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Department of the Treasury

Washington, DC 20224

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Date:
February 21, 2003

LEGEND

Parent =

Sub1 =

Sub2 =

Sponsor =

Pool =

Partnership =

State1 =

a% =

b% =

x% =

y% =

Dear :

This letter responds to your letter dated June 8, 2000, and subsequent correspondence on behalf of Parent, requesting various rulings regarding a proposed transaction.

FACTS

Parent, a State1 corporation, is the common parent of a consolidated group of corporations that includes Sub1, Sub2, and Sponsor. Sponsor is engaged in the business of originating and purchasing obligations, qualified small issue bonds, and qualified § 501(c)(3) bonds (the Obligations) the interest on which is excluded from gross income under § 103 of the Internal Revenue Code.

Sponsor, Sub2 and potentially one or more affiliated or related entities (each a Seller) will transfer and assign all of their right, title and interest in the Obligations to one or more State1 trusts (the Pool). In connection with assignment to the Pool, the Seller will represent that interest on each Obligation transferred to the Pool is exempt from gross income under § 103. A determination that interest on an Obligation was taxable as of the date of transfer to the Pool would result in a breach of this representation, thereby requiring Seller to repurchase the Obligation from the Pool. Otherwise, neither the Sponsor nor the Seller will have any further risk of loss in respect of the Obligations transferred to the Pool.

Contemporaneously with the assignment to the Pool, Sub2 or an affiliate will establish a second State1 trust (the Partnership). Parent represents that at all times the Partnership will have at least two owners and that the two classes of interest in the Partnership (see below) are properly treated as equity for federal tax purposes. Through a series of transactions, the Pool will issue certificates (pass-through certificates) to the Partnership that will entitle the Partnership to receive distributions of principal and interest based on amounts received with respect to the Obligations in the Pool (including amounts received pursuant to a credit facility), after reduction for fees and expenses of the servicer and the trustee of the Pool. After the transactions, the Partnership will own 100% of the Pool's pass-through certificates.

Partnership will issue two classes of interest: a preferred certificate that is entitled to a variable return on its capital contribution (variable rate certificates) and a junior class of certificate that is entitled to all of the remaining income of the Partnership (residual certificates). The variable rate certificates will entitle the owner to receive allocations of income and correlative distributions from the Partnership at a rate that is periodically reset by a third party (the remarketing agent) as the minimum rate that would be necessary for a variable rate certificate to have a sale price equal to the unreturned capital contribution of such certificate, but such allocations and distributions may not exceed the amount of tax-exempt income derived by the Partnership from the Pool for the applicable period (net of expenses). The owners of the variable rate certificates will pay approximately a% of the total paid to the Partnership for both classes of certificates and will be allocated x% of the net capital gains of the Partnership. The owners of the residual certificates will pay approximately b% of the total paid to the Partnership for both classes of certificates and will be entitled to all net profits of the Partnership in excess of that allocable to owners of the variable rate certificates and to y% of the net capital gains of the Partnership.

The Partnership generally will remain in existence for a period equal to 80% of the weighted average maturity of the Obligations in the Pool and may terminate earlier, upon the occurrence of one of the termination events specified in the Partnership agreement.

RULINGS REQUESTED

Parent has requested that we rule as follows:

1) The Pool will be classified as a grantor trust under subpart E of part I of subchapter J of Chapter 1 of the Code and that the Partnership will be treated as owning its share of the Obligations held by the Pool;

2) The Partnership will be classified as a partnership for federal income tax purposes;

3) For purposes of § 265(a)(2), the owners of the variable rate certificates and the owners of the residual certificates will be treated as holding their share of the Obligations owned by the Partnership in proportion to their positive capital account balances;

4) Tax-exempt income derived by the Partnership from its interest in the Obligations will have the same character in the hands of holders of the variable rate certificates and residual certificates as in the hands of the Partnership;

5) Allocations of income, gain, loss and deduction provided for in the Partnership agreement will have economic effect;

6) Under § 761(a), the Partnership may elect out of § 706(a) of the Code, and each member of the Partnership may take into account its distributive share of Partnership income, gain, loss and deduction as they are taken into account by the Partnership.

LAW AND ANALYSIS

Ruling Request #1

> The Pool will be classified as a grantor trust under subpart E of part 1 of subchapter J of Chapter 1 of the Code and that the Partnership will be treated as owning its share of the Obligations held by the Pool.

Section 301.7701-4(c)(1) of the Procedure and Administration Regulations provides that an “investment trust” will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. See Commissioner v. North American Bond Trust, 122 F. 2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders. An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under § 301.7701-2; however, an investment trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

Section 671 provides that where it is specified in subpart E that the grantor or another person shall be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.

Section 677(a) provides, in part, that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be, (1) distributed to the grantor or the grantor's spouse or (2) held or accumulated for future distribution to the grantor or the grantor's spouse.

Rev. Rul. 84-10, 1984-1 C.B. 155, concludes that each certificate holder in a mortgage pool trust is treated as the owner of an undivided interest in the entire trust corpus and must take into account the appropriate portion of the trust’s items of income, deduction, and credit under § 1.671-3(a).

Based on the facts and circumstances presented and the representations made, we conclude that Pool will be classified as a trust under § 301.7701-4(c) because it has a single class of ownership interests, representing undivided beneficial interests in the assets of Pool, and there is no power under the Pool agreement to vary the investment of the certificate holder(s). Moreover, based upon our examination of Pool's trust documents, we conclude that the Pool will be treated as a grantor trust under § 677(a) and the Partnership will be treated as owning its share of the Obligations held by the Pool.

Ruling Request #2

The Partnership will be classified as a partnership for federal income tax purposes.

Although Partnership will be organized under state law as a trust, § 301.7701-4(c)(1) provides, in part, that an investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under § 301.7701-2. Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. An eligible entity with at least two members can elect to be classified as either an association or a partnership.

Section 301.7701-3(b)(1)(i) provides that unless an entity elects otherwise, a domestic eligible entity is a partnership if it has two or more members.

Based on the facts and circumstances presented and the representations made, we conclude that, Partnership is an eligible business entity that will be classified as a partnership if no election is made under § 301.7701-3.

Ruling Request #3

For purposes of § 265(a)(2), the owners of the variable rate certificates and the owners of the residual certificates will be treated as holding their share of the Obligations owned by the Partnership in proportion to their positive capital account balances.

Section 265(a)(2) provides that no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income tax. Section 265(a)(2) is derived from § 1201(1) of the Revenue Act of 1917 and § 234(a) of the Revenue Act of 1918. It is clear from the legislative history relating to those sections that Congress intended to disallow interest under § 265(a)(2) only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax-exempt securities (purposive connection). *See, e.g.,* H. Rept. 767, 65th Cong., 10; S Rept. 617, 65th Cong., 6, 7 (1918); 65 Cong. Rec. 7541-7542 (1924); and 67 Cong. Rec. 2964 (1925). Where the required purposive connection is established, § 265(a)(2) of the Code will be applicable even though the taxpayer does not receive tax-exempt interest. *See, e.g.,* Clyde C. Pierce Corp. V. Commissioner, 120 F. 2d 206 (5th Cir.1941); Illinois Terminal Railroad Co. v. United States, 375 F. 2d 1016, 1022 (Ct. Cl. 1967).

As a result, the application of § 265(a)(2) requires a determination as to the taxpayer's purpose in incurring or continuing each item of indebtedness. Such a purpose may be established either by direct evidence (such as where the proceeds of a borrowing are used to purchase tax-exempt obligations) or by circumstantial evidence. Rev. Proc. 72-18, 1972-1 C.B. 740 provides guidelines as to both direct and circumstantial evidence regarding the application of § 265(a)(2) to taxpayers holding state and local obligations the interest on which is wholly exempt from federal income tax.

Section 3 of Rev. Proc. 72-18 provides the general rules relating to establishing a purposive connection between a borrowing and the acquisition or carrying of tax-exempt obligations. Sections 3.02 and 3.03 provide examples of direct evidence of a purpose to acquire or carry tax-exempt obligations. Those sections suggest that there may be direct evidence of a purposive connection between any borrowing from Sub2 (the servicer) that enables the Partnership to distribute tax-exempt interest to the certificate holders and the holding of those obligations for purposes of § 265(a)(2).

Section 3.04 provides that, in the absence of direct evidence linking indebtedness with the purchase or carrying of tax-exempt obligations, § 265(a)(2) will apply only if the totality of facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists. Section 3.05 provides that, generally, where a taxpayer's investment in tax-exempt obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will not ordinarily be inferred in the absence of direct evidence as set forth in §§ 3.02 and 3.03. In the case of a corporation (who is not a dealer in tax-exempt obligations), investment in tax-exempt obligations shall be presumed insubstantial only where during the taxable year, the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average total assets (valued at their adjusted basis) held in the active conduct of the trade or business.

Section 4 of Rev. Proc. 72-18 provides guidance for individuals (in the absence of direct evidence) on when a purpose to acquire or carry tax-exempt obligations may be inferred from circumstantial evidence. Section 4.05 provides guidance on attribution of tax-exempt obligations or indebtedness from a partnership to its partners for purpose of evaluating circumstantial evidence of a purposive connection between the two. That section provides that in the case of a partnership which incurs indebtedness or which holds tax-exempt obligations, the partners shall be treated as incurring or holding their partnership share of such indebtedness or tax-exempt obligations. For purposes of the Revenue Procedure, the interest of a partner in the partnership's assets and indebtedness shall be determined in accordance with his capital interest in the partnership. Although, by its terms, § 4.05 of Rev. Proc. 72-18 applies only to individual partners in a partnership, it is reasonable to apply similar principles to corporate partners when evaluating the circumstantial evidence linking partnership assets and indebtedness with the assets and indebtedness of a corporate partner for the purpose of applying the safe harbor provided in § 3.05.

We conclude that, for purposes of determining whether Sub1, Sub2, or the Sponsor holds more than 2% of their respective assets in tax-exempt obligations under the safe harbor provided in § 3.05 of Rev. Proc. 72-18, the interest of Sub1, Sub2, or the Sponsor in the Partnership's assets (including tax-exempt obligations) and indebtedness shall be determined in accordance with Sub1's, Sub2's, or the Sponsor's capital interest in the Partnership, that is, Sub 1's, Sub 2's, or the Sponsor's positive capital account balance. This conclusion has no relevance to determining Sub1's, Sub2's, or the Sponsor 's share of Partnership debt and assets where there is direct evidence of a purposive connection between indebtedness and the acquisition or carrying of the interest in Partnership**.**

Ruling Request #4

> Tax-exempt income derived by the Partnership from its interest in the Obligations will have the same character in the hands of the holders of the variable rate certificates and residual certificates as in the hands of the Partnership

Section 702(a) provides that, in determining a partner's income tax, each partner shall take into account separately the partner's distributive share of the partnership's items of income, gain, loss, deduction, or credit.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under § 702(a)(1) through (7) is determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Under § 702(b), the tax exempt income derived by the Partnership from its interest in the Obligations will have the same character in the hands of the partners as in the hands of the Partnership.

Ruling Request #5

> Allocations of income, gain, loss and deduction provided for in the Partnership agreement will have economic effect.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in Chapter 1, be determined by the partnership agreement.

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if -- (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof); or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(2)(ii) provides that in order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or bear the economic burden. Generally, an allocation has economic effect if the partnership agreement provides that: (1) the partnership capital accounts are maintained in accordance with § 1.704-1(b)(2)(iv), (2) upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions will be made to the partners in accordance with their positive capital account balances, and (3) partners are unconditionally required to restore the negative balance of their capital accounts to the partnership upon liquidation of their interests in the partnership. Alternatively, the partnership may satisfy the requirements of the alternate test for economic effect provided in § 1.704-1(b)(2)(ii)(d) if the partners agree to a qualified income offset in lieu of an unconditional deficit restoration obligation. If the partners so agree, allocations will have economic effect to the extent that they do not create or increase a deficit capital account for any partner (in excess of any limited deficit restoration obligation of that partner) as of the end of the partnership taxable year to which the allocation relates. Section 1.704-1(b)(2)(ii)(d)(3).

Section 1.704-1(b)(2)(iv)(b) provides that the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under § 752), and (3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) but excluding income and gain described in paragraph (b)(4)(i); and decreased by (4) the amount of money distributed to him by the partnership, (5) the fair market value of property distributed to him by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under § 752), (6) allocations to him of expenditures of the partnership described in § 705(a)(2)(B), and (7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g), but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii); and is otherwise adjusted in accordance with the additional rules set forth in paragraph (b)(2)(iv).

After reviewing the trust agreement provisions, and based on the representations made, we conclude that the allocations provided for in the agreement meet the requirement for economic effect set forth in § 1.704-1(b)(2)(ii) provided that the allocation does not cause or increase a deficit balance in any partners' capital account (in excess of any limited deficit restoration obligation of that partner) as of the end of the partnership taxable year to which the allocation relates. No opinion is expressed or implied regarding whether Partnership allocations will satisfy the requirements for substantiality provided in § 1.704-1(b)(2)(iii).

Ruling Request #6

> Under § 761(a), the Partnership may elect out of § 706(a) of the Code, and each member of the Partnership may take into account its distributive share of Partnership income, gain, loss, and deduction, as they are taken into account by the Partnership.

Section 761(a)(1) provides, in part, that under regulations, the Secretary may, at the election of all of the members of a partnership, exclude the partnership from the application of all or part of subchapter K, if it is availed of for investment purposes only and not for the active conduct of a business and if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

Section 1.761-2(a)(1) provides, in part, that an unincorporated organization described in §§ 1.761-2(a)(2) may be excluded from the application of all or a part of the provisions of subchapter K under conditions set forth in this section if such organization is availed of for investment purposes only and not for the active conduct of a business, and if the members of such organization are able to compute their income without the necessity of computing partnership taxable income.

Section 1.761-2(a)(2) describes an investing partnership that is eligible to be excluded from the application of all or part of the provisions of subchapter K. That section provides that, where the participants in the joint purchase, retention, sale, or exchange of investment property -- (i) own the property as coowners, (ii) reserve the right separately to take or dispose of their shares of any property acquired or retained, and (iii) do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then such group may be excluded from the application of the provisions of Subchapter K.

Section 1.761-2(c) provides rules relating to a partial exclusion from subchapter K. That section provides that an unincorporated organization which wishes to be excluded from only certain sections of subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of subchapter K. The request shall set forth the sections of subchapter K from which exclusion is sought and shall state that such organization qualifies under § 1.761-2(a)(1) and either § 1.761-2(a)(2) or § 1.761-2(a)(3), and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

Section 706(a) provides that, in computing the taxable income of a partner for a taxable year, the inclusions required by § 702 and § 707(c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

Section 706(b) provides the rules for determining a partnership's taxable year. Section 706(b)(1)(B) provides that the partnership's taxable year is determined by reference to partners and that, except as provided in § 706(b)(1)(C) (relating to business purpose), a partnership shall not have a taxable year other than—(i) the majority interest taxable year as defined in § 706(b)(4), (ii) if there is no taxable year described in clause (i), the taxable year of all the principal partners of the partnership, or (iii) if there is no taxable year described in clause (i) or (ii), the calendar year unless the Secretary by regulations prescribes another period.

Section 301.7701-4(c) provides in relevant part that an investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under § 301.7701-2; however, an investment trust with multiple classes of ownership interests in which there is no power under the trust agreement to vary the investment of the certificate holders will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

Example (4) under § 301.7701-4(c)(2) describes an investment trust with multiple classes of interest that is classified as a trust. In that example, Corporation N purchases a portfolio of bonds and transfers the bonds to a bank under a trust agreement. At the same time, the trustee delivers to N certificates evidencing interests in the bonds. These certificates are sold to public investors. Each certificate represents the right to receive a particular payment with respect to a specific bond. Under § 1286, stripped coupons and stripped bonds are treated as separate bonds for federal income tax purposes. The example notes that, although there are multiple classes of interest in the trust, the multiple classes simply provide each certificate holder with a direct interest in what is treated under

§ 1286 as a separate bond and that, given the similarity of the interests acquired by the certificate holders to the interests that could be acquired by direct investment, the multiple classes of interest merely facilitate direct investment in the assets held by the trust. Accordingly, the trust is classified as a trust.

Section 301.7701-2 provides that a business entity is any entity recognized for federal tax purposes that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified as either a corporation or a partnership.

The Partnership has multiple classes of ownership that do not merely facilitate direct investment in assets held by the Partnership. The variable rate and residual interests are interests in a business entity (treated as a partnership) through which the income, gains, losses and deductions attributable to the Obligation are divided in a manner that differs significantly from direct ownership of the Obligation. An entity with multiple classes of interests that does not satisfy the requirements of § 301.7701-4(c) is a business entity that, if treated as a partnership, generally cannot satisfy the requirements of § 761(a) because the income of such an entity generally cannot be adequately determined without the computation of partnership taxable income. Under the facts presented here, where the total income, gains, losses and deductions of the Partnership are allocated in varying proportions to the two classes of interests over the term of the Partnership (including special allocations of capital gains, market discount gains, and bond premium amortization), the first step in the calculation of the allocations is the computation of total income, gain, loss, and deduction of the Partnership. Under these circumstances, the Partnership does not satisfy the requirement of § 1.761-2(a)(1) that the partners be able to compute their income without the necessity of computing partnership income. See also Rev. Proc. 2002-68, 2002-43 I.R.B. 753.

As a consequence, we conclude that the Partnership may not elect out of § 706(a) under § 761(a).

Rev. Proc. 2002-68, provides an election that will alleviate the timing difficulties experienced by investors that invest in the Partnership. The revenue procedure allows certain partnerships that invest in assets exempt from taxation under § 103 to make an election that enables partners to take into account monthly the inclusions required under §§ 702 and 707(c).

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

/s/
Jeanne Sullivan
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)