

# The Legal Intelligence

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## Following the Paper Trail *Animosity Started Early and Persists in Avellino Case*

BY MICHAEL A. RICCARDI

*Of the Legal Staff*

A stream of e-mail documents and other messages appear to show that any working relationship between Common Pleas Court Judge Bernard J. Avellino and court leaders broke down even before the judge began to fire internal complaints about the management of Administrative Judge John W. Herron.

Verified by Herron as part of his new matter in response to Avellino's charge that his reassignment to non-jury criminal trials was a "retaliatory demotion," the newly-released internal court documents show that Avellino was stubbornly refusing to report his daily status to court personnel as early as May 1996, months before the present dispute began brewing.

The court documents also appear to show that even after Avellino began to comply with the state Supreme Court back-to-work order, he has refused to cooperate with directions from Herron



BONAVITACOLA



HERRON



DAVIS



AVELLINO

and the supervising judge of the criminal side of the court, Judge Legrome D. Davis.

The papers are mostly messages from Herron and Davis urging Avellino to follow procedures that other judges were following.

There are also January 1997 documents showing that Avellino, unlike other judges in the same program, refused to report his daily status even after he was ordered back to work after a boycott of duties in the first full week of the new year.

Davis e-mailed Avellino on May 17, 1996, when the judge was in a jury trial

program in criminal court, cordially asking Avellino to report his status to administrative officials.

"I was advised (probably mistakenly) that you decline to provide your status, putatively because the calendar judge already knows it," Davis wrote to Avellino, gently urging him to report his status to court officials. "I don't, so please do me a favor and tell ... your status. Thanks for your cooperation."

The exchanges became more rancorous as time went by.

*Avellino continues on 12*

### INSIDE THE LEGAL

#### Record Verdict in Susquehanna County

**3** A Philadelphia lawyer has brought home the first plaintiff's medical malpractice award in Susquehanna, winning the largest jury award ever in that county.

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#### Batson Applies to Blacks And Whites, Superior Ct. Rules

**4** The defense found that the defense's "facially neutral" reasons for using peremptory strikes against white jurors, where blacks with similar back-

# BUSINESS LAW

## FASITs: Entity of Choice For Securitization of Debt

BY SHELDON D. POLLACK

*Special to the Legal*

While many of us were away on vacation last summer, Congress did the unexpected and passed a major tax bill. The Small Business Job Protection Act of 1996 (P.L. 104-188) was signed into law by President Clinton on Aug. 20, 1996.

Many of the provisions in the 1996 act had been included in prior unsuccessful legislative proposals, and hence, were already familiar to practitioners.

Nevertheless, it will take some time to comprehend many of the other important provisions included in this legislation. One of these created an entirely new tax entity, the "financial asset securitization investment trust"—or FASIT, as it is known in tax parlance.

FASITs were first proposed in the Seven-Year Balanced Budget Reconciliation Act of 1995, which was vetoed by President Clinton in December 1995. Many of us thought that was the end of it. However, contrary to expectations, FASITs were resurrected in the 1996 act and will become reality on Sept. 1, 1997, when the provision becomes effective.

In the meantime, the Treasury Department is at work preparing regulations to answer some of the tricky issues that are raised by the new entity.



**SHELDON D. POLLACK** is Assistant Professor in the College of Business and Economics at the University of Delaware and practices law in Montgomery County. He is the author of "The Failure of U.S. Tax Policy: Revenue and Politics," published by Penn State Press in 1996, and numerous articles on taxes, law, and politics.

— achieving pass-through tax treatment can be problematic.

In particular, prior to the 1996 act, there was no ideal entity for the securitization of general debt obligations (secured and unsecured) with a short maturity.

The common practice of using a master trust has a number of tax and business drawbacks, the most prominent being that provisions must be made to restrict the transferability of the asset-backed securities (lest the master trust be classified as a "publicly traded partnership" taxable as a corporation) and to provide protection for the investors in the event of the insolvency of the sponsor or trust.

But the most significant drawback of a master trust is the uncertainty of the tax treatment of the securities issued to the investors. Whether the payments made on such securities is treated for tax purposes as "interest" or a "return on equity" makes considerable difference to both the

state law as a corporation, partnership, limited liability company, or trust. Trusts and corporations are the most likely candidates.

It would appear that even a separate pool of assets could qualify as a FASIT, although for business and management purposes, this would not make for a very workable arrangement.

To qualify as a FASIT, the entity must:

- Elect to be treated as a FASIT.
- Have only a single "ownership interest" held by an "eligible corporation."
- Have other interests that are "regular interests."
- Hold only "permitted assets" after the close of the third month of formation.
- Not be qualified as a RIC.

The Treasury regulations will provide for the specific method of making the FASIT election, which will be effective so long as the entity remains qualified as a FASIT or until it is revoked with the consent of the IRS. The other qualifications for FASITs are explained further below.

### OWNERSHIP INTERESTS; PERMITTED ASSETS

As noted above, there must be a single "ownership interest" in a FASIT. This ownership interest is that interest designated as such after the "startup day" (i.e., the first day of FASIT status under the election).

This ownership interest must be held by a non-exempt Subchapter C corporation (that is, the corporate owner may not be a RIC, REIT, REMIC, cooperative, or Subchapter S corporation).

ests will be treated as debt holders and the payments received by them with respect to their interests will be treated as "interest" for tax purposes, regardless of the outcome under the traditional debt/equity test.

Certain "high-yield interest" debt instruments are also permitted. Basically, these are regular interests that fail requirements (3), (4), and (5) above, with respect to principal amount, issue price, and yield to maturity.

The issuer is permitted to issue high-yield interests and retain eligibility as a FASIT, although the taxation of the interest paid on a high-yield debt instrument differs, as detailed later.

A high-yield debt instrument can be "interest only"—meaning the debt instrument has no principal amount and pays interest only on a notional amount.

Substantially all of the assets of a FASIT must be "permitted assets." These include:

- Cash or cash equivalents.
- Debt instruments which pay fixed interest or variable interest as permitted by the IRS in regulations.
- Certain "foreclosure property" (i.e., property acquired by foreclosure).

• Certain hedging instruments providing risk reduction (e.g., interest swaps, derivatives) and credit-enhancement contracts (e.g., letters of credit, insurance, guarantees).

Obviously, permitted assets is a broad category and includes a wide assortment of taxable debt obligations. But remember: Tax-exempt debt instruments

*FASITs are the ideal entity for the securitization of general debt obligations and will rapidly become the entity*

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The FASIT may have an unlimited number of holders and classes of "regulatory interests." A regulatory interest is that interest designated as such, issued after the startup day, and which:

- (1) Has a stated maturity of no more than 30 years.
- (2) Pays fixed interest or variable interest as provided by the IRS in regulations.
- (3) Entitles the holder to receive a specified principal amount unconditionally.
- (4) Is issued with a premium of no more than 25% of the stated principal.
- (5) Has a yield to maturity at issue that is less than 5 percentage points above the applicable federal rate (AFR) for the month issued.

A regular interest is treated for tax purposes as a debt instrument. This is one of the most important features of the FASIT, as investors who acquire the regular inter-

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# *FASITs are the ideal entity for the securitization of general debt obligations and will rapidly become the entity of choice for structured finance transactions involving credit card receivables, home equity loans and automobile loans.*

Obviously, permitted assets is a broad category and includes a wide assortment of taxable debt obligations. But remember: Tax-exempt debt instruments and assets which are not debt instruments, such as leases, may not be held by a FASIT.

Most important, new permitted assets can be contributed to the FASIT at any time. Thus, the FASIT can function like a true revolving pool, with the managers reinvesting proceeds from maturing debt obligations in new instruments.

This is what makes the FASIT the perfect vehicle for the securitization of credit card receivables and other similar obligations with short maturities. Likewise, as new pools of receivables are added to the trust, new tranches of securities (regular interests and high-yield interests) can be issued by the FASIT. In this way, the life of the FASIT can be extended indefinitely.

## FASITs

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One of the great benefits of the FASIT provision is that it provides certainty with respect to the tax treatment of the sponsor/owner, the entity, and the various holders of investment interests. Absent this statutory treatment, there would be considerable uncertainty as to the tax treatment of the payments to the various parties to the transaction.

### • FASIT.

The FASIT entity itself is not subject to federal income tax. All of the assets and liabilities of the FASIT are treated as those of the corporate owner.

Likewise, any income loss, gain, deduction, credit, etc., is treated as that of the owner. In essence, the owner's income or loss attributable to its ownership of the FASIT entity will be the spread between the interest paid on the regular interests and the high-yield interests issued by the FASIT to the investors and the interest earned by the FASIT on its investments (i.e., the return on the FASIT's permitted assets).

Any net taxable income must be included in income by the owner using the accrual method of tax accounting.

### • Regular Interest.

The regular interests are taxed as debt

instruments. However, the holder must take into income the interest received using the accrual method of tax accounting.

### • High-Yield Interest.

The holder of a high-yield interest must be a domestic, non-exempt Subchapter C corporation. Furthermore, the income received with respect to a high-yield interest cannot be offset by a net operating loss from any other source.

As a result of this requirement, corporate income tax will be paid on any "excess" profit received with respect to the ownership of a high-yield interest (i.e., that amount of "interest" which is above the market rate, and hence, which in essence is a return on equity).

### • Ownership Interest.

Any income, loss, gain, deduction or tax credits of the FASIT pass through to the holder of the ownership interest. The taxable income of the non-exempt corporate owner cannot be offset by losses from other non-FASIT sources.

Again, this is to ensure that corporate level tax will be paid on any net taxable income of a FASIT.

### • Transfer of Property to FASIT.

The sale or contribution of assets to a FASIT by the holder of the ownership interest triggers gain (but not loss) in an amount equal to the difference between the fair market value of such assets and

## Avellino

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Three days after Davis' request, Avellino shot back with the note that said, "I have not given 'status' to anyone since 1981. Apart from the fact that I disconnect the telephones when sitting, I think 'spying' on judges is insulting."

Five days after Davis' cordial inquiry,

the holder's adjusted basis in such assets.

A loss will be recognized when the property is disposed of by the FASIT. Treasury is authorized to issue regulations allowing for a deferral of gain recognition until the FASIT issues regular interests "supported" by the contributed assets.

This means that the "cost" of using a FASIT is that tax must be paid on any built-in gain in the contributed assets-which would not be the case if a master trust is used.

## CONCLUSION

FASITs are sure to become the favored entity for structured finance transactions involving credit card receivables, equity mortgages, car loans and other similar debt obligations with short maturities.

FASITs provide certainty of outcome as to the tax treatment of the payments made to investors, as well as for the securitization vehicle itself.

Great flexibility is granted under the statute as to the organization and operation of FASITs, especially with respect to reinvesting proceeds from debt obligations as they mature, which further enhances the attractiveness of the FASIT as a vehicle for the securitization of general debt obligations.

Sharpening the rhetoric somewhat, Davis ends the memo by telling Avellino to "GIVE ME A BREAK, PLEASE."

One day after Davis' e-mail message to Avellino, Herron told Avellino that "You have no authority to issue such a directive" preventing courtroom staff from providing his courtroom status to the calendar judge or other administrative authorities.

"The refusal to provide status infor-

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