REPORT # 599

TAX SECTION

New York State Bar Association

Report on the Federal Income Tax Treatment
of Real Estate Mortgage Investment Conduits

by the Committee on Financial Instruments

December 30, 1988

Table of Contents

TAX SECTION

New York State Bar Association

December 30, 1988

Real Estate Mortgage Investment Conduits

Dear Commissioner Gibbs:

I enclose our report on the real estate mortgage investment conduit ("REMIC") provisions of the Internal Revenue Code of 1986. The report suggests how a number of current issues should be treated in the forthcoming REMIC regulations.

The report was prepared by members of the New York State Bar Association Tax Section Committee on Financial Instruments. The principal authors were Thomas A. Humphreys, Charles M. Adelman, Bruce Kayle, Andrew B. Jones and David z. Nirenberg. Helpful comments were provided by James M. Peaslee, Jeffrey Hunter, Jeffrey A. Quinn, Elaine S. Fisher, James A. Gouwar, John Walker, Stuart B. Katz, Micah W. Bloomfield and Cindy Goldberg.

As you know, no substantive regulations have been issued under the REMIC statute since its enactment in 1986. While the area is a technical one, there is a sizeable group of practitioners that deal with these issues on a daily basis. Additionally, the volume of these transactions is substantial, and because of the high stakes involved (i.e., pass-through tax treatment) they require tax certainty. Accordingly, we would urge that regulations be promulgated as soon as possible.

The report, among other recommendations, urges that the regulations:

(1) expand and clarify the types of variable rate regular interests that can be issued by a REMIC;

(2) confirm that a regular interest can be subordinate to a residual interest;

(3) provide that credit enhancement in the nature of a guarantee be considered part of a REMICfs qualified mortgages;

(4) adopt a uniform federal definition of real property for REMIC purposes; and

(5) insofar as they affect the qualification of REMICs formed before the regulations are promulgated be given prospective effect only. The Tax Section of the New York State Bar Association hopes that this report will be useful to you in preparing regulations on the REMIC provisions.

Very truly yours,

Herbert L. Camp

The Honorable Lawrence B. Gibbs,
Commissioner of Internal Revenue,
Internal Revenue Service,
1111 Constitution Avenue, N.W.,
Washington, D. C. 20224

Enclosure

Copies w/encl. to The Honorable O. Donaldson Chapoton,
Assistant Secretary for Tax Policy,
Treasury Department,
3120 Main Treasury,
1500 Pennsylvania Ave., N.W.,
Washington, D. C. 20220

Donald Rocap, Esq.,
Acting Deputy Tax Legislative Counsel,
Office of Tax Legislative Counsel,
Department of Treasury,
1500 Pennsylvania Ave., N.W.,
Washington, D. C. 20220

Reed Shuldiner, Esq.,
Attorney-Advisor,
Office of Tax Legislative Counsel,
Department of Treasury,
1500 Pennsylvania Ave., N.W.,
Washington, D. C. 20220

James Malloy, Esq.,
Assistant Chief Counsel,
Office of the Chief Counsel,
Financial Instruments & Products,
1111 Constitution Ave., N.W.,
Washington, D. C. 20224

Susan Baker, Esq.,
Office of the Chief Counsel,
Financial Instruments & Products,
Room 4009,
1111 Constitution Ave., N.W.,
Washington, D. C. 20224

Tax Report #599

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on the Federal Income Tax Treatment of Real Estate Mortgage Investment Conduits

by the Committee on Financial Instruments

December 30, 1988

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on the Federal Income Tax Treatment of Real Estate Mortgage Investment Conduits

December 30, 1988

I. Introduction

In 198 6 Congress created the real estate mortgage investment conduit ("REMIC") as a vehicle for mortgage-backed securities transactions. Since then, there has been little interpretation of the REMIC statute by the Internal Revenue Service ("Service"). Substantive REMIC regulations, promised since early 1987, have yet to be issued.

This report, prepared by the New York State Bar Association Tax Section,[1] addresses the critical issues under the REMIC statute which need immediate attention from the Service in regulations.

An initial explanation of the principles that have guided the report's authors may be helpful to the reader. These principles are based on our understanding of the Congressional intent behind the REMIC statute.

---

1 This report was drafted by members of the New York State Bar Association Tax Section Committee on Financial Instruments. The principal authors were Thomas A. Humphreys, Charles M. Adelman, Bruce Kayle, Andrew B. Jones and David Z. Nirenberg. Helpful comments were provided by James M. Peaslee, Jeffrey Hunter, Jeffrey A. Quinn, Elaine S. Fisher, James A. Gouwar, John Walker, Stuart B. Katz, Micah W. Bloomfield and Cindy Goldberg.

When Congress created the REMIC vehicle, it was concerned about the increasing extent to which real estate mortgages were traded on secondary markets and the increasing use of “multiple class” arrangements to package such mortgages.[2] Congress, in essence, had four goals in dealing with the tax issues raised by these transactions.

First, Congress wanted a coherent set of federal income tax rules to cover mortgage securitization transactions. These rules would permit a corporation, trust or other entity used to securitize mortgages to forego an entity level tax on the income from such mortgages in return for compliance with certain rules.[3]

Second, Congress wanted to ensure that income from the REMIC's assets was properly allocated to the REMIC's interest holders.[4] This goal in the first instance involved ensuring that the entire gross income from the REMIC's assets is taxed to regular and residual interest holders. Thus, the REMIC regular interest holder is taxed on interest and on original issue discount under the special rules of section 1272(a)(6).[5] The REMIC residual owner is taxed on any remaining income from the

---

2 Staff of the Joint Committee on Taxation, 99th Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1986, at 411 (Comm. Print 1986), hereafter referred to as the “Blue Book”.

3 Id.

4 Id.

5 Section references are to the Internal Revenue Code of 1986 (“Code”) and the regulations promulgated thereunder.

REMIC's assets and is subject to the excess inclusion rules. Moreover, proper allocation of income involves ensuring that character of income inside the REMIC is, in most cases, translated into ordinary income for the regular and residual interest holders, thereby avoiding conversion of ordinary income into capital gain. Finally, proper allocation of income involves ensuring against deferral through the mandatory calendar taxable year, the accrual basis for regular interest holders, and quarterly inclusion of residual income.

Third, Congress wanted REMIC to be the exclusive vehicle for packaging multiple class securities.[6] Thus, it was felt that merely creating one more option for mortgage packaging transactions would not serve the Congressional goal of certainty of tax treatment.

Fourth, in order to ensure that REMIC would be used as the exclusive vehicle, Congress wanted it to be a flexible vehicle.

According to the Blue Book:

> The Congress believed that the new vehicle provided by the Act, since it is intended to be the exclusive one for the issuance of multiple class securities backed by real property mortgages, should be flexible enough to accommodate most legitimate business concerns while preserving the desired certainty of income tax treatment.[7]

---

[6] Blue Book, p. 411, Conf. Rep. No. 99-841, 99th Cong. 2d. Sess. 11-239 (1986), hereafter the “Conference Report”.

[7] Blue Book p. 411.

A few guiding principles can be distilled from this expressed Congressional purpose. These principles are used to analyze the various mortgage-backed security structures discussed in this report. First, there must be a legitimate business reason for the proposed structure. Second, there should not be any material possibility of tax avoidance if the structure is permitted. Third, income and deductions attributable to the REMIC's assets must be accurately allocated to the REMIC s interest holders. If these requirements are met, we believe that regulations should permit the structure. Our report reflects this understanding.

II. Summary of Recommendations

This report makes the following recommendations:

(a) The categories of permissible variable rate regular interests should be clarified and expanded;

(b) The treatment of two-tier REMICs should be clarified;

(c) A temporary reserve fund designed to pay interest on regular interests at the end of the first interest payment period of the REMIC's regular interests should be considered a cash flow investment;

(d) A reserve fund “outside” the REMIC should be respected; alternatively, a REMIC regular interest should be permitted to have an interest rate that is determined by reference to income on qualified reserve assets;

(e) Regular interests that are subordinated to a residual interest should be expressly permitted;

(f) Certain original issue discount (“OID”) issues with particular application to REMIC transactions should be clarified;

(g) The right of a third party to exercise a cleanup call when 10 percent or less of the REMIC's original qualified mortgages remain should not constitute an interest in the REMIC for purposes of section 860D(a)(2);

(h) A coupon stripped from qualified mortgages should be specifically excluded from the definition of an interest in the REMIC;

(i) Credit enhancement in the nature of a guarantee should be considered an incident of the REMIC's qualified mortgages under section 860G(a)(3);

(j) The definition of “real property” for purposes of determining whether a debt instrument is secured by an interest in real property under section 860G(a)(3)(A) should include associated fixtures even though such fixtures may be considered personal property under local law;

(k) The term “principally secured” in section 860G(a)(3)(A) should be defined to mean that the adjusted basis of personal property that secures a loan cannot be greater than 20 percent of the combined adjusted basis of real and personal property that secures the loan, with such amount being determined at the time the loan is originated;

(l) “Buydown” loans should be considered qualified mortgages under section 860G(a)(3)(A);

(m) The Service should use a “bright line” test to determine whether a REMIC has adopted arrangements designed to ensure that residual interests are not held by disqualified organizations;

(n) Residual interests that are not entitled to any distributions and that have no economic value should be permitted;

(o) The treatment of convertible loans held by a REMIC should be clarified by treating the purchase of a convertible loan after conversion of the loan as a prepayment; and

(p) Those regulations that could affect the qualification of REMICs formed before the regulations are promulgated should be given prospective effect only.

III. Discussion

A. Section 860G(a)(1) - Variable Rate Regular Interests

1. Background

Under section 860G(a)(1), a REMIC regular interest is defined as an interest in the REMIC that, among other things, pays interest at "a fixed rate (or to the extent provided in regulations, at a variable rate)."

Although no regulations have yet been released providing for variable rate regular interests, the Service has offered some limited guidance in two notices.[8] These notices announce the Service's intention to issue regulations relating to variable rates. The notices assure that any future guidance that is inconsistent with the notices will be prospective only. Regulations that are issued pursuant to these notices will apply to transactions closing on or after June 15, 1987.

In Notice 87-41, the Service announced that it will issue regulations permitting a REMIC regular interest to bear a variable rate that would be a permissible rate for a "variable rate debt instrument" (a "VRDI") as such term is defined under the Proposed Treasury regulations relating to OID ("Proposed Regulations").[9]

---

[8] Notice 87-41, 1987-1 C.B. 500; Notice 87-67. 1987-2 C.B. 377.

[9] Prop. Reg. §1.1275-5(a), (b), and (c).

Notice 87-41 also expanded the scope of debt instruments that would be treated as VRDIs for REMIC qualification purposes. The notice indicated that the phrase "interest based on current values of an objective index" in Prop. Reg. §1.1275-5(a) would be interpreted in the REMIC regulations to allow REMIC regular interests to pay interest expressed as a fixed multiple of an objective index plus or minus a constant number of basis points. This statement rendered inapplicable the last sentence of Prop. Reg. §1.1275-5(b), which does not allow a debt instrument with a rate of interest so expressed to be treated as a VRDI.[10] The notice also explained that regulations would allow interest on a REMIC regular interest to be subject to a maximum or a minimum rate.

---

[10] Prop. Reg. §1.1275-5(b) states:

> [I]nterest expressed as a fixed multiple of an objective interest index or as a constant number of percentage or basis points more or less than an objective interest index shall constitute interest based on an objective index. However, interest expressed as a fixed multiple of an objective index plus or minus a constant number of percentage or basis points shall not constitute interest based on an objective interest index.

Because the notice addresses only REMIC qualification issues, Notice 87-41 left open the question whether either a REMIC regular interest or a non-REMIC debt instrument paying interest at the rate described in the last sentence of the portion of the regulation quoted above could be treated as a VRDI for purposes of determining the accrual of OID or whether such regular interest would have "qualified periodic interest payments" within the meaning of Prop. Reg. §1.1273-1(b)(1)(ii)(A). See discussion infra Part 2(a).

Notice 87-41 allowed a number of CMO[11] -type transactions involving the use of floating rate tranches, primarily LIBOR-based VRDI's, to go forward. Nevertheless, the quickly evolving marketplace caused a number of issues to be raised with respect to a variety of other possible variable rates.[12] In particular, the need for guidance regarding permissible variable rates resulted from the increasing utilization of pass-through certificates backed by adjustable rate mortgage loans ("ARMs"). As proposals for pooling ARMs in pass-through REMICs emerged, the types of variable rates suitable for these pools did not appear to be permitted by Notice 87-41.

For example, in structuring an ARMs-backed pass-through transaction, issuers typically wished to tie the movement in the rate of interest on the REMIC regular interests to interest rate movement with respect to the underlying ARMs. Thus, one question that arose was whether a variable rate based upon a weighted average of the rates on the ARMs held by such a REMIC

---

11 CMO is an acronym for "collateralized mortgage obligation".

12 See Letter from Michael T. Lambert of McKenna, Conner & Cuneo (Sept. 9, 1987), reprinted in Tax Notes Today: Highlights and Documents 2662-4 (Sept. 25, 1987); Letter from Edward E. Gonzales of Skadden, Arps, Slate, Meagher & From (Aug. 19, 1987), reprinted in Tax Notes Today: Highlights and Documents 1933-4 (Sept. 3, 1987); Letter from Paul J. Sax of Orrick, Herrington & Sutcliffe (Aug. 10, 1987), reprinted in Tax Notes Today: Highlights and Documents 2364-5 (Sept. 15, 1987); and Letter from Thomas A. Humphreys of Brown & Wood (July 23, 1987), reprinted in Tax Notes Today: Highlights and Documents 1090-1 (Aug. 5, 1987).

would be a qualifying variable rate for REMIC purposes.[13] A somewhat related issue was whether the REMIC regular interests could pay at a rate that initially reflected “teaser rates” on the ARMs. In addition, issuers were investigating the use of “new” variable rates based upon indices not clearly permissible under Prop. Reg. §1.1275-5(b), such as the Eleventh District Cost of Funds Index (“COFI”).[14] The use of COFI was becoming especially significant for pass-through transactions because many

---

[13] This question also arises m any transaction involving the pooling of fixed rate loans that pass through interest at different rates, or in any pass-through transaction involving the pooling of mortgage loans with differing “teaser” rates or teaser periods.

[14] The Eleventh Federal Home Loan Bank Board District Cost of Funds Index, also known as “COFI” or the “Eleventh District Rate”, represents the monthly weighted average cost of funds (generally the interest cost on deposits) of member savings and loan institutions in the Eleventh Federal Home Loan Bank Board District. Under Prop. Reg. §1.1275-5(b), an objective interest index is a rate that 1) is made known publicly and is offered currently to borrowers in private lending transactions, or 2) reflects an average of yields on a class of publicly traded debt instruments. The COFI should be considered an objective interest index because the Federal Home Loan Bank Board for the Eleventh District publishes the COFI publicly and banks and thrift institutions write mortgages at rates equal to COFI plus a spread. Further, LIBOR is one of the enumerated indices in the regulation and LIBOR itself is an average of various banks' costs of funds. Nonetheless, because COFI mortgages were based on the index plus a margin and the meaning of “private lending transactions” was not clear, some practitioners thought that COFI should, but nonetheless might not, be a qualifying index. See, e.g., Letter from Michael T. Lambert of McKenna, Conner & Cuneo (Sept. 1, 1987), reprinted in Tax Notes Today: Highlights Documents (Sept. 25, 1987) (discussing semantic arguments that COFI could be a good section 1275 rate).

of the proposed transactions involved the pooling of mortgage loans originated in California, where COFI was the most common index for ARMs.

In Notice 87-67, the Service announced its intention to issue regulations authorizing REMIC regular interests to pay interest at a variable rate “based on” a weighted average of the interest rates on the qualified mortgages held by the REMIC, provided that interest on such qualified mortgages is payable at a fixed rate (in one or more accrual periods) or a permissible variable rate (in other periods). This notice generally was intended to bless the weighted average formula. Moreover, the notice acknowledged that the interest rate on each underlying mortgage loan initially need not be based on an interest index but rather would be a fixed rate for one or more accrual periods. Further, Notice 87-67 approved COFI as an objective interest index despite the fact that it is not entirely certain whether COFI technically qualifies as an objective interest index within the meaning of Prop. Reg. §1.1275-5(b).

2. Discussion

(a) Discrepancy Between OID Regulations and REMIC Regulations

The first unresolved issued presented under the notices arises from the manner in which they reinterpret the definition in the Proposed Regulations of a rate “based on an objective interest index” for REMIC qualification purposes but not necessarily for purposes of any other rules relating to OID. Without further clarification, certain types of interest paid on a qualifying variable rate REMIC regular interest may not be interest that is based on current values of an objective interest index within the meaning of Prop. Reg. §1.1275-5(b). As a result, it is possible that a qualifying variable rate REMIC regular interest may otherwise fail to qualify as a VRDI and that all interest income with respect to the regular interest would be treated as contingent payments.[15] Notice 87-41 does not purport to change the definition of a VRDI for OID purposes. We think, however, that the same definition should apply under both the REMIC rules and the OID rules. The REMIC regulations, if issued before the Proposed Regulations are revised, therefore should clarify that any rate that is a qualified variable rate under Notice 87-41 is also a rate “based on current values of an objective interest index” for purposes of Prop. Reg. §1.1275-5.[16]

---

[15] Prop. Reg. §1.1275-5(a); Prop. Reg. §1.1275-4.

[16] Failure to treat as VRDIs regular interests that bear interest at rates that qualify under Notice 87-41 would cause such interest to be taxed under the contingent payment rules of Prop. Reg. §1.1275-4. Those rules have been severely criticized, see, e.g., New York State Bar Association Tax Section Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations, reprinted in 34 Tax Notes 363 (January 26, 1987) (“NYSBA OID Report”), and the Service has avoided applying them to debt instruments where the interest rate reflects changes in market rates of interest but does not fall within the literal language of the Proposed Regulations. See Notice 88-27, I.R.B. 1988-11, 22 (auction rate notes); Notice 88-90, I.R.B. 1988-34, 22 (reset notes).

(b) Caps and Floors

(i) Periodic Adjustment Caps and Floors

A common term of many ARMs is that on each interest adjustment date, the interest rate may increase or decrease by no more than a specified number of basis points. Such limits are commonly known as periodic adjustment “caps” or “floors”. Notice 87-41 expressly approved maximum and minimum rates. The notice, however, did not elaborate on the definition of a “maximum or minimum rate”.

It has been assumed in the mortgage securities industry that in a REMIC ARMs pass-through transaction, interest rate adjustments on the REMIC regular interests could also be subject to periodic caps or floors. Given the approval of either a fixed rate or a variable rate based on an objective index of current market rates, there should be no objection to a rate subject to periodic caps or floors because such a rate moves along a path that is somewhere between that of a fixed and that of a freely floating rate. Moreover, the existence of a periodic cap or floor would not prevent a debt instrument from qualifying as a VRDI under the Proposed Regulations.[17] Therefore, income and deductions on such a regular interest can be computed under the Proposed Regulations.

[17] See Prop. Reg. §1.1274-3(d)(1)(v), Example 2. See also NYSBA OID Report at 402.

(ii) Variable Caps and Floors

As noted in the previous section, Notice 87-41 states that a REMIC regular interest will not fail to qualify as such merely because the interest rate is subject to a maximum or a minimum rate. This language should be clarified in regulations to make it clear that certain variable caps and floors, in addition to periodic adjustment caps and floors, are permissible. Two variable cap/floor arrangements that should be allowed are discussed below.

In one structure, a REMIC will issue floating rate regular interests based on one index, say LIBOR. Its qualified mortgages, however, will have interest rates that are based upon another index, for example a bank's prime rate. Normally, a prime rate for a given period would always be greater than LIBOR for the same period and therefore the REMIC would have enough cash from interest on qualified mortgages to pay interest on its regular interests. If, however, the prime rate drops below LIBOR for a particular period the REMIC will have insufficient interest to pay interest on its regular interests. The solution is to provide that the regular interests have a cap of prime. That is, interest on the regular interests is payable at LIBOR but in each accrual period the interest rate cannot exceed prime for that period or the corresponding accrual period for the qualified mortgages.

In a second structure, the REMIC holds qualified mortgages whose interest rate is based on an index. The regular interests will bear interest at a Notice 87-41 rate based on the same index. The interest rate on the regular interest is subject to caps and floors which are based on the initial caps and floors on the qualified mortgages. Upon a resale of a mortgaged property and the assumption of a qualified mortgage, the initial caps and floors on the mortgage may be adjusted based upon interest rates prevailing at the time of the change. The cap and floor on the regular interest should therefore be adjusted to reflect the new caps and floors on the qualified mortgages.

The rate on this type of regular interest can be viewed as a combination of a qualified variable rate subject to limits based on the interest paid on the underlying qualified mortgages. Computation of income on a variable rate regular interest can be done under the Proposed Regulations even with the variable caps or floors so there should be no objection to these caps or floors from an administrative or tax accounting standpoint.

To accomplish this we suggest that regulations provide as follows:

> The interest rate on a REMIC regular interest can be subject to a maximum rate or a minimum rate. Such maximum rate or minimum rate may vary over the life of such interest. Such rate may be set according to a formula designed to ensure that, in each accrual,

payment, or distribution period[18], the interest rate on the regular interest does not exceed the interest rate that could be paid or distributed by the REMIC, taking account of the interest rates on the qualified mortgages held by the REMIC (or such portion that are allocable to such regular interest)[19] and amounts paid on the other regular interests in the REMIC which are based on either a fixed rate or a variable rate that is determined prior to the determination of such maximum rate or minimum rate.[20]

(c) Fixed Rate Followed by a Variable Rate; Variable Rate Followed by a Different Variable Rate

As noted above, section 860G(a)(1) requires that a REMIC regular interest pay interest at a "fixed rate (or. . . at a variable rate)." One reading of the conjunction "or" as used in this requirement is that the rate of interest payable

---

18 The phrase "accrual, payment or distribution period" is used instead of the term "accrual period" to reflect the fact that interest rates on regular interests may be reset on days that do not correspond to the first day of the "accrual period" (as defined in the Proposed Regulations).

19 Regarding the parenthetical language, see section (f) below.

20 Another way to express this result would be to permit a regular interest to carry interest that is based upon Notice 87-41 in some periods and Notice 87-67 in other periods. In the first example, for instance, the rate could be expressed as the lesser of prime or the weighted average rate on the qualified mortgages.

While there may be some variable caps designed to frontload the accrual of interest, we think that these can be adequately addressed by the reallocation of income concepts contained in Prop. Reg. §1.1275-4(d).

must be either one fixed rate from the startup day[21] until maturity of the interest or a variable rate payable from the startup day until maturity. An alternative reading is that in any accrual period a REMIC regular interest must pay interest at either a fixed or variable rate, but the requirement is applied separately with respect to each accrual period, thus allowing a REMIC regular interest to pay at several different interest rates over its life so long as the terms under which the rate is to be calculated are established on the startup day.[22]

Notice 87-41 allows REMIC regular interests to bear interest at variable rates under circumstances where the regular interest would be treated as a VRDI. The Proposed Regulations clearly contemplate that a VRDI can include a debt instrument that provides for fixed interest in some accrual periods and variable interest in other accrual periods.[23]

---

[21] As defined in section 860G(a)(9).

[22] Cf. Treas. Reg. 51.368-2(h):

> As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction “or” denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if “stock and securities” are received in exchange as well as if “stock or securities” are received.

[23] See Prop. Reg. §1.1275-5(6)(4) (providing for the treatment of OID on VRDI's that have a fixed rate of interest in some accrual periods and a variable rate in other periods). In addition, the Proposed Regulations provide that interest paid at a fixed rate followed by a variable rate would constitute qualified periodic interest:

> Fixed rate followed by a variable rate. Any one of a series of payments based on one fixed rate followed by a variable rate (or another fixed rate determined by reference to a single objective interest index) shall constitute a qualified periodic interest payment, provided that the variable rate (or other fixed rate) is the same as the initial fixed rate on the issue date .... Prop. Reg. §1.1273-1(b)(ii)(B).

Also, the Proposed Regulations clearly contemplate that a variable rate followed by a variable rate based on a different formula still produces a VRDI.[24] Notice 87-67 further supports this interpretation, as it explains that with respect to the mortgages held by a REMIC, “a fixed or variable rate” would include a rate that was initially fixed for one or more accrual periods and based on an objective interest index for other accrual periods. Tax practitioners, relying on this type of analysis, have permitted a REMIC regular interest that pays interest at a fixed rate for one or more accrual periods followed by a variable rate for other accrual periods or at one variable rate for some accrual periods and a different variable rate (or at a variable rate based on a different formula) for other accrual periods. We think this interpretation of the VRDI definition is proper and that the regulations should confirm that this result is intended.

---

[24] Prop. Reg. §1.1275-5(d)(4)(ii); Prop. Reg. §1.1275-5(d)(5), Example (5).

Additionally, the fact that some interest on a regular interest is not QPIP should not keep the regular interest from qualifying as a VRDI. Clarification of this point would be helpful.

(d) Stepped Interest Rates

The regulations should also clarify that "stepped rate" REMIC regular interests, that is, regular interests that pay interest at a fixed rate for one or more payment, distribution or accrual periods and at a different, higher, fixed rate for other periods are permitted.[25]

The yield of a debt instrument typically varies with its maturity. However, the actual average maturity (as opposed to its expected average maturity at the pricing speed) of a regular interest cannot be determined on the issue date. In a typical case, the average interest earned over the

---

[25] "IRS Asked to Permit Ascending Rate Feature in Rules for New Mortgage-Pool Securities Vehicle," Daily Tax Report (BNA) (March 2, 1987). Neither the Code nor the legislative history prohibit stepped rate regular interests. The concern has been solely that the phrase "based on a fixed rate" [emphasis added] in section 860G(a)(1)(B) precludes multiple fixed rates. Unless a strong policy reason exists for not permitting such interests, the word "a" in section 860G(a)(1)(B) should be read to include the plural as dictated by 1 U.S.C. §1 (see §7701(k)(1)(1)) and Treasury regulation §1.368-2(h) (see footnote 22, p. 18).

1 U.S.C. §1 provides "in determining the meaning of any Act of Congress, unless the context indicates otherwise — words importing the singular include and apply to several persons, parties or things;..."

This rule of construction should not be limited to tangible "things". See Barr v. United States, 324 U.S. 83, 91 (1945).

life of a stepped rate regular interest increases with its actual average maturity. Thus, stepped rate regular interests protect the holders from decreases in prepayment speeds (and protect the residual holders from increases in prepayment speeds). If the only objection to such a rate would be caused by back loading of interest, this problem is addressed in the Proposed Regulations.[26] Moreover, back loading of interest would only cause an increase in excess inclusion income. Hence, the Government's interests are adequately protected.

In order to implement the prohibition on regular interests with disproportionately high interest rates, the regulations might provide that a stepped rate would not be permitted if the initial overall yield on the regular interest produced by the stepped rate was disproportionate to the specified principal amount, i.e., that such yield is substantially in excess of prevailing market interest rates (adjusted for risk).[27]

---

[26] Prop. Reg. §1.1273-1(b)(i); (ii).

[27] Conf. Rep. p. 11-229. Assuming that stepped rate regular interests are permitted, and further assuming that the regulations prohibit regular interests, that do not bear an interest rate otherwise permitted by section 860G(a)(1)(B), as amended by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), from having "disproportionately high" interest rates, the regulations should clarify whether such a disproportionate interest rate is determined separately with respect to each period, or with the respect to the regular interest as a whole. We believe the best approach to determine whether a regular interest is issued with a disproportionately high interest rate is to determine whether the regular interest was issued with a significant premium, that is, whether the interest's issue price exceeds its principal amount by more than a specified percentage (in the range of 25-30 percent). If it does not, then the interest rate should not be considered to be disproportionately high.

(e) Effect of Retaining Interest for Servicing or Otherwise

Notice 87-67 states that the Service will issue regulations authorizing regular interests that pay interest at a rate “based on” a weighted average of the interest rates on the qualified mortgages held by the REMIC, so long as interest on such qualified mortgages is payable at a fixed rate (in one or more accrual periods) or a permissible variable rate (in other accrual periods).

As an initial matter, the regulations should confirm what should be an obvious point a weighted average can be a weighted average of “net” interest rates on the qualified mortgages. The net interest rate on a mortgage is typically the gross amount of interest less a servicing fee and, possibly, an amount of excess interest designed to bring the price for the qualified mortgage down to par.[28] The retention of one or both of these amounts is a feature in almost every mortgage pass-through transaction. The regulations should confirm that a weighted average based on such “net” interest rates does not disqualify the regular interest. It should not make any

[28] Such an interest would be treated as a stripped coupon under section 1286. The fact that section 1286 may treat the remaining stripped coupons that the REMIC owns as principal should not affect the application of Notice 87-67.

difference for this purpose whether the amount of servicing (or excess servicing) is the same or different for each qualified mortgage. In fact, servicing (and excess servicing) are typically structured in a manner that results in a uniform rate on the regular interest. Thus, in an ARMs pass-through transaction the seller-servicer may be willing to forgo a servicing fee on some loans to be able to include them m the pool.[29] As discussed below we believe that interest based on a weighted average should be treated as QPIP. Accordingly, the use of a weighted average rate based upon different net rates should not result in any distortion of income.

A second issue concerns the term “based on” in Notice 87-67. Because the term is not defined in the notice, it is not clear whether the term is synonymous with the Notice 87-41 interpretation that “based on” includes multiples of a rate plus or minus a fixed number of basis points subject to maximum or minimum rates. Practitioners have assumed that the term “based on” as used in Notice 87-67 has the same meaning as in Notice 87-41 and that, accordingly, a weighted average rate

---

29 For example, assume that one $100,000 ARM bears interest at index plus 25 basis points and a second $100,000 ARM bears interest at index plus 125 basis points and that a 50 basis point fee is reasonable. The sponsor will not retain any servicing on the first loan because to do so would eliminate any spread over the index on that loan. Instead, he will retain 100 basis points on the second loan as servicing. The rate on the regular interest would be the weighted average of the net rates on the two ARMs.

less a fixed number of basis points may be "based on" a weighted average in the same manner that a rate is "based on" an objective interest index under Notice 87-41. This should be confirmed in regulations.

The final "weighted average" definitional issue can be illustrated by the following example. Assume that an issuer owns ARMs. Each ARM has a rate equal to the index ("Index") plus a spread ("Spread"). Each loan is also subject to a cap. The Spread and the cap may differ from ARM to ARM. Additionally, the ARMs may exit their teaser phases at different times and may have different reset dates for computing the Index. The issuer wants to create a REMIC to sell these ARMs in a pass-through format. The regular interests in the REMIC generally would bear an interest rate equal to Index plus a fixed number of basis points (the "Net Spread") that for each ARM is smaller than the Spread. For example, assume the Net Spread is 150 basis points. However, during the period in which any of the ARMs are in their teaser period, the regular interest would bear interest at the weighted average of the teaser rates for loans in the teaser period and the Index plus the Net Spread for loans that have exited the teaser period.

If interest rates rise the sponsor wants to be able to pass through as much interest as possible to the regular interest holders in order to increase the marketability of the regular interests. This is not possible if he retains a fixed spread on each mortgage. For example, if the loan cap is 13 percent and the issuer has a 2 percent fixed retained spread then the regular interest will have a cap of 11 percent. The 11 percent cap hinders the marketing of the REMIC regular interests because the cap may be too low.

In order to provide a higher cap on the REMIC regular interests, the issuer in this example can agree to have its retained interest reduced (but not below zero) to the extent that the Index plus the Net Spread exceeds 11 percent. For example, if the Index is 10 percent, the interest rate on the regular interest would be 11.5 percent and the Issuer's retained spread would be 1.5 percent.

Among other things, the fact that a weighted average rate is passed through to regular interest holders while ARMs are in their teaser periods and the fact that the interest rates on the ARMs reset at different dates may prevent Notice 8741 from applying. The possibility that the rate passed through to regular interest holders may increase notwithstanding the rate on the related ARM remaining constant (because it has reached its cap) may cause the regular interest to fail to be considered to be based on the weighted average rate of the ARMs in the pool, as required by Notice 87-67. (A weighted average rate could qualify under Notice 87-67 if the retained interest is a servicing fee and it is reasonable compensation for the services rendered. If, instead, the retained interest does not constitute reasonable servicing but an ownership interest, the spread may not qualify as a coupon strip because it is variable. Therefore, it may be treated as a second class of residual.)

We believe this problem should be addressed by permitting a regular interest to have an interest rate that is based on a weighted average calculated by taking into account a portion of the interest on a qualified mortgage so long as the interest on the qualified mortgages is, during each accrual period, either a fixed rate or a variable rate based on current values of an objective index. The regulations should allow such a rate to be subject to caps and floors. They should also permit the interest not taken into account to be either excluded from the REMIC or paid to residual interest holders.

Such a regulation should not involve any loss of income. The regular interest holders will, in effect, report their portion of the interest on the qualified mortgages and the remaining interest will be allocated to the residual owner or, in the case of a servicing fee or coupon strip, included in income under the rules of section 61 or 1286, respectively.

(f) Weighted Average Rates Based Upon Only a Portion of the Mortgages Held by the REMIC

In certain circumstances, a REMIC may want to issue a regular interest whose interest rate is based upon the weighted average of the interest rates of only a portion of the qualified mortgages held by the REMIC. We think that the regulations should clarify that such a rate is permitted.

This formulation may be useful where a sponsor wants to pool mortgages whose interest rates are significantly different. For example, this occurs where the qualifying mortgages have floating interest rates based on the same index but where the interest rate reset dates are different. In a commercial loan transaction, for example, loans may reset monthly, quarterly or semi-annually. The sponsor may want to put all these mortgages in one pool in order to use a so-called cross support feature.[30] This technique can be particularly useful for smaller issuers that do not accumulate enough of any one type of loan to form a REMIC based on only one type of loan.

By putting loans with different terms in the same REMIC, the sponsor is able to offer investors regular interests that reset monthly, quarterly or semi-annually in

---

[30] In a cross support feature the mortgage loans are divided into mortgage loan groups; each mortgage loan group contains mortgages with similar terms. The mortgages in each mortgage loan group are then split into senior and subordinated classes. A class of senior regular interests is issued for each mortgage loan group and one class of subordinated regular interests is issued representing ownership of all of the subordinated interests. The subordinated interest from each mortgage loan group is available to pay the senior interest relating to each of the other mortgage loan groups. The groups are nevertheless separated from an interest rate and prepayment standpoint. This structure thus achieves linkage for credit support purposes but separation for interest rate and prepayment purposes.

accordance with the terms of the underlying loans. That is, for example, an investor can choose a rate that resets quarterly by purchasing the regular interest relating to the quarterly reset loans. At the same time, by using a cross-support feature, the investor gets the credit support of all the loans in the pool.

This structure may also be useful where the loans to be pooled have widely different spreads over the same index. The issuer could strip all the spreads to the lowest common denominator but this may involve retaining a substantial portion of the pool. For example, if mortgage loan group A has a spread of 500 basis points over the index and mortgage loan group B has a spread of 50 basis points over the same index, the issuer would have to strip 450 basis points to bring the loans down to the lowest common denominator. It would rather have the REMIC issue two classes of regular interests – one based on a weighted average of the interest rates on the group A loans and one based on a weighted average interest rate of the interest rates on the group B loans.

These structures should be permitted in the REMIC regulations since there is no abuse and no inherent difficulty in measuring holders' incomes involved in such a transaction. In fact, separating loans into mortgage loan groups as described above may make it easier to compute interest and original issue discount deductions on the regular interests. This is because each regular interest more closely resembles the traditional fixed or floating rate debt instrument while a regular interest based on all the qualifying mortgages would carry a weighted average interest rate based upon widely disparate interest rates.[31]

(g) Contingent Interest

Notice 87-41 expressly linked qualification as a REMIC regular interest with treatment as a VRDI under the Proposed Regulations. While there are good policy reasons for this in an interim notice, we see no reason why a REMIC regular interest should not also be permitted to have interest that is contingent within the meaning of the Proposed Regulations. The chief policy concern here should be whether there are adequate rules under the Code to allow the REMIC and the regular interest holders to compute income and that those rules do not create any distortions that would reduce the impact of the excess inclusion rules.

We have previously criticized the contingent payment rules contained in the Proposed Regulations.[32] We believe, however, that if these rules are revised to more rationally treat contingent interest, there is no reason to

---

31 The regulations should address to what extent the REMIC must adopt different prepayment assumptions for the different pools of mortgages. In circumstances where the different characteristics of the mortgages warrant different prepayment assumptions (e.g., pools of fixed rate mortgages with significantly different coupon rates), the REMIC may be required to adopt different prepayment assumptions.

32 NYSBA OID Report at 388.

prohibit contingent interest regular interests. Additionally, under the contingent payment rules in the Proposed Regulations, the timing of interest deductions for the REMIC would be either the same or somewhat deferred relative to the timing of deductions under the VRDI rules. Accordingly, even if the contingent payment rules in the Proposed Regulations were to apply, excess inclusion income for the holder of the residual interest is likely to be increased. Thus, the government's interests should be adequately protected and regular interests with contingent interest payments should be permitted.[33]

Within the category of contingent interest regular interests, at least two types of rates should be addressed in the REMIC regulations, as follows.

(i) Interest Rates Related to the Cost of Money

This class of interest rates would include interest rates that vary according to a consumer price index or the gross national product deflator as well as interest rates that vary based on the value of an index that measures the return on a specified index of debt instruments. Examples of the former include an interest rate equal to a fixed number of basis

[33] If notwithstanding our suggestion, it is decided not to allow regular interests that have true contingent interest, the regulations should permit regular interests to bear interest based on any index (or determined by any mechanism, see Notice 27 and Notice 88-90) that reflects market rates of interest, not just those that are objective interest indices within the meaning of the Proposed Regulations.

points plus the increase in the consumer price index for each accrual period. Examples of the latter include an interest rate based on the increase in the value of a portfolio of government or corporate bonds between two measuring dates.

In each case, the interest rate is related to the cost of money but is not a traditional floating interest rate. Such rates, in particular the CPI based rate, may qualify under the VRDI rules. If not, however, they would be treated as contingent interest subject to the rules of Prop. Reg. §1.1275-4 or a successor provision.

(ii) Interest Rates Based on the Price of Commodities

This type of rate would include an interest rate based upon the price of a commodity such as gold or oil. Such rates have been used for debt instruments from time to time and are also treated under the contingent payment rules. While we know of no mortgage-backed securities transactions where such rates are now desirable, the regulations should consider whether such rates are appropriate. Although we feel less strongly about this than some other points, we believe they should be. While not currently contemplated, it is possible that such instruments or variations thereof could be useful for issuers and holders — for example by providing hedging devices. As discussed above, assuming the contingent payment rules prescribe a reasonable method of taxing the issuer and the holder, there should not be any income lost in such a transaction. Therefore, consideration should be given to specifically approving such rates in the REMIC regulations.

3. Committee Recommendations

The Committee recommends that Treasury accomplish the following in the forthcoming REMIC regulations with respect to variable rate regular interests:

(a)Conform the definition of a VRDI in the Proposed Regulations so that the phrase “a rate based on an objective interest index” has the meaning given to it in Notice 87-41;

(b)Permit the issuance of regular interests with periodic or variable caps or floors;

(c)Confirm that the meaning of “fixed or variable rates” contemplates variable followed by fixed, fixed followed by variable, or fixed followed by a different fixed rate or variable followed by a different variable rate, provided that the terms under which the rate is to be calculated in future periods are established on the startup day;

(d)Permit regular interests to carry “stepped” interest rates;

(e)Confirm that a weighted average can be based on "net" interest rates on qualified mortgages, thereby permitting, among other things, a different strip to be removed from each mortgage loan or a strip to be removed from some mortgage loans and not from others;

(f)Clarify that a weighted average includes a rate based on a portion of the interest on qualified mortgages provided the interest that is taken into account is, during each accrual period, either a fixed rate or a variable rate based on current values of an objective interest index;

(g)Permit a weighted average interest rate to include a weighted average interest rate based upon the interest rates on a portion of the qualified mortgages held by the REMIC; and

(h)Permit REMIC regular interests to have contingent interest in the case of interest rates related to the cost of money and consider permitting contingent interest on REMIC regular interests in other cases.

B. Section 860D - Two-Tier REMICS

1. Background

Several REMIC transactions in the past year have used a "two-tier" REMIC structure in which two REMICs, each meeting the requirements for REMIC status, are formed from the same pool of mortgage loans. In the typical two-tier structure, the first, or "lower level" REMIC holds mortgage loans, makes a

REMIC election, issues regular interests and a residual interest, and “contributes” the regular interests to the second or “upper level” REMIC. The upper level REMIC then issues its own regular interests, collateralized by the regular interests in the lower level REMIC. Under section 860G(a)(3)(C), regular interests in a REMIC are considered to be “qualified mortgages” and are thus qualifying assets for the upper level REMIC.

The two-tier REMIC has primarily been used in mortgage pass-through transactions where it would not be clear whether the rate of interest on the regular interests in a single tier structure would be treated as qualifying under Notice 87-41 or Notice 87-67.[34] This type of pass-through transaction is described on pp. 24 to 26 and basically involves a sponsor that initially retains a large retained interest but is willing to reduce this interest if interest rates increase substantially.

The solution practitioners have adopted because of questions about the application of Notice 87-41 and Notice 87¬67 is to use a two-tier REMIC. The lower tier REMIC holds the ARMs. It issues regular interests with interest rates that qualify under Notice 87-41. The regular interests would represent the different groupings of loans in the pool. For

---

[34] The two-tier structure has also been used where several mortgage originators want to pool their loans and create publicly traded regular interests. Each originator creates an individual REMIC and contributes the regular interests in that individual REMIC to a “master” REMIC. The master REMIC sells its regular interests to the public.

example, the first regular interest would be based on all the loans that exit the teaser phase in January, the second on the loans that exit the teaser phase in February and so on. The residual in this REMIC is the right to receive the excess of the interest on each ARM over the amount paid on the regular interests.

The regular interests in the lower tier REMIC are “contributed” to the upper tier REMIC. The upper tier REMIC issues one class of regular interests to the public. The interest rate on these regular interests is a weighted average of the interest rates on the regular interests issued by the lower tier REMIC. Because the regular interests in the lower tier REMIC are “qualified mortgages” for the second REMIC, the interest rate on the latter's regular interests qualifies under Notice 87-67. The residual interest could be represented by some minor right to float income or a _de minimis_ interest that will be entitled to no distributions. Alternatively, it could be an interest strip off of the regular interests.

The two-tier structure accomplishes the issuer's goal of distributing to investors a certain amount of interest payments on the underlying ARMs while retaining a specified but possibly varying portion of such interest payments. Thus, in this case the two-tier REMIC allows an issuer to structure successfully a REMIC transaction that might not otherwise be accomplished as a conventional REMIC.[35] The question thus arises as to whether tax principles such as the step transaction doctrine or the form over substance doctrine should be applied to collapse" the two REMICs into one.

2. Discussion

(a) General

There are several reasons why we believe that two-tier REMICs are currently permitted under the Code and why the regulations should confirm that such REMICs are permitted. First, section 860G(a)(3)(C) specifically includes a REMIC regular interest as a "qualified mortgage," thus clearly allowing a REMIC regular interest to serve as collateral for another REMIC. In addition, TAMRA's legislative history, in discussing the status of REMIC regular and residual interests as real estate assets for the purpose of the REIT and thrift asset tests, provides that if such REMICs are part of a tiered structure, they are to be treated as one REMIC for purposes of these asset tests:

> Thus, for example, if a REIT owns an interest in a REMIC which owns an interest in a second REMIC, the 95- percent test is applied to the REIT's interest in the first REMIC but not with respect to the REIT's interest in the second REMIC. Two REMICs are part of a tiered structure if it was contemplated when both REMICs were formed that some or all of the regular interests of one REMIC would be held by the other.[36]

---

[35] In a majority of the cases where a two-tier REMIC has been used, a one-tier REMIC may be possible but counsel is not entirely sure a one-tier REMIC will meet the literal provisions of Notice 87-67. Accordingly, the two-tier REMIC is used to provide complete certainty that the transaction works.

[36] H. Rep. No. 100-795, 100th Cong. 2d Sess. 85 (1988).

This statement seems to explicitly bless the two tier REMIC structure. If two-tier REMICs were collapsed, the resulting REMIC would have two residual interests and would be disqualified as a REMIC. The above-quoted passage, on the other hand, clearly contemplates that the entities in such an arrangement will qualify as REMICs.

Also, we believe that integration of tiered REMICs is inconsistent with the legislative scheme of the REMIC statute where pass-through status is conferred on an entity so long as the mechanical rules in the REMIC statute are complied with regardless of local law form.[37] For example, the Blue Book makes it clear that a coupon strip from the REMIC's qualified mortgages, which may resemble a residual interest, is not integrated and treated as an interest in the REMIC.[38]

(b) The Single Document Issue

As described previously, the two tier REMIC structure is collateralized by one pool of mortgage loans. The question thus arises as to whether it is necessary to follow all formal aspects of a REMIC issuance, e.g., to actually (physically)issue regular certificates in the lower tier REMIC. An alternative approach would be to simply designate a specified portion of each of the mortgage loans as a regular interest and designate the excess cash flow as the residual in

---

[37] See J. Peaslee & D. Nirenberg, Federal Income Taxation of Mortgage-Backed Securities (Probus Publishing Company, 1988) p. 100-102 (hereafter cited as “Peaslee & Nirenberg”).

[38] Blue Book, p. 416.

the lower tier REMIC. The certificates sold to investors would be designated the regular interests in the upper tier REMIC, which would be treated as the holder of all the regular interests in the lower tier REMIC. A separate residual interest in the upper tier REMIC would also be designated. These designations would be made in the pooling and servicing agreement for the transaction. Regular and residual interests in the upper tier REMIC as well as residual interests in the lower tier REMIC would actually be issued. Based on this approach, only one pooling and servicing agreement would be used, rather than two separate agreements that would achieve the identical result.

The “one document” approach is used because it is easier from a drafting perspective to describe both REMICs in the same pooling and servicing agreement. It should not be objectionable because the appropriate REMIC requirements are met for both REMICs, including designation of the residual and regular interests. Moreover, the necessary tax accounting trail is present and unambiguous -- the interest holders and assets of each REMIC would be clearly identified and income to the REMIC's residual and regular interests can be properly reported. Finally, it is clear that the path set out by those accounting trails is one that presents no opportunity for tax avoidance. Therefore, we urge that the regulations clarify, probably by example, that multiple REMICs can be designated in one pooling and servicing agreement.[39]

(c) Relation to Permissible Variable Rates

The final result of a transaction that involves constructing two tiers of REMICs for a single pool of mortgages (as opposed to creating a single REMIC as a conduit for several smaller pools) is a form of “self help” to expand the type of permissible variable rates for REMIC regular interests. As discussed in Part A.2(e), above, there should be no objection to permitting directly the type of variable rate achieved in these two-tier REMIC transactions, thereby simplifying the documentation and accounting for these transactions and eliminating entirely the single document issue.[40]

[39] Further, the creation of separate entities may create regulatory problems. For example, although there is an exemption from the Investment Company Act of 1940 for entities that invest primarily in real property, including whole mortgage loans, interests in a second REMIC may not always qualify as real property interests for this purpose.

[40] A two-tier REMIC would still be useful where several participants pool their mortgage loans through a so-called “conduit” issuer. This type of transaction, however, typically would not raise the single document issue.

C. Section 860G(a)(7) - Reserve Funds

1. Background

One of the types of qualified REMIC assets is a "qualified reserve asset". Section 860G(a)(7)(A) defines a qualified reserve asset as "any intangible property which is held for investment and as part of a qualified reserve fund".

A qualified reserve fund is any reasonably required reserve to provide for (i) full payment of REMIC expenses, or (ii) amounts due on regular interests in the event of defaults on qualified mortgages.[41] The REMIC legislative history provides that a reserve can also exist to pay amounts due on regular interests m the event of late payments on qualified mortgages.[42]

Section 860G(a)(7) provides that a reserve must be "promptly and appropriately reduced" as payments of qualified mortgages are received.

A reserve is disqualified (for the current taxable year and all subsequent taxable years) if more than 30 percent of the gross income from assets in there serve is derived from the sale or other disposition of property held less than three months.[43] Gains from dispositions necessary to prevent defaults on regular interests are disregarded for this purpose if the

---

41 TAMRA expands the definition to include as a permitted purpose payments on regular interests due to lower than expected investment returns on cash flow investments.

42 Conf. Rep. p. 11-227.

43 Section 860G(a)(7)(C).

threatened default resulted from defaults on qualified mortgages.[44]

2. Discussion

(a) Credit Enhancement

Many of the issues relating to qualified reserve assets arise in the context of credit enhancement. Because of their importance, these issues are discussed below in a separate heading under section G.

(b) Temporary Reserve Funds

In some REMICs, the regular interests will have a first interest accrual period that is somewhat longer than the normal interest accrual period. For example, a REMIC regular interest may pay interest quarterly except for the first quarter where it will pay interest for one quarter plus several days.

Because only one quarter's interest on the qualifying mortgages is available the REMIC will be short of cash to pay interest on the regular interests. In order to pay the additional few days of interest, m some cases[45], issuers have contributed money to the REMIC in an amount sufficient to pay the extra interest on the regular interests. This amount

44 Id.

45 A similar problem arises where, because of the distribution dates on the REMIC's assets compared to the distribution dates on it's regular interests, the REMIC has collected only two month's worth of interest on its qualified mortgages but owes three month's worth on its regular interests. The sponsor will contribute one month's interest to make up the shortfall.

typically will be paid by the REMIC to regular interest holders on the first quarterly payment date. In the case of quarterly pay regular interests, that date may be slightly after the “grace period” permitted by section 860D(a)(4).

These reserve funds do not specifically exist to pay REMIC expenses (which normally is interpreted to mean payment of trustee's fees, servicer fees, administrative fees, etc.) or to pay amounts due on regular interests due to a default (or late payment) on a qualified mortgage. Therefore, the assets in such reserve funds may not be qualified reserve assets. Even so, because the assets are ordinarily paid out of the REMIC within the three calendar month grace period, this has typically not caused a qualification problem. There is a different problem in all transactions with temporary reserve funds, however, because prohibited transactions income under section 860F(a)(2)(B) includes income earned at any time on assets that are neither qualified mortgages nor permitted investments. As a result, any net income from the temporary reserve fund would be subject to a 100 percent prohibited transactions tax. As a practical matter, this will cause the REMIC to put the money in a non-interest bearing account, which then gives the “float” to the financial institution (usually the trustee) that holds the account. Other solutions, such as putting the money in a tax-exempt money market account, are usually too complicated for corporate law or business reasons.

Such a reserve fund appears unobjectionable as a policy matter so long as it is only created to provide enough interest to make interest payments on regular interests for the first interest accrual period. This is because the amount involved is relatively small and because of the passive nature of the reserve fund. Additionally, income from the temporary reserve fund will be fully taxed to the REMIC's regular and residual interest holders.

To solve the problem, we recommend that the regulations treat such a reserve fund as a cash flow investment, i.e., an amount received “under” qualified mortgages for a temporary period before distribution to holders of interests in the REMIC. Treatment as a cash flow investment is appropriate because the fund represents an amount the REMIC would have received, had it held the qualified mortgages for the entire accrual period on the regular interest. Alternatively, we would recommend a technical correction providing that amounts contributed by the REMIC's sponsor that are used to pay the difference between the amount that accrues on a regular interest for its first accrual or payment period and the amount of interest collected on qualified mortgages would be treated as a cash flow investment under section 860G(a)(6) or qualified reserve fund under section 860G(a)(7)(B).

(c) Reserve Funds Outside the REMIC

Some of the problems raised by having a reserve fund in a REMIC can be solved by setting up a reserve fund outside the REMIC. The following example illustrates the need for such a reserve fund.

A sponsor (“Sponsor”) contributes fixed rate mortgages to a REMIC. The REMIC issues two classes of interests. The A class represents the right to 90 percent of principal and interest on the mortgages. The B class represents the right to 10 percent of principal and interest on the mortgages. The B class is subordinated to collections on the A class. The A and B classes are the regular interests in the REMIC, and a separate de minimis residual class (which is entitled to receive any amounts collected in excess of principal and interest on the qualified mortgages) is created. The Sponsor also contributes an initial cash deposit to a reserve fund (“Reserve Fund”) upon the REMIC's formation. As the subordinated regular interest receives payments, these payments are deposited in the Reserve Fund and the Sponsor is entitled to withdraw a like amount from the Reserve Fund (up to the amount of his initial contribution). The Reserve Fund is used along with amounts otherwise distributed to the Class B certificates to pay shortfalls on the Class a certificates due to defaults or late payments on the mortgage loans. The Sponsor and the Class B certificate holder share earnings on the assets in the Reserve Fund (which typically is invested in secure short-term investments) according to their contributions to the Reserve Fund.[46] The REMIC documents specifically provide that the REMIC does not include the Reserve Fund. Once the Sponsor has been repaid its initial deposit, the Class B certificate holders are entitled to any amounts left in the Reserve Fund after the Class A certificate holders have been paid in full and the REMIC is terminated. The Class B certificate holders specifically agree to include their share of principal and interest on their regular interests when paid even though these amounts are deposited in the Reserve Fund.

The Reserve Fund is set up outside the REMIC for two reasons. First, because earnings on the Reserve Fund will depend on the yield on the temporary investments, the Class B certificates and the Sponsor's interest in the Reserve Fund may fail to be treated as regular interests because they will not earn interest at a fixed rate or qualifying variable rate. Second, unless the separate Class C de minimis residual were eliminated and the sponsor given all rights in the REMIC not represented by the Class A and B certificates, the Sponsor's interest in the Reserve Fund may be treated as a second class of residual. By placing the Reserve Fund outside of the REMIC, any

[46] Normally, the Sponsor holds the Class B interest. If the Class B interest is transferred to a third party the terms of the transfer will usually ensure that the Reserve Fund is not treated as an association taxable as a corporation under Treas. Reg. §301.7701-4(c)(2).

interests of the holders of the Class B certificates or the sponsor in the Reserve Fund would be prevented from being treated as an interest in the REMIC.[47]

The issue is whether the Reserve Fund's form, as a fund outside the REMIC, will be respected or whether it will be considered part of the REMIC.

One view of this type of Reserve Fund is that it is so closely tied to all other elements of the REMIC transaction that it cannot be regarded as separate from the REMIC.

The alternative view is that separate accounting for income generated by the Reserve Fund is sufficiently within the intention of the REMIC statute to be considered to be separate from the REMIC and, as a result, the form of the transaction placing the Reserve Fund outside the REMIC should be respected.

Several formal and substantive aspects of the transaction in which the Reserve Fund is placed outside of the REMIC are consistent with the latter analysis. For example, under the pooling and servicing agreement for such a REMIC, amounts that are distributed to the Reserve Fund for credit enhancement will be deemed to be a distribution of such to the holders of the Class B certificates. Further, the documents

---

[47] In addition, if the transaction were somewhat modified and a separate "senior residual" class of interests were created (<u>see</u> discussion of senior residuals, <u>infra</u>), the Reserve Fund may not be a qualified reserve fund if it is inside the REMIC because part of its purpose is to guarantee payments to the residual interest holders in event of default on mortgages.

may require for federal income tax reporting purposes that such amounts be treated as if actually distributed to the Class B certificate holders. In addition, the documents will ensure that the Class B certificate holders retain indicia of ownership of the amounts distributed to the Reserve Fund. For example, the Class B certificate holders will have the right to direct investments and receive amounts earned from the investment of assets in the Reserve Fund. Moreover, the documents ensure that the Sponsor retains indicia of ownership in the initial deposit by providing that income from the investment of the initial deposit is distributed to the Sponsor and that at the termination of the REMIC, the initial deposit is returned to the Sponsor.

We think the better view is that such a Reserve Fund can be treated as being outside of the REMIC. It is clear that a segregated asset pool (i.e., a pool of assets not constituting a separate trust or other entity) may elect REMIC status. In the example outlined above, the assets of the Trust Fund exclusive of the Reserve Fund would clearly qualify as a REMIC that is a segregated asset pool. Moreover, the separate accounting for the Reserve Fund will accomplish accurate and dependable accounting for all income from the mortgage pool. This aspect of the separate Reserve Fund treatment should be viewed as entirely consistent with the tax accounting concerns underlying the enactment of the REMIC provisions. Finally, the Reserve Fund is closely analogous to assets of a party that provides credit enhancement. Where, as is the case in the example above, income from the Reserve Fund will be accounted for by, and assets in the Reserve Fund will (if not used) revert to the party providing the credit enhancement, there is no significant substantive difference from a third party guarantee that would require denial of REMIC status.

An alternative way to solve this problem would be a regulation which provides that a variable rate of interest on a regular interest could include interest measured by all or a portion of the income earned by the REMIC on qualified reserve assets. Pursuant to such a regulation the REMIC could issue a regular interest to the Sponsor in exchange for the initial contribution to the Reserve Fund. Income on the Reserve Fund could be distributed to the Sponsor as interest on his regular interest. The return of amounts advanced by the Sponsor would be treated as a payment in retirement of his regular interest. The Class B interests, which would be entitled to interest on amounts deemed invested by the Class B holders in the Reserve Fund, would also qualify because interest on their regular interests would be determined in part by interest on a qualified reserve asset. Permitting such an interest rate on a regular interest would seem to be unobjectionable from a tax accounting standpoint — income from the reserve assets would be fully taxed to holders of regular interests. Moreover, this solution would avoid having to determine whether assets in the Reserve Fund are “inside” or “outside” the REMIC.

D. Section 860G(a)(1); (a)(2) - Subordinated Regular Interests and Senior Residuals

1. Background

(a) Explanation of the Issue

The issue has been raised whether a class of regular interests in a REMIC can be subordinated in right of payment to the class of residual interests. Consider the following examples, all of which represent actual transactions in the mortgage-backed securities industry:

> Example 1: REMIC 1 issues four classes of regular interests that pay interest currently and pay principal sequentially and one class of residual interests that receives excess cash flow on each distribution date. Arguably, the residual interest is senior to the regular interests insofar as it receives current cash flows from the REMIC prior to payment in full of the regular interests.

> Example 2: REMIC 2 issues one class of regular interests and one class of residual interests. Both classes receive stated interest and principal and are paripassu, with cash flows being allocated first to interest until paid in full and then to principal. The residual also receives any excess cash flows. The

residual interest is senior to the regular interest to the extent that it receives interest in full before the regular interest receives principal.

Example 3: REMIC 3 issues two classes of regular interests, A and B, representing specified percentages of the principal and interest on the qualified mortgages and one class of residual interests, Class C, representing the right to a specified percentage of interest only. In the event of credit losses on the underlying mortgages, Class B and Class C are both subordinate to Class A but are paripassu with each other. Thus, the Class B regular interest is not senior to the Class C residual.

Example 4: REMIC 4 issues classes similar to REMIC 3, except that Class C is not subordinate to Class A and is therefore senior to regular Class B.

(b) Statute and Legislative History

An interest in a REMIC is a “regular interest” in the REMIC if (1) the terms of the interest are fixed on the startup day; (2) the interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount); and (3) the interest provides that interest payments (or other similar amounts), if any, at or before maturity are payable based on a fixed rate (or to the extent provided in the regulations, at a variable rate).[48] Unconditional entitlement to a specified principal amount (or other similar amount) does not fail to exist merely because the timing (but not amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.[49] The Code defines a "residual interest" as an interest in a REMIC which is not a regular interest and is designated as a residual interest.[50] The Code further states that a REMIC must have one (and only one) class of residual interests, and all distributions, if any, with respect to such interests must be pro rata.[51]

For federal income tax purposes, a regular interest (if not otherwise a debt instrument) must be treated as a debt instrument.[52] Likewise, for purposes of determining the taxable income of a REMIC, regular interests in the REMIC (if not otherwise debt instruments) must be treated as indebtedness of the REMIC.[53] The Conference Report adds that regular interests are to be treated as if they were debt instruments for all other

---

[48] Section 860G(a)(1). TAMRA modifies section 860G(a)(1) in ways not material here.

[49] Section 860G(a)(1)(B).

[50] Section 860G(a)(2).

[51] Section 860D(a)(3).

[52] Section 860B(a).

[53] Section 860C(b)(1)(A).

purposes of the Code.[54] Residual interests are taxed based on the net income or loss of the REMIC[55], and a REMIC is treated as a partnership (and holders of residual interests are treated as partners) for procedural and administrative purposes.[56] However, section 860A(a) provides that a REMIC is not treated as a trust, partnership, or corporation for purposes of Chapter 1 of the Code, and the Conference Report adds that regular interests may be in the form of debt, stock, partnership interests, interests in a trust, or any other form permitted by state law.[57]

When discussing the nature of the investors' interests in a REMIC, the Conference Report states that

> an interest in a REMIC would not fail to be treated as a regular interest if the payments of principal (or similar) amounts with respect to such interest <u>are subordinated to payments on other regular interests in the REMIC, and are dependent upon the absence of defaults on qualified mortgages</u>. Thus, the conferees intend that regular interests in a REMIC may resemble the types of interests described in Treas. Reg. § 301.7701-4(c)(2) (Example 2).* [*The status of an interest as a regular interest in this case does not depend on whether the subordinated interest is sold or retained.][58]

---

[54] Conference Report at I-231.

[55] Section 860C(a).

[56] Section 860F(e).

[57] Conference Report at 11-228.

[58] Id. (emphasis added).

2. Discussion

As a technical matter, the statutory definition of a residual interest does not prevent it from being senior to a regular interest. Thus, each of the residuals described above meets the definition of a residual interest. Moreover, the regular interests also meets the statutory definition of regular interests. Furthermore, there is no requirement in the statute that a residual interest must be subordinated to a regular interest. Therefore, any such requirement would have to be adopted by regulation as a significant “gloss” on the statutory provisions. We do not think the arguments for doing so are convincing.

The argument has been made that if a class of regular interests is subordinated to the class of residual interests, the holders of the subordinated regular interests are not unconditionally entitled to receive specified principal amounts (or other similar amounts). The Conference Report language quoted above evidences a legislative intent that subordination of a class of regular interests to another class of regular interests is permissible. Further, it can be fairly inferred that a holder's right to a specified amount of principal (or similar amount) is unconditional even if the right is contingent on the absence of defaults on the qualified mortgages. Where a class of regular interests is subordinated to the class of residual interests, the rights of the holders of such subordinated regular interests to specified principal (or similar) amounts are contingent only on the absence of defaults on the underlying mortgages. In view of this language, the Conference Report in no way precludes subordination of a class of regular interests to the class of residual interests, and, in fact, describes the nature of a regular interest in such a way that this kind of subordination should not disqualify the subordinated interest as a regular interest. The absence of an express reference to residual interests in the Conference Report can be explained by the fact that at the time the language was written the mortgage-backed securities industry had not yet invented securities involving senior residuals (with the exception of Example 1 above, to the extent this is really “senior”).

It may be argued, however, that such a broad reading of the Conference Report's language is not appropriate. There appear to be at least two possible, stricter readings of the statute's requirement that holders of regular interests be unconditionally entitled to receive a specified principal (or other similar) amount. First, unconditional entitlement to a specified amount may mean that the class of residual interests must, in all events, be subordinated to the classes of regular interests. Under this view, if a REMIC experiences credit losses with respect to its qualified mortgages, the class of residual interests must absorb the credit loss before any class of regular interests is required to do so, and Examples 2, 3 and 4 above would fail to include qualifying regular interests. If strictly applied, this view would require that distributions allocable to the class of residual interests be withheld by the REMIC to protect against possible future credit losses on the qualified mortgages and, thereby, secure the classes of regular interests against possible future infringement on the rights of such classes to specified principal amounts (and interest based on a fixed rate). Under this strict view, Example 1 would fail as well.[59]

Under a second reading of the statute, unconditional entitlement to specified principal amounts would not mean that the class of regular interests is, in all events, subordinated to all classes of regular interests. The statute would permit a REMIC structure to allocate credit losses proportionately among the classes of REMIC interests (including the residual interests). However, such a formula could not allocate credit losses in such a way that a class of regular interests is subordinated to the class of residual interests. Under this interpretation, Example 3 would qualify (as would Example 1), but Examples 2 and 4 would be unauthorized by the statute.

It is difficult to find policy arguments in favor of either of the above readings. In support of the first reading, it could be argued that because the residual interest

---

[59] It is inconceivable that anything as strict as precluding Example 1 was intended, since this is essentially the basic structure for CMOs or "Sears" multi-class pass-throughs recognized at the time the REMIC statute was adopted. See Reg. §301.7701-4(c). In fact, a very large number of REMIC securities have been issued with terms similar to those of Example 1.

in any REMIC is akin to stock in a corporation and the regular interests are akin to debt, payments on the residual must be subordinated to the payments required to be made on the regular interests. The residual holder, as “owner” of the REMIC, should not be able to divert to itself any funds to which the regular holders were entitled. This argument proceeds from two sources. The first is the use of the word “residual” itself to connote the interest, suggesting something “left over” after the regular interests are paid. The second is based on the Senate's version of the Tax Reform Bill of 1986, which would have treated the residual interest “as equity.”[60] Further, the Senate Finance Committee Report stated that, “holders of residual interests generally are treated as holders of stock in a corporation.”[61] Nevertheless, this version of the REMIC statute was not enacted, and these arguments appear to provide a more stringent test than that envisioned by Congress. Although there are statements in the statute and Conference Report that a regular interest is generally to be treated like debt, there is no statement that the residual interest should be treated like equity. Moreover, section 860A(a) expressly provides that a REMIC is not treated as a trust, partnership, or corporation, which seems to clearly dispel the notion of a debt/equity analog for the REMIC

[60] Tax Reform Bill of 1986, Section 1441(a), as reported by the Senate Finance Committee, proposing section 860C(d)(1) of the Code.

[61] S. Rep. No. 99-313, 99th Cong., 2d Sess. 798 (1986).

structure. Furthermore, in certain respects all interests in a REMIC are treated as ownership interests in the underlying mortgages. For example, both regular and residual interests in a REMIC generally constitute “qualifying real property loans” in the hands of a mutual savings bank or a domestic building and loan association in the same proportion that the assets of the REMIC would be so treated.[62] Finally, analogizing the residual to stock in a corporation is inconsistent with the notion that a residual can have no economic value.[63]

Another, possibly more relevant, policy argument is that the statute does not specify a tax accounting method for a REMIC with a senior residual interest and that the amount of REMIC taxable income (and therefore tax liability on excess inclusion income) will be understated. We believe that this concern is unjustified when the effect of the credit losses is properly analyzed. It would appear to be true that to the extent the subordinated regular interest does not recover its adjusted basis, it would be entitled to a bad debt deduction equal to the unrecovered portion thereof under section 166. The REMIC itself will also take a bad debt deduction equal to the credit loss on the qualified mortgages as well as the usual deductions for

---

62 Section 593(d)(4).

63 That such a residual is permitted is implied by the statute (see section 860(E)(c), flush language, which permits the Secretary of the Treasury to adopt regulations concerning certain aspects of the excess inclusion rules for residuals that “do not have significant value”) and explicitly stated in the Blue Book (p. 416). See discussion at pp. 102 to 103.

interest and original issue discount accrued with respect to the classes of regular interests.[64] These deductions will flow through to the residual interest class. This apparent double counting of the loss will not occur, however, since the REMIC should also treat as cancellation of indebtedness income an amount equal to the bad debt deduction taken by the subordinated regular interest. The effect is that the tax loss will be taken by the party that bears the economic loss, and the bad debt deduction at the REMIC level will not flow through to the residual class to the extent such class does not bear the credit loss. Further, even a senior residual interest is expected to have a yield in excess of 120% of the applicable federal rate. Accordingly, the subordination arrangement will have no effect on capturing the excess of REMIC taxable income over 120 percent of the applicable Federal rate.[65]

3. Recommendation

We recommend that the regulations specifically provide that a regular interest can be subordinated to a residual interest. Thus, the regulations should clarify that a regular interest's payments are still unconditional even though

---

64 In theory, this loss and the regular interest holder's bad debt deduction should both occur at the same time, since the triggering event for both is a failure to recover the full unpaid principal balance of the mortgage loan upon foreclosure. If any uncertainty exists, this point could be clarified in regulations.

65 Section 860E(c)(1).

they are contingent on losses on mortgage loans and whether or not other regular or residual interests have credit priority. Put another way, the test of whether a regular interest is “unconditionally entitled” to a fixed amount would be made on the basis that all qualified mortgages would pay their full amounts of interest and principal.

E. Section 1272(a)(6) - Special OID Issues

1. Background

The regular interests issued in virtually all REMIC transactions have features whose treatment sensibly could be addressed in future clarification of the OID rules. Most of these issues have been identified and discussed in the NYSBA OID Report. Issues already discussed in the NYSBA OID Report are raised here to indicate the frequency and importance of their application to various REMIC transactions.

2. Discussion

(a) CMO Transactions

One issue that arises in a great number of REMIC CMO transactions is whether interest payments on a regular interest may be treated as qualified periodic interest payments where the interest payment for a short first accrual period is combined and paid with the interest payment for the first full accrual period. Another issue that arises frequently is whether the absence of any payment of interest for a short first accrual period will cause none of the interest payments on a regular interest to be treated as qualified periodic interest. Both of these issues were fully explored in the NYSBA OID Report (see pp. 370-371), and we wish to reiterate the conclusions drawn therein.

(b) Pass-Through Transactions

(i) Teaser Rates

REMIC pass-through transactions usually involve issuing regular interests that have characteristics similar to the characteristics of the underlying mortgage loans. One frequently encountered feature of a residential mortgage loan is the existence of a rate of interest that for an initial period (usually not exceeding six months or a year) that is less than the fixed or adjustable rate otherwise applicable (a “teaser rate”). Application (or non-application) of the OID rules to mortgage loans that have teaser rates affects the computation of the income with respect to the regular interests whose terms reflect the teaser rates.

The utility of expansion of the de minimis rule to accommodate most reasonable teaser rates was addressed at length in the NYSBA OID Report (see pp. 415-416). It bears repeating here that exclusion of most teaser rate mortgage loans from the OID rules will strike a true blow for simplicity, will conform the tax treatment of these mortgage loans to the expectations of most mortgagors, and will reduce significantly the hundreds if not thousands of computations that a REMIC issuer would be required to make, all without discernible loss of revenue.[66]

(ii) Weighted Average Rates

As contemplated by Notice 87-67, REMIC regular interests may bear interest that reflects the weighted average of interest rates on the REMIC's qualified mortgages. If the qualified mortgages are fixed rate mortgages with different interest rates, or are ARMs with different indices, different margins above the applicable interest index or different interest adjustment periods, it will not be the case that for any period during which the regular interest reflecting these rates is outstanding, the interest borne by that regular interest could be expressed either as a fixed rate or as a rate based on an objec¬tive interest index. In the case of ARMs, even if the index, margin and adjustment periods on the underlying mortgage loans are uniform after the initial teaser periods, the interest rate on the regular interest may vary for the period of time that the mortgage loans are in the teaser period if the mortgage loans do not all exit the teaser period at the same time.

---

[66] The backloading of income inherent in a teaser loan should be viewed as a de minimis amount under any reasonable standard and therefore exercise of the discretion given the Service to reallocate income under Prop. Reg. §1.1275-5(d)(4) is unnecessary.

It is unclear how the OID rules would be applied to the regular interests of this type. First it is unclear how much of the interest payable with respect to such regular interests would be treated as qualified periodic interest. Under the Proposed Regulations, the existence of initial teaser rates most likely will prevent the interest from being treated entirely as QPIP. Nevertheless, it appears likely that the lowest possible rate expressed as a fixed number of basis points above or below the applicable index could be treated as QPIP (because the rate of interest currently payable cannot ever be less than this amount). Even in the absence of initial teaser rates, variations in the weighted average rate of interest passed through to regular interest holders may prevent any interest from being treated as QPIP.[67]

---

[67] In order for interest to be treated as QPIP, that interest must, among other things, be “equal to the product of the outstanding principal balance of the [regular interest] and a single fixed rate of interest or a variable rate tied to a single objective index of market interest rates...” See Prop. Reg. §1.1273-1(b)(ii). In the case of regular interests with a variable rate based on the weighted average of interest rates on a pool of fixed rate mortgages, the rate passed through may not be considered to be either a single fixed rate of interest or a qualifying variable rate. In the case of regular interests with a variable rate based on the weighted average of interest rates on a pool of ARMs, the rate passed through may in some circumstances be considered to be based on a qualifying variable rate. Nevertheless, it may be difficult to reach this conclusion for a pool of ARMs that have different indices, different margins, or different adjustment dates. Ignoring the impact of teaser rates, it may be possible to assert that the interest payments on each “weighted average” regular interest represent payments on separate regular interest reflecting each mortgage loan in the pool, which interest payments all are properly treated as qualified periodic interest. This assertion may fail because of the documentation of the regular interest as a single instrument or because of the “aggregation rule” of Prop. Reg. §1.1275-2 (d).

In addition, it is unclear whether such regular interests would be treated as variable rate debt instruments or as debt instruments all of whose interest payments in excess of any qualified periodic interest are treated as contingent within the meaning of the Proposed Regulations. In the case of regular interests that pass through a weighted average of rates on adjustable rate mortgages, it may be possible to conclude that the regular interest itself bears interest at a rate based on current values of an objective interest index, even if the rate on all of the qualified mortgages is not uniform. Nevertheless, in the case of regular interests that pass through a weighted average of the rate on fixed rate loans, there seems to be little room under the existing definition in the Proposed Regulations to treat the regular interest as a VRDI.

We think interest stated as a weighted average should be treated as QPIP because such interest resembles interest based on an objective interest index. Thus, the interest fluctuates based on the level of fixed or variable interest rates on loans in the mortgage pool, i.e., this level of interest rates is the index. Accordingly, an interest rate that meets the Notice 87-67 requirements (including the suggested modifications in this report) should be treated as QPIP. Moreover, it should not matter whether the underlying mortgage loans are fixed or adjustable rate.

For purposes of computing OID on any such regular interests (if for example, an expanded de minimis rule is not adopted to accommodate teaser rates), treatment as a variable rate debt instrument would seem appropriate for any such regular interest meeting the requirements of Notice 87-67. In particular, it would be useful to clarify that OID on any such regular interest would be subject to the rules relating to variable rate debt instruments under Prop. Reg. §1.1275-5(d).

(iii) Negative Amortization

Another common feature of a residential mortgage loan that may be reflected in a REMIC regular interest is the possibility of "negative amortization." Accounting for income on a loan that has the possibility of negative amortization also has been addressed in the NYSBA OID Report (see p. 415). The approach suggested therein represents a sensible method of accounting for income both at the REMIC level and for the regular interest that also may have negative amortization.[68]

[68] Notice 87-67 discussed above, requires that interest on the underlying mortgage loans be "payable" in each accrual period at a fixed or qualifying variable rate. We believe that for this purpose interest on negative amortization loans will be considered "payable," so long as it accrues at an appropriate rate, even if it is not currently due.

(c) Legending

As discussed in the NYSBA OID Report (see pp. 385-388), we believe that the legending requirement generally is intended to alert holders of the fact that a debt instrument has OID and also to allow the holder to compute the amount of OID includible in income for any period. As the NYSBA OID Report discusses, the extent to which the first goal is accomplished is questionable, particularly in view of the increased usage of book-entry systems. Moreover, in the case of REMIC regular interests (or other debt instruments where OID is computed under section 1272(a)(6)), OID for any period can be computed only by reference to information concerning the amount of prepayments that have occurred during the period. Accordingly, no information supplied on the face of a debt instrument would be sufficient to allow the holder of the instrument to compute OID for any period. As a result, the legending requirement serves almost no purpose, and the need to rely on the publication and reporting of information is even more obvious for these instruments. Accordingly, the regulations should eliminate the requirement that regular interests (and other section 1272(a)(6) debt instruments) be legended.

(d) Negative Amounts of Original Issue Discount

If the actual rate of prepayments on the qualified mortgages held by a REMIC differs from the rate used in determining the original yield to maturity for a regular interest, then the amount of OID that is produced under the formula found in section 1272(a)(6) may be a negative number. This is particularly likely to occur in the case of a REMIC regular interest that entitles the holder to an amount of interest that is disproportionately great compared to the principal amount of the regular interest[69] if prepayments occur more rapidly than anticipated. The legislative history of the 1986 Act states that in the event that the formula found in section 1272(a)(6) produces a negative number for any accrual period, the amount of original issue discount allocable to that period would be treated as zero, and the computation of OID for the next accrual period (and presumably for each successive period until the formula produced a positive amount of OID) would be made by treating the first accrual period and the later ones as a single accrual period.[70]

In the case of a regular interest the principal (or similar) amount of which exceeds its issue price, the literal application of rule described in the Conference Report does not make sense. Under that rule, it might not be possible to determine the income of one taxable year until

---

[69] TAMRA added section 860G(a)(1)(B)(ii) to the Code, which permits an interest in a REMIC to qualify as a regular interest if the interest payments thereon "consist of a specified portion of the interest payments on qualified mortgages and such portion does not vary during the period such interest is outstanding." The legislative history indicates that a regular interest described in section 860G(a)(1)(B)(ii) may "qualify as a regular interests [sic] even if the amount of interest is disproportionate to the specified principal amount." H.R. Rep. No. 795, 100th Cong., 2d Sess., at 81. See also S. Rep. 445, 100th Cong., 2d Sess., at 102-103.

[70] Conference Report at 11-239; Blue Book at 426.

several years later -- an accrual period could span a number of years, and any positive amount of OID that eventually resulted under the formula would, under the normal rules for calculating daily portions of OID, be allocated ratably over the entire period. Nonetheless, the concept of limiting deductions for negative amounts of OID is not wholly without merit. In the typical case contemplated by the Conference Report, i.e., a regular interest issued at a discount from its principal amount, a negative amount of original discount would arise from prepayments being made at a rate slower than anticipated. It is not unreasonable to prohibit a regular interest holder from taking a deduction for such negative original issue discount because, absent default, the holder is certain to recover that discount when principal payments are finally made.[71]

The Conference Report, however, did not contemplate the issuance of regular interests that, in substance, represent solely (or at least primarily) the right to receive payments of interest. Thus, the Conference Report did not contemplate regular interests with issue prices significantly exceeding their principal (or similar) amounts.[72] In such a case,

71 Negative OID for the standard regular interest with an issue price that is less than its principal amount is unlikely to occur because the prepayment assumption used to calculate OID initially is not changed to reflect actual experience.

72 Prior to the enactment of TAMRA, a regular interest could not bear interest at a disproportionately high rate; thus, regular interests were rarely issued at prices that exceeded their principal amounts (and any such issue premium was never more than a small amount).

the application of the rule would result in severe distortions in the timing of income -- no deduction would be allowed for tax purposes, even though the negative accrual of original issue discount[73] would generally represent an actual economic loss.[74] We believe this loss should be allowed, at least to the extent it represents a loss of future payments of interest at above market rates and not a delay in receipt of principal payments. Accordingly, we recommend that the following rule be adopted:

> In the case of REMIC regular interests (and other debt instruments to which section 1272(a)(6) applies), if the original issue discount in any accrual period is determined (under section 1272(a)(6)) to be a negative number, a deduction will be allowed for such negative original issue discount (allocated ratably to all days in the accrual period) except to the extent that such deduction would reduce the holder's adjusted tax basis in the REMIC regular interest (or other debt instrument) below its revised principal balance, and the adjusted issue price at the beginning of the next accrual period will be increased by any amount of negative original issue discount for which no deduction was allowed.

---

73 A regular interest that has an issue price that exceeds its principal amount will have original issue discount if the interest (or similar) payments thereon are included in the stated redemption price at maturity. Interest payments on regular interests that qualify under new section 860G(a)(3)- (B)(ii) will, in many cases, be included in the instrument's stated redemption price at maturity because the interest payments will vary with the principal amount of the qualified mortgages and not necessarily with the principal amount of the regular interest.

74 While the rate of prepayments on the qualified mortgages merely affects the timing of the receipt of principal payments on a regular interest, because interest stops accruing on a mortgage when it is prepaid, the rate of prepayments affects the amounts of interest that will be paid.

F. Section 860D - What is an Interest in the REMIC?

1. Background

Section 860D(a)(2) requires that all of the "interests" in a REMIC must be either regular interests (section 860G(a)(1)) or residual interests (section 860G(a)(2)). Finding the appropriate definition for interests in a REMIC is critical to making the statute work. If the definition is too narrow, an entity inadvertently may fail to be a REMIC for failing to have a residual interest because a right intended to be a residual failed to qualify because it was not an interest.[75] If the definition is too broad, many rights that arise in the ordinary course of business for a REMIC (for example, the right in a servicer to be repaid for an advance), will be considered interests and the entity will fail to qualify as a REMIC because it has interests that are neither regular nor residual interests. One commentator has suggested an interest in a REMIC be defined "as either (1) any right to receive payments from the REMIC that are made in respect of an investment in the REMIC (including an interest in particular assets of the REMIC), or (2) any property interest or contract that is designated as a residual interest."[76] We believe that this definition has the appropriate

[75] As discussed below, there does not appear to be any requirement that a residual interest be entitled to any distribution or have any minimum value. Thus, the definition of an interest cannot exclude contractual rights that do not entitle the holder thereof to any distribution.

[76] Peaslee & Nirenberg, p. 63.

breadth to avoid causing common transactions to fail to qualify as REMIC, while still prohibiting the sort of abuses that the single residual rule of section 860D(a)(3) was directed against. Below, we describe two situations where the suggested definition reaches the proper result but must otherwise be dealt with in considering any alternative definition.

2. Discussion

(a) Cleanup Calls

One issue is whether the right to exercise a •'cleanup call" at par can be a prohibited class of interest in the REMIC. A "cleanup" call is one exercisable when the principal balance of the qualified mortgages in the REMIC falls below a small percentage (usually five or ten percent) of their original principal balance. It is designed to enable a sponsor to terminate the REMIC when administrative expenses (which do not always decrease in proportion to a decrease in the principal balance of the mortgages) become too great a burden. The cleanup call historically has been exercisable at par because the investor only requires that he get his original investment back. In a REMIC, however, a par cleanup call raises the question whether the holder of the call right has an "interest in the REMIC" because he has a right to receive any appreciation in the mortgages that exists when the call is exercised. If the suggested definition of interest in a REMIC were adopted the right to acquire a REMIC's assets as part of a cleanup call would not be considered an interest in the REMIC because the holder of that right would not acquire it for investment.

Because under current law the scope of the term interest is not clear, many current transactions attempt to solve this problem by providing that the price for a cleanup call is the greater of par or the fair market value of the mortgages. This is a change in the normal business deal from prior non-REMIC transactions that were done as grantor trusts. A greater of par or fair market value call makes it necessary to value the mortgages when the call is exercised. This is an inexact undertaking and raises the possibility that in an audit an agent of the Service would try to argue that the holder of the call (usually the sponsor) reserved an economic profit for himself by understating the fair market value of the mortgages. In fact, difficulty in valuation is one reason why sponsors prefer par calls.

We think that if the suggested definition of interest is not adopted then regulations should carve out cleanup calls at par from the section 860D(a)(2) rule. The reason is that such a call exists merely as a matter of administrative convenience. Thus, the right to profit from the call is incidental. Moreover, a par call does not raise problems about who will be taxed on income associated with the transaction. The REMIC will include the difference, if any, between its basis and the par call price in income and such amounts will be taxed to the residual owner. The sponsor will report income on the mortgages based on its par purchase price.

A cleanup call should be defined for this purpose as the right given to a third party (including a sponsor, an administrator, a residual interest holder or other person) upon formation of the REMIC that permits the third party to purchase the qualified mortgages at par from the REMIC at a time when the principal balance of the qualified mortgages is ten percent or less than their original principal balance.

(b) Interests Retained by the Sponsor

Another issue that arises is whether the sponsor's retained interests can ever be "interests" in the REMIC that violate the section 860D(a)(2) prohibition.[77]

The most important situation arises when the sponsor retains a coupon strip on the mortgages. The Blue Book states and the regulations should confirm that a coupon strip retained on the mortgages in the REMIC is not an "interest" in the REMIC for purposes of section 860D(a)(2).[78]

---

[77] If the retained interest is merely a right to receive reasonable compensation for servicing the mortgages then such an interest should not be considered an interest in the REMIC. Conference Report p. II-229.

[78] Blue Book p. 416.

G. Section 860D, G - Credit Enhancement

1. Background

A typical feature of conventional mortgage REMIC transactions is some form of credit enhancement. This may take the form of insurance, a guarantee by either the REMIC sponsor or a third party, or a letter of credit. Additionally, in almost all cases a servicer will have an obligation to make recoverable advances designed to “smooth out” cash flows on the underlying qualified mortgages or to pay interest for a full 30 days on mortgage loans that prepay in the middle of a month with interest only to the date of the prepayment (the differences being either limited to the servicer's aggregate servicing compensation that month or not so limited). The REMIC legislation is silent on these types of arrangements, leaving unclear whether or to what extent they could cause problems in the areas of qualified REMIC assets, interests in a REMIC, or contributions to a REMIC after the startup day. Because they are so commonplace, they need immediate attention in REMIC regulations.

As noted earlier, section 860G(a)(7) provides that a qualified reserve asset is any intangible property which is held for investment and as part of a qualified reserve fund. A qualified reserve fund is any reasonably required reserve to provide for full payment of the REMIC's expenses or amounts due on regular interests in the event of defaults on qualified mortgages. The Conference Report clarifies that the qualified reserve can be “additional security for the payments due on regular interests. . . that otherwise may be delayed or defaulted upon because of defaults (including late payments) on the qualified mortgages”.[79]

The Blue Book contains a cryptic statement that property “would not fail to be considered to be held for investment solely because the REMIC holds the property” to protect against defaults on regular interests stemming from defaults or late payments on the qualified mortgages.[80] This statement was apparently included because commentators had questioned whether an asset held to protect against defaults, such as an insurance contract, was “held for investment” as required under section 860G(a)(7).

To analyze the issues relating to credit enhancement, it will be helpful first to address the business reasons why credit enhancement is useful in the typical residential mortgage transaction. In a normal pool of first lien, conventional home mortgages the default rate will range up to five percent of the principal amount of such loans. In order to assure investors buying a security that they will not automatically lose a part of their investment, credit enhancement has been necessary since the first mortgage securitization transactions.

---

[79] Conference Report p. II-227.

[80] Blue Book p. 414.

For example, in Rev. Rul. 70-544 and 70-545,[81] the Government National Mortgage Association ("GNMA") guaranteed pools of mortgages that were treated as grantor trusts for federal income tax purposes. Rev. Rul. 77-349[82] dealt with a conventional mortgage pool where the credit enhancement was a letter of credit that covered five percent of the pool. In PLR 8051114[83] the Service sanctioned a senior-subordinated pass-through trust that in effect provided self-insurance for the senior class of pass-through certificates. This structure was later blessed in Reg. §301.7701-4(c)(2), Example 2, and in the legislative history of the REMIC provisions.[84]

Choice of a credit support mechanism is primarily a matter of cost. Given a particular pool of mortgages, a sponsor will be able to determine the cost of various forms of credit support and the benefit that can be derived from one type versus another. Additionally, these forms of credit support may be used in conjunction; for example, an insurance policy might insure the senior certificates in a senior-subordinated pass-through trust.

---

[81] Rev. Rul. 70-544, 1970-2 C.B. 6; Rev. Rul. 70-545, 1970-2 C.B. 7.

[82] Rev. Rul. 77-349, 1977-2 C.B. 20.

[83] (September 25, 1980). The GCM underlying this ruling was subsequently revoked. See GCM 39040 (September 30, 1983) revoking GCM 38311 (March 18, 1980).

[84] Conference Report p. II-228. See the discussion above of senior residuals, pp. 49 - 59.

With this background in mind, a specific review of each of the forms of credit support may also be helpful.

(1) Insurance. Many mortgage loans carry their own insurance. This insurance, which is known as primary mortgage insurance or PMI, is the type that a typical homeowner may be required to buy if his down payment is less than a specified percentage of his home's purchase price. The premium is usually paid at the house closing. The policy simply provides that upon a default of the homeowner the insurer will pay an amount equal to any defaulted payments up to the insurance amount.

A second type of insurance is so-called pool insurance. This is an insurance policy that covers defaults on a specified pool of mortgage loans up to a specified level. For example, a typical pool policy would cover defaults up to five to 10 percent of all principal payments due on the underlying mortgage loans. If more than the specified percentage of the mortgages in the pool go into default, the pool insurer is not obligated to pay those losses. If a loss is paid, the pool insurer succeeds to the pool owner's rights in the defaulted mortgage and attempts to collect the money due from the homeowner. The premium for the policy is paid in one lump sum or possibly as an annual fee equal to a fixed number of percentage points applied to the pool principal balance.

A third type of insurance insures the REMIC regular interest (and possibly the residual interest) directly. Thus, the policy provides that if a REMIC interest holder does not receive the amounts that he would be entitled to receive under an assumption that the loans pay off according to their stated due dates, then the insurer will make the necessary payment on the regular interests. This type of policy is different from pool insurance because it typically guarantees the entire REMIC regular interests (or at least the senior class of REMIC interests). The premiums on this type of policy are also paid in one lump sum or annually over the life of the REMIC. The cost for such a policy can be substantial, for example, it may equal between 5-10% of the initial offering price for the REMIC interests. The policy is typically held by the trustee as agent for the REMIC interest holders or possibly as the REMIC's agent.

(2) Letter of Credit. The letter of credit is issued by a third party bank in favor of the REMIC. It provides that in the event of a default or late payment on a qualified mortgage that is not covered by a recoverable advance, then the REMIC can draw upon the letter of credit to pay amounts due on regular interests. The letter of credit bank is entitled to recoup amounts paid out of future cash flow on the mortgage that is defaulted or late. Additionally, the letter of credit bank may be entitled to recoup the amount paid out of cash flows on other

qualified mortgages held by the REMIC. For this service the bank either receives a one-time fee or is paid an annual letter of credit fee.

Other more limited letters of credit may also be used. For example, a letter of credit may back up a servicer's obligations to make advances. This mechanism is typically used where the servicer's credit makes him an unacceptable risk to the public rating agencies that will rate the REMIC's interests.

(3) Guarantees. The best known type of guarantee is that provided by GNMA. Other government agencies including the Federal National Mortgage Association (“FNMA”) and the Federal Home Loan Mortgage Corporation (“FHLMC”) guarantee 1 mortgage loans. These guarantees differ in certain respects. For example the GNMA guarantee is a guarantee of timely payment of principal and interest while one form of the FHLMC guarantee is of timely payment of interest and payment of principal within one year.

(4) Advances. The typical mortgage transaction will include an obligation to advance. This is basically an obligation of the servicer of the loans designed to smooth out cash flows on the mortgages. Thus, in the typical residential mortgage transaction the servicer will have an obligation to advance principal and/or interest on a delinquent mortgage if payment is not made by the mortgagor on the due date. The servicer must typically advance only where he believes the advance to be

recoverable from that same mortgage loan. If the advance proves not to be recoverable, the servicer typically has the right to recover the advance from all of the cash flow on mortgages in the pool. Advances may or may not bear interest. In addition in certain transactions, particularly commercial loan transactions, advances may be voluntary rather than mandatory. Thus, the servicer is under no obligation to advance even where he believes the advance to be recoverable. In this case, however, as a practical matter the servicer may still advance where necessary to avoid a default on the REMIC's regular interests.

2. Discussion

Although the REMIC legislation is generally silent about insurance contracts, guarantees, letters of credit and other types of credit support, it seems likely that this is because it was assumed that credit support would automatically be permitted. For example, the typical arbitrage CMO that existed when Congress enacted the REMIC statute used government guaranteed mortgages to back an issue of multi-tranche CMOs. If the GNMA, FNMA or FHLMC certificates used to back such a CMO were (to the extent of the guarantee's value) not treated as qualifying mortgages for REMIC purposes, such transactions would be impossible to do. It also seems unlikely that the credit support mechanisms described in the statute and legislative history (i.e., senior- subordinated arrangements and reserve funds) were designed to be the exclusive credit support arrangements for REMICs. Finally, there does not seem to be any analytic or policy reason for distinguishing between government guaranteed collateral and conventional loans backed by insurance, letters of credit or other guarantees. The government guarantee programs have limits on the types of collateral that can be guaranteed (usually loans with first mortgages that do not exceed a specified amount), while the REMIC statute defines a qualified mortgage as any obligation secured by an interest in real property. A rule that sanctioned government guaranteed collateral but precluded many types of obligations not covered by government guarantee programs seems anomalous, particularly because the need for credit support for some loans (e.g., second mortgages and mobile home loans) not covered by government guarantee programs is acute. It appears then that Congress must have viewed credit support as incidental to the REMIC's qualified mortgages.

Pre-REMIC law indicates that guarantees relating to the REMIC's qualifying mortgages are incidents of the mortgage loans. Thus, for example in Rev. Rul. 70-544, supra note 81, the Service held that a pool of mortgages guaranteed by GNMA was an interest in mortgages on real property under sections 593(d), 856 and 7701. The ruling did not attempt to bifurcate the two components, i.e., the loan and the guarantee. This makes good sense because the mortgage will in virtually all cases represent the greatest part of the combined value and precise valuation of the two components would be impossible. Additionally, Rev. Rul.

70-545, <u>supra</u> note 81, reaches the same result in the case of "fully modified" pass-through certificates where GNMA agreed to advance principal and interest when due even if not paid by the underlying obligor. Thus, the fully modified pass-through certificates were also considered interests in mortgages on real property. As a result, no allocation of purchase price of a certificate to the right to receive advances was required in the ruling. This result is also consistent with the treatment of guarantees generally, <u>i.e.</u>, that payments from the guarantor take on the character of the guaranteed payment.

Based on the statute, legislative history and pre-REMIC law, we believe the regulations should provide that any of the types of credit enhancement mentioned above (<u>i.e.</u>, insurance, letter of credit, guarantees, or advances) should be treated as incidents of the REMIC's qualified mortgages. As incidents of the mortgage loans, the guarantees mentioned above would be treated as part of the qualified mortgages for purposes of determining whether substantially all of the REMIC's assets are qualified mortgages and permitted investments, as required under section 860D(a)(4).

The regulations should provide, in addition, that it is not necessary to treat such credit enhancement as a separate asset for purposes of the asset tests in sections 593(d), 856 and 7701. Instead, the regulations should promulgate a rule of administrative convenience that any type of credit

Enhancement held by the REMIC is disregarded in determining whether a REMIC regular interest or residual interest is a qualifying asset for those purposes. The theory of this exception is that the credit enhancement performs the same function as the guarantees in Rev. Rul. 70-544 and Rev. Rul. 70-545. Because it is difficult to value contracts that provide for credit enhancement at any given time and because their terms are integrally related to the qualified mortgages, any other result would be impossible to administer.

H. Section 860G(a)(1)-Problems with the Regular Interest Definition

1. Background

A regular interest is defined as an interest in a REMIC the terms of which are fixed on the startup day and which:

(a) unconditionally entitles the holder to receive a specified principal amount (or other similar amount) and

(b)provides that interest payments.(or other similar amounts) if any, at or before maturity are payable based on a fixed rate (or to the extent provided in regulations, at a variable rate).[85]

The statute also provides that:

[85] TAMRA adds a new clause that permits regular interests whose interest consists of a specified portion of the interest payments on qualified mortgages so long as such portion does not vary during the period the regular interest is outstanding.

> The interest shall not fail to meet the requirements of subparagraph (A) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.

Determining whether a holder is considered unconditionally entitled to receive a specified principal amount and determining whether interest payments are fixed has proven to be one of the major issues under the REMIC statute.

2. Discussion

(a) Prepayment Interest Shortfalls

When a mortgage is prepaid, interest ceases to accrue as of the prepayment date. When loans are pooled, such "prepayment interest shortfalls" are typically passed along to the holders of certificates that represent an interest in the pool.

In the REMIC context, such shortfalls should not affect qualification as a regular interest because interest on the regular interest is still "based on" a fixed rate of interest under section 860G(a)(1)(B). Nonetheless, the issue has troubled some practitioners.

This concern has caused some practitioners to provide that servicing compensation in any month is reduced in an amount necessary to pass through a constant interest rate to the regular interest holders. Absent extremely unlikely prepayment scenarios, it is expected that the servicing compensation would exceed the amount of any interest shortfalls. This solution, however, still does not protect against cases where there are extraordinary prepayments and the shortfall exceeds total servicing compensation during the month. It also raises questions about whether the servicer's obligation to make up shortfalls is an asset that is neither a qualified mortgage nor a permitted investment. Finally, the servicer may not be willing as a business matter to have its fee reduced.

In practice, interest shortfalls of this nature would be expected to represent a very small portion of the total interest remitted. Accordingly, no ability to manipulate the timing of income to REMIC interest holders would result if flexibility were granted in addressing this issue. Moreover, any actual timing differences for holders of interests would be extremely minor, if not trivial. Finally, requiring adjustments to servicing compensation may be disruptive to established procedures. Accordingly, we think the regulations should contain an example showing that interest on a regular interest will be considered to be “payable based on a fixed rate (or a [qualifying] variable rate)” if interest is stated at a fixed (or a qualifying variable rate) rate even though that rate may be reduced where prepayment interest shortfalls are passed through to regular interest holders. Such an example is consistent with section 860G(a)(1) because it allows the regular interest to more closely track the cash flow on the underlying qualified mortgages.

(b) Prepayment Penalties

Many commercial mortgages provide that the obligor must pay a prepayment penalty if the loan is paid before its stated maturity. Such prepayment penalty may be a fixed amount which declines over time or may be computed according to a formula designed to preserve the holder's return based on interest rates at the time of prepayment (i.e., a yield maintenance formula). Despite this common provision, the REMIC rules are silent on whether regular interests can have prepayment penalties. The issue here is whether the holder is "unconditionally entitled to receive a specified principal amount" under section 860G(a)(1) or, if such a penalty is considered interest,[86] whether interest on the regular interest is payable "based on a fixed rate." In the absence of regulations many practitioners have advised their clients that such prepayment penalties must be paid to residual interest holders.

There should not be any objection to passing prepayment penalties through to either regular or residual interest holders. For example, in a typical REMIC pass-through transaction the regular interests will commonly mirror the terms of the underlying loans. This should include the ability to mirror the prepayment premiums on such loans.

---

[86] It is unclear under current law whether such a prepayment penalty is treated as interest or a penalty to reacquire the debt instrument. Compare Rev. Rul. 72-587, 1972-2 C.B. 74 (prepayment premium is not interest), with Rev. Rul. 86-42, 1986-1 C.B. 82 (prepayment premium is interest).

In addition, we think that the regulations should provide that a regular interest can have a prepayment premium so long as such premium is reasonable in amount and is in the nature of a penalty for prepayment of the regular interest.

The regulations should also allow such a premium to be paid where the maturity of a regular interest has been shortened because of actual prepayments on other classes of regular interests.

(c) Interest on Late Payments

A typical bond may provide for interest at a higher, default rate on the bond's principal balance if the issuer has failed to pay scheduled principal. Many regular interests have been issued with this same feature. The business purpose for such a provision is to penalize the issuer for failing to pay interest when due. A regular interest should not be considered to fail to provide for payments based on a fixed rate where such default interest is provided for and the regulations should so state. Alternatively, a regular interest may provide that no interest accrues on a defaulted payment. This is typically done because the underlying collateral is expected to pay on a timely basis (for example, a government guaranteed mortgage backed pass-through certificate that provides for timely payment of principal and interest) and because there is no source of funds to pay the default interest if a default does occur. The REMIC regulations should also treat such regular interests as providing for payments based on a fixed rate on the theory that default is a contingency that does not make a debt instrument less fixed under general federal income tax principles.[87] Such treatment should extend to interest that is not paid because of default.

I. Section 860G - Qualified Mortgages

1. Background

Section 860G(a)(3) provides that a qualified mortgage includes (i) any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property which is (A) transferred to the REMIC on or before the startup day, or (B) purchased by the REMIC within the 3-month period beginning on the startup day, (ii) qualified replacement mortgages, and (iii) regular interests in another REMIC transferred to the REMIC on or before the startup day. We think the "qualified mortgage" definition should be clarified by defining two key terms, "real property" and "principally secured." Additionally, we believe that certain special types of loans should be specifically treated as qualified mortgages.

2. Discussion

(a) Definition of Real Property

The Code does not define the term "real property" under section 860G(a)(3). The key question is whether

[87] See Prop. Reg. §1.1275-4(b)(1): "a payment shall not be considered a contingent payment merely because the amount of or the liability for the payment may be impaired by insolvency or default".

local law definitions of “real property” should apply for purposes of the REMIC rules or whether a federal definition should be used. The answer to this question is fairly easy based on the treatment of this issue elsewhere in the Code, as well in Notice 87-41.

The regulations under section 856 define the term “real property” for purposes of the real estate investment trust rules. These regulations provide a federal definition of real property:

> The term “real property” means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term “real property” includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term “real property” as used in section 856 and the regulations there under. The term includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, invididual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc. even though such items may be termed fixtures under local law.

This approach makes good sense because it avoids the difficulties that would arise where the local law of a particular jurisdiction (probably the jurisdiction where the underlying property was located) determined whether a REMIC's assets were to be treated as qualified mortgages. As a matter of tax administration it would be extremely difficult for an agent who audits a REMIC's federal income tax return to determine for each type of property and each jurisdiction whether the security for the REMIC's loans is real or personal property under local law. One definition for federal purposes is needed, and the time-honored Reg. §1.856-3(d) definition appears appropriate.

It also appears that the Service has already acknowledged that a federal definition of real property is necessary. Thus, Notice 87-41 provides that loans secured by mobile homes will be qualified mortgages under section 860G(a)(3) if the mobile home meets the definition under section 25(e) "without regard to state law classifications." This notice was promulgated in response to concerns that some state laws defined mobile homes as personalty rather than real property.[88]

Accordingly, we believe the REMIC regulations should use a definition similar to that found in Reg. § 1.856-3(d) to define "real property" under section 860G(a)(3). This definition would not depend on local law concepts of real property but instead would be a federal definition designed to include most fixtures but to exclude from the definition of real property machinery and other assets accessory to the operation of a business.

---

88 See letter from Thomas A. Humphreys, Brown & Wood, dated April 16, 1987 in 35 Tax Notes 446. See also BNA Daily Tax Report, April 28, 1987, p. G-6.

(b) Application of the Principally Secured Concept

(i) Definition of Principally Secured

Congress did not intend to restrict qualified mortgages only to obligations that were secured 100 percent by real property. Thus, unlike the REIT statute, section 860G(a)(3) defines a qualified mortgage as an obligation “principally secured” by an interest in real property. The real question is what “principally secured” means.

Again, other Code sections provide a useful analogy. Section 856(d)(1)(C) provides that rental income that is at least 85 percent attributable to real property will be included in a REIT's gross income for purposes of the 95 percent and 75 percent tests under section 856(c). In Rev. Rul. 81-203, 1981-2 C.B. 137, the Service permitted mortgages in which at least 80 percent of the principal amount of the loan was not secured by a hypothecated savings account to be considered real property loans in their entirety under sections 593 and 7701. (The mortgages involved PAMs (i.e., pledged account mortgages) in which cash equal to not more than 20 percent of the principal amount of the loan is placed in a savings account as additional collateral.)[89]

[89] The ruling stated, however, that no more than 1 percent of the total principal amount of the mortgage loans in the pool was secured by the savings accounts.

Taken literally, “principally” should mean “of first importance or primarily.”[90] That is, so long as the real property that secures the mortgage is the most important security, the loan would be a qualified mortgage. Thus, so long as the value of the real property is more than 50 percent of the total value of all security, the loan would be a qualified mortgage. It does not appear, however, that this is what Congress intended.

In the most common mortgage securitization transactions that involve first liens on residential property, real property is the only security for the loan. In mortgage securitization transactions involving commercial loans, real property generally will provide the predominant security for most mortgages. In most transactions, a uniform federal definition of the term real property, such as the one we have suggested, would remove any uncertainty involving loans that are secured by both real and incidental personal property.

Having said this, it appears that issues will still arise under the qualified mortgage definition. Thus, some common loans may include personal property (other than fixtures that would be included in the proposed definition of real property we have suggested). For example, some loans secured by hospital facilities or nursing homes may also be secured by incidental personal property such as beds, desks and chairs.

---

[90] Malat vs. Riddell, 383 U.S. 569 (1966).

Also, some loans secured by farm property include as security farm equipment or farm structures that are movable and might not be considered real property within our proposed definition.

We believe that Congress intended that loans secured by commercial real property should be eligible to be securitized using REMICs even if the loans are secured by a incidental amount of personal property. To provide the necessary leeway, we would propose that if the value of real property securing a loan is greater than 80 percent of the face amount of the loan, the loan would be considered "principally" secured by an interest in real property. As noted, above there is some precedent for the 80 percent standard in Rev. Rul. 81-203 and it would permit PAMs, such as those in the ruling, to be included in a REMIC. It is also consistent with the notion that substantial means a more than 20 percent interest (i.e., that 20 percent or less is insubstantial).[91] Moreover, an 80 percent standard would give enough leeway so that incidental personal property as described above could secure a loan without disqualifying it as a qualified mortgage.

(ii) When and How Should Principally Secured be Determined

The time to apply the principally secured test is another aspect of the qualified mortgage definition that needs to be addressed in regulations. Theoretically, the test

---

[91] See GCM 36292 (May 29, 1975).

could be applied either at the time the loan is originally made or when the loan is transferred to the REMIC. At origination, it would be a relatively simple matter to determine what percentage of the obligation is secured by real property because all the necessary information would be available. If, however, a determination is made at the time the loan is placed in the REMIC, an appraisal would be required in order to determine the current make-up of the security of the loan. Compliance with such a requirement in a transaction involving more than a few loans (e.g., if government-backed loans are the REMIC collateral) would be impossible.

The second issue is how to apply the 80 percent test. This could be done in at least two possible ways. The first approach would calculate the ratio of the value of real property security to the value of all security on the loan. The second approach would compare the face amount of the loan to the value of the real property securing the loan and express the relationship as a percentage.

The REIT area deals with the choice between the two methods in contradictory fashion. Section 856(d)(1)(c) uses something akin to a ratio of values approach to calculate qualifying "rents from real property" (85 percent of total rents must be attributable to real property). However, Reg. §1.856-5(c) states that the ratio of face amount to value is an appropriate method for determining what portion of the interest on a mortgage secured by real and personal property is considered interest on a loan secured by real property.

A table comparing the two approaches appears below:

Mortgage Principal Amount	100	100	100
Real Property Value at Origination	75	90	100
Personal Property Value at Origination	25	25	0
Fair Market Value of Real Property Upon Contribution to REMIC	100	100	80
Ratio Approach	75%	78%	100%
Face Amount to Value Approach	75%	90%	100%

Assuming an 80 percent test as a safe harbor for the term “principally secured”, Mortgage One would not be considered a qualified mortgage under either the ratio approach or the face amount to value approach. The difference between the two approaches is illustrated by Mortgage Two. Here, the obligation is over-collateralized, but what effect should the excess collateral have? Under the ratio approach, no priority is given to either collateral type and the mortgage fails the 80 percent threshold. The face amount to value approach, however, considers the real property securing the loan first and disregards personal property beyond the amount of the mortgage as irrelevant.

Mortgage Three illustrates a valuation problem in which the mortgage could be considered not to be principally secured. This example also supports the idea that the principally secured determination must be made when the mortgage is originated and not at a later time. If the value of the real property falls (due to external market conditions - for example, farm land) the mortgage might not be considered principally secured if the principally secured determination is made after the loan is originated. However, since the mortgage is secured only by the real property, it should still be principally secured under a literal reading of the statute.

We think the face amount to value approach is the appropriate one because it focuses on whether there is sufficient value in the real property to secure the mortgage. It is also consistent with the REIT rules in the area most closely related to this issue. We would also recommend that the 80 percent test be measured at the time the loan is originated. It would be met if the REMIC has a reasonable basis to believe that the loan was principally secured at that time by real property based upon the 80 percent test.

(c) Others Loans that Should be Considered Qualified Mortgages

The category of qualified mortgages has already been expanded by Notice 87-41 (mobile home loans) and TAMRA (co-op loans). It has also been expanded, by private letter ruling, to include installment land contracts.[92]

In addition to the foregoing, the regulations should address the status of certain typical types of loans.

(i) Relocation Loans with Interest Subsidy Reserves

In this type of loan, an employer grants a mortgage interest subsidy to a relocating employee. The subsidy is compensation to the employee. It terminates upon termination of employment.

It seems relatively clear that this sort of loan is a qualified mortgage. Even though the REMIC receives a portion of each interest payment from the employer the payment is being made on behalf of the employee. The employee is taxed on the payment and receives the full interest deduction for the mortgage interest. Additionally, the full interest and principal on the loan is secured by the property. Therefore, if the employer cannot pay the subsidy, and the employee defaults,

---

[92] PLR 8832017 (May 13, 1988).

the REMIC can foreclose on the property. Even with the subsidy feature, therefore, the loan is principally secured by an interest in real property.

This type of relocation loan should be contrasted with a third party payment that alters the payment characteristics of the loan and that is not secured by the underlying real estate. Thus, for example, if a third party decided it could enhance the value of an ARM pool by converting it to a fixed rate pool it could contribute ARMs to a REMIC along with a contract entitling the REMIC to swap the floating rate payments for fixed rate payments. In this case, however, the payment created was never provided for in the original loan documents while it is in the relocation loan. Additionally, the third party agreement is not secured by the underlying real estate. Thus, a default on the swap does not trigger a default on the mortgage. Finally, the swap payment cannot be considered to be paid first to the mortgagor and then to the REMIC. This situation is clearly distinguishable, therefore, from the relocation loan case.[93]

(ii) Buydown Loans

In the typical buydown loan, a developer will offer financing for a home purchase with interest rates that are below market. The financing will be arranged through a bank.

---

[93] Of course, there may be other policy reasons to permit a REMIC to enter into an interest rate swap agreement. Cf. section 856 (c)(6)(G) (added by TAMRA) (certain interest rate swaps are treated as securities and payments to a REIT thereunder are qualifying income for the 95 percent income test).

The developer will provide a fund of money for the bank; payments from the fund when added to the interest rate on the mortgage produce a market rate of interest. When the loan is sold to a REMIC, the REMIC has a right to receive payments from the buydown fund to supplement interest on the loan. The loan documents provide that if payment is not made from the buydown fund, the obligor is still liable for the full note rate; this obligation is secured by the real property.

The issue here is whether the buydown loan is principally secured by an interest in real property. For example, the typical buydown fund would have a value that is less than 20 percent of the face amount of the mortgage loan. Further, the fair market value of the real property will in virtually every case exceed the amount of the loan. Thus, even though the fund is security for the loan, it is clearly not the principal security. Moreover, failure to pay the buydown percentage would result in a default on the loan -- in other words, the buydown fund serves as a secondary guaranty of payment of the full interest and principal on the loan. Accordingly, a buydown loan would seem to meet the “principally” requirement because the primary security for the loan is the real property, rather than the buydown fund.[94]

---

[94] See e.g., Rev. Rul. 81-203, supra, (a pledged account mortgage, a residential mortgage loan for which the obligor's savings account is pledged as additional collateral, constitutes a “loan secured by an interest in real property” under section 7701(a)(19)(C)(v) and, within certain limits, the full amount of such loans that underlie a FHLMC participation certificate will be treated as “qualifying real property loans” under section 593(d)); P.L.R.s 8452021 (September 20, 1984) and 8430112 (April 27, 1984) (similarly for loans backed by buy-down funds); Reg. §301.7701-13(k)(1).

J. Section 860D(a)(6); 860E(e) – Reasonable Arrangements Designed to Ensure that Residual Interests Are Not Held by Disqualified Organizations

1. Background

TAMRA amends the REMIC rules to provide that a REMIC must, in order to qualify as a REMIC, make reasonable arrangements designed to ensure that residual interests are not held by disqualified organizations.[95] A "disqualified organization" is defined as:

> [T]he United States, any State or political subdivision thereof, any foreign government, any inter-national organization or agency or instrumentality of the foregoing; any tax-exempt entity (other than a Section 521 cooperative) not subject to the tax on unrelated business income, and any rural electrical and telephone cooperative.

Failure to make "reasonable arrangements" results in the failure of the entity to qualify as a REMIC. In addition, a tax is imposed on anyone who transfers, or who acts as an agent in connection with the transfer of, a residual interest to such disqualified organization. The amount of the tax is the tax that would be paid at the highest corporate rate (currently 34%) on the present value of all anticipated excess inclusions on the residual interest after the transfer. The explanation of TAMRA's

[95] TAMRA thus adds new section 860D(a)(6).

predecessor by the Joint Committee on Taxation states that Treasury regulations would most likely provide that the anticipated excess inclusions be calculated on the basis of prior history of the REMIC and the prepayment assumption used to determine the accrual of OID under section 1272(a)(6).[96] TAMRA requires the REMIC to provide to all residual holders information sufficient to calculate the amount of the transferor tax. The transferor or agent will not be liable for the tax if it receives an affidavit of the transferee stating that the transferee is not a disqualified organization, and if the transferor does not have actual knowledge at the time of the transfer that the affidavit is false.

2. Discussion

Given the severity of the consequences to a REMIC that fails to make "reasonable arrangements" to prevent a residual interest from being sold to a disqualified organization, it is important that there be a bright-line test for whether "reasonable arrangements" have been made. The Joint Committee on Taxation explanation cited above states that such arrangements would include placing in the REMIC documents a restriction prohibiting disqualified organizations from owning a residual interest in the REMIC, and a notice to residual interest holders of the nature of the restriction. "Reasonable arrangements" would

---

[96] Staff of the Joint Committee on Taxation, 100th Cong., 2d Sess., Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238), at 83-84, 86-87 (Joint Comm. Print 1988).

not be deemed to have been made if it is contemplated at the time the REMIC is formed that disqualified organizations would own residual interests in it.[97]

In order to prevent the transfer of a residual interest to a disqualified organization, a REMIC may, in addition to the foregoing measures, require that all transferors of residual interests certify to the REMIC that they have no knowledge that the proposed transferee is a disqualified organization, or that all transferees provide the REMIC with a transfer affidavit to the effect that the transferee is not a disqualified organization. However, it is burdensome for a REMIC to keep track of every transfer of residual interests that takes place. Furthermore, the seriousness of the consequences to a REMIC of a sale of its residual interests to a disqualified organization requires that there be no room for difference of opinion as to what constitutes “reasonable arrangements.”

We recommend that Treasury regulations provide a bright-line test for what constitutes “reasonable arrangements.” A REMIC should be considered to have made “reasonable arrangements” to prevent the transfer of residual

---

[97] It should be clear, however, that where the residual ownership is merely transitory, ownership by a disqualified organization should be ignored. The TAMRA legislative history provides that a transfer within 7 days of the startup day pursuant to a binding contract will be ignored. H. Rep. No. 100-795, 100th Cong., 2d Sess. 80 (1988). Otherwise, no disqualified organizations (e.g., the U.S. government) could sell mortgages using a REMIC.

interests to a disqualified organization if (1) the REMIC documentation provides that no residual interest may be held by a disqualified organization; and (2) such documentation provides for notice to residual interest holders (for example by requiring a legend on the residual certificates) that they may not transfer the residual interest to a disqualified organization. This test for “reasonable arrangements” places on the potential transferor the burden of avoiding sales of residual interests to a disqualified organization. However, we believe that the threat of imposition of the transferor tax on the transferor will be sufficient incentive to ensure that the holder of residual interests will take steps to prevent the transfer of his interests to a disqualified organization.

K. Section 860G(a)(2) - Residual Interests

Section 860D(a) provides that a REMIC must have one, and only one, class of residual interests. All distributions, if any, with respect to residual interest must be pro rata. A residual interest is defined as any interest that is not a regular interest and is designated as a residual interest.

Although the Code does not state that a residual interest need have any minimum value in order to qualify as a residual interest, the Blue Book does state that Congress intended that an interest in a REMIC could qualify as a residual interest regardless of its value.[98] Thus, even an interest that receives no distributions at all would still qualify as a residual interest. This would be true even if the net present value of the taxes expected to be due on income from the residual interest exceeded the amount of cash expected to be distributed.

Furthermore, the flush language of section 860E(c)(1) implicitly permits residual interests with little or no value. That section provides an alternative method of computation of excess inclusions if “residual interests in a REMIC do not have significant value.” Therefore, it would appear that there is no de minimis requirement for an interest to qualify as a residual interest.

We believe this to be the correct view, although the Service has not explicitly stated that a residual interest does not need to have a minimum value. Regulations should confirm this view, particularly because one of the goals of the REMIC legislation was to avoid the need for disputes about how much residual equity was required in a CMO-type transaction. So long as a residual exists, it performs the function of making sure that the REMIC's net income is taxable to REMIC interest holders. Therefore, there should be no objection from a tax accounting or loss of income standpoint to a residual interest with little or no value.

---

[98] Blue Book, p. 416.

L. Section 860F(a) - Convertible Adjustable Rate Mortgages

1. Background

A recent innovation in home mortgages is the convertible adjustable rate mortgage (“Convertible ARM”). A Convertible ARM is the same as a typical ARM except that the mortgagor has the option of converting the interest rate on the mortgage from an adjustable rate into a fixed rate upon the payment of a conversion fee. Generally, the fixed rate will be set at the market rate at the time of conversion for similar fixed rate instruments. Although mortgagors usually must pay a conversion fee that includes a premium for exercising the option, in addition to reimbursing the mortgagee for the administrative expenses of converting the loan, they save loan origination fees and mortgage recording costs. Thus, Convertible ARMs allow mortgagors to exchange their adjustable rate mortgages for fixed rate mortgages with lower transaction costs and without the attendant difficulties of refinancing.

Investors in mortgage securities prefer to buy either fixed rate securities or securities that vary according to an objective index rather than securities that pay a weighted average of the interest rates underlying mortgages which carry both fixed and variable rates. Therefore, as a business matter, the most effective way to securitize Convertible ARMs is to use the Convertible ARMs to back adjustable rate pass-through certificates and to dispose of any ARM that converts to a fixed rate. Rather than attempting to sell individual mortgages on an ad hoc basis, the entity that “securitizes” the Convertible ARMs usually contracts either with the original seller of the mortgages or a third party for the purchase of any converted mortgage at a price equal to its principal balance plus accrued interest at the time of conversion (the “Liquidity Contract”). Since the fixed rate on the converted mortgage is a market rate set at the time of conversion, the fair market value of the loan should be roughly equal to its principal balance plus accrued interest.

2. Discussion

The chief problem is that the disposition of the Convertible ARM, pursuant to the Liquidity Contract, appears to be a prohibited transaction. Therefore, any gain realized on the sale is subject to a 100 percent tax under section 860F(a)(1). Since the mortgage is sold for its principal amount plus accrued interest, which should equal its fair market value, the REMIC would not have any gain on the sale unless (i) the mortgage was acquired by the REMIC at a discount and (ii) the discount had not been fully included in the REMIC's income prior to the sale.

We recommend that the regulations provide that the sale of a Convertible ARM in connection with its conversion into a fixed rate mortgage be treated as a prepayment of the mortgage. If a mortgagor refinanced his property, using the proceeds to prepay a regular ARM, it would be treated as a prepayment.[99] This is basically what happens when the Convertible ARM is converted and sold. Both transactions are triggered solely by the mortgagor's decision to exchange his adjustable rate for a fixed rate and both transactions result in the REMIC receiving cash equal to the mortgage's outstanding principal balance plus accrued interest. The only real difference between these transactions is that the mortgagor has lower transaction costs. Therefore, since this entire transaction is substantively the same as a prepayment of a regular ARM through refinancing it should be treated the same for tax purposes. Such treatment should apply whether or not the REMIC is required to sell the loan pursuant to the arrangement with the sponsor or other third party. To permit the sale of a converted ARM by a REMIC and attendant distribution of the sale proceeds is in no way to permit the REMIC to engage in “business” activities inconsistent with its passive nature and pass-through status.[100] Finally, there is no abuse potential in this treatment. Whatever amounts the REMIC receives in excess of the loan's adjusted basis will be treated as ordinary income.

---

[99] For an example of how this rule could be formulated see the draft REMIC notice prepared by James M. Peaslee, Tax Notes Vol. 41, No. 7, November 7, 1988, p. 608.

[100] Grantor trusts are permitted to sell trust property and distribute the sale proceeds, so long as there is no reinvestment. Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1945); Rev. Rul. 77-349, 1977-2 C.B. 20.

The regulations should also make it clear that mere conversion of the loan is not treated as a replacement of the old loan with a new loan which would not be a qualified mortgage to the extent the conversion occurs outside the three-month replacement period in section 860G(a)(4)(B). This is important in a situation where the REMIC may, but is not required to, sell the mortgage back to the sponsor.

M. Retroactivity of REMIC Regulations

1. Background

Section 7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling or regulation relating to the internal revenue laws, shall be applied without retroactive effect.

2. Discussion

As noted at the beginning of this report, it has been two years since the REMIC legislation was enacted. In that time, over $95 billion of mortgage securities have been packaged as REMICs. Not all of these transactions have followed the typical transaction Congress had before it when the REMIC statute was enacted. Instead, mortgage investment bankers have been continuously proposing and adopting new structures to meet the demands of the marketplace. Some of these structures are described in this report.

In the absence of regulations or other guidance, tax practitioners have relied upon the statute and legislative history in approving or disapproving these structures. In many cases, the Code and Conference Report are remarkable for what they omit, the obvious inference being that timely regulations were to fill in the gap. Since those regulations have not been forthcoming we do not believe clients should be disadvantaged because their tax lawyers' good faith attempt to predict the content of the regulations was unsuccessful. Thus, we would urge that REMIC regulations that affect qualification issues be issued with prospective effect only.

One way to accomplish this would be to issue proposed regulations with a proposed effective date 30 days after the proposed regulations are published in the Federal Register. This would avoid a disruption of the market like that caused by the disqualified organization rules in the technical corrections legislation in October, 1987. We do not believe there is any substantial risk of transactions trying to “beat the clock” if this approach is used, primarily because the proposed regulations would be taken by the tax bar as indicative of the Service's view of the law since 1986, even if not literally applicable.