

**MEMO# 3767**

May 8, 1992

## **REVENUE RULING ON TRANSFER OF A SUBORDINATED INTEREST IN AN INVESTMENT TRUST**

May 8, 1992 TO: TAX COMMITTEE NO. 18-92 RE: REVENUE RULING ON TRANSFER OF A  
SUBORDINATED INTEREST IN AN INVESTMENT TRUST

The Internal Revenue Service has recently issued the attached Revenue Ruling dealing with the effect of the sale of a subordinated interest in a trust with a senior/subordinated structure on the tax status of the trust. The Service concluded that the sale of the subordinated interest would not cause the investment trust to be classified as an association taxable as a corporation or a partnership. This is a reversal of the Service's previous position, in which they had held that any transfer of the subordinated interest by the trust sponsor would cause the trust to fail to be a trust for tax purposes. The investment trust in the Revenue Ruling was formed by the transfer to a trust of a pool of fully-amortizing, fixed-rate automobile loans in exchange for two classes of pass-through certificates: a Senior class and a Subordinated class. The Senior certificates were entitled to 90 percent of all distributions, while the Subordinated certificates were entitled to 10 percent. Under the terms of the trust, any shortfalls in payments on the pooled loans arising as a result of defaults or delinquencies would first reduce the distributions to the Subordinated certificate holders. Only after shortfalls have reduced the distributions on the Subordinated certificates to zero will the distributions to Senior certificate holders be affected. Under Treas. Reg. section 301.7701-4(c)(1), a multiple class investment trust is ordinarily classified for tax purposes as an association or a partnership. However, such a trust will be classified as a trust for tax purposes if (1) there is no power under the trust agreement to vary the trust's investments, and (2) the trust is formed to facilitate direct investment in the assets of the trust and the multiple classes of ownership interest are incidental to that purpose. The regulations contain an example identical to the fact pattern in the Revenue Ruling, except that the subordinated interest is retained by the sponsor. The regulation states that although the trust had multiple classes, the classes are substantially equivalent to undivided - 1 - interests in the asset pool coupled with a limited recourse guarantee running from the sponsor to the senior certificate holders. Therefore, the multiple classes are considered incidental to the trust's purpose of facilitating direct investment in the trust's assets, and the trust is a trust for federal income tax purposes. Until the issuance of this Revenue Ruling, the Service had always taken the position that retention of the subordinated interest by the sponsor was necessary for a transaction to qualify under the analysis set forth in the example in the regulations. We will keep you informed of further developments. David J. Mangefrida Jr. Assistant Counsel - Tax

Attachment

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