems. For instance, the test can be satisfied by creating a risk-bearing interest, i.e., a structure will pass muster if it increases the after-tax expected yield on some interests while not having adverse consequences to others, so long as at least one partner might be adversely effected. Moreover, the test does not address the possibility that a partner who bears risk might hedge against that risk outside the partnership.

uted currently, along with any losses from defaults. Class B is allocated interest once losses allocated to Class A zero out the Class A capital account.<sup>88</sup> These allocations have a substantial economic effect for variations in the default rate will significantly alter the returns to the two classes. Under the normal rules of Subchapter K, holders of Class A interests would have ordinary income and an offsetting capital loss. Holders of Class B would have a mixture of deferred interest income (once Class A is paid out), ordinary income representing the market discount in the bonds, and capital gain when the principal paid out through the pool exceeds an investor's basis in its interest. Under the FASIT rules, each class of interests would bear tax on its expected yield.

I am not saying that such a structure would in fact pass muster.<sup>89</sup> While

88. A concrete example may help. The partnership buys a pool of 1,000 ten-year notes each with a principal amount of \$100 and bearing interest at 10%. The probability that a note will default in any given year is 10%. The notes trade at a significant discount. The risk-free interest is 5%, and the notes trade for \$68.50. In year one, 100 notes default producing a tax loss of \$6,850 (100 times the purchase price of the note, \$68.50) and interest is paid on 900 notes. Class A zeros out in year seven with an initial investment of \$34,000, which is slightly more than the present value of the projected cash flows discounted at a rate of 5%.

	0	1	2	3	4	5	6	7	8	9	10
A income		9,000	8,100	7,290	6,560	5,322	3,017	955			
loss		6,850	6,165	5,549	5,001	4,521	4,042	2,829			
distribution		9,000	8,100	7,290	6,560	5,322	3,017	0			
capital account	34,000	27,150	20,985	15,436	10,436	5,915	1,873	0			
B income						578	2,293	3,825	4,300	3,870	14,442
loss								802	3,288	2,946	2,672
distribution						578	2,293	4,780	4,300	3,870	38,280
capital account	34,501	34,501	34,501	34,501	34,501	34,501	34,501	32,744	29,456	26,510	0

The deferral of income to Class B is a product of two effects. First, all market discount income is allocated to Class B. Second, income is shifted from Class B to Class A in the early years. The taxable income of Class A exceeds economic income (cash paid minus the decrease in value of expected cash flows), as the following table shows:

Year	1	2	3	4	5	6	7
A taxable income	2,150	1,935	1,741	1,559	801	(1,025)	(1,873)
A economic income	1,702	1,337	999	684	390	144	0

This second effect makes it possible to create interests that predictably bear deferred income out of a pool of notes that do not trade at a discount. To do this requires a large pool with multiple tranches using low-grade notes bearing a high rate of interest and a correspondingly high expected rate of default. For example, in one simulation using ten-year notes with a stated interest of 10% (the assumed risk-free rate of interest was 5%) and a default rate of 4.5% per year, I created five equal size classes of interests with the slowest paying class bearing no taxable income until year seven.

89. I.R.S. Notice 95-53, which was directed at lease strips and other stripping transactions, identifies other rules and principles that the Treasury might bring to bear, including § 701 (the anti-abuse regulation), § 482 (which allows the Treasury to reallocate items in transactions between related parties), § 446(b) (the clear reflection of income doctrine), and a bevy of common law principles. See I.R.S. Notice 95-53, 1995-2 C.B. 334, 335; I.R.C. § 446 (1994); I.R.C. § 701 (1994). The regulation proposed to deal with stripping transactions is not relevant to this issue. See Prop. Treas. Reg. § 1.7701(1)-2, 61 Fed. Reg. 68,175

it seems to me that this structure satisfies the § 704(b) regulations, events of the last few years have shown that the government will not abide exotic plans that exploit Subchapter K or other pass-through rule regimes to create interests that predictably bear deferred income or have other disturbing tax characteristics. In particular, the government is likely to argue that the structure described in the last paragraph is a conduit financing arrangement. The government made this argument in two recent rulings challenging well-publicized transactions that shifted income or deductions between taxpayers by using financial intermediaries.<sup>90</sup> It grounded these rulings on § 7701(l), which was enacted in 1993 and gives the Commissioner broad authority to issue regulations dealing with "conduit financing arrangements."<sup>91</sup> One of these rulings states a principle broad enough to cover the structure described in the last paragraph.<sup>92</sup> Boiled down, this principle would recharacterize as a conduit financing arrangement any partnership structure in which payments made to a partner eroded the value of that partner's interest and the payments (with associated allocations of income) shifted taxable income from one partner to another.<sup>93</sup> The structure described in the last paragraph runs afoul of the principle if not the precise letter of this ruling because the alloca-

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(1996). In the variant of a stripping transaction that uses a partnership, an entity that is effectively tax exempt transfers rental or other property that generates income and expense to a partnership that involves some other entities that can make use of the deductions. The rent or other income is prepaid and that income is allocated to the transferor, which then liquidates its interest in the partnership. The remaining partners then reap the benefits of depreciation or other expenses of producing the income without being taxed on the corresponding income. See I.R.S. Notice 95-53, 1995-2 C.B. 334. The proposed regulations apply if one party assumes the obligations of another party to provide property or services in the future while the other party has already received, or retains the right to receive, payments for providing such property or services. See Prop. Treas. Reg. § 1.7701(l)-2, 61 Fed. Reg. 68,175, 68,176 (1996).

90. See I.R.S. Notice 97-21, 1997-11 I.R.B. 9 (responding to "fast-pay preferred stock"); I.R.S. Notice 95-53, 1995-2 C.B. 334 (responding to stripping transactions). Notice 95-53 is discussed at *supra* note 89.

91. Section 7701(l) gives the Secretary of Treasury authority to "prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title." See I.R.C. § 7701(l) (1997).

92. See I.R.S. Notice 97-21, 1997-11 I.R.B. 9. In the example in Notice 97-21, a corporate sponsor transfers high quality debt instruments to a REIT taking back all the common stock. The REIT issues preferred stock that is sold to foreigners or tax-exempt entities. The cash flow on the debt is used to service the preferred stock, which carries a dividend rate well above the market rate of interest for 10 years. After 10 years the preferred stock stops paying dividends and it is slowly liquidated at a rate of one percent of the issue price per year. The sponsor's interest is similar to a zero-coupon bond: it predictably rises in value as the 10 years elapse. The Notice takes the position that the described transaction is in reality a financing transaction. It relies on § 7701(l). See *id.*; I.R.C. § 7701(l).

93. The Notice states that eventual regulations will cover the case where (1) a conduit entity is used; (2) an interest in the entity is "partially or fully self-amortizing," meaning that payments that are made are expected to decrease its value; and (3) and these payments "are treated by the conduit entity as a distribution of earnings and profits or otherwise as reducing the conduit entity's or any other taxpayer's taxable income." I.R.S. Notice 97-21, 1997-11 I.R.B. 9.

tion of losses erodes the value of a Class A interest while the allocation of income shifts taxable income from Class B to Class A.

It is anyone's guess whether the government would prevail were this issue litigated under the current statute and regulations.<sup>94</sup> Section 7701(l) is directed at a different problem.<sup>95</sup> While that statute is broadly written, a literal reading of it would not reach cases such as this.<sup>96</sup> Courts do not always side with the government when it takes positions that are not well-grounded in the Tax Code or regulations in challenging tax-motivated transactions.<sup>97</sup> However, such legal arguments may be largely beside the point. The government may strengthen its legal position by issuing regulations in support of its position. While regulations usually apply only prospectively to transactions occurring after the regulation is issued, the Treasury has the power to make regulations retroactive.<sup>98</sup> And in a few

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94. The government might also try to argue that either interest is debt and not equity. However, the little case law on debt-equity characterization in a partnership mostly involve challenges by the government to purported debt, not purported equity. The cases are collected in WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 3.03[3] at 3-26 to 3-27 (1990). The government lost in two cases where it argued that a purported equity interest that carried a guaranteed return with a set yield was in reality debt. See Lamar Hunt, 59 T.C.M. 635 (1990); Investors Ins. Agency, Inc. v. Commissioner, 72 T.C. 1027 (1979), *aff'd*, 677 F.2d 1328 (9th Cir. 1982).

95. What Congress had in mind when it enacted § 7701(l) was the case where a foreign person lent money to a United States person through a conduit entity established by the parties in a third nation with which the United States had a tax treaty exempting interest income from tax. The legislative history cites Aiken Indus., Inc. v. Commissioner, 56 T.C. 925 (1971), as an example. For a clean example of such an arrangement, see Treas. Reg. § 1.881-3(e), ex. 11 (as amended in 1995). FP is organized in country N, which has no tax treaty in the U.S. FP owns 100% of the stock of FS, which is organized in country T. Country T has a tax treaty with U.S. exempting interest; country N does not. FP makes an interest-free demand loan of \$10 million to FS. FS then lends \$10 million to DS, a U.S. borrower, on a 10-year interest bearing note.

The legislative history states that the rule has broader application. There is a statement that the principle applies "not solely to back-to-back loan transactions, but also to other financing transactions . . . [including] multi-party transactions involving debt guarantees or equity investments." *House Report to the Revenue Reconciliation Act*, H.R. REP. NO. 103-111, pt. e, at 729 (1993).

96. On its face, § 7701(l) only empowers the Secretary to disregard an intermediary entity in a financing transaction and collapse the transaction into direct financing by one party to another. In the example in text, the statute is invoked to recharacterize a contract between one party and the intermediary.

97. A notable example of a government defeat when it took a position weakly grounded in the blackletter law of the Code and Regulations is *Cottage Sav. Assoc. v. Commissioner*, 499 U.S. 554 (1991), which rejected the argument that a loss should not be recognized on the exchange of equivalent portfolios of loans because the taxpayer's position was supported by a literal reading of the relevant statute and regulation. *Brown Group Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), is another notable government defeat. The court allowed a U.S. corporation to avoid tax under Subpart F on unremitted profits from its foreign operations by conducting those operations through a partnership. The decision offers a striking illustration of the different reactions judges have to the IRS as an advocate and the IRS as a writer of regulations. The court refused to close what it conceded was a "loophole" in the law, taking the position that to do so was Congress's job. The court did, however, note the § 701 anti-abuse regulations with approval. See *id.* at 222. This suggests that the government could have strengthened its hands in the litigation by making the anti-abuse regulations retroactive.

98. See I.R.C. § 7805(b)(3) (West Supp. 1997), which allows Treasury to "provide that any regulation may take effect or apply retroactively to prevent abuse." Even without such



instances it has used that power. This power is the ultimate weapon in the government's arsenal aimed at tax planners who exploit loopholes and gaps in existing tax law.

There is a more subtle difference between Subchapter K and the REMIC and FASIT system. The difference is most pronounced in REMICs, which typically hold long-term fixed rate mortgages and issue a series of debt instruments (or "tranches") with different maturities. The difference results from a financial phenomenon—typically the yield curve slopes upward, meaning that longer maturity debt bears a higher rate of interest—and an accounting convention. By convention, interest on fixed-rate debt is assumed to accrue at a constant rate. Because of this phenomenon and convention, a typical REMIC will earn more interest income in its early years than the amount it pays out. The cash flows wash because there is an offsetting discrepancy in principal paid in and out. Interest paid in and out equalizes over time, but a lower amount is paid out in the early years when the shorter maturity, lower rate tranches are being paid off.<sup>99</sup>

In a REMIC, this asymmetry in the accounting for interest paid into and out by the pool produces what has been called "phantom income."<sup>100</sup> The FASIT and REMIC rules are designed to ensure that this "phantom income" bears tax. The rules require that there be an ownership or residual interest in an entity so that someone bears this phantom income. Additionally, they require that this interest be held by a tax-paying corporation. Consequently, a residual interest can have negative value: a corporation is paid to assume the interest. There are no such restrictions in Subchapter K. A partnership can hold long-term, non-mortgage debt and issue a series of debt instruments. In an environment with a rising yield curve, the partnership will pay out interest at a slower rate than it receives it. This defers income to the persons holding debt through the partnership while producing a residue of "phantom income" to the partnership. If the partnership interest is held by a foreigner or a corporation with net operating losses, then this "phantom income" will escape tax.

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authority, the Treasury could achieve much the same effect as making a ruling retroactive by applying it prospectively to transactions that were entered into prior to the ruling. This was done in I.R.S. Notice 97-21, 1997-11 I.R.B. 9.

99. A simple example can illustrate this phenomenon. Assume a pool of three-year notes that pay eight percent. It is carved up into three tranches with maturities of one, two, and three years, which bear interest at rates of 7.7%, 8%, and 8.2% respectively. Over time, equal amounts of principal and interest will be paid into and out of the pool. But in year one, the pool will have phantom income because the interest it is deemed to earn at a flat rate of 8% on outstanding principal will exceed the interest it pays on the three tranches, since the pool is paying a rate of only 7.7% on some of the principal. See Kirk Van Brunt, *Tax Aspects of REMIC Residual Interests*, 2 FLA. TAX REV. 149 (1994) (providing a more elaborate example).

100. See *id.* at 211-15.

#### IV. SECURITIZATION OF TAX PREFERENCE ASSETS, THE EFFECT OF ACCOUNTING ASYMMETRIES IN THE FASIT MODEL, AND MORE ON TAX ALCHEMY USING PARTNERSHIPS

Under the REMIC and FASIT models, there is only a minor potential tax advantage to slicing up debt instruments through an intermediary because most interests in the intermediary themselves take the form of debt. This means that they will bear the tax on their expected yield however cash flows and risks are divided. This model works best when debt instruments are held through the intermediary; the income paid into and paid out by the intermediary roughly offset. Income and deductions may not perfectly offset—the phenomenon of “phantom income” is a case in point—but such discrepancies are likely to be minor. Viewed in the abstract, the phenomenon of phantom income results from an asymmetry in how interest is accounted for on the pool of mortgages held by the entity and how interest is accounted for on the debt instruments issued by the entity. Accounting asymmetries could have profound effects if assets other than debt instruments could be held through a FASIT or REMIC (they cannot).

Tax preferences are an important source of asymmetry. Preferred stock is a case in point. From an economic perspective preferred stock is similar to debt. However, the interest-like payment is subject to a tax preference: the dividends received deduction.<sup>101</sup> While a FASIT may not hold preferred stock, the FASIT structure could be replicated by creating a partnership that had a single small class of equity that issued debt in one or more classes. Such a partnership would generate a large residue of dividend income and unused interest deductions. This residue would flow through to the equity owner. While the equity interest might seem to be an attractive investment for a tax-paying corporation (the idea would be to deduct the entire amount of the interest while shielding seventy percent of the dividend income from tax with the dividend's received deduction<sup>102</sup>), the anti-arbitrage rule in section 246A, which reduces the dividends received deduction on debt-financed stock, eliminates this tax benefit. The equity owner is in the same position as someone who borrows to invest in preferred stock.

The analysis proceeds along roughly the same lines if tax-exempt bonds are held through a partnership with a FASIT-type capital structure. The partnership generates a residue of tax-exempt income and interest deductions, but the anti-arbitrage rule in section 265 prevents the equity owner

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101. See I.R.C. § 243 (1994).

102. Assume preferred stock with a face value of \$100 that pays a dividend of 6% is held through an intermediary that issues debt with a face value of \$99 that pays 6.1% interest. The residual dividend income would be \$6 annually and the residual interest deduction would be \$6.04. This would generate an annual tax benefit worth \$1.48 to a corporation at a 35% rate (the interest deduction reduces taxes by \$2.11 and the tax paid on the dividends is \$.63 (.35 \* .3 \* \$6)).

from utilizing the interest deductions.<sup>103</sup> While this analysis suggests that Treasury should not be concerned with the use of partnerships to securitize tax-preference assets so long as the partnership has a FASIT-type capital structure (i.e., the partnership has a single class of equity with all other interests taking the form of debt), it also shows why tax planners are not satisfied with this option, for income flowing through to the holders of debt interests loses its preferred character.

A partnership might be used to securitize preferred stock or tax-exempt bonds by structuring the "pay-through" interests—i.e., the interests that receive the dividend or interest payments as they flow through the pool—as equity rather than debt. This possibility takes us into uncharted legal terrain.<sup>104</sup> A taste of the problems in store for the Treasury as tax planners venture into this terrain can be had from considering how a partnership might be used to strip dividends from preferred stock. In a simple version of a dividend strip using a partnership, preferred stock is held through a partnership that has two classes of interests. One class receives all the dividends while the other class receives the payment on liquidation or sale of the stock.<sup>105</sup> Call these two classes the "DO" (dividend only) and "LO" (liquidation only) interests. This structure has promising tax characteristics. The hope is that in the hands of a corporation, a DO interest will produce a stream of income that is shielded from tax by the dividends received deduction, followed by a loss of the unrecovered basis in the interest on liquidation. Moreover, the hope is that the LO interest, which is similar to a zero-coupon bond, will bear deferred income.

The government does not have dependable weapons in Subchapter K to challenge this sort of arrangement. It could challenge the substantiality of the allocations, but, as we have seen, introducing risk with regards to the amount or the timing of the dividends or the liquidation payment weakens this argument. And the substantiality test could be satisfied by

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103. There is a debate about the merit of § 265 and other anti-arbitrage rules that are keyed to debt-financed investments in tax-preference assets. For a vigorous, multi-faceted defense of these rules, see Calvin H. Johnson, *Is An Interest Deduction Inevitable?*, 6 V.A. TAX REV. 123 (1986). For a critique of the rules, see William A. Klein, *Borrowing to Finance Tax-Favored Investments*, 1962 WIS. L. REV. 608.

104. It is difficult to take a large publicly traded partnership down this path today. Under SEC Rule 3a-7, an investment intermediary is subject to regulation as an investment company, and so will be taxed as a corporation under the publicly traded partnership rules, unless the securities it sells to the public at large are high-grade fixed income securities. See 17 C.F.R. § 270.3a-7 (1997).

105. As with the interest-strip, allocation of all the dividend income to the dividend interest will create an imbalance in the capital accounts. On liquidation, a dividend interest would have a positive balance in its capital account equal to its initial balance. The fast-pay preferred stock structure shows one way to eliminate the imbalance: provide that the preferred interest will be paid a nominal return after a set date for a prolonged period until a pre-ordained liquidation date. See *supra* note 94. Alternatively, if the portfolio of preferred stock can be expected to generate losses, then the positive balance might be wiped out using a structure in which the fast-pay interests are allocated all losses until the capital account is wiped out as well as being allocated all dividends until that time. See *supra* note 87.

introducing complications in the basic structure that mute the tax benefits while accentuating the risk to a class of interests, for example, create a third class of interests that has a right to dividends over a specified level.<sup>106</sup> As I noted in the discussion of interest stripping, the government may have more success with the argument that this is really a conduit financing arrangement, though, again, it may not.

The government could also bring to bear provisions in Subchapter C and elsewhere in the Tax Code that address related shenanigans with preferred stock. However, it will find that the interposition of a partnership weakens these arguments. Section 305(e), which was enacted in 1993, taxes the holder of the zero-coupon bond like interest created by stripping preferred stock as if he held a zero-coupon bond.<sup>107</sup> This provision applies only to a “purchaser” of “stripped preferred stock,” who is defined as a person who acquires stripped stock in a transaction where their basis in the stock is not determined by reference to the basis in the stock of the person from whom they acquired the stock.<sup>108</sup> A partnership that purchases preferred stock is not a purchaser of stripped preferred stock under this definition, and neither is a partner who holds an LO interest, even if the partnership is considered an owner of the stock. The partner’s basis in the stock is, in part, a function of the partnership’s basis in the stock.

The government would be on slightly firmer footing in challenging the dividends received deduction claimed by a corporate holder of a DO interest. It could take the position that the preferred stock was not ever held for the forty-five day period required by section 246(c); at all times the holder of a DO interest is in a position similar to a person who holds preferred stock under an obligation to sell (the holder of the LO interest is in the position of the buyer).<sup>109</sup> However, this argument is not a clear winner either. The ultimate question here is whether a holder of preferred stock bears a risk of loss on the stock. The holder of a DO interest bears a significantly greater risk of loss than does a person who holds stock under an obligation to sell, because a holder of a DO interest is exposed to the risk that dividends will not be declared for a substantial period of time. Further, the section 246 regulations say little about risk-shifting arrangements using partnerships.<sup>110</sup>

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106. As it is written, the substantiality test is met if a special allocation can result in *any* significant interest doing substantially worse than it would have done post-tax had the allocation not been made. Thus, creating a third class of interests on top of the dividend interest and the liquidation interest can satisfy the test with regards to those interests.

107. See I.R.C. § 305(e) (1994).

108. See I.R.C. § 305(e)(5)-(6) (1994) (defining “purchase”).

109. See I.R.C. § 246(c)(4)(A) (1994).

110. There is only this statement in the regulations: “[A] taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if the taxpayer holds an interest in, or is the beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding the application of this section . . . .” Treas. Reg. § 1.246-5(c)(6) (1997).

This is not an isolated problem that can be fixed with a ruling or two. Dividend stripping is illustrative of a larger set of problems created by basic features of tax law in general and partnership tax law in particular.<sup>111</sup> A great many rules and principles in income tax law turn on the concept of ownership, which increasingly is associated in tax law with risk bearing on the thing ostensibly owned. Section 246(c) is a case in point. It denies the dividends received deduction to a transitory owner of preferred stock and recognizes a person as an owner only if he bears a risk of loss on the stock. The use of partnerships undermines the application of section 246(b), and it will undermine the application of other rules and principles that are keyed to ownership and risk, for partnerships cloud the issue of ownership and permit unique risk tailoring. Subchapter K is not much of an impediment to such arrangements because its rules were designed to be flexible; while there are some constraints, the most important of these—the substantiality test for special allocations—is indeterminate and primitive.

## V. THE ROAD AHEAD: THE POTENTIAL OF ANTI-ABUSE LAW

It would be a mistake to abolish the “passive-type” income exception to the publicly traded partnership rules for this would close Subchapter K to publicly traded entities. It is important to keep Subchapter K open as a tax regime for the securitization of assets that either do not qualify under the FASIT rules or that cannot economically be securitized under the FASIT rules because those rules would strip them of their preference income. Indeed, an argument can be made for expanding the scope of the exception to cover some assets that now are excluded, in particular insurance contracts. In the short-run, the government will have no choice but to address the use of partnerships as passive financial intermediaries through the growing web of anti-abuse law. These include the substantiality test in the section 704(b) regulations,<sup>112</sup> the general anti-abuse rule in the section 701 regulations,<sup>113</sup> and the rules being developed under the “conduit financing arrangement” principle of section 7701(l).<sup>114</sup> In this section, I examine how far the government might go using this evolving body of law.

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111. See, e.g., Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643 (1995). Use of a partnership also assists in exploiting tax law's penchant for “cubby-holing” investments to determine their tax consequences. For an explanation of cubby-holing. See Randall K.C. Kau, *Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products*, 68 TAXES 1003, 1007 (1990). See also Edward Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943, 947-48 (1989).

112. See Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 1997).

113. See Treas. Reg. § 1.701-2 (as amended in 1995).

114. See I.R.C. § 7701(l). See also Treas. Reg. § 1.7701(l)-2, 61 Fed. Reg. 68175 (1996).

A. THE NECESSITY AND INSUFFICIENCY OF  
ECONOMIC SUBSTANTIALITY

The substantiality test in the section 704(b) regulations runs into a problem at a deeper level than do most other “substance over form” principles. A comparison of the substantiality test with the “constructive sale” principle illustrates the point. People disagree on where to draw the line in defining a “constructive sale.”<sup>115</sup> Enforcing a constructive sale principle is difficult because of line-drawing and monitoring problems, but at a deeper level most people who are knowledgeable about tax would accept the basic premise behind the principle, which is that some arrangements are so substantively similar to a sale that they should be taxed as such notwithstanding their form. The constructive sale principle works at this deep level because of a common understanding that there is a thing called a sale that has certain identifiable economic characteristics and that should bear certain tax consequences.

The substantiality test in section 704(b) does not work at this deep level. Satisfying the substantiality test means that allocations in a partnership agreement will be respected for tax purposes, which means that tax consequences of the parties arrangement will follow from the application of the rules in Subchapter K. However, this does not make us confident that we are taxing their arrangement properly, in the same way we are confident that we are taxing an arrangement properly as a sale when it has the substantive elements of a sale. The fundamental reason is that while we have vague ideas of certain arrangements that are within the concept of partnership where the rules in Subchapter K measure income pretty well (the proverbial “mom and pop partnership” comes to mind as an example), because of the breadth and vagueness of the concept of a partnership there are many arrangements that come within this concept where we expect that the rules in Subchapter K do not measure the partners’ income particularly well.

While passing the substantiality test should not be sufficient to bring an arrangement under the rules in Subchapter K, it should not be a necessary condition for respecting allocations. One justification for the substantiality test is that in a “normal” partnership income and loss are shared pro rata. Deviations from this norm are allowed, but only if they have economic substance. I would justify the test in a somewhat different way that takes account of the “plasticity” of the partnership form. We realize that given the plasticity of the partnership form, people often can achieve their economic goals using a partnership through a variety of arrangements that have different tax consequences. This thought is troubling because we expect that people will select the partnership arrangement that bears the least aggregate tax. To limit this discretion,

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115. See Revenue Reconciliation Act of 1996, § 9512, TAX NOTES TODAY, Mar. 20, 1996; Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 641 (1995) (describing constructive sale rules proposed by the Treasury and an alternative proposal by Professor Schenk).

we require that there be an economic justification for variations from some baseline. The chosen baseline (pro rata allocations) has the virtues of simplicity and familiarity, and it may even be the baseline from which most people start in structuring partnerships.

B. WHEN DOES IT VIOLATE THE "INTENT OF SUBCHAPTER K" TO USE PARTNERSHIPS TO CIRCUMVENT RULES OUTSIDE OF SUBCHAPTER K?

My argument that passing the substantiality test should not be sufficient to justify applying Subchapter K to an arrangement is grounded on the provocative claim that there are a significant number of economic arrangements where applying the rules in Subchapter K produces the wrong tax result. This is a provocative claim, for it presupposes a theory explaining why a result is wrong. Such a theory cannot be derived from Subchapter K itself, and while we might appeal to broad principles of good tax policy, such as the principle "taxable income should equal economic income," those principles are mostly aspirational and so are not that helpful as guides. In this section, I suggest a more modest basis for condemning certain results under Subchapter K: we suspect a result is wrong when a partnership is used to circumvent tax rules contained outside Subchapter K or to achieve tax results that could not be achieved were the same thing done not using a partnership entity.

Subchapter K is particularly susceptible to the argument that it should not be used to circumvent other tax rules because its rules are often justified on the ground that they enable people to do through a partnership what they could also do outside of a partnership. For example, the rule allowing special allocations was originally justified in this way,<sup>116</sup> and so too was the rule giving partners outside basis for partnership nonrecourse debt.<sup>117</sup> This justification leaves off when a partnership is used to circumvent tax rules outside of Subchapter K. And it weakens when a partnership is used to do things that cannot be done outside of a partnership.

Much of existing anti-abuse law is best understood as a measure to prevent the use of partnerships to circumvent tax rules outside of Subchapter K. Sections 707(a)(2)(A) and (B), which were enacted in 1984, have this character. They are aimed at "disguised sales" and the like, and were expressly justified on the ground that partnerships should not be used to "circumvent the requirement to capitalize certain expenses and other rules and restrictions concerning various expenses" or to achieve "tax free treatment in cases which are economically indistinguishable from sales."<sup>118</sup> One of the targets of the general anti-abuse regulation in

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116. See H.R. REP. NO. 83-1337, at A223-24 (1954); S. REP. NO. 83-1622, at 379 (1954) (giving as examples of valid allocations the allocation of foreign source income to a foreign partner and the allocation of income from separate assets to different partners).

117. See *Federal Income Tax Project: Subchapter K Proposals on the Taxation of Partners* 231-32 (Am. Law Inst. 1984).

118. H.R. CONF. REP. NO. 98-861, at 233 (1984).

section 701, as that regulation was first proposed, was transactions using “partnerships to avoid the purposes of other provisions of the Internal Revenue Code.”<sup>119</sup> This target is not stated explicitly in the final regulations, but it is implicit in the first factor said to bear on the abusiveness of a partnership transaction: whether the partners would have had a greater tax liability had they done whatever they did outside of Subchapter K.<sup>120</sup> And a concern with the use of partnerships to avoid other tax rules is at the heart of the second part of the anti-abuse regulations, which allows the Commissioner to look through a partnership, treating a partner as if he owned partnership assets directly, “to carry out the purpose of any provision of the Internal Revenue Code.”<sup>121</sup>

The deep problem presented by this sort of anti-abuse rule (there is also a line-drawing and monitoring problem) is determining when it is improper to use a partnership to circumvent tax rules outside of Subchapter K. It is not always improper; for instance, the anti-abuse regulations say that a partnership may properly be used to avoid the corporate tax.<sup>122</sup> Section 701 regulations say that this is so because “Subchapter K is intended to permit taxpayers to conduct joint business activity . . . without incurring an entity-level tax.”<sup>123</sup> However, this merely states the conclusion. How are we to go about determining the “intent of Subchapter K” in other cases?

The practical answer to this question is that Treasury will tell us; and some questions are sufficiently open to debate that whatever Treasury says goes. For example, Treasury could (and probably should) proclaim that it was not “the intent of Subchapter K” to allow partnerships to be used to evade the rules on dividend stripping. Such a pronouncement would go part of the way towards addressing the problems raised in Part IV. I have no doubt that a court would uphold such a regulation.

A more interesting question that goes to the limits of the Treasury’s power is whether the Treasury could proclaim that it violates the “intent of Subchapter K” to use a partnership to circumvent the FASIT rules. Such a proclamation would go a long way towards addressing the problems discussed in Part III. One difficulty with such a pronouncement is that it would be legally unsound. It is inconsistent with the publicly traded partnership rules, which allow debt instruments to be held through a publicly traded partnership that is taxed under Subchapter K.<sup>124</sup> It is

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119. Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581 (1994). This was one of two targeted uses of partnerships. The other was “transactions using partnerships to achieve tax results that are inconsistent with the underlying economic arrangements of the parties or the substance of the transactions . . .” *Id.*

120. See Treas. Reg. § 1.701-2(c)(1) (as amended in 1995) (a defining factor bearing on the abusiveness of a partnership arrangement whether “[t]he present value of the partners’ aggregate federal tax liability is substantially less than had the partners owned the partnership’s assets and conducted the partnership’s activities directly).

121. Treas. Reg. § 1.701-2(e)(1) (as amended in 1995).

122. See Treas. Reg. § 1.701-2(d), ex. 1(i) (as amended in 1995).

123. Treas. Reg. § 1.701(d), ex. 1(ii) (as amended in 1995).

124. See I.R.C. §§ 7704(d)(1)(A), (d)(1)(E) (West Supp. 1997).



also inconsistent with Congress's apparent intent in enacting the FASIT rules. Congress chose to not make the FASIT rules exclusive knowing that partnerships were being used to securitize debt instruments.

Such a pronouncement would be unwise as well as of dubious legality because of the line-drawing problem. A line drawing problem is inherent in any anti-abuse rule that taxes one thing because it is like something else, but the problem in this case is of a different order. The decision to make the FASIT rules exclusive raises a host of difficult policy questions. What, for example, should be done about tax-exempt bonds? And can a partnership be used as a vehicle for securitizing ordinary debt instruments with market discount (the FASIT rules would strip the tax benefits for market-discount bonds held through a FASIT<sup>125</sup>)? It is better not to try to address difficult questions like these through the framework of an anti-abuse rule because, by necessity, anti-abuse rules are vaguely drawn. Questions that raise important policy questions will go unasked and unanswered.

### C. FORMULATING MIDDLE RANGE "INVIOABLE" TAX PRINCIPLES

I have yet to discuss the most controversial parts of anti-abuse law under the section 701 regulations and under section 7701(l). These parts of the law consist of examples of specific transactions that are deemed to be abusive, a few general principles that are said to underpin these rulings, and a set of factors that purport to explain how the principles are applied. The deep problem in this body of law lies in the gap between the decisions in the specific cases and the general principles and factors. While the cases seem rightly decided the stated principles and factors do not really explain the decisions because they are too broad—there are too many counter-examples in tax law where outcomes that violate the principles and that exhibit the factors are countenanced. This gap opens the anti-abuse rules to the valid criticism that the government is over-reaching,<sup>126</sup> and, perversely, it diminishes the effectiveness of anti-abuse law because a natural reaction is to interpret the law as case specific. This part of anti-abuse law also is open to criticism and is of diminished effectiveness because of the fact that in these cases the government is opposing positions that are well-grounded on the literal language of the Code with weak statutory authority on behalf of its own position. Strengthening this part of anti-abuse law requires tightening the law. What is needed are middle range principles that explain the specific decisions and

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125. Under current law, market-discount bonds held through a REMIC or a FASIT are stripped of this preference because the market discount is "included in gross income for the taxable years to which it is attributable." I.R.C. § 860C(b)(1)(B) (West Supp. 1997); see also I.R.C. § 860H(b)(2) (West Supp. 1997).

126. See e.g., William F. Nelson, *The Limits of Literalism: The Effect of Substance Over Form, Clear Reflection and Business Purpose Considerations On the Proper Interpretation of Subchapter K*, 73 TAXES 641, 658 (1995); Kenneth W. Gideon, *Use, Abuse, and Anti-Abuse: Policy Considerations Affecting the Nature of Regulatory Guidance*, 73 TAXES 637, 639 (1995).

that command general respect. The rulings under section 7701(l) are a step in this direction for they state more limited principles than do the section 701 regulations. Still, there are complaints from the bar that these principles sweep too far.<sup>127</sup> A consequence of this tightening of anti-abuse law is that there will be some troubling cases that anti-abuse law cannot reach.

Example 7 of the section 701 regulations is a good illustration of a transaction that most now would consider abusive.<sup>128</sup> The case has many elements in common with the transaction that was held to be abusive by the Tax Court in *ACM Partnership v. Commissioner*,<sup>129</sup> and it also has many elements in common with the transaction that was held to be abusive in the “anti-stripping” ruling and regulations.<sup>130</sup> A partnership is formed by a foreign corporation, a domestic corporation, and a promoter, which contribute \$9,000, \$990, and \$10, respectively. The partnership uses this money to buy offshore equipment, which it proceeds to lease out under a long-term lease. Next it sells the right to the future leasehold income for \$9,000, which is income under the rule on prepayments and is allocated among the partners pro rata (\$8,100, \$891, and \$9 respectively). Then the foreign corporation liquidates its interest for \$9,000. Because a section 754 election is not made, the partnership is left with equipment with an inside basis of \$10,000 (its cost), though the combined outside basis of the domestic corporation and the promoter is only \$1,890 at this point. The partnership borrows \$8,000 and buys an asset to increase its outside basis. Finally, it sells the equipment subject to the lease for

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127. See Richard M. Lipton, “Obligation-Shifting” Proposed Regulations—Is Deemed Loan Treatment the Right Approach, 86 J. TAX’N 209 (1997).

128. Treas. Reg. § 1.701-2(d), ex. 7 (as amended in 1995).

129. *ACM Partnership v. Commissioner*, 73 T.C.M.(CCH) 2189 (1997). The Tax Court’s decision in *ACM Partnership* stands for the proposition that if a tortuous route is taken to get from one point to another solely for the tax benefits that lay along the more difficult route a court may disregard the route that was taken and place the transaction on a different route. This principle is akin to one formulation of the step-transaction doctrine, the so-called “end result test,” wherein “purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.” *McDonald’s Restaurants v. Commissioner*, 688 F.2d 520, 524 (7th Cir. 1982) (quoting *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969)). *ACM Partnership* adds an important gloss to this principle: the route taken will be disregarded if the additional transaction cost of taking that route exceeded any reasonably possible additional profit.

The obvious objection to this principle is that it is wildly overbroad. Taxpayers regularly incur additional transaction costs to structure investments in tax-advantaged forms. Using insurance as an investment vehicle is a common example. Two related factors mentioned in *ACM Partnership* narrow the principle somewhat, though both are very indeterminate. One factor might be called legislative intent: sometimes Congress endorses cumbersome tax-saving strategies. Equipment-leasing in the early 1980s is an example. The other factor is custom. Commonplace cumbersome tax-saving strategies are immune from challenge on this ground. Using insurance as an investment vehicle is distinguishable on the second ground; it may be distinguishable on the first.

130. See Prop. Treas. Reg. § 1.7701(l)-2, 61 Fed. Reg. 68,175, 68,179 (1996); I.R.S. Notice 95-53, 1995-2 C.B. 334.

\$1,000, realizing a \$9,000 loss that is allocated to the two partners. Generating this artificial loss was the point of the transaction.

The section 701 regulations do a poor job of explaining precisely what makes this transaction abusive. The outcome violates the general principle stated in the regulations—the outcome does not “clearly reflect the partner’s income”<sup>131</sup>—but so too do many other outcomes under Subchapter K for it is a realization-based system and not an accretion-based system. The regulations purport to limit this principle by stating that outcomes that do not clearly reflect income are not tolerated when they are a byproduct of the application of rules that were adopted for “administrative convenience and other policy objectives” and the outcome was not “clearly contemplated” by the rule.<sup>132</sup> This statement has about the same content as the aphorism “pigs get fat, hogs get slaughtered.” Both statements in this context mean do not push tax law too far.

What guidance there is in the regulations on what is too “swinish” is found in a list of factors that are said to bear on the determination “[w]hether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K.”<sup>133</sup> These factors include: (1) the fact that the partners’ aggregate federal tax liability is substantially less than it otherwise would have been;<sup>134</sup> (2) the fact that transaction has a step or steps with little economic significance but that generates substantial tax savings (such as interest of the foreign corporation’s role and the dealings with the equipment in example 7);<sup>135</sup> (3) the fact that a partner has a nominal or risk-free interest (such as the foreign corporation in example 7);<sup>136</sup> and (4) the fact that a partner is effectively exempt from tax (yet another factor bearing on the perfidy of the role of the foreign corporation in example 7).<sup>137</sup>

This list of factors narrows the principle somewhat but it remains overbroad. A testament to this effect can be found in the section 704(b) regulations since the same factors that were present in example 7 of the section 701 regulations can be present in what is plainly meant to be a valid special allocation.<sup>138</sup> Example 2 in the section 704(b) regulations<sup>139</sup> involves disproportionate allocations of depreciation deductions from debt-financed equipment with a gain chargeback.<sup>140</sup> Add two facts to example 2—the equipment is leased out under a long-term lease for its entire useful life to a lessee with a gilt-edged credit rating and the partners

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131. Treas. Reg. § 1.701-2(a)(3) (as amended in 1995).

132. *Id.*

133. *See* Treas. Reg. § 1.701-2(c) (as amended in 1995).

134. *See* Treas. Reg. § 1.701-2(c)(1) (as amended in 1995).

135. *See* Treas. Reg. § 1.701-2(c)(2) (as amended in 1995).

136. *See* Treas. Reg. § 1.701-2(c)(3) (as amended in 1995).

137. *See* Treas. Reg. § 1.701-2(c)(5) (as amended in 1995).

138. *See* Treas. Reg. § 1.704-1(b) (as amended in 1994).

139. *See* Treas. Reg. § 1.704-1(b)(5), ex. 2 (as amended in 1994).

140. *See id.*

come from different tax clienteles (the partner who gets the depreciation deductions values them while the other one is tax exempt)—and all the factors that were present in example 9 are present in example 2. But it is clear that the addition of these facts should not change the outcome in example 2 because the conclusion that this arrangement has economic effect flows from an irrebuttable presumption in the section 704(b) regulations that the value of the equipment equals its basis.<sup>141</sup> Example 8 in the section 701 regulations<sup>142</sup> describes a case that is similar to example 2 in the section 704(b) regulations with the additional damning facts. The explanation is that this outcome was “clearly contemplated” by the “value equals basis safe-harbor.”<sup>143</sup> This is a conclusion masquerading as reasoning.

The Treasury took another crack at example 7 in the anti-stripping ruling and regulation and came up with a more limited principle.<sup>144</sup> The regulation is directed at “obligation-shifting transactions” in which one party assumes the obligation of another to provide property or services in the future under a lease or similar agreement where the other party has already been paid to provide that property or those services.<sup>145</sup> Putting it differently (and a little more broadly), the regulation aims at transactions that result in different taxpayers bearing income and the expense associated with producing that income. Example 7 is covered by the regulation because the corporate partner and the promoter assume the foreign partner’s obligation to provide the offshore equipment under the lease while the foreign partner has already been paid the future rents. There are complaints that the anti-stripping regulation is too broad. Richard Lipton has observed that it might apply to “[a]ny sale of property that occurs after rent prepayments”<sup>146</sup>—but the class of cases it covers is much narrower than that covered by the section 701 regulations. This principle can be even further limited by adding some of the factors from the section 701 regulations, such as the fact that the separation of income and expense makes the parties better off in the aggregate because they are in different tax clienteles.

In the ruling on step-down preferred stock, Treasury also was able to define the abuse in reasonably narrow terms.<sup>147</sup> The ruling addresses a REIT transaction with two classes of interests where one class of interest is paid all of the income flowing through the REIT for a period of years and thereafter is paid a very low yield. The effect is to defer income to the other class because dividends paid by a REIT are deductible. The first class is sold to tax-exempt investors who are indifferent to the extra

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141. See Gergen, *supra* note 16, at 16-17 (explaining this point).

142. See Treas. Reg. § 1.701-2(d), ex. 6 (as amended in 1995).

143. See Treas. Reg. § 1.701-2(d) (as amended in 1995).

144. See Prop. Treas. Reg. § 1.7701(l)-2, 61 Fed. Reg. 68,175, 68,179 (1996); I.R.S. Notice 95-53, 1995-2 C.B. 334.

145. See Prop. Treas. Reg. § 1.7701(l)-2(h)(1), 61 Fed. Reg. 68,175, 68,181 (1996).

146. Lipton, *supra* note 127, at 211.

147. See I.R.S. Notice 97-21, 1997-11 I.R.B. 29. Cf. Treas. Reg. § 1.707-4(a)(4), ex. 2.

income. Earlier I gave an example of a partnership transaction that accomplished the same result.<sup>148</sup> One could challenge this transaction under the section 701 regulations (the outcome does not “clearly reflect the income” of the partners, it reduces taxes, due to the nature of the assets held by the REIT the economic risk borne is small in relation to the tax benefits, and one party is tax-exempt), but the ruling is narrower. It targets tax-saving transactions where one party has what it is called a “self-amortizing interest,” meaning that the interest is expected to shrink in value, and income is shifted to that party from another party. Putting it differently (and a little more broadly), the ruling aims at transactions where a payment that in reality represents the recovery by a party of an investment is cast as income to that party in order to divert income from another party.

These are workable anti-abuse principles because they are sufficiently limited in scope that there are relatively few cases with the defined features where it is undesirable for tax planners to worry about the position they are taking. If over-breadth remains a problem, then the principles can be further limited by adding elements from the section 701 regulations to identify the cases that are likely to be problematic from a tax perspective. In particular, the principles might be limited to cases where the arrangement results in a substantial tax savings to the parties.

A consequence of reworking anti-abuse law along these lines is that there will be some troubling cases that the law does not reach. For example, a partnership is formed to acquire tax-exempt bonds with market discount. Market discount on tax-exempt bonds is taxed as ordinary income on maturity or sale of the bonds.<sup>149</sup> This feature of tax law presumably hampers secondary markets in tax-exempt bonds because the optimal clientele for the exempt stream of income, persons who pay tax at the top marginal rate, may not be same as the optimal clientele for bonds that yield deferred taxable ordinary income.<sup>150</sup> The partnership is used to distill out these two streams of income using two classes of interest. One class is allocated the tax-exempt interest, the other class is allocated the market discount.

The Treasury could challenge this arrangement under the existing section 701 regulations. The outcome does not “clearly reflect the income” of the second class of investors for their interests predictably bear deferred income.<sup>151</sup> The investors will pay less aggregate tax if different tax clienteles invest in the two classes.<sup>152</sup> The same outcome could not be

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148. See *supra* note 99.

149. See I.R.C. § 1276 (West Supp. 1997).

150. See Arthur M. Miller, *Memorandum on Secondary Market Bond Securitization*, TAX NOTES TODAY, May 24, 1993, on treatment of market discount. Miller states “such a hybrid security would be virtually unknown in the municipal area, and would not be attractive to investors. Some of the largest purchasers of tax-exempt obligations are mutual funds that in many cases are not permitted, as a matter of investment policy, to earn any taxable interest income.” *Id.*

151. See Treas. Reg. § 1.701-2(a)(3) (as amended in 1995).

152. See Treas. Reg. § 1.701-2(b) (as amended in 1995).

achieved if the investors held the bonds directly,<sup>153</sup> and if the bonds are high grade, then no one investor bears much risk.<sup>154</sup> But once one concedes that the heart of the regulation is the examples, and its "soul" are the "middle range" principles that might plausibly be extrapolated from these examples, then this arrangement is not open to challenge under anti-abuse law. It does not violate either of the "middle range" principles in the section 7701(l) rulings, nor does it involve the use of a partnership to create artificial losses,<sup>155</sup> to duplicate losses,<sup>156</sup> to distort basis,<sup>157</sup> or to artificially suppress the value of an asset,<sup>158</sup> which are the abuses targeted by the examples in the section 701 regulations.

## VI. CONCLUSION

The limitations on what the Treasury can do within the existing framework of partnership tax law point, finally, to the need to develop alternative bodies of rules to govern passive financial intermediaries. An immediate need is for rules to govern vehicles used to securitize debt-like instruments that yield tax preference income, such as tax-exempt bonds and preferred stock. Legislation has been proposed that would permit the securitization of tax-exempt bonds.<sup>159</sup> Whatever the technical flaws

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153. See Treas. Reg. § 1.701-2(c)(1) (as amended in 1995).

154. See Treas. Reg. § 1.701-2(c)(3) (as amended in 1995).

155. See Treas. Reg. § 1.701-2(d), ex. 9 (as amended in 1995).

156. See Treas. Reg. § 1.701-2(d), ex. 10 (as amended in 1995).

157. See Treas. Reg. § 1.701-2(d), ex. 13 (as amended in 1995).

158. See Treas. Reg. § 1.701-2(d), ex. 6 (as amended in 1995).

159. See JOINT COMMITTEE ON TAXATION STAFF, 104TH CONG. STAFF DESCRIPTION OF MISCELLANEOUS TAX PROPOSALS SCHEDULED FOR HEARINGS ON JULY 11-13 BEFORE HOUSE WAYS AND MEANS COMMITTEE, 229 (Joint Comm. Print 1995). A draft of an earlier version of the legislation with an explanation from Arthur M. Miller of Goldman Sachs can be found at *supra* note 150. The proposed rules bear the acronym TEMIC. Like a REMIC, a TEMIC would have regular interests and one class of residual interests. As in a REMIC, income would accrue on regular interests under the rules that apply to debt instruments, i.e., income would accrue on an expected yield basis. The key to the TEMIC structure is that some of this income would be designated as tax-exempt interest. This feature allows the tax-exempt income to flow through to the regular interests. The tax-exempt income from each period would be allocated among the regular interests according to a fixed schedule. If the pool had excess tax-exempt income, then the excess would carry forward. Regular interest income that was unshielded by tax-exempt income flowing through the pool would be treated as interest paid by the pool. Such an amount would be ordinary income to the regular interest holder and an expense to the pool. The deduction would flow through to the residual interest holder.

The proposed TEMIC rules would allow tax exempt income to be allocated among regular interests in any manner, so long as the allocation follows a fixed schedule. This feature of the rules is meant to allow the separation of tax-exempt income and market discount on tax-exempt bonds with market discount. However, the rules would strip the tax benefit from the market discount through two rules. First, following the REMIC rule, the market discount would be converted into OID income to the vehicle, § 860(b)(1)(B), which would be netted out at the entity level by the OID accruing on the regular interests. Second, the holder of a regular interest that bore taxable interest income would not be allowed to use NOLs to shield that income from taxation and could not be a tax-exempt entity.

The proposed TEMIC rules would not allow tax-exempt income to be allocated to the residual interest. Were the rule otherwise, a TEMIC could be used to circumvent the anti-arbitrage rule in § 265. The TEMIC would issue regular interests paying taxable interest and allocate the tax-exempt interest to the residual interest. The residual interest would

in this legislation, they are of a far lesser order of magnitude than the existing flaws in Subchapter K. Admittedly, the proliferation of rule systems is not an attractive solution. Today we have two general rule systems for "flow-through" passive investment intermediaries (Subchapter K and the trust rules) and three special rule systems (the REIT, REMIC and FASIT rules). In ten years time we may add rule systems for intermediaries holding tax-exempt bonds, preferred stock, common stock, and insurance contracts. However, this proliferation of rule systems seems inevitable because a rule system that works passably well for one type of asset is likely to be unsuitable for other types of assets.

In designing these alternative rule systems, a hidden cost to imposing restrictions on the nature of the assets that they may hold or on the nature of their capital structure should be kept in mind. Such restrictions can become a strait-jacket on innovation if a rule system is made the exclusive legal regime for holding certain types of assets without incurring an entity-level tax on the intermediary, as was done with the REMIC rules. Making a system optional solves that problem, but it creates another problem by making it possible for people to circumvent the rules by using an entity that is taxed as a partnership. The latter problem creates the need for anti-abuse rules, which can cause undue uncertainty in tax planning. While there is no perfect solution to these dilemmas, there are some things that can be done to minimize these tradeoffs. For example, unnecessary restrictions on assets, ownership, and capital structure should be avoided in designing an alternative rule system to lessen the pressure to go outside that system to Subchapter K. The objectives of these systems should be identified so that anti-abuse rules can be tailored to address the use of partnerships to frustrate those objectives.

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end up generating tax-exempt income and an interest deduction. The tax-arbitrage possibility could also have been addressed by applying § 265 to bar the deduction for interest paid to a regular interest. This option was rejected because it would subject market discount to double taxation. *See generally* Miller, *supra* note 150.