REPORT #867

TAX SECTION

New York State Bar Association

REPORT OF THE NEW YORK STATE BAR
ASSOCIATION TAX SECTION ON CERTAIN
ISSUES PRESENTED BY INTEREST STRIPS
IN SECURITIZATION TRANSACTIONS

March 8, 1996

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FEDERAL EXPRESS

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Report on Interest Strips in Securitization Transactions

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report recommending that the Service consider issuing regulations or rulings that change or clarify the tax treatment of interest strips arising in securitization transactions. We believe that modifications or clarifications of current law are needed to address the following issues:

(1) The extent to which holders of stripped coupons or stripped bonds created in securitization transactions should aggregate them and account for them as though they were a single debt instrument;

(2) Whether holders of stripped bonds or stripped coupons from debt instruments that are subject to prepayment should apply a prepayment assumption in accruing income, even though the strips are not Real Estate Mortgage Investment Conduit ("REMIC") regular interests and are not otherwise subject to the "prepayment assumption catch-up" method ("PAC Method") method of accounting described in section 1272(a)(6);

(3) In the case of REMIC regular interests that are equivalent to interest-only strips, the interaction of the PAC Method of accounting with the rules for amortization of premium under section 171;

(4) Whether a right to a portion of the interest from a debt instrument that varies based on a floating interest rate index (a "variable strip") should be considered a "stripped coupon" within the meaning of section 1286, so that a grantor trust could issue an ownership interest equivalent to such a right under Example (4) of the Sears Regulations (Reg. § 301.7701-4(c)); and

(5) Whether stripped coupons and financial instruments used to hedge prepayment risk should be integrated to avoid character and timing mismatches.

These issues arise in three different settings, each of which is considered in the Report. First, taxpayers that originate and/or service portfolios of mortgages or other receivables frequently hold rights to interest

payments that may be considered to exceed reasonable compensation for services, and thus are treated as stripped coupons. Second, trusts that qualify as grantor trusts may issue certificates entitling holders either to all or to a specified portion of the interest payments from debt instruments held by the trusts. Third, REMICs holding mortgages subject to prepayment risk may issue regular interests entitling holders to all or to a specified portion of the interest payments from those mortgages.

The Report makes the following recommendations. First, Treasury should amend Reg. § 1.1275-2 (c) to provide that coupons or bonds stripped from a portfolio of loans held by a single entity are to be aggregated and accounted for as a single debt instrument, at least for purposes of accounting for original issue discount income.

Second, assuming, as we recommend, that aggregate accounting for stripped coupons and stripped bonds is required, Treasury should issue regulations requiring use of the PAC Method. Although the PAC Method does not apply to stripped coupons and stripped bonds under current law, Treasury has authority by regulation to require its use. The PAC Method more clearly reflects income than alternative methods.

Third, Treasury should consider the issuance of regulations coordinating section 171 with section 1272(a)(6). Such regulations might provide that a deduction under section 171 is allowed in the case of a REMIC regular interest if premium amortization determined under the PAC Method exceeds interest income for an accrual period. The REMIC would include a corresponding amount in income. We do not express a view as to whether such regulations would be the most appropriate way to coordinate section 171 with section 1272(a)(6). We note, however, that the uncertainty under current law as to the interaction of these provisions may result in anti-government “whipsaw,” with regular interest holders claiming deductions for premium that REMICs (and thus residual interest holders) do not include in income.

Fourth, Treasury should clarify, either by regulation or revenue ruling, that a variable strip is a stripped coupon within the meaning of section 1286, and that a grantor trust can issue an interest equivalent to a variable strip without violating the Sears Regulations.

Finally, Treasury should consider rules to avoid timing and character mismatches between stripped coupons and financial instruments used to hedge prepayment risk. Such integration might be allowed either by an amendment to the "Arkansas Best" character rules (Reg. § 1.1221-2) or by an amendment to Prop. Reg. § 1.1275-6. We do not express a view as to whether such rules would be appropriate.

Please let Rick Reinhold or me know if we can be of further help in developing guidance to address these issues.

Respectfully submitted,

Carolyn Joy Lee
Chair

Enclosure

Tax Report #867

REPORT OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION ON CERTAIN ISSUES PRESENTED BY INTEREST STRIPS IN SECURITIZATION TRANSACTIONS

March 8, 1996

I. SUMMARY OF ISSUES CONSIDERED AND RECOMMENDATIONS

This Report[1] considers whether the Internal Revenue Service should clarity or modify the treatment of holders of stripped coupons and stripped bonds created in securitization transactions. Treatment of such strips is not clear under current law because it is not clear (a) whether they should be aggregated and (b) how prepayments should be taken into account in accruing income. This Report also considers how the prepayment assumption catch-up method (or "PAC Method") applies to holders of regular interests issued by real estate mortgage investment conduits ("REMICs") that are equivalent to interest-only strips. This Report then considers whether the scope of the "Sears Regulations,"[2] which permit grantor trusts to issue ownership interests equivalent to interest-only strips, should be clarified or modified. Finally, this Report considers the problem of character and timing mismatches between servicing rights treated as stripped coupons and financial instruments used to hedge those rights.

This Report considers the following issues:

(1) Should the holder of stripped coupons or stripped bonds created in a securitization transaction be required to aggregate them and account for them as though they were a

[1] This Report was drafted by Patricia Cunningham, James Gouwar, Robert Scarborough and Donald Sung. Helpful comments were received from David Hariton, Stephen Land, Carolyn Lee, James Peaslee and Michael Schler.

[2] Reg. § 301.770l-4(c).

single debt instrument? Should any such aggregation be only for purposes of computing accruals of original issue discount, or for all tax purposes, including determining the timing and character of losses?

(2) Should the holder of stripped bonds or stripped coupons from debt instruments that are subject to prepayment be permitted or required by regulation to apply a prepayment assumption in accruing income even though the strips are not REMIC regular interests and are not otherwise subject to section 1272(a)(6)?

(3) In the case of REMIC regular interests that are equivalent to interest-only strips, how does the PAC Method for accruing original issue discount set forth in section 1272(a)(6) interact with the method for amortizing premium on debt instruments subject to section 1272(a)(6) referred to in the legislative history of the 1986 Tax Reform Act?

(4) Should a right to a portion of the interest from a debt instrument that varies based on a floating interest rate index (a “variable strip”) be considered a “stripped coupon” within the meaning of section 1286, so that a grantor trust could issue an ownership interest equivalent to such a right under Example 4 of the Sears Regulations?

(5) Should stripped coupons and financial instruments used to hedge prepayment risk be integrated to avoid character and timing mismatches?

Our recommendations are as follows:

(1) The Service should amend Reg. § 1.1275-2(c) to clarify that a holder of bonds or coupons stripped from a portfolio of loans held by a single entity is required to aggregate such stripped bonds or stripped coupons and account for them as a single debt instrument, at least for purposes of computing accruals of original issue discount Although not clear, such aggregation arguably is required under the current regulations, and such aggregation is generally the most practical approach in securitization transactions because it does not require the allocation of basis among the bonds or coupons based on the separate underlying loans in the portfolio. We note, however, that to the extent losses with respect to coupons from loans that prepay would be capital losses, aggregation for all tax purposes may produce a character advantage for taxpayers by effectively netting those losses against interest income with respect to coupons from loans that do not prepay.

(2) Assuming that it requires aggregate accounting for stripped coupons, the Service should issue regulations that require use of the PAC Method. Although the PAC Method does not apply to stripped bonds or stripped coupons under current law, we believe that the Service has the authority by regulation to permit or require holders of stripped bonds or stripped coupons to use the PAC Method. The PAC Method provides a method of accounting that more clearly reflects income from stripped bonds or stripped coupons than alternative methods, including, for example, a method that ignores the possibility of prepayments, or a method provided by the proposed contingent debt regulations (Prop Reg § 1.1275-4).

(3) The Service should consider issuance of regulations coordinating section 171 and section 1272(a)(6). Such regulations might provide that a deduction under section 171 is allowed in the case of a REMIC regular interest if the amount determined under the PAC Method is negative for an accrual period. Allowance of such a loss would result in recognition of a corresponding amount of income to the REMIC. We do not express a view as to whether such regulations would be the most appropriate way to coordinate section 171 and section 1272(a)(6) and we note that to allow a loss based on the present value (rather than the absolute amount) of projected future payments could effectively allow taxpayers to claim losses that have not been realized. However, current uncertainty as to the interaction of sections 171 and 1272(a)(6) may result in anti-government "whipsaw," with regular interest holders claiming deductions for premium which residual interest holders do not include in income.

(4) The Service should clarify, either by revenue ruling or by regulation, that a variable strip is a stripped coupon, and that a grantor trust can issue interests corresponding to variable strips without violating the Sears Regulations. Although not certain, such treatment appears to be correct under current law, and there is no policy objection to permitting grantor trusts to issue such interests, provided that clear tax rules are in place governing the timing and character of income realized by their holders.

(5) The Service should consider providing rules to avoid timing and character mismatches between interest-only strips and financial instruments used to hedge prepayment risk Such integration might be allowed either by an amendment to the

"Arkansas Best" character rules (Reg. § 1.1221-2) or by an amendment to Prop. Reg. § 1.1275-6. We do not express a view as to whether such rules would be appropriate.

II. BACKGROUND

The issues considered in this Report arise in three different settings. First, taxpayers that originate and/or service portfolios of mortgages or other receivables frequently hold rights to interest payments that may be considered to exceed reasonable compensation for services. Second, trusts that hold debt instruments but that do not qualify as REMICs may issue ownership interests entitling holders to either all or a specified portion of the interest payments or the principal from those debt instruments. Third, REMICs holding mortgages subject to prepayment may issue regular interests entitling-holders to all or a specified portion of the interest payments or the principal payments from those mortgages. Each of these three situations is considered below.

A. Excess Servicing

An originator of a loan portfolio that sells the portfolio will often retain a portion of the interest payments from the loans in the portfolio. Such retained interests can take the form of "servicing rights," "retained yield," or a certificated interest in a trust to which the portfolio is transferred, and they may be created in a variety of transactions. These transactions include transfers of portfolios to entities that qualify as REMICs, transfers of portfolios to entities that qualify as grantor trusts, and transactions that are mere loan participation agreements for federal income tax

purposes. In addition, such retained interests can be, and often are, transferred to subsequent purchasers.

To the extent that they are not compensation for services to be performed (or exceed reasonable compensation for services to be performed), these retained interests are treated as "stripped coupons" within the meaning of section 1286, and originators are required to allocate a portion of their adjusted basis in the loans to the retained interest.[3] Such a retained interest is not treated as an interest in either the entity or in the assets of the entity. Thus, if the entity otherwise qualifies as a REMIC, the fact that the originator stripped coupons from the loans would not cause the coupons to be treated as interests in the REMIC.[4] Similarly, if the entity otherwise qualifies as a grantor trust, the stripped coupons held by the originator would not be treated as a separate class of ownership interest in the assets of the trust within the meaning of the Sears Regulations.[5] The total amount to be received by a holder of servicing rights that are treated as stripped coupons will be contingent if the underlying loans are subject to prepayment.

B. Ownership Interests in Trusts

Trusts that hold loan portfolios frequently issue two classes of ownership interests to investors: one class of interests entitles holders to all of the principal payments from the loans; and the other class entitles holders to all of the interest payments. Because the two classes of ownership interests

[3] See Reg. Rul. 91-46, 1991-2 C.B. 358.

[4] See Reg. § 1.860D-1(b)(2)(ii).

[5] See Rev Rul. 91-46, supra.

are, respectively, equivalent to stripped bonds and stripped coupons within the meaning of section 1286, such a trust would qualify as a grantor trust, and holders of the two classes of interests would be treated as though they owned directly stripped bonds or stripped coupons. Thus, holders of each class would be subject to tax under section 1286. The total amount to be received by holders of the second class will be contingent if the loans in the trust are subject to prepayment or if they bear interest at a variable rate.

C Regular Interests in Real Estate Mortgage Investment Conduits

REMICs may issue regular interests that entitle holders to all or a specified portion of the interest payable on some or all of the mortgages held by the REMIC. Such regular interests are not required to provide for any payment of principal. The total amount paid on such a regular interest will be contingent if (a) the REMIC's mortgages are subject to prepayment, (b) the REMIC's mortgages provide for interest at a variable rate or (c) the REMIC's mortgages provide for interest at a fixed rate, but the regular interest provides for payment of a specified portion of that interest determined using a variable rate.

III. ISSUES IN ACCOUNTING FOR STRIPPED BONDS AND STRIPPED COUPONS (OTHER THAN REMIC INTERESTS)

Under section 1286, a stripped bond or stripped coupon is treated for purposes of sections 1271 through 1288 as a bond issued on the purchase date and having original issue discount equal to the excess of (a) the stated redemption price at maturity (or, in the case of a coupon, the amount payable on its due date) over (b) such bond's or such coupon's ratable share of

the purchase price.[6] Holders of servicing rights that are treated as owning stripped coupons, and holders of trust interests that are treated as owning stripped bonds or stripped coupons, face two different issues in applying section 1286:

(1) to what extent should those stripped bonds or stripped coupons be aggregated and treated as a single debt instrument?

(2) how should holders accrue original issue discount income, given that the amount and/or timing of payments is contingent on prepayments?

A. Aggregation

Section 1286 treats each right to each interest payment, and the rights to principal from a single loan, as a separate bond. Thus, for example, if a servicer has a retained interest in the interest payments from a pool of 2000 automobile loans, each of which provides for up to 50 monthly payments, section 1286 standing alone would treat the servicer as holding 100,000 separate bonds, each with original issue discount. A right to receive principal from each underlying loan would be treated as a separate debt instrument.

The separate debt instruments deemed to exist under section 1286 may be aggregated by the regulations under section 1275, however. In general, "debt instruments issued in connection

[6] Section 1286(a) provides that "[i]f any person purchases . . . a . . . stripped bond or stripped coupon, then such . . . bond or coupon . . . shall be treated for purposes of this part as a bond originally issued on the purchase date ..." The term "coupon" includes any right to receive interest on a bond.

with the same transaction or related transactions (determined based on all the facts and circumstances) are treated as a single debt instrument for purposes of sections 1271 through 1275 and the regulations there under. This rule ordinarily applies only to debt instruments of a single issuer that are issued to a single holder."[7] It should be noted that this aggregation rule does not necessarily apply for purposes other than sections 1271-1276, including determining the character and timing of losses.

1. Alternatives for Applying Aggregation Rule

It is not clear how this aggregation rule applies to the separate debt instruments which section 1286 treats as issued in a securitization transaction in which stripped coupons are created. There are three possible approaches:

a. Loan-by-Loan Accounting

First, all rights to payments that relate to a single underlying loan might be aggregated and treated as a single debt instrument ("loan-by-loan accounting"). Under this approach, the servicer in the example above would be treated as holding 2000 separate debt instruments, each corresponding to one of the underlying loans. The argument for this approach under current law is that all stripped coupons or stripped bonds created or acquired in the same transaction are, under section 1286, treated as debt instruments issued in the same transaction,[8] but that

[7] Reg. § 1.1275-2(c)(l).

[8] See J. Peaslee & D. Nirenberg, Federal Income Taxation of Mortgage-Backed Securities 247 n.64 (1994).

only coupons relating to a single underlying loan have the same issuer (i.e., the obligor on the underlying loan). Under this approach, the holder would be required to allocate basis among its rights to payments from each of the underlying loans in accordance with their relative values, and determine a separate yield to maturity for each.

b. Aggregation of All Loans in a Portfolio

Second, all rights to payments relating to all the underlying loans might be aggregated and treated as a single debt instrument ("aggregate accounting"). Under this approach, the servicer in the example above would be treated as holding a single debt instrument, either for purposes only of determining accruals of original issue discount (i.e., for purposes of sections 1271-1275), or for all tax purposes. This approach is supportable under Reg. § 1.1275-2(c) on either of two theories. First, the person effecting the stripping transaction (generally the entity that originates and services the loans), rather than the obligors on the underlying loans, might be viewed as the "issuer" of the stripped coupons, so that all the coupons would have the same issuer.[9] Second, although the regulations "ordinarily" do not aggregate debt of different issuers, it could be argued that securitization transactions should be an exception to this rule. Under this approach, no allocation of a taxpayer's basis in a trust certificate would be necessary. Despite uncertainty as to whether this approach is legally supportable, the approach of aggregating for all tax purposes (together with the PAC Method) is reportedly commonly used by trustees for

[9] Cf. Section 1275(c)(2)(offeror of stripped coupons treated as "issuer" under information reporting rules).

purposes of information reporting because of the practical difficulties presented by alternative approaches.

c. Coupon-by-Coupon Accounting

Third, the aggregation rule in Reg. § 1.1275-2(c) might be viewed as not applicable. Thus, in the case of interest-only strips, each of the coupons would be treated as a separate debt instrument ("coupon-by-coupon accounting"). Under this approach, the servicer in the example above would be treated as holding 100,000 separate debt instruments, each providing for a single payment. Under this approach, the holder would be required to allocate basis among its rights to each of the different interest payments on each of the underlying loans in accordance with their relative fair market values, with such allocation presumably taking into account the likelihood that each such payment will never be received because the underlying loan will be prepaid. The argument for this approach is that the aggregation rule of Reg § 1.1275-2(c) should not be interpreted to override the plain language of section 1286, which treats each coupon as a separate debt instrument.

This approach is inconsistent with regulations issued under section 1286 in 1991 addressing the taxation of purchasers of mortgage loans treated as stripped bonds.[10] Those regulations permit taxpayers holding interests in mortgages from which coupons have been stripped to account for any discount as market discount, and to treat stated interest as qualified stated interest, if the mortgage loans were either not bought at a

[10] Reg. § 1.1286-1; see also Rev. Proc. 91-49, 1991-2 C.B. 777.

substantial discount (as calculated under the original issue discount rules) or less than 100 basis points had been stripped off. It is possible to treat a stripped bond as bearing qualified stated interest, and to accrue discount on such bonds under the market discount rules, only if each sued loan is treated as a single debt instrument with a single issue price The preamble to the final version of these regulations confirms that they assume aggregation of all coupons related to a single mortgage with the mortgage itself. The preamble states that the regulations are "premised also on the assumption that stripped coupons may be treated as stated interest with respect to the bonds from which they are stripped."[11] Such treatment would not be possible if the holder of stripped bonds treated each right to an interest payment as a separate debt instrument. Although these regulations are not consistent with coupon-by-coupon accounting, they are consistent with either loan-by-loan accounting or aggregate accounting.

2. Recommendations

In a securitization transaction, the second of the three approaches, aggregating ail loans in a portfolio, is more administrable than the other two. Those other approaches are generally not practical, for they would require taxpayers to allocate their basis in a trust certificate among thousands of loans (if loan-by-loan accounting is required) or tens or hundreds of thousands of coupons (if coupon-by-coupon accounting is required). Therefore, we recommend that the Service consider amending Reg. § 1.1275-2(c), or issuing administrative guidance, explicitly to require aggregation of all stripped coupons or stripped bonds from a portfolio of loans held by a

[11] T.D. 8463, 1993-1 C.B. 184, 185.

single entity (e.g., a single grantor trust), at least for purposes of sections 1271-1275 of the Code.

If stripped coupons or stripped bonds were aggregated only for purposes of sections 1271-1275, they would be treated as separate debt instruments for purposes of determining the timing and character of losses. Thus, for example, if an underlying loan were to prepay, the holder would be entitled to a loss at that time equal to the holder's basis in all of its remaining rights to payments from that loan. That loss would not be netted against income from other underlying loans that have not prepaid. The difference between an approach that nets losses against income and an approach that does not would be important if those losses were capital in character. Whether the loss allowed when an underlying loan prepays would be capital is discussed below.

The second approach (aggregate accounting) is unlikely to be either more or less favorable for the taxpayer from the standpoint of timing than the first approach (loan-by-loan accounting) if all the underlying loans have similar yields and maturities (e.g., are all five-year automobile loans). If, however, the loans in a portfolio have varying maturities and loans of shorter maturities have lower yields than loans of longer maturities, aggregation would tend to accelerate income, and thus to be less favorable for the taxpayer from a timing standpoint compared to loan-by-loan accounting. Thus, requiring aggregation rather than loan-by-loan accounting should not lose revenue from deferral of income if loans with longer maturities have higher yields than loans with shorter maturities.

Either aggregate accounting or loan-by-loan accounting would produce less favorable results for taxpayers from a timing

standpoint than coupon-by-coupon accounting, assuming an upward-sloping yield curve.[12]

If losses with respect to rights to coupons from loans that prepay would be capital losses, aggregate accounting for all tax purposes (rather than only for purposes of sections 1271-1275) would be more advantageous for taxpayers from a character standpoint than loan-by-loan accounting. In effect, such aggregate accounting would permit taxpayers to net losses from coupons from some loans, which may be capital losses, against ordinary interest income from coupons from other loans.

Whether such losses would be capital would depend both on whether the issuer of the loan from which the coupons are stripped is a corporation and on whether the taxpayer is a corporation. Even assuming that the taxpayer holds stripped coupons as capital assets, their worthlessness would not give rise to a capital loss under the general definition of capital loss in section 1222, because such worthlessness would not be the result of a sale or exchange. Although the worthlessness of a security, as defined in section 165(g), that is held as a capital asset is treated as the sale or exchange of a capital asset, coupons from loans issued by individuals (such as typical home mortgage loans, automobile loans or consumer loans) would not be

[12] For an explanation of why coupon-by-coupon accounting defers income, assuming an upward-sloping yield curve, see Kayle, "Where has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions," 7 Va. Tax Rev. 303 (1987).

securities.[13] Thus, worthlessness of coupons stripped from loans issued by individuals would give rise to ordinary losses in the hands of a corporate taxpayer.

There are two situations in which the character of a loss on worthlessness of coupons may be uncertain. The first involves coupons stripped from loans issued by corporations, whether held by individuals or corporations. If such coupons are considered "securities," their worthlessness would give rise to a capital loss under section 165(g); otherwise, in the case of a corporate holder, it should give rise to an ordinary loss, and, in the hands of an individual holder, would be subject to the discussion below of sections 166 and 171. Although it is clear that a "bond, debenture, note, or certificate or other evidence of indebtedness issued by a corporation" in registered form or with interest coupons is a "security," it is not clear whether the coupons themselves are securities within the meaning of section 165(g). Section 1286 treats stripped coupons as bonds for purposes of sections 1271-1288, but does not deal with their treatment under section 165. It is not clear that a stripped coupon should be considered an "evidence of indebtedness." In fact, two rulings issued before the enactment of section 1286 indicate that a coupon should not be so treated. Rev. Rul. 58-536, 1958-2 C.B. 21, 24 (detached coupons are themselves not "bonds, debentures, or certificates or other evidences of indebtedness"); I.T. 3312, 1939-2 C.B. 168 (same).

[13] Section 165(g)(2)(C) defines a "security" as "... a bond, debenture, note or certificate, or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form."

The second situation in which the character of a loss from stripped coupons may not be clear is that of stripped coupons that are not securities and that are held by individual taxpayers. Such losses arguably might be considered to be losses from the worthlessness of a “bad debt”; in that case, they would be short-term capital losses under section 166(d). However, it is not clear that a debt instrument that pays in accordance with its terms is a “bad debt” within the meaning of section 166 and the regulations thereunder. In addition, losses suffered by a holder of stripped coupons that prepay are more appropriately compared to losses suffered by holders of premium bonds that prepay when some of that premium has not yet been amortized. The premium on a bond is equal to the present value of the above-market portion of the interest coupons on the bond, taking into account the possibility of prepayment. Similarly, the value of stripped coupons is equal to the present value of those coupons, taking into account the possibility of prepayment. When a bond prepays with unamortized premium, that premium is taken into account as an ordinary loss under section 171(b)(2). Analogously, the holder of stripped coupons should be entitled to an ordinary loss.

Aggregate accounting for all tax purposes may produce results that differ from those produced by aggregate accounting only for purposes of accounting for original issue discount income. Aggregate accounting only for purposes of computing original issue discount income (like loan-by-loan accounting and coupon-by-coupon accounting) would clearly permit taxpayers to claim a loss when a single underlying loan prepays. As discussed above, the character of that loss may be uncertain, however.

In contrast, aggregate accounting for all tax purposes may deny a taxpayer a loss when an underlying loan prepays,

because the prepayment of the underlying loan would not result in disposition of the aggregate debt instrument.

Whether the loss would be denied under aggregate accounting would depend on the approach adopted to deal with the possibility of prepayment in accounting for stripped coupons that are aggregated. If, as we recommend in this Report, the PAC Method of section 1272(a)(6) is required for stripped coupons, and if sections 171 and 1272(a)(6) are coordinated to permit allowance of losses, a taxpayer would be allowed a loss when an underlying loan prepays, just as under an approach that adopts aggregate accounting only for purposes of accounting for original issue discount income. Thus, the practical effects of adopting one version of aggregate accounting rather than the other depend on whether the PAC Method is applied to stripped coupons and on how section 171 is coordinated with the PAC Method. Both of these issues are discussed below.

B. Method of Accounting for Prepayments

Under each of the three approaches to applying Reg. § 1.1275-2(c), a holder of interest- only strips would hold one or more debt instruments providing for payments that are contingent in amount, resulting in uncertainty as to how income should be accrued. Under the first approach (loan-by-loan accounting), the taxpayer would be treated as holding a self-amortizing installment obligation corresponding to each of the underlying loans. The actual number of payments received on each such installment obligation would be contingent on when the corresponding loan prepays. Under the approach of aggregating for all tax purposes, the taxpayer would be treated as holding a single self-amortizing installment obligation. The number of payments would be fixed (assuming that not all of the loans will

prepay), but the amount of each payment would be contingent on the number of loans that are still outstanding. Under the third approach (coupon-by-coupon accounting), the payment of each of the separate debt instruments corresponding to each of the interest payments would be contingent on whether the corresponding underlying loan has prepaid at the time that such payment is due.

1. Alternatives for Taking Prepayments into Account

There are several alternative methods of accounting that might be used to take prepayments into account:

a. Section 1272(a)(6) PAC Method

The first method is to apply the PAC Method described in section 1272(a)(6) to holders of stripped bonds or stripped coupons. Section 1272(a)(6) provides that the PAC Method applies to any regular interest in a REMIC, any qualified mortgage held by a REMIC, and any other debt instrument if payments under such debt instrument may be accelerated by reason of prepayments of other obligations securing such debt instrument. Under the PAC Method, a holder includes OID income in each accrual period equal to the excess of (a) the sum of all amounts received during the accrual period (other than qualified stated interest) and the discounted present value of all remaining payments under the debt instrument as of the end of the accrual period (computed based on a prepayment assumption, on the original projected yield and on events as of the end of the accrual period) over, (b) the adjusted issue price as of the beginning of the accrual period.

The PAC Method could be used for a grantor trust certificate representing interests in stripped coupons only if the taxpayer uses aggregate accounting (i.e., aggregates all of its rights to payments from all of the underlying loans and treats them as a single asset) for purposes of accruing OID. This is because the PAC Method requires the taxpayer to project payments using a payment schedule for a loan that differs from the payment schedule provided by the terms of the loan. The PAC Method predicts the balance of the pool as a result of the prepayment in full of some loans. If a prepayment assumption is used on a loan-by-loan basis, any prepayment in full will be ahead of the schedule for such loan and any loan that does not prepay will be behind the projected schedule. Accordingly, unless the portfolio is treated as a single asset, those differences will not offset even if the pool prepays exactly as projected. Although in the case of regular interests issued by REMICs, a loan-by-loan approach to projecting cash flows can be used, albeit with great difficulty, the consequence is still a projection of cash flow from a single asset. Therefore, use of a prepayment assumption makes sense only if the pool of loans is accounted for

Section 1272(a)(6) does not apply under current law to a holder of a grantor trust certificate that represents ownership of stripped coupons or stripped bonds. Although such a trust certificate may be economically similar to a REMIC regular interest, it is not a REMIC regular interest. In addition, it is not a debt instrument secured by other debt instruments. Although payments on a grantor trust certificate that represents ownership of stripped bonds may be accelerated by reason of prepayments on loans held by the trust, the certificate represents direct ownership of the rights to payments from those loans, and not a debt instrument secured by them. Therefore, it is not a debt

instrument of the type to which section 1272(a)(6) applies. Nevertheless, many trustees reportedly apply the PAC Method for purposes of information reporting for trust certificates that represent ownership of stripped bonds or stripped coupons.[14]

b. Application of Contingent Debt Rules

Rules applicable to debt instruments with contingent payments might govern stripped coupons. Regardless of which of the three approaches to aggregation is adopted, those stripped coupons would be treated under section 1286 as one or more debt instruments for purposes of sections 1271-1288, and the amount of payments on each of those debt instruments would be contingent on when the underlying loans prepay. Thus, the stripped coupons would appear to be debt instruments that provide for contingent payments, and thus to be contingent debt instruments as defined in Prop. Reg. § 1.1275-4(a)(1). Proposed Reg. § 1.1275-4(a)(2)(iv) excepts debt instruments subject to section 1272(a)(6); however, as noted above, section 1272(a)(6) does not now to apply to stripped coupons. The method provided by the proposed contingent debt rules could be combined with any of the approaches to aggregation discussed above.

c. OID Accrual Assuming No Prepayments

A holder of stripped coupons or stripped bonds might accrue original issue discount based on the assumption that no prepayments will occur, and that the amounts received will be the amounts that would be payable if the underlying loans remain outstanding until maturity. The effect of actual prepayments would depend on which of the three approaches to aggregation

[14] See Peaslee & Nirenberg, supra note 8, at 247 n.66.

applies. If all rights to payments from each underlying loan are aggregated and treated as a self- amortizing installment obligation, the holder would be allowed a loss at the time that an underlying loan prepays. If rights to all payments from all underlying loans are aggregated for all tax purposes, but the PAC Method is not applied, a holder might be allowed no loss until the last underlying loan has been retired. Under coupon-by-coupon accounting, a holder would accrue original issue discount income with respect to each separate coupon based on that coupon's yield to maturity. When an underlying loan prepays, the holder would be allowed a loss equal to the adjusted issue price of all coupons relating to that loan that have not yet become due. Similarly, if aggregate accounting is adopted, but only for purposes of accounting for original issue discount income and not for all tax purposes, a loss should be allowed when an underlying loan prepays.

2. Recommendations

To ignore expected prepayments distorts income compared to an approach that takes expected prepayments into account in determining the rate of accrual of original issue discount income. A holder of stripped bonds or stripped coupons that accrues income by ignoring prepayments will accrue original issue discount income using a yield that will match the actual yield only in the highly unlikely event that none of the underlying loans prepay. In the case of interest-only strips, the actual yield will be lower than the yield computed assuming no prepayments. In the case of principal-only strips, the actual yield will be higher than the yield computed assuming no prepayments.

Although section 1272(a)(6) does not apply to stripped bonds or stripped coupons under current law, we believe that the Service has the authority by regulation to require or to permit holders of stripped bonds or stripped coupons from loans subject to prepayment to use the PAC Method. Such regulations might be issued (a) under the Service's general authority under section 446 to provide methods of accounting that clearly reflect income, (b) under the authority of section 1286(f) to provide rules for the determination of the income of holders of stripped bonds and stripped coupons[15] or (c) under the authority of section 1275(d) to provide rules for the taxation of debt instruments with contingent payments.

The PAC Method seems preferable to the method of accounting provided by the proposed contingent debt regulations for two reasons. First, it is a method of accounting specifically designed by Congress to deal with the kind of contingency faced by holders of rights to payments from loans subject to prepayment. Second, it makes adjustments to take into account prepayments of loans at a more appropriate time than would the proposed contingent debt regulations. Under the PAC Method, if loans actually prepay at a faster or slower rate than originally projected, projections of future cash flow are adjusted immediately to take those prepayments into account.[16] In contrast, under the proposed contingent debt regulations, no adjustment is made to the original issue discount income accrual schedule until a payment that was originally projected is in fact

[15] The legislative history of section 1286(f) states that it would be appropriate for the Service to use its regulatory authority to modify the general rules of section 1286 in the case of coupons that are payable after a bond's call date. H.R. Rep. No. 760, 97th Cong., 2d Sess. 555 (1982).

[16] See section 1272(a)(6)(B)(ii) (present value of remaining payments redetermined as of end of each accrual period based on "events which have occurred before the close of the accrual period").

not made or a payment that was not originally projected is in fact made.[17]

We recognize that the Service might conclude, however, that it is not appropriate by regulation to permit use of a method of accounting by holders of stripped bonds and stripped coupons that takes into account projected prepayments when the PAC Method was expressly limited by Congress to REMIC regular interests and certain other debt instruments described in section 1272(a)(6). Therefore we propose for consideration an alternative method (the "Strip Yield Method"), which is described below. The Strip Yield Method is similar to the PAC Method except that it would assume prepayments at a rate of zero. The Strip Yield Method could be combined with either aggregate accounting (either only for purposes of sections 1271-1275 or for all tax purposes) or loan-by-loan accounting.

The principal features of the Strip Yield Method are as follows. First, the Strip Yield Method, unlike the PAC Method, would ignore prepayments until they actually occur, and thus would not permit original issue discount to be accrued based on projected prepayments. Second, the Strip Yield Method, like the PAC Method, would make adjustments in each accrual period based on actual prepayments as of the end of that accrual period. Third, even if combined with loan-by-loan accounting, the Strip Yield Method would not require allocation of a taxpayer's basis

[17] See Prop. Reg. § 1.1275-4(b)(3)(iv). Presumably, this method would operate by projecting the aggregate amount of payments during each accrual period of the instrument's term, and making adjustments if the aggregate amount actually received in that period were more or less than projected. Thus, unless loan-by-loan accounting is required, this method presumably would not operate by projecting a payment schedule with respect to each underlying loan, with adjustments if the actual payments from a particular underlying loan differ from those projected.

in a trust certificate among the rights to payments represented by that certificate. The Strip Yield Method does not require basis allocation or computation of a separate yield to maturity with respect to each underlying loan if combined with loan-by-loan accounting for the following reason. Although all of the loans are treated as separate assets, the taxpayer is permitted, as a matter of administrative convenience, to use the same yield in valuing its interests in each of the loans In effect, basis is allocated by valuing the taxpayer's rights in each loan by discounting projected payments at the same yield.[18]

Under the Strip Yield Method:

1. A holder would project cash flows from its interests in a loan portfolio (e.g., a portfolio of mortgage loans or automobile loans held by a grantor trust) using either a loan-by-loan calculation or an aggregate calculation. (If taxpayers were permitted to choose between these two methods, once an election is made, the holder would be required to continue to use the same method throughout the term of the portfolio.)

2. Cash flow would be projected assuming no prepayments by any of the underlying borrowers.

3. A yield (the "Strip Yield") would be determined based on the amount paid for the interest (or adjusted basis allocated in the case of a retained interest) and the projected cash flow.

[18] We believe that the Service could authorize use of the Strip Yield Method by issuing a revenue procedure. Such a revenue procedure would authorize use of the Strip Yield Method to value stripped coupons purchased in the aggregate where there is separate trading. In contrast, issuance of regulations would seem to be necessary to authorize use of the PAC Method.

4 Income would be accrued using the Strip Yield.

5. An adjustment to the projected future cash flow (but not to the Strip Yield) to take into account actual payments or realized losses (i.e., defaults) on the loan portfolio for each accrual period.

The following examples illustrate how the Strip Yield Method would work in the case of a holder of stripped coupons, both under the loan-by-loan approach and the aggregate approach to projecting cash flows:

Example 1: Aggregate versus Loan-by-Loan Approach Without Any Prepayments. Assume a portfolio of two loans that pay interest annually and principal at maturity. One has a principal balance of $100 million and matures in three years. The other has a principal balance of $50 million and matures in four years. At the beginning of Year One, A pays $250,000 for a 5 basis point strip (0.05%) off of the $100 million loan and a 10 basis point strip (0.10%) off of the $50 million loan.[19]

Under a loan-by-loan approach to projecting cash flows, a total cash flow of $350,000 in payments would be projected ($100,000 for each of the first three years and $50,000 for the fourth year). The strip yield would be 16.48% annually, with each projected payment assumed to bear the same rate.

[19] Non-amortizing loans are used for ease of illustration. Naturally, amortizing receivables have weighted average lives substantially shorter than their stated lives and the exact rate of amortization is affected by the interest rate on the receivable. For example, in the case of a mortgage loan that has a 360 month (30 year) stated maturity, weighted average life is 201.82 months if it bears interest at a 7% rate and 206.65 months if it bears interest at a 9% rate. In the case of a loan that has a 60 month (5 year) stated maturity, weighted average life is 32.24 months if it bears interest at a 7% rate and 32.73 months if it bears interest at a 9% rate.

Under an aggregate approach to projecting cash flows, the two strips would be viewed as a single asset with an initial weighted average coupon ("WAC") of 6.67 basis points (0.0667%)[20] on a notional balance of $150 million and a weighted average maturity ("WAM") of 3.33 years.[21] Under this analysis the projected cash flow would equal $333,333 and A's annual yield would equal 14.83%. The WAC and the WAM would be recalculated for each accrual period and then applied to the combined strips' notional balance. For Years Two and Three, the WAC would remain constant and the WAM would decrease by one year from the preceding year. However, due to the retirement of the $100 million loan at the end of Year Three, the WAC would increase to 10 basis points (i.e., the rate on the remaining loan) and the WAM would be one year (i.e., only decrease by one-third of a year from the preceding year). As a consequence, the projected cash flow would change by increasing from $33,333 to $50,000 and by being deferred by 8 months. The receipt of income in excess of the accrued amount would be ordinary income when received.

Although this example illustrates that the aggregate approach to projecting cash flows can result in a slower accrual of income than the loan-by-loan method, the converse can also be true. If, instead, the $100 million loan had the longer life, then the WAM would have been 3.67 years and the projected cash

[20] This would be calculated by (a) adding the products derived by multiplying the strip rate on each loan by its notional balance and (b) dividing the result by the entire notional balance. In this case, that is [($100 million x .0005) + ($50 million x 001)]/$150 million.

[21] The weighted average maturity would be calculated by taking the sum of the products derived by multiplying the number of years to maturity (or portion thereof) for each principal payment by the principal payment and dividing by the entire principal balance. In this case, that is [(3 years x $100 million) + (4 years x $50 million)]/$150 million = 3.33 years.

flow under the aggregate method would be $366,667 initially, whereas on a loan-by-loan basis the projected cash flow would remain at $350,000. At the beginning of the fourth year, the projected cash flow would decline by $16,667 and be deferred by 4 months as a result in the adjustments to the WAC and the WAM. As a result, a loss would be claimed in such year Accordingly, the aggregate approach of projecting cash flows would have a tendency to accelerate a strip's income relative to a loan-by-loan approach to projecting cash flows when a larger percentage of interest is retained from loans with shorter lives, and understate income relative to the loan-by-loan approach when a smaller percentage of interest is retained from loans with longer lives.

As the following example illustrates, the two approaches to projecting cash flows result in different accruals of income. Under either approach, however, the Strip Yield Method will cause the accrual of income at a rate that exceeds the rate at which income accrues economically for a holder of stripped coupons from loans that are expected to prepay, because the Strip Yield is computed without taking prepayments into account until they actually occur. As a result, a prepayment will always cause a loss equal to the adjusted issue price of the taxpayer’s interests in the loans that prepay.

Example 2: Aggregate Versus Loan-by-Loan Approach Projecting Cash Flows With Prepayments. Assume, instead, a portfolio of 1,500 prepayable loans that pay interest annually, each with a principal balance of $100,000. 1,000 of the loans each have a net rate (a rate net of servicing and administrative fees) of 8.05% and a bullet maturity of three years. Five hundred of the loans each have a net rate of 8.10% and a bullet maturity of four years. If A purchased all net interest in excess of 8% (i.e., 5 basis points off of each loan with an 8.05% net rate and 10 basis points off of each loan with an 8.10% net rate), A's strip has the same projected cash flows as in the preceding example.

A would accrue income under a loan-by-loan method by projecting $50 per year for three years from each loan with a net rate of 8.05% and $100 per year for four years from each loan with a net rate of 8.10%. A prepayment would result in a loss equal to the adjusted issue price with respect to any payment that disappears as a consequence of the prepayment. The adjusted issue price with respect to such payment would equal its present value determined using the Strip Yield. Therefore, a prepayment of 100 loans with net rates of 8.05% at the end of Year Two would result in a deduction of $4,292.62 ($5,000 present valued one year at the loan-by-loan Strip Yield of 16.48%).

Under the aggregate approach, A would project cash flows from a notional balance equal to the portfolio balance with a rate equal to the pool's WAC and with a maturity equal to the pool's WAM. This cash flow would be discounted at the Strip Yield and, to the extent it was less than the adjusted issue price from the prior period (reduced by distributions), a loss would be claimed. Therefore, a prepayment of 100 loans with net rates of 8.05% at the end of Year Two would result in a WAM of 1.345 years

and a WAC of 0.0672%. As a consequence, the future cash flow would be $131,120.69 (a reduction of $2,212.64 from the projection of $133,333.33) with a present value using the Strip Yield and projecting cash flow using the aggregate method of $112,827.16[22] This would be $1,981.11 less than the adjusted issue price of $114,808.27 ($250,000 accruing at Strip Yield calculated under the aggregate method of 14.83% and reduced by $200,000 in distributions).

IV. ACCOUNTING FOR REMIC REGULAR INTERESTS

In this Part, we consider taxation of holders of REMIC regular interests that provide for a specified portion of the interest from the mortgages held by the REMIC and either no principal or a disproportionately small amount of principal (collectively, "IO Interests"). These certificates can take the form of something as common as a WAC strip off of a fixed rate pool (that is, an instrument whereby the holder receives all of the interest at the mortgage rate in excess of expenses and a fixed rate paid to the other regular interest holders) or as exotic as an instrument whose payment rights vary inversely with fluctuations in a specified index in addition to declining with decreases in the balances of the underlying mortgages.

[22] In calculating this number, the fact that the WAM was increased by approximately 4 days was taken into account by converting the annual Strip Yield under the aggregate method to a daily yield and then presents valuing the cash flow on this basis assuming 360 days in the year.

A. Alternative Methods of Accounting for IO Interests

The manner in which the REMIC and IO Interest holders should account for interest income generally, and for the recovery of the issue price of IO Interests in particular, is unclear under current law. Section 1272(a)(6) provides a method of accounting (the PAC Method) for original issue discount, which applies to all regular interests in a REMIC. Thus, section 1272(a)(6) clearly applies to accrue original issue discount in the case of a REMIC regular interest issued at a price that is less than the sum of all principal payments provided by that interest. It is not clear whether, and if so, how, section 1272(a)(6) applies to IO Interests, which are not issued at a price that is less than the sum of all principal payments because they do not provide for any principal payments (or provide for disproportionately small amounts of principal payments). At the time that section 1272(a)(6) was enacted in 1986, REMICs were not permitted to issue IO Interests,[23] so that in enacting section 1272(a)(6), Congress did not contemplate its application to IO Interests.

Whether income from an IO Interest is taken into account under section 1272(a)(6) depends on whether it is considered original issue discount. Rather than original issue discount, the interest payable to the holder of an IO Interest might be considered "qualified stated interest" within the meaning of Reg. § 1.1273-1(c)(1). In that case, the holder would include payments of interest in income, but would be viewed as having purchased

[23] See S. Rep. No. 445, 100th Cong. 2d Sess. 87 (1988) (definition of regular interest "broadened to encompass interests which entitle the holder to interest payments consisting of a specified portion of the interest payments on qualified mortgages").

the IO Interest at a premium equal to the excess of the purchase price over the amount payable on maturity of the bond (i.e., any principal payable to the holder of the IO Interest). See section 171(b)(1)(B). Under section 171(b), such premium would be allowable as an offset against interest income. The legislative history of the 1986 Tax Reform Act provides that the amount of amortizable bond premium with respect to a REMIC regular interest that is allowable as an offset would be determined using a prepayment assumption, which is to be the same prepayment assumption that would be used in computing original issue discount.[24] Thus, the excess of the issue price of an IO Interest over the amount of principal, if any, payable with respect to the IO Interest, would be recovered using a prepayment assumption.

Both of these two methods of accounting—the PAC Method of accounting for OID and the "premium amortization method" -- take future prepayments into account. Below we consider the effects of applying each of these methods in detail, and we also consider, for purposes of comparison, the effect of applying a third method based on the proposed contingent debt regulations.

The method of accruing income from an IO Interest would also affect the income of the holder of the residual interest in the REMIC, because the timing of the REMIC's deductions would correspond to the timing of the income of the IO Interest holder.

[24] H.R. Rep. No. 841, 99th Cong. 2d Sess. II-842 (1986). The legislative history refers to "debt instruments that would be subject to the OID rules contained in new Code sec. 1272(a)(6) (without regard to whether the debt instrument has original issue discount)," which would include all REMIC regular interests. In the case of such debt instruments, the same prepayment assumption that would be used in computing original issue discount under section 1272(a)(6) is to be used in computing the accrual of market discount and in amortizing amortizable bond premium. The legislative history, like section 1272(a)(6) was written at a time when REMICs could not issue IO Interests.

Thus, we consider not only the effects of each method on the IO Interest holder, but also the effect on the REMIC, and we also consider the effects on secondary market purchasers of an IO Interest.

1. Premium Amortization Method

a. Description of Method

Under the premium amortization method, all of the payments on an IO Interest would be treated as qualified stated interest and included in income by the holder of the IO Interest (and deducted by the REMIC) as such payments accrue. Any amount paid for the IO Interest in excess of its specified principal amount (which principal amount could be zero) would be treated as premium eligible for elective amortization under section 171 by the holder of the IO Interest. Such amount would also be included in the REMIC's income under section 61 (regardless of whether the holder elects to amortize the premium under section 171).

Under section 171(e) the amount of premium amortization allocable to each accrual period would be treated as an offset to the interest income otherwise reportable for that period by the IO Interest holder. The same amount should be reported as income by the REMIC for the accrual period.[25]

[25] This result is unclear because Reg. § 1.61-12(c)(2), which only applies to corporations, provides that bonds issued at a premium create income that must be prorated over the life of the bonds. In light of amendments to section 171 to require premium to be amortized using a constant yield method and changes to the premium amortization rules of section 171, the ratable method is of questionable continuing validity. We believe that a REMIC should be treated as accruing the premium as income based on the prepayment assumption, original yield to maturity, and adjustments for actual prepayments as described above, so that its income corresponds to the premium being amortized.

Based on the legislative history of the 1986 Tax Reform Act, the amount of premium allocable to any interest payment would be determined using the PAC Method, and using the same prepayment assumption that would be used if the regular interest had original issue discount accrued under section 1272(a)(6).

b. Consequences to the Original IO Interest Holder

For the original IO Interest holder making an election under section 171, the amount of the offset to interest for each accrual period would be determined by using a three-step analysis. First, the remaining expected payments on the IO Interest would be calculated (which would exclude payments received during the accrual period). These expected payments would be determined by applying the original prepayment assumption determined at the time the REMIC was created (the "Original Prepayment Assumption")[26] to the mortgage loans remaining at the end of the relevant accrual period. Second, the expected payments would be discounted by the IO Interest holder's

[26] In this Report, the Original Prepayment Assumption refers to the prepayment assumptions applicable to the REMIC as a whole and not those which may have been negotiated separately with an IO Interest holder. It is worth noting that IO Interests are often sold based on a prepayment assumption that differs from that on the basis of which the REMIC's other classes are sold We believe that a single prepayment assumption must be used by the REMIC and all classes of regular interests for a single portfolio of mortgage loans. Otherwise, the REMIC would be projecting two different cash flows for the mortgages and its regular interests, which would make it impossible for the REMIC to compute its income in a logically consistent manner. Notwithstanding this inconsistency, the REMIC could use different prepayment assumptions for different portions of its mortgages, just as it can assume different portfolios of mortgage loans will prepay differently. Because IO Interests represent a specified portion of the interest from its mortgage loans, a REMIC could use different prepayment assumptions for different portions. To accomplish this, however, it would also be necessary for it to allocate basis to each such portion and treat it as a separate asset.

yield to maturity.[27] Third, the present value would be deducted from the IO Interest holder's adjusted basis and the result would be claimed as an offset to the interest income.

It is unclear how an IO Interest holder would recover its basis if it did not make the election under section 171. Arguably, this could depend on whether the holder was entitled to any specified principal amount or whether the specified principal amount was zero. If the holder was entitled to specified principal payments and no election was made under section 171, then the holder's basis would be allocated solely to such principal payments. As a consequence, the holder would recognize a loss upon the receipt of each payment. Assuming the IO Interest is a capital asset that loss appears to be capital under section 1271(a).

However, if the holder was not entitled to any specified payments, the holder would not recognize a loss until maturity (i.e., the receipt of the final payment). Because no payment was received in redemption of a principal payment, it would appear that section 1271(a) would not apply Furthermore, because a REMIC regular interest does not fit within the definition of a security under section 165(g)(2)(C), such loss would not be treated as a loss from a worthless security. Although a section 166 (bad debt deductions) may create a short-term capital loss for taxpayers

[27] A holder's yield to maturity is determined at the time of acquisition by such holder and is the constant yield (compounded as of the close of each accrual period) that would cause the present value of the expected payments on the IO Interest to equal the holder's basis for the interest. In contrast to stripped coupons, it is clear that all payments on an IO Interest must be discounted at the same yield because they are all part of a single instrument.

other than corporations, for corporate taxpayers it would seem that such a loss would be ordinary because there would be neither an actual nor a deemed sale or exchange of the IO Interest.

The application of section 171 under the premium amortization method is not clear in two situations, first, the situation in which the amount of premium allocable to a particular interest payment exceeds the amount of that payment; and second, the situation in which the amount of premium allocable to a particular interest payment is negative. Each of these situations is considered below in turn

In applying the premium amortization method, the premium allocable to a particular interest payment may exceed the interest income for such period. This would occur if actual prepayments occur at a rate that is sufficiently faster than anticipated when the IO Interest was issued.

We do not believe that there is necessarily any restriction in section 171 that would limit the premium taken into account to the amount of interest against which it is applied as an offset. Section 171(e) merely provides that, in lieu of a deduction, the amount of any premium allocated to an interest payment “shall be applied against (and operate to reduce) the amount of the interest payment.” It does not deny a deduction for that portion of the premium allocable to an interest payment that exceeds the amount of the payment.

The history of section 171(e) does not indicate any Congressional intent to deny a deduction for premium that exceeds the interest payments against which it is allowable as an offset. Section 171(a)(1) generally provides that amortizable bond premium is allowable as a deduction. Prior to the 1986 Tax Reform

Act, some taxpayers were taking advantage of a timing mismatch of up to one year between this deduction and corresponding interest income:

> It was understood that taxpayers purchased bonds at a premium in one year, with the first interest payment falling in the following year, and deducted a portion of the premium in the first year against other income.[28]

To prevent such timing mismatches; Congress enacted section 171(e). As originally enacted, section 171(e) provided that the amount of the deduction allowable under section 171(a)(1) was to be treated as an interest deduction.[29] Thus, the original version of section 171(e) would not have denied a deduction for amortizable bond premium, but instead provided for it to be taken into account under the timing rules applicable to interest expense and subjected it to limitations on the allowability of interest deductions.

The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") amended section 171(e) to treat amortizable bond premium "as an offset to interest income on the bond, rather than as a separate interest deduction item subject to the various provisions relating to interest deductions."[30] Although the purpose of the TAMRA amendment is not clear from its legislative history, it may have been intended to avoid the anomalous result of requiring taxpayers to include interest in income but suffer disallowance of deductions for premium under rules restricting

[28] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 363 (1986).

[29] See P.L. 99-514, section 643(a).

[30] S. Rep. No. 545, 100th Cong. 2d Sess. 75 (1988) (emphasis added).

deduction of interest expense, such as section 265(b). There is no evidence in the legislative history that the purpose of the change was to deny a deduction for premium in excess of interest income; had this been Congress's intent, Congress would have repealed section 171(a). It appears that Congress simply did not contemplate a situation in which the amount of premium expense allocable to an interest payment would exceed the amount of that payment.

We note that allowing a deduction to regular interest holders should result in recognition of a corresponding amount of income by residual interest holders. To the extent that current law is unclear, regular interest holders may be taking the position that a deduction is allowed under section 171(e), while REMICs (and thus residual interest holders) are taking the position that they do not realize income. Thus, uncertainty as to current law may result in anti-government whipsaw.

Second, the premium amortization amount could be negative. It is also unclear how section 171 would work in this situation. Presumably, the offset to interest income could be negative, resulting in greater income than the total interest payment. In the alternative, an offset could be denied. This, however, would distort the REMIC's income, causing it to be artificially overstated.

As previously discussed, the section 171 election would allow to the IO Interest holder an offset against its interest income. This offset would prevent the deferral, reduction or disallowance of such deduction that could otherwise occur for certain taxpayers under the Code. If the election was not made, the loss would appear to be ordinary for corporations holding an IO Interest with no specified principal balance. For noncorporate

taxpayers who did not make the section 171 election, the loss would be a short-term capital loss if such loss were treated as a bad debt loss under section 166(d). If the loss were not treated as a bad debt loss, it would appear to be an ordinary loss allowable under section 165 for such taxpayers as well.

The more difficult issue is the treatment of the loss for a taxpayer that holds an IO Interest with a specified principal balance and does not make the election under section 171. As stated above, the loss would be capital and recognized as principal payments are received. This result is undesirable from a tax administration standpoint, however, because of the opportunity for abuse. If this were the result, an IO Interest could be structured so that it paid all of its principal in a short period of time with the stated interest continuing to be paid over a much longer period. As a consequence, such an IO Interest would artificially create and accelerate a capital loss. Moreover, IO Interests in which interest was not paid proportionate with principal could create capital losses even for holders with section 171 elections in effect. Therefore, we recommend guidance providing, in the absence of a section 171 election, either that any loss on an IO Interest be deferred until maturity of the interest or that a loss cannot be claimed any earlier than a holder with a section 171 election in effect could claim such loss.

c. Consequences to REMIC Residual Holders.

As noted above, the timing of the REMIC's income is unclear. The guidance should clarify that the REMIC has additional income to the extent of the offset of the premium amortized on the IO Interest. It should be noted that, although the REMIC and the IO Interest holder will be required to use the

same Original Prepayment Assumption, the yield each uses could differ. The REMIC's yield would be based on the price to the public of the interest. This yield would be the same as the yield used by the original holder (unless there were multiple original holders of the IO Interest each of whom purchased the interest at a different price); however, it would be unlikely to be the same yield as that used by a subsequent holder. The character of such income would be ordinary to the REMIC both because it is premium amortization and because any amount of a REMIC's net income or loss (which is passed through to the residual holder) is always treated as ordinary under section 860C(e)(1).

d. Consequences to Secondary Market Purchasers.

A secondary market purchaser would calculate its purchase yield by calculating the expected payments using the Original Prepayment Assumption (regardless of prepayment expectations at the time of its acquisition) and calculating its yield based on its purchase price.[31] Although this would result in a secondary market purchaser and the REMIC using different yields to calculate their amortization deductions and income, respectively, this result is consistent with the fact that the secondary market purchaser would have a different amount of premium to amortize than the REMIC would have to accrue. The same treatment would also apply to an original IO Interest holder who purchased a portion of a class of IO Interests at a price other than such class's issue price.

[31] The original prepayment assumption should not be adjusted to reflect current market expectations. See H R. Rep. No. 841, 99th Cong., 2d Sess. II-842.

2 PAC Method

a. Description of Method.

The PAC Method projects a payment schedule for the IO Interest (a “Payment Schedule”) using the Original Prepayment Assumption and treats all such payments as included in the IO Interest's stated redemption price at maturity. The yield to maturity on the IO Interest would be calculated by determining the constant yield that would cause the expected payments shown on the Payment Schedule to equal the IO Interest’s issue price. The holder's income in each period would be calculated pursuant to section 1272(a)(6), which generally treats as OID income during an accrual period the excess of (a) the sum of all payments received during the accrual period and the present value of all of the remaining payments over (b) the adjusted issue price at the beginning of the period. The present value of the remaining payments is calculated by assuming that the underlying loans will be prepaid in future periods in accordance with the Original Prepayment Assumption (but taking into account the actual prepayments that have occurred to date), and using a discount rate equal to the IO Interest holder's yield to maturity. It is possible that this calculation may produce a negative number.

b. Consequences to the Original IO Interest Holder.

Assuming that the present value of the expected future payments at the end of an accrual period exceeds the holder's adjusted issue price for the IO Interest, the holder would report income for the accrual period by allocating such excess ratably to each day in the accrual period. The answer is less clear where

the present value of the expected future payments is sufficiently lower than the holder's adjusted issue price that "negative OID" is created.

The legislative history of the Tax Reform Act of 1986 states with respect to negative OID:

> The conferees intend that, in no circumstances, would the method of accruing OID prescribed by the conference agreement allow for negative amounts of OID to be attributed to any accrual period. If the use of the present value computations prescribed by the conference agreement produce such a result for an accrual period, the conferees intend that the amount of OID attributable to such accrual period would be treated as zero, and the computation of OID for the following accrual period would be made as if such following accrual period and the preceding accrual period were a single accrual period.[32]

Although at first glance this statement seems to mean that an IO Interest holder cannot claim a loss prior to maturity, if read in the context of the REMIC rules as originally enacted, this statement clearly does not deal with-the issue.[33] As originally enacted, the REMIC rules did not permit IO Interests, which, as discussed above, were authorized only in 1988. Thus,

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[32] H.R. Rep. No. 841, 99th Cong., 2d Sess. II-239 (1986).

[33] This conclusion is consistent with the conclusion in our two previous Reports on the taxation of REMICs. In those Reports, we concluded that the legislative history of the 1986 Act should not prevent allowance of negative accruals of original issue discount in appropriate cases. See New York State Bar Association Tax Section, "Report on the Proposed Real Estate Mortgage Investment Conduit Regulations," section XII.B.l. (March 19, 1992); New York State Bar Association Tax Section, "Report on the Federal Income Tax Treatment of Real Estate Mortgage Investment Conduits," section III.E(6)(d) (December 30, 1988).

the statement in the 1986 Act legislative history set forth above cannot have dealt with the tax treatment of IO Interests. Instead, this statement addressed the tax treatment of regular interests issued at a price less than their fixed principal amounts, resulting in original issue discount. The holder of such a regular interest, in contrast to the holder of an IO Interest, is assured (if the underlying mortgages do not default) that it will ultimately receive the amount of the original issue discount. Accordingly, the statement in the 1986 Act legislative history means that the holder of a regular interest cannot claim a loss with respect to an amount which it is ultimately sure to receive. It does not deal with the question of losses with respect to amounts that are not necessarily sure to be received.

Even if this statement is viewed as governing IO Interests, it need not be interpreted to mean that the holder of a REMIC regular interest cannot claim a deduction for negative value under any provision of the Code. Instead, this statement could mean that the OID rules themselves will not create a deductible loss, which is logical because such rules involve income accrual, not deductions. This language does not deal with the question of whether a loss might be allowable under another section of the Code, such as section 171.

In the case of an IO Interest, a drop in present value means that expected payments have “disappeared” due to prepayments. Except for debt instruments that are “securities” within the meaning of section 165(g)(2)(C), where payments on a debt instrument become partially uncollectible, a corporate taxpayer is able to claim a bad debt deduction under section 166

if such amounts are charged off on its books.[34] This loss would be an ordinary loss for corporate taxpayers (deductible as a partially worthless bad debt), but a short-term capital loss for other taxpayers (deductible only at maturity).

The present value of the IO Interest may decline so far below its adjusted issue price that there is no longer any reasonable expectation of further income accruals. Failure to allow the deduction of "negative OID" could result in a corporate holder being unable to claim a loss until the retirement of an IO Interest, even though there has been no expectation of additional payments for a significant period of time.[35] Therefore, assuming the decline in projected payments results in payments being treated as uncollectible for purposes of applying section 166, resulting in a currently deductible loss for corporate taxpayers, the issue is how to determine that a payment has become uncollectible for purposes of calculating the loss realized. There are at least three choices. First, each payment that disappears (ye., prepayments are higher than projected) is

[34] This position is not inconsistent with Technical Advice Memorandum 9538007 (June 13, 1995), which addressed the accrual of original issue discount that was of doubtful collectibility. The holding in that ruling is not relevant to our case because the instrument discussed in the TAM was a "security" within the meaning of section 165(g)(2)(C), and therefore, not eligible for a bad debt deduction, and because accrual of income and the deduction of bad debts are separate events. See Spring City Foundry v Commissioner, 292 U.S. 182 (1934), in which the Supreme Court held that a corporation was required to include the income from a sale of goods on credit in 1920, the year the right to receive such income became fixed, notwithstanding the fact that, in the same year, the company determined that part of such debt was worthless. The Court noted that the deduction related to a separate event and would be considered separately from the accrual of income.

[35] For example, during 1992 and 1993, mortgage prepayments increased so dramatically that future income accruals became virtually impossible in many cases.

treated as uncollectible, essentially resulting in a deduction equal to the difference between the adjusted issue price and the present value of projected future payments, (i.e., the amount of negative OID). Second, a deduction would only be allowed to the extent that total projected payments are less than the adjusted issue price. Third, a deduction would be allowed only once the payments on the IO Interest could not exceed the adjusted issue price even if the underlying mortgage paid as scheduled (i.e., no further prepayments).

c. Consequences to REMIC Residual Holders.

Under the PAC Method, the consequences to the REMIC residual holder depend directly on the treatment of the IO Interest holder. To the extent that the IO Interest holder accrues original issue discount income, the REMIC accrues a deduction, reducing the net income reported by the residual holder. The more difficult question arises, as above, when the present value of the IO Interest declines below the adjusted issue price. There are two possibilities. First, if a bad debt deduction is or could be claimed by a corporate IO Interest holder, the REMIC should be treated as relieved of its obligation to repay the portion of adjusted issue price that has become uncollectible. As a consequence, it should have income from the cancellation of debt under section 108 that, under section 108(e)(3) (which provides for adjustments for unamortized discount), would equal the amount of the bad debt deduction. However, because such excess typically would cause the REMIC to be insolvent (i.e., it would not have the money to pay this debt) its gross income would not include these amounts.[36]

[36] The REMIC's income could include these amounts if the residual was entitled to some cash flow. However, in the typical REMIC transaction, the residual is entitled to little, if any, cash flow.

Accordingly, the basis of its assets would have to be written down under section 108(b)(2)(E).[37] Although the amount of such write down would be limited by the basis solvency rule of section 1017(b)(2), this would not impose a limitation because a REMIC's asset basis should exceed the regular interest balance by at least the amount of the write down.[38]

d. Consequences to Secondary Market Purchasers.

The treatment of secondary market purchasers also depends on whether a bad debt deduction is allowed. If a bad debt deduction is allowed, the adjusted issue price of the IO Interest should be decreased. As a result, the impact of high levels of prepayments would be limited to the periods in which they occurred and would not carry over to additional periods. Therefore, regardless of the degree of prior prepayments, it would always be possible for the present value to increase in each accrual period above the remaining adjusted issue price. As a consequence, a secondary purchaser, regardless of the amount paid for an IO Interest, would generally expect to accrue original issue discount income from the IO Interest. As a consequence of accruing original issue discount, such purchaser would accrue market discount or acquisition premium, depending on the price paid for such interest.

[37] The basis of its assets would be used because a REMIC does not have the other tax attributes affected by section 108(b)(2) other than in the rare case where the REMIC has foreign tax credits, which, in any event, are written down after asset basis.

[38] To the extent that a residual holder has recognized “phantom” income (i.e., income generated as a function of the yield curve that can only be offset by future losses and not by cash) that has not been offset by the corresponding “phantom” loss, the REMIC's asset basis will exceed the adjusted issue prices of its regular interests. Otherwise, its asset basis should generally equal at least the adjusted basis of its regular interests.

On the other hand, not applying the bad debt analysis under this method would produce dramatically different results. As previously noted, absent adjustment to the adjusted issue price of an IO Interest under the bad debt analysis, it is possible for prepayments that dramatically exceed original expectations to make it exceptionally unlikely or impossible for the present value of the remaining payments ever to exceed the adjusted issue price. Therefore, the amount of original issue discount accrued in the hands of a holder, whether an original holder or subsequent purchaser, would be zero. For a subsequent purchaser who would purchase such an instrument at a substantial discount (reflecting actual events and current risk perceptions with respect to the IO Interest), this would also mean that no accrual of market discount would need be made.[39] As a result, such purchasers could first recover their purchase price from such IO Interest and then sell it. Any gain on sale would be capital to the extent that it exceeded the yield requirements of section 860B(c).[40] The gain would not be treated as market discount because no market discount would have accrued.

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[39] See H R. Rep. No. 841, 99th Cong. 2d Sess. II-842 (1986) (until Treasury issues regulations, market discount on an obligation issued with original issue discount accrues proportionately to the original issue discount on the instrument. Therefore, if no original issue discount accrues, the market discount accrued apparently would be zero.)

[40] Under section 860B(c) a taxpayer can only treat as capital gain that portion of gain on the sale of a REMIC regular interest that represents a yield in excess of 110 percent of the applicable federal rate. The conversion transaction provisions of section 1258 could also apply (i.e., if the interest were sold as a capital gain converter or under future regulations), but this would only increase the necessary ordinary yield from 110 percent to 120 percent of the applicable Federal rate compounded semiannually.

Thus, unless there is an adjustment to the issue price of the IO Interest to take into account negative accruals, a secondary market purchaser with an adjusted issue price substantially in excess of the present value of the projected future payment would find that it can recover its basis before accruing any income and, except as required by section 860B(c) or possibly section 1258, treat gain on sale as capital.

The potential anomalies of recovering basis before the accrual of income and converting at least some income that should be ordinary into capital gain could be addressed in regulations by requiring the accrual of market discount independent of the accrual of original issue discount. To address effectively this situation these regulations would substantially increase the complexity of rules that are already fairly complex because in essence the rules would need to divide the projected cash flow on the IO Interest into two parts, with all projected cash flow used to calculate original issue discount and something less than all cash flow used to calculate the accrual and timing of inclusion of market discount.[41] Market discount would equal the excess of the revised issue price at the time of purchase over the purchase

[41] Unlike original issue discount, absent an election under section 1278, accrued market discount is not included in income until the taxpayer realizes gain on the disposition of the bond or receives a partial principal payment. Section 1276(a).

price.[42] A separate yield would need to be calculated and market discount would accrue based on increases in the present value of the projected payments discounted at the market discount yield, excluding those payments that would be treated as original issue discount accrued after the acquisition of the IO Interest by the taxpayer Because the yield would be based on the adjusted issue price at the time of acquisition, this system would overstate income to the extent that full recovery of the adjusted issue price is not projected. In addition, if as a result of events occurring after the acquisition by the secondary purchaser, the present value of the projected future payments became less than the unrecovered revised issue price, a loss should be allowed at least to the extent of previously accrued market discount. In any event, this discussion illustrates the necessary complexity of a system that requires the independent accrual of market discount

[42] Section 1276(b)(2)(B). The revised issue price differs from the adjusted issue price primarily in that the adjusted issue price is increased by accruals of original issue discount occurring after acquisition while the revised issue price is not. See section 1278(a)(4). Reductions in the adjusted issue price would also need to be adjusted to take into account such difference. This calculation also raises the question of how to calculate market discount where the projected payments do not exceed the adjusted issue price at the time of the secondary market purchase but some lower level of prepayments would cause the IO Interest to produce sufficient cash to allow for the recovery of the adjusted issue price. Naturally, this is a somewhat different question than the negative present value of projected payments for original issue discount purposes because, at least for the initial calculation, the projected payments are not reduced to their present value number. The yield could be calculated and income accrued against the lower amount of projected payments or could be calculated assuming the prepayment assumption to be modified to provide for full recovery of the adjusted issue price. In the first case, the adjusted issue price is effectively reduced for market discount purposes, and therefore it would seem a corresponding reduction for original issue discount purposes should also be allowed, which would result in a loss to non transferring holders. The alternative would require an artificially high accrual, and because of the partial prepayments, a corresponding artificially high inclusion in income of market discount. This would ultimately result in a loss, which might be capital in character.

Thus, unless the original holder is allowed a loss, with a corresponding adjustment to the adjusted issue price of the IO Interest, a secondary market purchaser might not be required to recognize income that accrues economically after the purchaser acquires the IO Interest.

3. Contingent Interest Method

a. Description of Method.

The contingent interest method follows the treatment of contingent payment debt obligations under the original issue discount rules described in Prop. Reg. § 1.1275-4. Although the regulations expressly provide that they do not apply to REMIC regular interests,[43] the noncontingent bond method described in those regulations is an alternative method that might be considered for debt instruments with payments the amount of which is contingent on prepayments.

As with the PAC Method, the contingent interest method would require the development of a payment schedule for the IO Interest. The payment schedule would be based on the Original Payment Assumption. Then, the holder's yield to maturity would be calculated using the payment schedule and the issue price of the IO Interest. The yield would be used to determine the daily portions of interest to be accrued during each taxable year. The sum of these daily portions generally would be treated as income to the holder of the IO Interest and as a deduction to the REMIC. To the extent that the amount actually paid to the IO Interest holder differs from the amount shown on the payment schedule, adjustments would be made.

[43] Prop. Reg. § 1.1275-4(a)(2)(v).

b. Consequences to the Original IO Interest Holder.

As described above, the original IO Interest holder would generally be deemed to have income equal to the sum of the daily portions calculated by using the payment schedule and the yield derived therefrom. When the actual payments deviate from the payments shown on the payment schedule, an adjustment would be made.

If the actual payment for any period exceeds the amount shown on the payment schedule (a “net positive adjustment”), the difference would be treated as additional interest income to the holder. If on the other hand, the amount actually paid is less than the amount shown on the payment schedule (a “net negative adjustment”), the difference is treated first as a reduction of any interest the holder would otherwise have had to accrue on the instrument for the taxable year and second as ordinary loss. However, the amount of ordinary loss allowed for this purpose would be limited to the amount by which the holder's total interest inclusions on the instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the instrument in prior taxable years.

Any amount of the net negative adjustment which cannot be used because of this limitation is carried over until it can be used or until the instrument is disposed of, at which time it will reduce the amount of the holder's amount realized with respect thereto.

c. Consequences to REMIC Residual Holders.

In general, this method would entitle the REMIC residual holder to claim a deduction when and to the extent that the holder of the IO Interest recognizes income. To the extent that the holder is entitled to claim an ordinary loss, the REMIC residual holder would be required to report ordinary income. However, the amount of this ordinary income would be limited to the amount by which the REMIC residual holder's total interest deductions with respect to the IO Interest exceeds the total amount of its net negative adjustments treated as ordinary income on the IO Interest in previous years. If the instrument is retired, any remaining net negative adjustment would be deemed to result in cancellation of debt income for the REMIC residual holder.

d. Consequences to Secondary Market Purchasers.

Purchasers of IO Interests in the secondary market would be required to use the originally projected payment schedule in determining the amount of income they would be required to recognize in any taxable year. However, in calculating the amount of income which they would be required to recognize in any taxable year, such purchasers also would be required to take into account the difference between their adjusted basis in the IO Interest and the adjusted issue price of the IO Interest on the date they acquired it.

If, for example, the secondary holder paid an amount in excess of the interest's adjusted issue price at the time of acquisition, that excess would have to be allocated in a “reasonable” manner among all of the payments which the secondary holder is expected to receive and would be treated as a negative

adjustment thereto. The negative adjustment allocable to any particular payment would then be added to any negative adjustment or netted against any positive adjustment made to that payment in the taxable year in which the payment is made to come up with a total net negative or positive adjustment for the year.

If the secondary holder paid an amount less than the interest's adjusted issue price at the time of its acquisition, this amount also would be required to be “reasonably” allocated among all of the payments expected to be received and treated as a positive adjustment thereto.

Once these additional adjustments have been made, the secondary holder would be treated in the same way as the original holder for the purpose of determining the timing and character of any income or loss from the interest.

B. Recommendation

We recommend that the Service consider clarification by regulation of the interaction of section 171 and section 1272(a)(6). Such regulations would clarify whether the premium amortization method or the PAC Method is the correct method of accounting for IO Interests, and should clarify whether, if the adjusted issue price of an IO Interest at the beginning of an accrual period exceeds the sum of the interest payments during the accrual period and the present value of all remaining payments at the end of the accrual period, the excess is allowable as a deduction under section 171 One possible approach would be to provide that both section 171 and section 1272(a)(6) apply to IO Interests. Under this approach, if the calculations required under the PAC Method produce a negative number, that amount would be deductible under section 171; if, however, those

calculations produce a positive number, that amount would be includible in income under section 1272. We do not express a view, however, as to whether this approach should be adopted.

V. TREATMENT OF VARIABLE STRIPS AS STRIPPED COUPONS UNDER SECTION 1286

In this Part we consider whether a right to a variable portion of the interest from a loan (a “variable strip”) is a stripped coupon within the meaning of section 1286 If so, a grantor trust can, under the Sears Regulations, create an ownership interest entitling the holder to a variable portion of the interest from loans held by the trust.

A variable strip can be created either from fixed rate or variable rate loans. A variable strip from a fixed rate loan might entitle the holder to all of the interest from the loan in excess of the current value of a specified variable rate. A second variable strip from the same loan would entitle the holder to interest from the loan up to that same specified variable rate. Thus, in the case of a loan bearing interest at 8%, one variable strip would entitle the holder to the excess of 8% over the current value of LIBOR and the other variable strip would entitle the holder to interest at LIBOR, but not to exceed 8%.

A variable strip from a variable rate loan might entitle the holder either to all of the interest in excess of a predetermined fixed rate or to all of the interest in excess of a different variable rate.

We believe that variable strips should be considered stripped coupons within the meaning of section 1286(e), and therefore that grantor trusts should be permitted to issue ownership interests equivalent to variable strips from loans that they hold. This conclusion is consistent with the language of section 1286 and with the policies underlying the Sears Regulations. However, because there is uncertainty about current law, we recommend that the Service clarify, either by revenue ruling or regulation, that a variable strip is a stripped coupon within the meaning of section 1286(e), and thus that grantor trusts can issue ownership interests equivalent to variable strips.

Section 1286(e) defines a stripped coupon as any coupon relating to a stripped bond, defines the term coupon as any right to receive interest on a bond, and defines a stripped bond as a bond issued with coupons after the ownership of any coupon is separated from the bond. Beyond the statutory language, there is no guidance under current law as to what constitutes a stripped bond or stripped coupon within the meaning of section 1286.[44] Based on the language of section 1286(e), however, the holder of a variable strip would seem to hold a "coupon," because the holder has a right to receive interest from the bond.

[44] The legislative history of section 1286 provides little insight into the proper tax treatment of variable strips. Congress enacted section 1286 to curtail the manipulation of the timing and character of income through coupon-stripping transactions. See S. Rep. No. 494, 97th Cong., 2d Sess. 216 (1982). Under section 1286(f), Congress granted the Treasury broad regulatory authority to modify the general rules of section 1286 "where, by reason of varying rates of interest, put or call options, or other circumstances," the general rules do not accurately reflect the income of the person disposing of a stripped bond or stripped coupon or the holder of a stripped bond or stripped coupon. Treasury has not yet issued regulations under section 1286(f).

If variable strips are considered to be stripped coupons under section 1286, a grantor trust should be permitted to create variable strips from debt instruments held by such trust under Example 4 of the Sears Regulations. This conclusion is not clearly supported by that example, however, because that example involves ownership interests entitling holders to the entire amount of each interest payment due on a bond. In Example 4 of the Sears Regulations, a trust holding a portfolio of bonds issued certificates evidencing interests in the bonds. Each certificate entitled the holder to receive a particular payment on a specific bond. Although the trust had multiple classes of ownership interests, the example states that the existence of multiple classes is considered incidental to the trust purpose of facilitating direct investment in the bonds. The example relies on application of section 1286 to certificate holders and on the existence of a statutory scheme for taxing partial ownership interests in debt instruments.[45]

Treatment of variable strips as stripped coupons would not violate the policies underlying the Sears Regulations. According to the preamble to those regulations, the reason for prohibiting multiple-class investment trusts is that the potential exists for complex allocations of income among the various classes of ownership interests in such trusts and there are no established tax rules to account for such allocations:

[45] The preamble to the proposed version of the Sears Regulations makes the reliance on section 1286 even more apparent. The preamble states that "[i]n section 1232B of the Code [predecessor to section 1286], Congress has provided a method for taxing transactions involving... 'stripped bonds' and 'stripped coupons.' Thus, it would be inconsistent with section 1232B to treat typical 'coupon stripping' arrangements in which bonds are held by a custodian and interests in specifically identifiable stripped coupons or bonds are sold as either associations or partnerships " 1984-1 C.B. 777, 779.

> Multiple class trusts depart from the traditional form of fixed investment trust in that the interests of the beneficiaries are not undivided, but diverse. The existence of varied beneficial interests may indicate that the trust is not employed simply to hold investment assets, but serves a significant additional purpose of providing investors with economic and legal interests that could not be acquired through direct investment in the trust assets. Such use of an investment trust introduces the potential for complex allocations of trust income among investors, with correspondingly difficult issues of how such income is to be allocated for tax purposes. These issues are properly foreign to the taxation of trust income, where rules have not developed to accommodate the varied forms of commercial investment, and no comprehensive economic substance requirement governs the allocation of income for tax purposes.[46]

If variable strips are treated as stripped bonds or stripped coupons and as such are subject to the rules of section 1286, and if there were clear rules in place for their taxation, this policy would not be violated; a trust issuing variable strips would not be required to make an entity- level allocation of income from the underlying debt obligation. Section 1286 treats holders of stripped coupons as owning separate debt instruments and requires that they take into account the interest and OID that accrues on these separate debt instruments.

If variable strips are considered stripped coupons within the meaning of section 1286, clear rules exist, or at least will exist after finalization of the proposed contingent

[46] T.D. 8080, 1986-1 C.B. 371.

debt regulations, for their taxation. If a variable strip is treated as a stripped coupon, it will be treated as a separate debt instrument issued with original issue discount. Since the amount payable on this separate debt instrument is contingent on the level of a variable interest rate, the total payments on this separate debt instrument will be contingent. The proposed contingent debt regulations (Prop. Reg. § 1.1275-4) provide a method of taxing such a debt instrument. They provide that, in the case of a contingent payment debt instrument that would be a "variable rate debt instrument" except that it does not guarantee the holder any minimum amount of principal, the holder is to construct an equivalent fixed rate debt instrument by projecting the payments on the instrument by assuming that the value of the variable rate used in determining the contingent payments will be its value as of the issue date.[47] The holder then accrues original issue discount on the equivalent fixed rate debt instrument, and makes adjustments to take into account differences between projected payments and actual payments.[48]

We note that the same issue presented by variable strips (i.e., how to tax a debt instrument that provides for payments contingent on a floating interest rate index) is also presented by a strip of all of the interest from a floating rate bond. Rights to the interest payments from such a bond are clearly stripped coupons under section 1286. Thus, treatment of variable strips as stripped coupons would not raise an issue that is not already present under current law.

[47] See Prop. Reg. § 1.1275-4(b)(4)(iii)(B); Reg. § 1.1275-5(e).

[48] See Prop. Reg. § 1.1275-4(b)(2).

We note, however, that variable strips are very similar economically to certain notional principal contracts. For example, there is little difference in substance between (a) an interest rate floor contract entitling the holder to payments equal to the excess of 8% over LIBOR on a notional principal balance equal to the principal amount of a bond and (b) a variable strip from a fixed rate bond bearing interest at 8% entitling the holder to that portion of the interest in excess of LIBOR. Such an interest rate floor contract is subject to the timing rules of Reg. § 1.446-3.[49] Under those rules, the amount paid by the taxpayer for an interest rate floor contract is generally recognized over the term of the agreement by allocating it in accordance with the prices of a series of cash-settled option contracts.[50]

There are two important differences between the timing rules that would apply to variable strips under the approach in the proposed contingent debt regulations and the timing rules that apply to notional principal contracts such as interest rate caps and floors. First, original issue discount income accrues on the adjusted issue price of a debt instrument that is subject to the contingent debt rules. In contrast, assuming that a cap or floor is not recharacterized as a loan, no interest income accrues on the unamortized balance of its purchase price. Second, under the approach in the proposed contingent debt regulations, the values of the payments are projected based on the initial value of the variable interest rate used to determine those payments. Assume, for example, a variable strip entitling the taxpayer to the excess of interest at a rate of 8% over

[49] See Reg. § 1.446-3(c)(1)(i).

[50] See Reg. § 1.446-3(f)(2)(iv).

LIBOR, issued at a time when LEBOR is 6%. Payments would be projected by assuming that each payment will be the same, i.e., 2%. In contrast, the notional principal contract rules take into account the option values of the rights to payments. Since option values increase based on the length of time until settlement, the notional principal contract rules would allocate different amounts of basis to payments under an interest rate floor contract, with more allocated to later payments than to earlier payments.

These two differences between taxation of interest rate cap and floor contracts and taxation of similar variable strips may tend to offset each other. Failure to impute interest on the unamortized balance of a cap or floor contract makes taxation of such contracts more favorable than the taxation of a variable strip with the same cash flows. However, use of option pricing, because it defers basis recovery, makes taxation of a cap or floor contract less favorable than taxation of a variable strip with the same cash flows. Thus, although variable strips are similar economically to certain notional principal contracts, we note that they are subject to different tax rules. It is not clear whether one of these two sets of rules is consistently more favorable than the other to taxpayers. Treatment of variable strips as stripped coupons may highlight inconsistencies between these two sets of rules, however, by expressly permitting creation of a class of financial instruments that are similar to notional principal contracts but that are subject to different tax rules.

VI. HEDGES OF INTEREST-ONLY STRIPS

In this Part, we consider potential character and timing mismatches between income and expense from stripped coupons and gain and loss from other financial instruments used to hedge them.

A. How Holders of Stripped Coupons Face Character and Timing Mismatches if They Hedge

A holder of stripped coupons from loans subject to prepayment is subject to the risk that the loans may prepay more rapidly than expected, thereby eliminating the holder's rights to future payments. The risk of an increase in prepayment rates exists whether the loans bear interest at a fixed rate or at a floating rate. If interest rates fall, obligors on fixed rate loans can reduce their interest expense by prepaying and refinancing with new loans that bear interest at a lower rate. Although obligors on floating rate loans cannot reduce current interest expense by refinancing if the rate on their loans has adjusted down to the market rate, they may nevertheless refinance in order to lock in the new lower market rate and avoid future increases in rates. The loss suffered by a holder of mortgage servicing rights (like the loss suffered by any holder of stripped coupons from bonds subject to prepayment) from an increase in prepayment rates would tend to be offset by appreciation in rights to fixed payments in the future resulting from a fall in market interest rates.

The holder of stripped coupons can, to some extent, hedge against the risk of changes in value of those coupons resulting from changes in prepayment rates by buying financial instruments that change in value with changes in interest rates.

Since prepayment rates tend to vary inversely with market interest rates, such instruments will produce gains when interest rates fall, prepayment rates rise, and the rights to interest payments fall in value.

Taxpayers that hedge prepayment risk are subject to potential character mismatches: losses from the financial instruments used as hedges may be treated as capital losses, while corresponding gain from the stripped coupons is realized in the form of ordinary income. As a result of this character mismatch, losses from the financial instruments may not be usable against income from the stripped coupons and the taxpayer may be required to report taxable income in excess of economic income from the two positions.

Taxpayers that hedge prepayment risk also are subject to (or are able to enjoy) potential timing mismatches. A taxpayer may dispose of a financial instrument that hedges prepayment risk at a gain or loss, while the corresponding gain or loss from the hedged stripped coupons is unrealized.

Businesses that service mortgages and other loans and hold servicing rights in the form of stripped coupons from those loans[51] are particularly likely to face these issues, because they are particularly likely to hedge against prepayment risk.

There are two sets of regulations that prevent character and timing mismatches in the case of certain hedges of debt instruments--the regulations dealing with business hedging transactions (Reg. § 1.1221-2 and Reg. § 1.446-4) and Prop. Reg.

[51] See Part I. A., above, for a discussion of excess servicing rights treated as stripped coupons.

§ 1.1275-6-—but neither prevents character and timing mismatches arising from hedges of stripped coupons.

1. Reg. § 1.1221-2 and Reg. § 1.446-4

Regulations issued in response to the Supreme Court's 1988 Arkansas Best[52] decision generally treat gain or loss from a hedging transaction as ordinary if sale or exchange of the hedged property could not produce capital gain or loss, and certain other conditions are met.[53] Those regulations also generally require that income, deduction, gain or loss from a hedging transaction reasonably match income, deduction, gain or loss from the items being hedged.[54] These regulations do not generally apply to hedges of property, such as property used in the taxpayer's business ("section 1231 assets"), that could produce capital gain on sale.[55]

Thus, if a sale of mortgage servicing rights by a taxpayer could produce capital gain, the regulations do not apply to a taxpayer's hedges of those rights. Unless the taxpayer is a bank or a dealer that holds the servicing rights treated as stripped coupons for sale to customers, sales of such rights will give rise to capital gain or loss, whether those servicing rights are retained or purchased; this gain or loss generally would be taken into account when realized.

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[52] Arkansas Best v. Commissioner, 485 U.S. 212 (1988).

[53] See Reg. § 1.1221-2(c)(5)(i). In addition, if the hedge is of property held or to be held by the taxpayer, the hedge must be entered into primarily to reduce risk of price changes or currency fluctuations.

[54] Reg. §1.446-4.

[55] Reg. § 1.1221-2 contains a special rule treating gains and losses on hedges of supplies such as jet fuel as ordinary. This special rule does not apply to hedges of other section 1231 assets, however.

A sale of purchased servicing rights would generally give rise to capital gain or loss. Assuming that the purchased servicing rights are viewed as stripped coupons, a sale would give rise to capital gain or loss unless the taxpayer is a bank or is a dealer that holds the servicing for sale to customers.[56] To the extent that purchased servicing rights are not viewed as stripped coupons, they should be viewed as section 1231 assets, the sale of which also would give rise to capital gain.

A sale of retained servicing should generally give rise to capital gain or loss, whether or not that retained servicing exceeds reasonable compensation for services. To the extent that a sale of retained servicing constitutes a sale of the right to receive payments that exceed reasonable compensation for services, the taxpayer should be treated as selling stripped coupons. Unless the taxpayer is a bank or a dealer, a sale of stripped coupons should give rise to capital gain or loss. To the extent that retained servicing does not exceed reasonable compensation for services, its sale also should give rise to capital gain or loss, based on authority that treats the sale of retained servicing as a sale of property and rejects the view that it should be considered an assignment of income.[57] Under section 1221 (as interpreted by Arkansas Best), such a sale of

[56] If the taxpayer is a bank, gain or loss on sale of the mortgage servicing rights treated as stripped coupons would be ordinary gain or loss under section 582(c).

[57] See Rev. Rul. 77-190, 1977-1 C.B. 88; John T. Stewart III Trust v. Commissioner, 63 T.C. 682 (1975), acq. 1977-1 C.B. 1.

property would produce capital gain or loss.[58]

Thus, Reg. § 1.1221-2, which prevents character mismatches from certain business hedging transactions, and Reg. § 1.446-4, which prevents timing mismatches from those transactions, generally would not apply to hedges of stripped coupons.

2. Prop. Reg. § 1.1275-6

Prop. Reg. § 1.1275-6 would (if and when effective) generally provide for the integration of certain debt instruments with a hedge or combination of hedges if the combined cash flows are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. Hedges of stripped coupons generally would not qualify for integration under this rule. Because it is generally not possible to find a financial instrument that will hedge prepayment risk exactly, the combined cash flows from stripped coupons and a financial instrument used to hedge those coupons will not be substantially equivalent to the cash flows on a fixed or variable rate debt instrument.

[58] But see Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963). In that case, the taxpayer, a mortgage originator assigned loans to investors, retaining the right to receive payment from the mortgages as compensation for servicing the loans. Investors terminated certain servicing agreements and paid the taxpayer a termination fee, for which they were reimbursed by the new servicing agents. Holding that in substance property rights passed from the taxpayer to the new servicing agents by sale or exchange, the court nevertheless held that the amount realized was taxable as ordinary income to the extent that it was a substitute for future earnings. In addition, notwithstanding Arkansas Best, the Internal Revenue Service has recently taken the position in litigation that sales of mortgage servicing rights produces ordinary income. See Kleinbard, "What's New with New Financial Products?", 7 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures and Other Strategic Alliances, Financings, Reorganizations, and Restructurings 114 n. 61 (Practicing Law Institute, 1994).

B. Recommendation

We recommend that the Service consider issuance of regulations that would prevent character and timing mismatches for hedges of stripped coupons from loans subject to prepayment. One approach would be to expand the definition of "ordinary property" in Reg. § 1.1221-2(c)(5) to include servicing rights treated as stripped coupons, provided that the taxpayer sells only a negligible amount of those servicing rights. Such an expansion would be modeled on the rule in Reg. § 1.1221 - 2(c)(5)(ii) for noninventory supplies. Another approach would be to expand Prop. Reg. § 1.1275-6 to require integration of stripped coupons with financial instruments held to hedge them, even though the combined cash flows are not equivalent to the cash flows from a fixed or variable rate debt instrument.