Tax Avoidance Using Self-Amortizing Investments In Conduit Financing Entities

Notice 97–21

The Internal Revenue Service understands that certain persons are engaging in multiple-party financing transactions to avoid taxes imposed by the Internal Revenue Code. These transactions are designed to allow a person (the ''sponsor'') to avoid tax on substantial amounts of income (or to shelter substantial amounts of other income) by using a conduit entity whose income tax treatment artificially allocates the conduit entity's income to participants that are not subject to federal income tax.

Example

An example of these transactions is as follows:

A corporate sponsor forms a real estate investment trust or a foreign corporation (the ''Company''). The Company issues two classes of stock. The corporate sponsor holds substantially all of the common stock of the Company. The other class (the ''fast-pay preferred stock'') is held by persons that are not subject to federal income tax (the ''exempt participants''). The fast-pay preferred stock has limited voting rights and provides for preferred ''dividends'' equal to 13 percent of the stock's issue price each year for 10 years.

The Company holds income-producing assets (such as one or more mortgage loans) that are the obligations of or guaranteed by the corporate sponsor or that are guaranteed by a federal agency. At all times during the first 10 years after the fast-pay preferred stock is issued, the Company is required to invest in assets that will produce income, and cash flows, at least equal to 101 percent of the dividends payable on the fast-pay preferred stock.

During the first 10 years, the Company may also make distributions on its common stock. It is not, however, permitted to distribute more than 105 percent of its income in any year. Accordingly, it is not permitted to make any distributions representing a meaningful return of initial investment to the holders of the common stock during the first 10 years.

In year 11, and thereafter, the fast-pay preferred stock provides for distributions in each year of 1 percent of its original issue price. As a result, after the first 10 years, the fair market value of the fast-pay preferred stock is substantially less than the amount for which the exempt participants purchased it.

Beginning in year 11, the Company may be merged into another corporation without the separate approval of the exempt participants provided that the exempt participants receive a formula payment equal to the present value of the annual 1-percent dividend payments on the fast-pay preferred stock (computed using a discount rate of 10 percent). Otherwise the fast-pay preferred stock cannot be called by the Company.

As illustrated by this example, the fast-pay preferred stock performs economically much like a 10-year, self-amortizing debt instrument. That is, payments on the fast-pay preferred stock reflect in part recoveries of the amount originally invested by the exempt participants and in part a market yield on the unamortized portion of the original investment. The economic self-amortization of the fast-pay preferred stock is conceptually inconsistent with characterizing the full amount of each payment as a ''dividend'' (and thus as income on an investment).

At the end of 10 years, the Company's obligation to make distributions on the fast-pay preferred stock will have virtually ceased, and substantially all of the net value of the Company will be represented by its common stock. Because only the current income of the Company will have been distributed during the first 10 years, the value of the Company's assets is unlikely to have declined significantly. Accordingly, the sponsor's investment in the Company economically performs like a zero-coupon investment, substantially increasing in value as the exempt participants' interest in the Company declines. If the Company makes the formula payment to the exempt participants after the initial 10-year period, the Company may be merged into or consolidated with a corporate sponsor or its affiliate. In the event of a merger, the corporate sponsor expects to receive substantially all of the Company's assets with the Company's high basis and to avoid recognizing any gain.

Thus, in the example, the corporate sponsor's expectation in investing in the Company is that it will realize a predictable economic benefit at the end of the 10-year period without ever incurring any tax liability for that benefit. Alternatively, if the principal asset of the Company is a debt instrument or other obligation issued by the sponsor, the sponsor could be viewed as attempting to use deductions from that debt instrument or obligation to shelter income, without ever having to recognize its share of the income that corresponds to those deductions. These expectations result from the parties' treatment of the full amount of the payments to the exempt participants as dividends. This treatment causes substantially all of the Company's income to be allocated to the exempt participants, even though a significant portion of that income inures economically to the sponsor.

Alternative tax-avoidance structures may involve the use of other conduit entities whose income is generally subject to U.S. income tax only at the shareholder level, where the amount of the tax depends on the receipt or nonreceipt by the shareholder of earnings and profits from the conduit entity. The terms of the stock issued by the conduit entity may also vary, and the stock may be subject to options to buy or sell.

Proper Characterization of the Transactions

Under section 7701(*l*) of the Internal Revenue Code, the Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among two or more of the parties in order to prevent the avoidance of tax. Treasury and the Service expect to issue regulations recharacterizing any transaction (for example, the transaction described above) in which (1) a conduit entity is interposed between two or more parties, (2) an investment in the conduit entity is economically, taking into account all relevant factors including options to buy or sell, partially or fully self-amortizing (that is, the value of the investor's interest in the conduit entity is expected to decrease over time as payments are received), and (3) payments by the conduit entity that represent a recovery of investment to the investor 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.

It is expected that, under these regulations, the sponsor will be treated as having engaged in a transaction directly with the other parties to the debt instruments, leases, or other assets held by the conduit entity, and the holders of the self-amortizing interests in the conduit entity will be treated either as having engaged in the transaction directly with the other parties or as having engaged in an income ''stripping'' transaction with the sponsor. *See, e.g.*, section 1286 of the Code. If the sponsor is the issuer of a debt instrument held by the conduit entity, the sponsor may be treated as having issued one or more instruments directly to the holders of the self-amortizing interests in the conduit entity. In that event, the sponsor's obligation under any asset held by the conduit entity will be ignored for purposes of determining the sponsor's taxable income. The regulations issued under section 7701(l) of the Code will be applicable to taxable years ending on or after February 27, 1997. Thus, all amounts accrued or paid on or after the first day of the first taxable year ending on or after February 27, 1997, will be subject to the regulations, regardless of when a particular share of stock or a particular debt instrument was issued or acquired. To the extent that a payment or accrual under a conduit financing transaction is not subject to these regulations, the Service may determine under existing tax principles, depending on the facts of the particular case, that the transaction does not produce the results intended by the participants.

Persons that wish to comment on the subject matter of this notice may submit comments to: CC:DOM:CORP:R (OGI–103642–97), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (OGI–103642–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. Comments will be available for public inspection.

This notice was issued to the public on February 27, 1997.

For further information regarding this notice, contact Jonathan Zelnik of the Office of Assistant Chief Counsel (Financial Institutions & Products) at (202) 622–3940 (not a toll-free call).