Internal Revenue Service

Number: **200347016**
Release Date: 11/21/2003
UILC: 1272.06-00, 1275.08-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:Br.3/PLR-148363-02
Date: November 26, 2002

LEGEND

Taxpayer	=
Company	=
Trust 1	=
Credit Card Issuer	=
Debt	=
Trust 2	=
a	=
b	=
c	=
d	=
e	=
f	=
Date 1	=
Date 2	=
Counterparty	=

This is in response to a letter dated August 30, 2002, and subsequent correspondence requesting a ruling on whether the Debt (described below) is a qualifying debt instrument for purposes of §1.1275-6 of the Income Tax Regulations.

FACTS

Company is a holding company that, through its subsidiaries and affiliates, provides investment, financing, advisory, insurance, banking, and related products and services. Company plans to initiate a new securitization program in which financial assets (generally debt instruments and pass-through interests in debt instruments) would be contributed by a sponsor to a trust (the Taxpayer) that is treated for federal income tax purposes as a partnership.

A fixed investment trust (Trust 2) would be formed to hold interests in the Taxpayer. Units in Trust 2 would be offered for sale to the public.

One of the financial assets that will be owned by the Taxpayer is the Debt. The Debt, which will be issued by Trust 1, will pay interest each year at a floating rate of a %. Except as provided below, the Debt's principal is required to be repaid in full on Date 1.

To secure the Debt and the subordinated financial interests to be issued by Trust 1, Trust 1 has acquired an interest in a revolving pool of credit card receivables from designated credit card accounts issued by the Credit Card Issuer. The Debt is secured by a fixed principal balance of the credit card receivables. The principal balance of the credit card receivables initially held by Trust 1 to secure payment of the Debt will substantially exceed the principal amount of the Debt. As principal payments are received, Trust 1 is required to purchase additional receivables from the designated credit card accounts to maintain the fixed principal balance of the collateral (repurchase requirement). Through the repurchase requirement, Trust 1 will attempt to maintain a constant level of receivables through Date 1 by using principal payments to purchase additional credit card receivables in lieu of making principal payments on the Debt. The repurchase requirement also keeps the principal balance of the Debt constant until Date 1. Taxpayer represents that the only reasons Trust 1 will not maintain a constant level of receivables (that is, Trust 1 will make principal payments on the Debt before Date 1 because Trust 1 is not reinvesting the principal payments) are: 1) a lack of sufficient new receivables from the designated credit card accounts to replace the older receivables that are repaid, causing a significant decline in the amount of credit card receivables in the pool securing the Debt, or 2) default, insolvency, receivership, conservatorship or other similar financial difficulties of the Credit Card Issuer that require disposal of the underlying receivables. According to the Taxpayer, the receivable pools and the Debt are structured so that there is only a remote possibility that the first event will occur.

Debt holders will receive only interest payments until Date 1, at which time the principal on the Debt must be repaid in full if there is sufficient cash flow in Trust 1. Principal would be repaid after Date 1 only in the event of dramatic default experience of the underlying credit card receivables pool. In the event that the Debt cannot be repaid in full on Date 1, the due date of the Debt is automatically extended for approximately two years to Date 2. If by Date 2 the Debt has not been fully paid, Trust 1 will be liquidated, and the Debt will be repaid to the extent of available assets of Trust 1.

The Taxpayer represents that the likelihood of late payment on the Debt is remote because the principal balance of the credit card receivables initially held by Trust 1 to secure payment of the Debt will substantially exceed the principal amount of the Debt. The Taxpayer further represents that the likelihood of late payment on the Debt is even more remote given the existence of other subordinated interests in Trust 1; if there are insufficient funds to pay off all of the ownership interests, the Debt will be paid off before the subordinated interests. There will be at least two financial interests subordinated to the Debt, each representing e% of the principal amount of the Debt. Therefore, at least f% of the principal amount must be in default before payment on the Debt is likely to be late.

It is expected that the Debt will have AAA credit quality as measured by relevant credit rating agencies. Counsel to the issuer of the Debt opine that the Debt is indebtedness for federal income tax purposes and should be treated by holders for federal income tax purposes as indebtedness with a term ending on the scheduled maturity date (Date 1) that is secured by the credit card receivables.

Taxpayer will issue certificates with an aggregate stated amount of $ b. These certificates will provide for a fixed interest rate of c%. Trust 2 will be formed to hold interests in Taxpayer. Trust 2 will offer to the public $ d of these units, which will provide for a fixed interest rate of c%.

Taxpayer intends to enter into an interest rate swap notional principal contract ("Interest Swap NPC") to convert the floating rate interest payments received on the Debt into fixed rate payments. The Taxpayer also intends to identify the Debt and the Interest Swap NPC as an integrated transaction that would be treated as a single synthetic fixed rate debt instrument pursuant to § 1.1275-6. The Debt may be issued with premium, original issue discount (or with only a de minimis amount of original issue discount).

LAW

Section 1.1275-6(a) provides that a taxpayer holding a "qualifying debt instrument" and entering into a §1.1275-6 hedge of the debt instrument may integrate the two positions if the combined cash flows of the two positions are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. If integration is permitted, the two positions will be treated as one instrument subject to the rules of § 1.1275-6 rather than the rules that would otherwise apply to each separate position.

Section 1.1275-6(b) excludes from the definition of a qualifying debt instrument any debt instrument to which § 1272(a)(6) of the Internal Revenue Code applies. Section 1272(a)(6) applies to (i) any regular interest in a REMIC or qualified mortgage held by a REMIC, (ii) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument (or, to the extent provided in regulations, by reason of other events), or (iii) any pool of debt instruments the yield on which may be affected by reason of prepayments (or, to the extent provided in regulations, by reason of other events). See §1272(a)(6)(C).

Section 1.1275-2(h) provides rules for remote or incidental contingencies. Except as otherwise provided, the treatment of a contingency under § 1.1275-2(h) applies for all purposes of §§ 163(e) and 1271 through 1275 and the regulations thereunder, including § 1.1275-6 (see the preamble to T.D. 8674, 1996-2 C.B. 84). Under § 1.1275-2(h)(2), if there is a remote likelihood that a contingency will occur, it is assumed that the contingency will not occur. Whether a contingency is remote is determined as of the issue date of the debt instrument. This section further provides that the possibility of impairment of a payment due to insolvency, default, or similar circumstances will not be considered a contingency.

ANALYSIS

As noted above, payments of principal on the Debt may be accelerated in certain circumstances as a result of payments on the credit card receivables securing the Debt. This possibility raises the question whether the Debt is subject to § 1272(a)(6)(C) and, therefore, is ineligible to be a qualifying debt instrument under § 1.1275-6.

Under the original issue discount (OID) provisions, the possibility of prepayment is a contingency to which special rules apply. For example, see § 1272(a)(6) and §1.1272-1(c). However, under § 1.1275-2(h)(2), if the likelihood of a contingency is remote, it is assumed that the contingency will not occur for all purposes of the OID provisions. Therefore, if the likelihood of prepayments on the Debt is remote, it will be assumed that the prepayments will not occur. Consequently, the Debt will not be subject to § 1272(a)(6) and the Debt will be a qualifying debt instrument for purposes of § 1.1275-6.

In general, Trust 1 is obligated to use the funds from principal payments to purchase additional credit card receivables from the Credit Card Issuer rather than pay the principal through to the Debt holders prior to Date 1. There are two basic situations where Trust 1 must make principal payments to the Debt holders prior to Date 1. First, principal will be accelerated in the event of default, insolvency, receivership, conservatorship or other similar financial difficulties of the Credit Card Issuer. As a general matter, this type of contingency is ignored for purposes of the OID provisions. For example, see §§ 1.1272-1(c) and 1.1275-2(h). The other situation where Trust 1 would make principal payments prior to Date 1 would occur if Trust 1 cannot obtain enough replacement credit card receivables from the Credit Card Issuer to maintain the fixed receivables principal balance. Principal on the Debt will not be repaid prior to Date 1 as long as the amount of receivables in the pool match or exceed the principal amount of the Debt. The Debt is structured so that, in all scenarios within reasonable expectation, the receivable balances in the pool will equal or exceed the principal amount of the debt until Date 1. The terms of the Debt provide that principal on the Debt would be paid prior to Date 1 if the amount of receivables in the pool is less than the principal amount of the Debt. For such a situation to occur, there would need to be either a drastic reduction in credit card usage or a drastic prepayment of credit card receivable balances so that an inadequate amount of replacement receivables are available. The Taxpayer represents that the likelihood of either event is remote within the meaning of §1.1275-2(h).

CONCLUSION

Based on the information and representations submitted by the Taxpayer, the Debt is not subject to § 1272(a)(6) for purposes of § 1.1275-6.

This ruling is directed only to the Taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Except as specifically set forth above, no opinion is expressed regarding the federal tax consequences of the transactions described above under any other provisions of the Code or regulations. In particular, no opinion is expressed on whether the Debt is indebtedness for federal income tax purposes or whether the Taxpayer has satisfied all of the other requirements under § 1.1275-6 to treat the Debt and the Interest Swap NPC as an integrated transaction.

A copy of this letter must be attached to the federal tax return of the Taxpayer for the taxable year in which the Taxpayer acquires the Debt.

This letter is based on the facts presented and the applicable law in effect on the date of this letter. If there is a change in material fact or law before the transactions considered in this ruling take effect, the ruling will have no force or effect.

Sincerely yours,

William E. Blanchard
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)

enclosures:

copy of this letter
section 6110 copy