Tax-Exempt Bond Securitization

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David Z. Nirenberg, Brent L. Feller, and Steven L Kopp describe tax-exempt municipal debt securitization transactions and the tax issues associated with these transactions.

Introduction

Tax-exempt municipal debt such as bonds, bank loans, and finance leases (together, "Bonds") are often securitized by being transferred by a sponsor to a single-class or multiple-class trust with certificates of beneficial interest sold to investors, often with some certificates retained by the sponsor of the securitization.[1] Typically, the trusts have one or two classes of equity interest and securitize a fixed pool of Bonds. Sometimes additional Bonds are added to an existing trust to avoid the expense of establishing a new trust, but it is unusual to provide a trust with the power to reinvest principal, interest, or the proceeds of a disposition of the Bonds (other than for a short time prior to distribution or in an expense reserve fund).[2] Because of tax constraints (discussed below), the issuing trusts (the "Issuers") typically do not issue debt to finance the purchase of the Bonds and rarely issue multiple classes of equity that are redeemed sequentially.[3] Because most Issuers are trusts, for ease of presentation, this article will assume that all Issuers are trusts that issue equity interests in the form of certificates.

The primary issues from a federal income tax perspective for parties to a securitization transaction with respect to Bonds are (i) whether the Issuer is transparent from a federal income tax perspective; that is, whether (a) the Issuer is exempt from tax on its income, and (b) whether the tax-exempt interest from the Bonds held by the Issuer will retain its tax-exempt character in the hands of its certificate holders, and (ii) whether the certificates will be respected as equity for tax purposes (and not, *e.g.*, recharacterized as newly issued taxable debt secured by, rather than representing an indirect ownership interest in, the Bonds).[4] After first discussing these paramount issues, this article continues with a discussion of special rules that cause interest that is otherwise exempt from federal income tax to be taxable in the hands of otherwise transparent Issuers

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(and, accordingly, their investors). The article continues with discussions, in the context of Issuers that are treated as partnerships for federal income tax purposes, of (i) concerns that arise from hedging the risks of ownership of certain equity interests with total return swaps and (ii) an elective, simplified federal income tax information reporting regime. Finally, the article ends with a short discussion of state and local tax issues with respect to the securitization of the Bonds.

From a federal income tax perspective, there are two basic types of Issuers: grantor trusts and partnerships. Both grantor trusts and partnerships are transparent for tax purposes. Grantor trusts are typically, but not exclusively, used for Issuers that have a single class of certificates, and partnerships are typically used for Issuers that have two (or more) classes of certificates.

Grantor Trusts

For a typical simple, single-class securitization of Bonds, a grantor trust (also known as a "fixed investment trust"), holds Bonds and issues certificates representing the ownership (also referred to as the equity) interests therein.[5] The certificates are typically issued in a single class by a trust that holds a fixed pool of Bonds, which may bear interest at either a fixed or variable rate. The amount of interest passed through to investors is, in essence, the total interest received on the Bonds, net of the trust's expenses. In some cases, a custodial arrangement or participation agreement is used instead of a trust. Although there is no significant difference in the substantive taxation with those structures, different information reporting rules may apply.

A grantor trust is created by a sponsor who transfers the Bonds to the trust in return for its certificates, which represent the ownership interests in assets of the trust. The sponsor will then typically sell all or a portion of the certificates to investors. As noted above, certificates typically are issued in a single class, but sometimes two classes are issued that are identical except that payments on one class are subordinate to payments on the other in the case of a default on the underlying Bonds. Occasionally, the trust acquires insurance or another form of credit protection for its Bonds. Grantor trusts holding Bonds typically do not enter into any derivative contracts.[6] Because interest on indebtedness incurred or continued to purchase or carry Bonds is not deductible, Issuers, whether grantor trusts or partnerships, rarely issue debt.[7]

If an arrangement qualifies as a grantor trust, the trust is ignored for federal income tax purposes, and each certificate holder is treated as owning its *pro rata* share of the trust's assets and being the obligor on its proportionate share of the trust's liabilities.[8] Accordingly, each holder is deemed to receive or pay its share of any trust income or expense as the same is received or paid by the trust and the character of assets, income, and expense passes through the trust to certificate holders. Thus, interest passed through to an investor that would be excluded from gross income if earned directly by the investor is treated as excludable to the same extent. Similarly, gain from the sale of any of the Bonds that would be capital gains in the hands of the investor passes through to those investors as capital gains (although the investor's holding period in a Bond would not begin prior to its acquisition of its certificate, regardless of when the Issuer acquired the Bond). Distributions on certificates are not separately taxed.

In order for the Issuer to be recognized as a trust for federal income tax purposes, there can be no significant power (a "power to vary") under the trust agreement to change the composition of the asset pool or otherwise to reinvest payments received on, or the proceeds of a sale or redemption of, the Bonds.[9] A power to vary investments, as it is described in IRS rulings, is "one whereby the trustee, or some other person, has some kind of managerial power over the trusteed funds that enables it to take advantage of variations in the market to improve the investment of all the beneficiaries."[10] Notwithstanding the general prohibition on having a power to vary the investments of a grantor trust, the following do not constitute an impermissible power to vary: (i) a power to substitute or add certain property to the trust for a short period following the creation of the trust, after which no further assets can be transferred to the trust; (ii) a power to sell trust assets; (iii) a power to invest principal and interest received on Bonds for a short period (prior to a certificate's regular distribution date) in short-term high-quality investments that are held to maturity; (iv) a power to accept a borrower's offer to exchange new Bonds for (or to modify) Bonds already owned that are in default or are reasonably expected to default; (v) a power to establish reasonably required reserve funds; (vi) a power to change the credit support of Bonds held in an investment trust in which the power is exercisable only to the extent necessary to maintain the value of the trust assets; (vii) the power to modify the terms of a debt instrument if the modification would not be characterized as a deemed exchange under Reg. §1.1001-3; and (viii) the power to take any other action that is consented to by 100 percent of the equity holders.[11] Some tax practitioners permit a trust to acquire assets at any time if the Issuer is under an obligation to purchase the asset, for example, pursuant to a forward contract, that was in place in connection with the establishment of the trust.[12]

In addition to the requirement of having no significant power to vary the investments of the trust, a grantor trust (whether holding taxable or tax-exempt bonds) is prohibited, with limited exceptions, from having more than one class of certificates. The two main exceptions are for (i) certificates that are divided into classes (a) representing interest that is stripped off (that is, the ownership of the interest is separated from the ownership of) the related principal payments on a bond and (b) representing the principal and any interest not stripped off of the bond and (ii) certificates that are divided into senior and subordinated certificates (the latter of which absorbs credit risk prior to allocation of losses to the former).

Although grantor trust securitizations can be structured to rely on these exceptions, when two classes of interest are desired, sponsors tend to prefer entities taxed as partnerships rather than grantor trusts because the latter are typically subject to onerous tax accounting rules (described immediately below) that do not apply to the former. For example, Code Sec. 1286 contains special rules governing the taxation of stripped bonds and stripped coupons. A stripped bond is a bond issued with coupons (which, for this purpose, include any rights to receive stated interest) where there is a separation in ownership between the bond and any coupons that have not yet come due. A stripped coupon is a coupon relating to a stripped bond. The tax treatment of stripped bonds and stripped coupons is generally the same, and the term "stripped bond" will be used in this discussion to refer to both.

Code Sec. 1286 generally transforms the discount at which a stripped bond is purchased into original issue discount ("OID"). Specifically, in simplified terms, Code Sec. 1286(a) provides that a stripped bond will be treated for purposes of applying the OID rules of the Code as a bond originally issued on the purchase date (or the date such bond is transformed into a stripped bond) having OID equal to the excess of the aggregate amount of payments required to be made on the stripped bond over its purchase price (or deemed purchase price).

Code Sec. 1286(c) limits the discount on a stripped bond that is treated as tax-exempt interest to the discount that produces a yield to maturity equal to the coupon rate of interest on (or, at the purchaser's election, the original yield to maturity of) the whole tax-exempt bond. The remaining discount is treated as OID on a taxable bond. This limitation on tax-exempt OID ensures that the aggregate tax-exempt OID on all stripped tax-exempt bonds representing interests in a single bond cannot exceed the tax-exempt interest (including OID) on the whole bond. However, if a Bond is stripped and one class of stripped bonds has a yield less than the cap while others have a yield in excess of the cap, there is no rule that raises the cap for those whose tax-exempt yield is limited by the cap to permit them to "use" the unused portion of the other class's cap. Accordingly, the aggregate amount of tax-exempt interest is reduced. For this reason, Bonds rarely are stripped inside grantor trusts if one or more of the classes of stripped bonds is likely to have, for any reason, a yield greater than the unstripped Bond's coupon (or yield). In such cases, non-*pro rata* interests are typically created in the form of certificates characterized for federal income tax purposes as partnerships, because Code Sec. 1286(c) does not apply to partnership interests.

Even if the stripping of interest was not a prerequisite for a senior/subordinate securitization of Bonds, the utilization of a grantor trust for such a securitization typically raises an analogous issue. If the underlying Bonds are trading at or near their par amount, a grantor trust's senior class generally would trade at a premium, which would require premium amortization and would reduce the certificate holder's tax-exempt interest that it would otherwise be entitled to, while the holder of the junior class (which would initially trade at a discount) would have market discount which would generate taxable income at the sale or redemption of the Bond. A partnership structure (discussed below in the text) would prevent these issues from arising.

Partnerships

Transparency Generally for Tax Purposes

Entities, such as trusts, that are characterized for federal income tax purposes as partnerships are used in securitization transactions because partnerships are transparent for tax purposes. That is, they generally are not subject to federal income taxation at the partnership level and the partnership's income, deductions, gains, losses, and credits flow through the partnership to its partners, generally with the character of any such item determined at the partnership level. The use of an Issuer that is characterized as a partnership avoids the grantor trust-related disadvantages discussed above—the limitation on the power to vary the assets of the trust,[13] the prohibition on multiple classes of equity, and the conversion of tax-exempt interest into taxable discount OID in the case of certain permissible multiple-class trusts. Accordingly, in a properly structured partnership securitization transaction, all of the tax-exempt interest on the securitized Bonds will flow through the partnership to the partners, and the receipt of such interest by the partners will retain that characterization and be exempt from federal income tax.

The demand for short-term or variable rate Bonds (principally from mutual funds) exceeds the supply. To fill the gap, fixed rate Bonds are often converted into synthetic floating rate Bonds and a residual class using a two-class trust certificate structure. The variable rate certificates are known in the market as tender option bonds or TOBs although the term TOB also is used in the market to refer to the issuer used for this type of securitization. For clarity, this article will refer to the securities as "TOBs" and the issuers thereof as "TOB Issuers." Although there are variations, a TOB Issuer typically holds a single series of fixed rate Bonds and issues two classes of certificates representing ownership interests in the TOB Issuer (and thus indirect ownership interests in the Bonds).[14] One class (the "floating rate certificates") is entitled to all or a portion of the principal on the Bonds and interest on the principal amount (payable solely out of interest on the Bonds) at a rate determined periodically by a remarketing agent to be the rate that would cause the floating rate class to have a value equal to par. In order to ensure that the rate is in fact a market rate, each holder of a floating rate certificate has a "tender option" to have its security remarketed periodically (most often, but not exclusively, weekly) at par to another investor (or put to a liquidity provider in the event of a failed remarketing).[15] The second class (the "residual certificates") is entitled to all remaining principal and interest. The floating rate certificates are entitled to a portion of any gain (generally, at least five percent) from the disposition of the Bonds. All remaining capital gains, all accrued market discount, and, with very limited exceptions, all losses are allocated to the residual certificates. Except in the case of a "tender option termination event" (described below) payments made on the floating rate certificates are senior to payments made on the residual certificates and supported, in the event of a failed remarketing, by a "liquidity provider" that will directly or indirectly acquire (or finance the Issuer's acquisition of) the floating rate certificates, typically with a right to reimbursement from the holders of the residual certificates.[16]

As a result of the two-class structure, the trust is not classified for federal income tax purposes as a trust, but rather as a partnership. Thus, because the trust is treated as a partnership for federal income tax purposes, the Code Sec. 1286 stripped bonds rules (discussed above) do not apply, and the entire amount of tax-exempt income earned by the trust can be allocated to investors.

The two classes of interest of a trust would normally be sufficient to classify the trust as a partnership. However, tax practitioners have some concern that the IRS will seek to recharacterize the floating rate interest as newly issued debt of the trust (or the holder of the residual interest)—and not as an equity interest in a partnership (in which case the TOB would fail to qualify as a partnership). Accordingly, to reduce the risk of any such recharacterization, TOBs are typically structured by giving the floating rate holders equity-like features not typically found in debt instruments.[17] For example, in the event interest on a Bond is determined to be taxable, the tender option is terminated, and the bonds are distributed *pro rata* between the floating rate certificate holders and the residual certificate holders (rather than, as would be the case if they represented debt, first to the floating rate certificate holders to the extent of their entitlement to principal and accrued interest). Similarly, the tender option is often terminated, and the Bonds are distributed *pro rata* between the floating rate and residual certificate holders, if there is a default on a Bond. These two features extend some of the economic *burdens* or risks of being an equity holder to the floating rate certificate holders and, consequently, support the treatment of the TOB as a partnership for federal income tax purposes.

Similarly, in addition to a right to a portion of the principal and interest on the Bonds held by the Issuer, floating rate certificate holders are given a portion of the gain realized on the disposition (or in some cases the marking to market) of the Bonds. This provides the floating rate holder some of the economic *benefits* of being an equity holder. That gain allocated to the floating rate certificates is typically five percent, but where the potential for gain is extremely limited, such as with Bonds that are immediately callable and are not likely to generate much gain, to defend against any argument that the potential for gain is insufficient to support characterization of the floating rate certificates as equity, the percentage of the gain distributed on the floating rate certificates is often increased. Similarly, in cases in which particular equity-type rights allocated to the floating rate certificate holders is minimized, other equity-type rights are given to such holders to help support their treatment as equity in the trust. For example, if the holder of the residual certificate either directly or indirectly provides credit enhancement to the floating rate certificate holders (*e.g.*, by not having the tender option terminate in the event of a default on the Bonds), this diminution of an equity risk for federal income tax purposes is typically offset, paradoxically, by allocating to the floating rate certificates an additional share of the underlying gain on the Bonds.[18]

Limitations of Transparency

Guaranteed Payments

Payments made to a partner that are determined without regard to the income of the partnership are treated as "guaranteed payments," not allocations of the partnership's income, and, as such, are treated as ordinary income.[19] To avoid risking having payments made on the floating rate certificates be treated as guaranteed payments (in which case they would no longer represent tax-exempt interest), payments made on the floating rate certificates are typically capped at a maximum rate that causes the aggregate amount paid on the floating rate certificates each month not to exceed the aggregate amount of tax-exempt interest earned by the TOB in that month.

Recharacterization of Certain Partnerships as Corporations

Certain entities that would otherwise be treated as partnerships for federal income tax purposes are treated as corporations. Such treatment will defeat the purpose of a securitization transaction because the tax-exempt nature of interest on the Bonds held by the Issuer would not pass through to the certificate holders. In addition, capital gains earned by the Issuer will be subject to corporate income tax and the payment of those capital gains (net of the corporate tax) will be taxable (as dividends) in the hands of investors. Two examples of entities that otherwise would be characterized as partnerships but are treated as corporations are certain "publicly traded partnerships" and "taxable mortgage pools."

A publicly traded partnership ("PTP") is an entity otherwise classified for federal income tax purposes as a partnership that has equity interests that are either traded on an established securities market or readily tradable on a secondary market (or the substantial equivalent thereof). With limited exceptions, notably for partnerships that meet a passive income test, PTPs are classified as corporations. Notwithstanding having publicly traded (or readily tradable) equity interests, however, a partnership will not be treated as a corporation if at least 90 percent of the partnership's gross income is treated as qualifying income. Qualifying income generally includes interest, including tax-exempt interest, and capital gains, but only if such income is not derived in a financial business.[20] A typical TOB is treated, for federal income tax purposes, as a passive investor and not treated as engaged in a financial business.[21] Accordingly, the typical TOB need not concern itself with the PTP rules.

An Issuer otherwise treated as a partnership also will be taxable as a corporation if the Issuer is treated as a taxable mortgage pool (a "TMP").[22] As a general rule, an Issuer that does not elect to be treated as a REMIC[23] will be considered a TMP if (i) substantially all of its assets (defined as 80 percent) are debt obligations, (ii) more than 50 percent of those debt obligations are real estate mortgages, (iii) the Issuer is the obligor under debt obligations with two or more maturities (which, under an anti-abuse rule, treat certain equity interests as debt obligations of the issuer solely for purposes of the TMP rules),[24] and (iv) payments on the debt obligations under which the Issuer is the obligor (including equity interests treated as debt under the anti-abuse rule) bear a relationship to payments on the debt obligations that the Issuer holds as assets. Payments meet the "bears-a-relationship" prong of the definition if the timing and amounts of payments on the Issuer's liability obligations (which would include equity interests subject to the anti-abuse rule) are "in large part" determined by the timing and amount of payments (or projected payments) on the obligations held by the issuer.[25] For purposes of the definition of a TMP, real estate mortgages include obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property.[26] Bonds, particularly those that are used to finance hospitals and housing (including dormitories), may qualify as real estate mortgages for this purpose.

Debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of or delay in the maturities of the obligations.[27] Traditional two-class TOBs need not be concerned with the TMP rules because they only have two classes of equity (and no classes of debt). In order to constitute a TMP, a TOB would need three classes of interests because at least one class of interest in any entity will be treated as equity in that entity for federal income tax purposes, so in order to have two classes of interest that constitute debt, there must be at least two classes of interest *in addition to* an equity class. Thus, if a TOB has only two classes of interests, only one of them could be recharacterized as debt, and, accordingly, the TOB would not be treated as having the requisite two classes of debt (even under the anti-abuse rule).

Securitizations with taxable obligations that are often referred to as collateralized bond obligations (or "CBOs") or collateralized loan obligations (or "CLOs") often involve the issuance of multiple classes of debt secured by taxable bonds or commercial loans, where the debt is divided into multiple classes that are both (i) senior and subordinate and (ii) fast pay/slow pay (that is, paid sequentially). The use of a similar structure with Bonds is rare because the Bonds most likely to be good candidates as a business matter in such a securitization tend to be Bonds used to finance hospitals and housing (in which case the Bonds would be secured by real property) and, thus, would risk causing the issuer to be a TMP, and thus not a partnership.

Substantial Users

Bonds, such as private activity bonds, may also be issued for certain statutory purposes to finance loans to nongovernmental entities that are referred to as conduit borrowers. The federal tax rules governing these types of Bonds can be quite complex. For certain Bonds, the proceeds of which are used by a nongovernmental entity, otherwise tax-exempt interest will be taxable to a holder who is a "substantial user" of a financed facility or who is a related person to a substantial user.[28] In other words, an obligation that would otherwise be federally tax-exempt will not be treated as a tax-exempt in the hands of a substantial user of a financed facility or a related person to a substantial user.[29]

A "substantial user" is generally any nongovernmental person who regularly uses a part of a financed facility in its trade or business.[30] More specially, a substantial user is generally any nongovernmental person (i) for whom the facility or a part thereof was specifically constructed, reconstructed or acquired, or (ii) (x) if the gross revenue derived by such user with respect to such facility is more than five percent of the total revenue derived by all users of such facility or (y) the amount of area of the facility occupied by such user is more than five percent of the entire useable area of the facility.[31] A lessee or sublessee of all or a portion of the facility, depending on the facts, may also be a substantial user.[32]

The analysis used to determine whether a holder of an obligation is a related person to a substantial user can be quite complex. Generally, the following are "related persons" to a substantial user: (i) two or more persons if the relationship between such persons would result in a disallowance of losses under Code Sec. 267 or 707(b);[33] (ii) two or more persons which are members of the same controlled group of corporations; (iii) a partnership and each of its partners (and their spouses and minor children); and (iv) an S corporation and each of its shareholders (and their spouses and minor children).[34] For this purpose, a related person includes any partnership of which a substantial user of the property is a partner, regardless of the size of that partner's interest in a partnership.[35] Thus, if one of its certificate holders is a substantial user, a TOB Issuer will always be a related person for this purpose, and if one of its certificate holders is related person (but not a substantial user itself) a TOB Issuer may, on account of various attribution rules that apply, be a related person to a substantial user. For this reason, TOB Issuers holding private activity bonds typically prohibit both substantial users and related persons from acquiring either floating rate or residual certificates (without a specific determination that their acquisition would cause the TOB Issuer itself to be a related person).[36]

Further, if the loan to the conduit borrower made with the proceeds of the Bonds is designated as a "program investment,"[37] which designation permits the issuer of the Bonds to earn a 1.5 percent spread over the yield on the loan of proceeds of the Bonds (instead of a .125 percent spread), the documents for the Bonds must generally prohibit the borrower of proceeds of the Bonds or any "related party" to the borrower from purchasing the Bonds.[38] For this purpose, a "related party" to the borrower[39] is generally defined (with some exceptions and by cross-reference to the term "related person" in Code Sec. 144(a)(3)) as (i) two or more persons if the relationship between such persons would result in a disallowance of losses under Code Sec. 267 or 707(b);[40] and (ii) two or more persons which are members of the same controlled group of corporations. Bonds are subject to this prohibition where the issuer elects to be permitted to earn a larger spread for investment of the proceeds of the Bonds under the rules governing rebate and prohibiting earning income from the arbitrage between the tax-exempt rates on the bonds and the taxable rates on taxable investments of the proceeds.[41] The application of attribution rules is complex and, for this reason, TOB Issuers holding Bonds the proceeds of which are designated program investments often prohibit both the borrowers of the proceeds of the Bonds and their related parties from acquiring either floating rate or residual certificates (without a specific determination that their acquisition would cause the TOB Issuer itself to be a related person).[42]

Hedging Residual Interests with Total Return Swaps

Many holders of residual interests hedge the risks of ownership of those residual interests. This is particularly true of banks that acquire Bonds, often 100 percent of an issue, through direct purchases, as banks often view their business as earning a spread between their funding costs and the fully hedged costs of their debt investments. Banks often, substantially simultaneously, (i) acquire a Bond, (ii) transfer it to a TOB, and (iii) hedge their exposure by entering into a total return swap (a "TRS") the reference asset of which is the Bond held by the TOB (the "Reference Bond"), not the residual interest itself.[43] Although there is no specific technical reason to avoid entering into a TRS on the residual interest, most tax practitioners think the risk of the IRS recharacterizing the long position of the TRS as ownership of the residual interest is greater (albeit only modestly) than the minimal risk of the IRS recharacterizing the long position of a well-drafted TRS referencing a Bond as a tax ownership of the Bond.[44] Among other reasons, (i) there is a plethora of authorities that support treating a properly documented TRS on a Bond (or other security) as a notional principal contract and not a disguised sale of the Reference Bond (or other security),[45] and (ii) it would be difficult to treat the TOB Issuer as not owning the Reference Bond if the TOB Issuer is not a party to the TRS and the holders of substantially all of the capital interests in the TOB Issuer (the floating rate certificates) are not even aware of the existence of the TRS.

It is crucial that any TRS be respected as a notional principal contract and not treated as the transfer of the tax ownership of the Reference Bond to the long party on the TRS. Such a recharacterization would cause the bank, as short party (and the party with title to the Reference Bond), to not be the owner of the Bond for federal income tax purposes, but rather, be treated as owning a newly issued debt instrument of the long party who in turn is treated as the owner of the Bond for federal income tax purposes. In that case, because the Bank would not be the owner of the Bond for federal income tax purposes, the bank could not transfer tax ownership of the Bond to the TOB Issuer.[46]

Further, where the long party on the TRS is the issuer of the Bond or the conduit borrower, additional issues arise. If a Bond is treated, on account of a TRS, as transferred to the issuer of the Bond, the Bond may be treated as redeemed and the short position of the TRS may be treated as a newly issued refunding Bond, the interest on which may or may not be tax-exempt depending on the facts.[47] The requirements for interest on a bond that is deemed issued in exchange for a Bond that is being redeemed are beyond the scope of this article. It is worth noting, however, that if a Bond were considered reissued, the issuer of the Bond would be required to determine whether the newly reissued Bond would qualify as a tax-exempt bond under current law; if so, it would be required to file a new Form 8038 (or 8038-G or 8038-GC, as applicable) in respect of the newly reissued Bond.[48] LTR 201502008 (May 21, 2014), in concluding that the extension of the maturity of a TRS on a municipal bond will not adversely affect the tax exemption of interest on the Bond under certain Bond arbitrage rules, indicated that the issuer of the Bond filed a new IRS Form 8038 (Information Return for Tax-Exempt Private Activity Bond Issues) solely on a protective basis in case the Bond was treated as reissued on account of the TRS. Such a filing is not necessary where the TRS is respected as a notional principal contract, but some Bond issuers do file a new Form 8038 (or 8038-G or 8038-GC, as applicable) protectively when they or a conduit borrower enter into (or modify) a TRS on one of their Bonds.

If the long party on the TRS is the conduit borrower, even if the TRS is not treated as transferring tax ownership, it may still be treated as causing a reissuance of the Bonds. The IRS may take the position that payments required to be made pursuant to the TRS effectively modify the terms of the Bond and if those modifications are significant, the Bond may be treated as reissued and the Bond redeemed in exchange for a new Bond. Reg. §1.1001-3(f)(6)(i), part of the regulations addressing reissuance of debt instruments provides:

> For purposes of this section, the obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. In determining whether there is a significant

> modification of a tax-exempt bond, however, transactions between holders of the tax-exempt bond and a borrower of a conduit loan may be an indirect modification under paragraph (a)(1) of this section. For example, a payment by the holder of a tax-exempt bond to a conduit borrower to waive a call right may result in an indirect modification of the tax-exempt bond by changing the yield on that bond.

As noted above, if a Bond is treated as redeemed in exchange for a new bond, the new Bond may or may not be tax-exempt depending on the facts.[49]

The typical TRS will not be treated as causing a reissuance under Reg. §1.1001-3(f)(6)(i). Among other reasons: (i) the payments under the TRS run directly between the bank and the conduit borrower (or issuer of the Bond), not through the indenture trustee and not to the owner of the Bond (here the TOB Issuer), (ii) if the Bond is transferred from the TOB Issuer, the transferee is entitled to the full coupon on the Bond (without regard to the TRS), (iii) a default by the bank on its obligations to make payments pursuant to the TRS does not reduce the amount due on the Bond, (iv) payments are required to be made on the Bond a few days prior to the conduit borrower's (or Bond issuer's) receipt of payments on the TRS, requiring the conduit borrower (or Bond issuer) to fund the entire coupon on the Bond and not just the payment net of payments received pursuant to the TRS and (v) the TRS is settled in cash with the long party not having the option or obligation to reacquire the Bond itself.

If, nonetheless, a TRS causes a Bond to be reissued because the payments made by the bank under the TRS are treated as reducing the amount due under the Bond, even if the deemed modification of the Bond is a qualified refunding and the interest on the newly issued Bond continues to be federally tax-exempt, the amount of interest for tax purposes would, presumably, not be the Bond's full coupon, but rather, would be on the Bond coupon net of the payments made on the TRS, which generally would reduce the amount of tax-exempt interest.

Further, Reg. §1.148-10(e) provides that if a Bond issuer enters into a transaction with a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of arbitrage rules, the IRS may depart from the rules as necessary to clearly reflect the economic substance of the transaction. The regulation provides that the IRS

> may recompute yield on an issue or on investments … treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue. For example, if the amount paid for a hedge is specifically based on the amount of arbitrage earned or expected to be earned on the hedged bonds, a principal purpose of entering into the contract is to obtain a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148.

Typical TRSs are structured for valid business purposes and not to obtain a material financial advantage based on the difference between taxable and tax-exempt interest rates. Some comfort on the IRS's view of when to apply Reg. §1.148-10(e) to TRSs with conduit borrowers comes from LTR 201502008, discussed above, in which the IRS determined that

> the structure of the original financing, including the TRS, and the proposed extension of the TRS does not reflect a principal purpose by the Borrower to obtain a material financial advantage by either rate exploitation or by overburdening. Improved market conditions and the improved credit quality of the Borrower are the motivating factors for the extension. The modified pricing reflected in the extension was negotiated in an arms' length transaction based on fair market value pricing and not on the amount of arbitrage earned or expected to be earned on the hedged bonds in a manner that is inconsistent with the purposes of §148.

Based on that, the IRS concluded that "(i) the extension of the TRS will not be an abusive arbitrage device under §1.148-10(a) and (ii) the TRS described herein will not be integrated with the Bonds under the authority of the Commissioner in §1.148-10(e)."

Interestingly, though, LTR 201502008 also indicates:

> Bondholder has represented that the Bonds were issued as current refunding bonds and all sale and any investment proceeds were expended for the refunding purpose within 30 days of issuance. The Bonds do not have a reserve fund and … [t]here are no replacement proceeds otherwise created and no transferred proceeds were received.

It is not clear that the lack of proceeds was (or should have been) important in the IRS's determination not to attack the transaction at issue. However, in an abundance of caution, many Bond issuers provide that where there are proceeds of the Bond, solely for purposes of the arbitrage and rebate rules concerning the Bonds, the issuer of the Bond will treat the TRS as a "qualified hedge" or otherwise treat the Bond and TRS as integrated if that reduces the yield on the Bonds and thus the amount of arbitrage the Bond issuer may earn and retain.[50]

Finally, as discussed above, Bonds that finance a loan that is a "program investment" are required to have a prohibition on their being held by a borrower under a conduit loan or a related person. This arguably would require the conduit borrower, if not permitted to hold a Bond directly, to terminate the TRS upon a determination that a TRS is treated as transferring tax ownership of a Bond to it.

Rev. Proc. 2003-84

One potential problem with using partnerships for securitizing Bonds is that the partnership rules are complex and differences between the taxable year of a partnership and that of a partner could lead to deferral and/or acceleration of income for that partner.[51] Money market funds, including those that pay exempt interest dividends, typically declare dividends daily and find the uncertainty and unevenness of the timing of income problematic. Rev. Proc. 2003-84, however, allows a trust or other Issuer that is an "eligible partnership" to elect to be governed by an elaborate set of substantive and reporting rules (set out in the revenue procedure) that largely place the trust and its owners in the same position as if they made an election out of partnership tax accounting. A trust makes the election by stating its intention to do so in its constituent documents. The most significant requirements for an entity to be an "eligible partnership" are as follows: (1) at least 95 percent of its income must be tax-exempt interest or gain from the sale of Bonds and (2) principal payments and the proceeds of any other disposition of a Bond must be distributed to investors and not reinvested.[52]

In the case of an electing trust, at the end of each calendar month, each partner is required to include in its income its distributive share of the trust's tax-exempt income (and taxable income, if any) since the end of the prior month. In other words, the taxable years of the partnership and partners do not affect the timing of income. Other than in connection with a disposition of a Bond, trusts generally will not have any income other than tax-exempt income.

An electing trust is not required to file partnership tax returns and issue annual Schedule K-1s to its investors. Instead, it must (1) file an abbreviated Form 1065 in connection with the establishment of the trust, providing the IRS with certain identifying information about the trust, including contact information for the person responsible for providing information about the trust to the IRS and investors, and (2) on request by the IRS or an investor, make available all the information necessary to compute the investor's share of the trust's tax-exempt and other income. An eligible partnership must file the abbreviated Form 1065 for the first taxable year during which the election is in effect. The abbreviated Form 1065 must be filed by the date that the partnership's income tax return for that taxable year would ordinarily be due and must be signed by a person with the authority to sign the partnership's Form 1065. The revenue procedure sets out the information that must be provided on the face of the Form 1065 and in an attachment to the abbreviated Form 1065.

In order for the trust to have the information available to comply with its obligations to make information available to the IRS, each person owning an interest in a trust through a nominee is required to provide to the trust certain identifying information about itself and its nominee.[53] In lieu of the forgoing, the common manager for a group of RICs may elect to be responsible for collecting, retaining, and providing on demand to the IRS information about the beneficial ownership of the certificates held by the RICs it manages.

In addition to alleviating the need to comply with the regular annual reporting requirements that are applicable to partnerships generally, an election under Rev. Proc. 2003-84 causes certain partnership audit rules not to apply, which rules could cause a partnership to be subject to tax at the partnership level in the case of an under-reporting (or inaccurate allocations) of partnership income.[54]

Certain entities that qualify under Rev. Proc. 2003-84 also are entitled to favorable risk retention rules.[55]

State and Local Income Tax Considerations

An Issuer needs to be tax transparent, not only for federal income tax purposes, but also for purposes of the state of its establishment. Entities that are grantor trusts or partnerships for federal income tax purposes are similarly transparent for tax purposes in Delaware, a state where many Issuers are established.[56] Many other states treat grantor trusts and partnerships as transparent for state (and where relevant, local) tax purposes but some have a modest entity-level minimum tax.

Bonds issued in some states are exempt not only from federal income taxation, but also from state (and local) personal income taxation in the state of issuance. (The exemption sometimes also applies for state corporate income or franchise tax purposes but often does not.) Whether or not the state income tax exemption for interest on Bonds of an issuer located in a particular state may be passed through to the residents of that state depends on whether that state treats entities characterized as grantor trusts and partnerships for federal income tax purposes as transparent for state (and local) income tax purposes. That depends on the rules of the particular state; an Issuer's transparency for tax purposes in the state of its establishment is not sufficient to ensure that any other state's tax exemption on interest flows through to investors in that other state. Fortunately, in most states, entities classified as grantor trusts or partnerships for federal income tax purposes are treated as transparent for state (and local) income tax purposes and the exemption from state and local income tax taxes does pass through.

ENDNOTES

* Portions of this article were derived from James M. Peaslee and David Z. Nirenberg, Federal Income Taxation of Securitization Transactions and Related Topics (5th ed., Tax Analysts, 2018) (hereafter "Peaslee & Nirenberg"). The material in this article is current through October 5, 2021.

1 The issuers of Bond-backed securities are typically trusts, but a partnership, LLC, or other entity taxable on a flow-through basis also may be used.

2 In addition, as discussed in the text below, a broad reinvestment power also is generally prohibited.

3 References to Issuers in this article refer to the issuers used in the securitization of the Bonds, not to the issuers of the Bonds themselves.

4 A third significant issue is whether the sponsor has actually transferred tax ownership of the Bonds to the Issuer for federal income tax purposes (as opposed to retaining tax ownership of the Bonds, with the Issuer being treated as loaning money secured by the Bonds to the sponsor). Technically, debt vs sale treatment of the Bonds is separate and distinct from the issue of how the Issuer and its securities are characterized for federal income tax purposes. However, because the two issues are intertwined, the discussion in the text below, other than with respect to hedging with total return swaps, discusses these issues together. For more in-depth and separate discussions of financing vs sales treatment and debt vs equity characterization, *see* Peaslee & Nirenberg, Chapter 3.

5 As described below in the text, the stripped bond and market discount rules cause sponsors to structure most multiple-class securitizations as partnerships rather than grantor trusts.

6 There is no general prohibition on grantor trusts holding Bonds entering in derivative contracts; it just is not common. Under Code Sec. 265(a)(1) no deduction is allowed under Code Sec. 212 for expenses allocable to tax-exempt interest, but this rule does not apply to deductibility under Code Sec. 162 (except, under Code Sec. 265(a)(3), for regulated investment companies ("RICs")).

7 Code Sec. 265(a)(2).

8 *See*, *e.g.*, Rev. Rul. 84-10, 1984-l CB 155; GCM 39113 (Jan. 12, 1984).

A recent Ways and Means Committed proposal would, if enacted in its current form, treat newly created grantor trusts as separate from their owners for certain purposes. While the proposal likely was intended only to cover estate planning type trusts, it literally seems to apply to fixed investment trusts. If it were to apply to such trusts, it could lead to unfortunate results. Consider the following examples.

> **Example 1.** Taxpayer T acquires a tax-exempt bond at par ($100) and contributes it to a grantor trust. When the bond is worth $105 the trust is liquidated, and the bond is distributed to T. T recognizes $5 of capital gain and gets $105 in basis in the bond. The Bond has $5 of amortizable bond premium, which amortizes and reduces basis but, because the bond is tax-exempt, is non-deductible. This would be a horrific result.

9 The term "trust agreement" is interpreted broadly to include any agreement whereby the trust gives authority to another person to act in the name of the trust, as, *e.g.*, a servicing agreement.

10 Rev. Rul. 75-192, 1975-1 CB 384; *see also* Rev. Rul. 78-149, 1978-1 CB 448.

11 The prohibition on the power to vary a grantor trust's assets is discussed in Peaslee & Nirenberg, Chapter 4, Part D.4. The discussion in the text is about an Issuer's ability to permit certain actions that do not violate the prohibition on having a power to vary its investments. Any exchange of Bonds or modification of the terms of the Bonds (including in their credit enhancement) could cause the Bonds to be treated as reissued for federal income tax purposes and would raise the issue of whether interest on the new or modified Bonds was exempt from federal income tax, a topic beyond the scope of this article.

12 Completing a forward purchase involves no managerial power and is unaffected by market variations.

13 Varying the assets of a partnership Issuer is often not permitted because it would prevent making an election under Rev. Proc. 2003-84, 2003-2 CB 1159, discussed below in the text.

14 Though less common, floating rate Bonds sometimes are securitized this way as well.

15 Where fixed rate term financing is desired as a business matter, the tender option is removed and the Issuer remains in existence for a fixed term shorter than the maturity of the Bonds, but in this scenario the residual certificate is subordinate, not only in the case of default, but also in the case of a loss on sale of any Bond at the termination of the Issuer. The Issuers in these transactions are often called "Term A/B Trusts."

16 A small number of securitizations involve preferred shares ("Shares") in RICs that hold Bonds and pay exempt-interest dividends (dividend that are treated as tax-exempt interest). Securitizations of Shares and Bonds are structured similarly, but differ somewhat because, among other reasons: (i) Shares may pay, in addition to exempt-interest dividends, capital gain and ordinary income dividends, (ii) Shares typically provide for the payment of additional amounts (also known as a gross-up) to compensate holders for receiving taxable income, (iii) special tax accounting rules apply to Shares, and (iv) a few tax advisors believe that conventional credit enhancement of Shares is not permitted (and must be obtained via an alternative structure such as through the acquisition of a put option on the Shares).

17 Treatment of multiple-class trusts as partnerships for federal income tax purposes is discussed in Peaslee & Nirenberg, Chapter 4, Part D.5. There is a plethora of authorities that hold that (absent an abusive situation) the characterization of a security or financial transaction will be respected even though the economic consequences to an investor are substantially the same as those that would arise on some other analogous security or via some other type of financial transaction. One relevant example is Example 3 of the so-called "Sears regulations,"

discussed in Peaslee & Nirenberg, Chapter 4, footnote 253, which treats a two-class trust as a partnership notwithstanding the economic similarity of the transaction to a single class trust that owns stock and writes a covered call option. Nevertheless, TOBs (for conservative tax planning) are structured in the manner indicated below in the text to ensure the classification, for federal income tax purposes, of the senior certificates as equity in the Issuer and thus an indirect ownership interest in the Bonds, rather than as newly issued debt of the Issuer the interest on which would be taxable.

[18] In some cases, a lesser percentage (one or two percent) of the gain is shared but the floating rate holders are entitled to an alternative economic benefit (analogous to equity holders) by being entitled to a portion of the residual cash flow that would otherwise be paid entirely to the holders of the residual class. In Notice 2008-80, 2008-40 IRB 820, the IRS announced that it was considering additional conditions for qualification under the TOB-related revenue procedures, including, a minimum five percent gain share and a requirement that the partnership liquidate or provide the floating rate holders the right to require a disposition of the TOB Issuer's Bonds (which would prevent allowing the gain share to be paid based on marking the Bonds to market). The notice was heavily criticized for suggesting limitations that would frustrate commercial desires but had no bearing on the appropriateness of the monthly closing election. *See, e.g.*, David Z. Nirenberg, Steven L Kopp, and Sharon Kim, *IRS Proposes Additional Eligibility Requirements for Tender Option Bond Trusts*, J. Tax'n Fin'l Products, 2009, at 17. Modifications of Rev. Proc. 2003-84 (discussed below in the text) were included in IRS Business Plans for a few years starting in 2007–2008 but were ultimately dropped and no changes were made.

[19] Code Sec. 707(c).

[20] The PTP rules are found in Code Sec. 7704. Tax-exempt interest is treated as income for this purpose despite not being included in gross income. *See* Code Sec. 7704(d)(4) which references Code Sec. 851(b)(2)(A) where tax-exempt interest is treated as interest as provided by Code Sec. 851(b)(3) (flush language).

[21] Investing and trading in securities is not treated as a financial business. *See* Reg. §1.7704-3(a)(2).

[22] The TMP rules are found in Code Sec. 7701(i) and the regulations thereunder.

[23] In very general terms, a REMIC (or "real estate mortgage investment conduit") is an entity that holds a fixed pool of real estate mortgages, issues one or more regular interests and a single class of residual interest, elects to be taxed as a REMIC, and meets certain other tests. The regular interests are treated as debt of the REMIC for federal income tax purposes (regardless of their form or what their characterization would be under general tax principles) and the residual interest is taxed as if it were the sole class of equity in the REMIC and the REMIC were transparent. Because the regular interests are characterized as debt of the REMIC for federal income tax purposes, tax-exempt income earned by a REMIC that is passed through to the holders of the regular interests is treated as taxable income to such holders.

[24] Reg. §301.7701(i)-1(g)(1).

[25] Reg. §301.7701(i)-1(f).

[26] Reg. §301.7701(i)-1(d).

[27] Reg. §301.7701(i)-1(e).

[28] Code Sec. 147(a). The rules for substantial users and related persons are extremely complex and a complete discussion of the topic is beyond the scope of this article. The rules are summarized herein solely for the purposes of discussing a common limitation on the ownership of floating rate certificates and residual certificates.

[29] The federal tax opinion provided by bond counsel when the Bonds are issued generally states that the Bonds are not tax-exempt in the hands of a substantial user (or a related person thereto).

[30] The regulations use the term "nonexempt person." Reg. §1.103-11(b).

[31] *Id.*

[32] *Id.*

[33] These rules generally look to family relationships and certain ownership interests involving partnerships, trusts, stocks and corporations.

[34] The definition of related person is found in Code Sec. 147(a)(2).

[35] Code Sec. 147(a)(2).

[36] TOB programs generally prohibit ownership of certificates by related persons to a substantial user (even if they might not cause the TOB Issuer to be a related person to a substantial user) because it is difficult to apply certain attribution rules to know what percentage of a TOB's profits a certificate holder (or its owner) is considered to have. For example, in any given year the interest income of a TOB Issuer may be paid 100 percent to the floating rate certificate holders and 0 percent to the residual certificate holders but may in a different year be allocated significantly less than 50 percent to the floating rate certificate holders and significantly greater than 50 percent to the residual certificate holders. Similarly, gain on the disposition of a Bond is typically given mostly to the residual certificate holder but that gain often is trivial in amount compared to the interest allocated to the floating rate certificates and is often paid only once, at the liquidation of the trust.

[37] Reg. §1.148-1(b).

[38] *Id.*

[39] Reg. §1.150-1(b); Code Sec. 144(a)(3). For a governmental unit or a 501(c)(3) organization, a related party is any member of the same controlled group. Reg. §§1.150-1(b), 1.150-1(e).

[40] *See* note 33, *supra*, and accompanying text.

[41] The arbitrage rules are described in note 50, *infra*.

[42] *See* note 36, *supra*.

[43] Sometimes, the short party pays the long party less than 100 percent of the positive change of value of the Reference Bond, and no more than the amount of gain in the Bond it retains as holder of the residual certificate (taking account of gain paid on the floating rate certificates). This is not a requirement for tax purposes, but rather is done to avoid having the taxpayer be economically "short" the potential gain on the Bond.

[44] A TRS on a residual interest would presumably cause Code Sec. 1260 (gains from constructive ownership transactions) to apply but that section would not recharacterize tax-exempt interest as taxable income or gain.

[45] *See, e.g.,* Rev. Rul. 80-135, 1980-1 CB 18 (municipal bond lender does not continue to own municipal bond and payment received by lender as in lieu of interest is not excludible from gross income under Code Sec. 103); Rev. Rul. 60-177, 1960-1 CB 9 (same with respect to dividends on a securities loan of stock). *See also Provost*, SCt, 1 USTC ¶153, 269 US 443, 46 SCt 152 (securities loans incident to short sales that transfer legal title to borrower are treated as transfers for purposes of the stamp tax notwithstanding that the borrower is obligated "to give the lender all the benefits and the lender is bound to assume all the burdens incident to ownership of the stock ..., as though the lender had retained the stock"); *Bickford-Smith*, CtCls, 48-2 USTC ¶10,639, 80 FSupp 660, 112 CtCls 144 (a decedent was not treated as the owner of stock for estate tax purposes that he was required to turn over to the British government to be used as collateral for a loan to the British government even though the British government was accountable for paying the equivalent of dividends and, at *its* option, paying the market value or returning the same or substituted shares in the future).

[46] A discussion of the taxation of total return swap is beyond the scope of this article. We note, however, that most taxpayers that hold residual certificates and enter into total return swaps on the Bonds enter into these transactions through a business unit that is subject to mark-to-market tax accounting:

> From time to time, proposals are made to change the taxation of derivatives, including total return swaps, most recently in the Modernization of Derivatives Tax Act of 2021, introduced August 5, 2021 ("MODA"). If enacted, MODA would unify and simplify the treatment of derivatives, including total return swaps, by providing a single timing rule, character rule, and sourcing rule for all derivatives. MODA would (i) require a broader group of taxpayers to mark derivatives to market, (ii) treat gain or loss from derivatives and certain assets they hedge or are otherwise related to as ordinary income or loss, and (iii) source the income from derivatives to the country of residence, incorporation, or organization of the taxpayer (generally making payments free of withholding taxes). MODA would have little practical effect on most taxpayers that hold residual certificates

and enter into total return swaps on the Bonds, because as noted above, most taxpayers entering into these transactions enter into them through a business unit that is already subject to mark-to-market tax accounting.

47 Notice 88-130; Notice 2008-41.

48 The various versions of Form 8038 are required to be filed by the issuers of Bonds in connection with their issuance. Form 8038 is for private activity bonds, Form 8038-G is for governmental bonds, and Form 8038-GC is for small governmental bonds, leases and installment sales.

49 If the new Bond qualifies as tax-exempt under the law in effect when the TRS is entered into (or modified), the issuer will need to take certain steps to protect the tax exemption, including filing a new IRS Form 8038 (or 8038-G or 8038-GC, as applicable).

50 In exceedingly general terms, under Code Sec. 148, Bonds lose their tax-exempt status if they are arbitrage bonds. Subject to certain exceptions, a Bond will be an arbitrage bond if, among other reasons, certain proceeds of the issue of Bonds are used to acquire investments with a yield above the yield on the Bonds. When the investment yield is higher than the bond yield, the excess is called "arbitrage earnings." Having arbitrage earnings does not automatically cause Bonds to be arbitrage bonds because certain exceptions may apply. Bonds must be tested under two independent sets of arbitrage rules—the yield restriction rules of Code Sec. 148(a) and the rebate rules of Code Sec. 148(f)—to determine if they are arbitrage bonds. If the bonds satisfy either set of rules, they are arbitrage bonds:

> The yield restriction rules limit the investment yield that may be earned with bond proceeds. Bonds are arbitrage bonds if, with limited exceptions, the issuer expects to invest or actually does invest all or part of the bond proceeds at a yield materially higher than the bond yield. The arbitrage rebate rules require that certain arbitrage earnings must be paid, or "rebated," to the U.S. Treasury. That is, even if an issuer is permitted to invest in higher yielding investments under the yield restriction rules, it may have to rebate those arbitrage earnings to the U.S. Treasury. If an issuer is required to pay a rebate under these rules, but does not, the bonds are "arbitrage bonds."

> For an excellent description of the arbitrage rules related to tax-exempt bonds please see Chapter V of Cholst and Breitmeyer, 183 T.M. Tax-Advantaged Bonds published by Bloomberg.

51 Under Code Sec. 706(a), a partner generally includes in income for a taxable year the partner's allocable share of items of partnership income, gain, loss, deduction, and credit for the partnership's taxable year ending within or with the partner's taxable year. Annual inclusion of income under Code Sec. 706(a) can be incompatible with the needs of money market funds. For example, if a money market fund's taxable year does not correspond to the taxable year of a TOB Issuer in which it holds an interest, the money market fund may not be allocated sufficient tax-exempt interest income from the TOB Issuer to pay exempt-interest dividends in a timely manner:

> No similar issue arises with grantor trusts because each certificate holder is treated as owning its *pro rata* share of the trust's assets and being the obligor on its proportionate share of the trust's liabilities and, thus, is deemed to receive or pay its share of any trust income or expense as the same is received or paid by the trust.

52 Equivalent requirements apply to shares in mutual funds that pay exempt-interest dividends.

53 This is in contrast with the general rule for partnerships pursuant to which the nominee is required to inform the partnership of its holding a partnership interest as nominee. *See* Code Sec. 6031(c).

54 Under Code Sec. 6221(a), with various exceptions, "[a]ny adjustment to a partnership-related item shall be determined, and any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item shall be determined, at the partnership level." Under Rev. Proc. 2003-84, 2003-2 CB 1159, §8.02(2), however, a partnership making an election under the Revenue Procedure "is not required to file a partnership return under §6031(a) and, as a result, is not a partnership as defined under §6231(a)(1). Consequently, the entity and its members will not be subject to the provisions of subchapter C of chapter 63 [which includes Code Sec. 6221]."

55 *See, e.g.*, 24 CFR §267.10(c) which provides:

> (c) Tender option termination event. The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity [(as defined for risk retention purposes)] may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but that upon the occurrence of a "tender option termination event" as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84, as amended or supplemented from time to time will meet the requirements of an eligible vertical interest.

> (d) Retention of a municipal security outside of the qualified tender option bond entity. The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may satisfy its risk retention requirements under this Section by holding municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.

56 Delaware Tax Reg. §1.502.1(b) provides:

> Classification of entities—The classification of entities for Delaware tax purposes shall be as prescribed for federal tax purposes. Unless inconsistent with Delaware law, the provisions of Sections 301.7701-1; 301.7701-2; and 301.7701-3 of the Regulations to the Internal Revenue Code of 1986 are hereby adopted for Delaware purposes.