REPORT #715

TAX SECTION

New York State Bar Association

Report on the Proposed Real Estate Mortgage

Investment Conduit Regulations

March 19, 1992

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TAX SECTION

New York State Bar Association

March 26, 1992

The Honorable Shirley Peterson
Internal Revenue Service
Office of the Commissioner
Room 3000-C
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Real Estate Mortgage Investment Conduit Regulations

Dear Commissioner Peterson:

I enclose our report prepared by the Committee on Pass-Through Entities on the proposed regulations issued by the Internal Revenue Service under the real estate mortgage investment conduit ("REMIC") provisions of the Internal Revenue Code of 1986. The principal authors of the report were Thomas A. Humphreys and Bruce Kayle.[1]

The report comments on those proposed regulations and addresses certain issues that were not covered in those proposed regulations, including the taxable mortgage pool rules.

Although the regulations deal comprehensively and fairly with the highly specialized area of REMICs, we believe that there are a number of generally minor defects in the proposed regulations. The report, among other recommendations, urges the following changes to the proposed regulations:

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[1] Other authors were Charles M. Adelman, Micah Bloomfield, Loretta J. Finger, Nicholas L. Gunther, Douglas Jacobs, Lisa Levy, Terence B. Meyers and David Z. Nirenberg.

(1) final regulations should clarify certain aspects of the “reasonable arrangements test”;

(2) in applying the “significant value requirement,” the test based on the anticipated life of the REMIC should be modified to one base - the weighted average life of the REMIC;

(3) safe harbors should be provided whereby the transferor of a residual interest would not be treated as having the impeding of the assessment or collection of tax as any significant purpose of its transfer;

(4) the procedures for payment of any tax imposed on the transfer of a residual interest to a disqualified organization should be clarified;

(5) the treatment of unrecognized gain or loss upon the exchange of mortgages for residual interests should be modified more closely to reflect economic reality;

(6) the types of permissible “interest only regular interests” should be expanded;

(7) additional safe harbors should be provided for types of loan modifications that would not result in disqualification of a REMIC; and

(8) final regulations should address two issues of great practical importance not otherwise addressed in the proposed regulations -- the treatment of a payment made to a transferee of a residual interest and the numerous questions arising from the taxable mortgage pool rules.

(9) negative accruals of OID should be allowed in appropriate cases and the determination of the accrual of market discount and certain other computational issues should be clarified;

The Tax Section of the New York State Bar Association hopes that this report will be useful to you in preparing final regulations concerning the REMIC provisions.

Very truly yours,

John A. Corry

Enclosure

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Tax Report #715

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON PASS-THROUGH ENTITIES

Report on the Proposed Real Estate Mortgage Investment Conduit Regulations

March 19, 1992

I. INTRODUCTION

On September 27, 1991, the Internal Revenue Service ("Service") issued proposed regulations ("Proposed Regulations") under the real estate mortgage investment conduit ("REMIC") provisions of the Internal Revenue Code of 1986 ("Code"). This report comments on the Proposed Regulations.[1] The report also addresses certain issues that were not covered in the Proposed Regulations, including the taxable mortgage pool rules in section 7701(i).[2] As noted below, prompt guidance on these latter rules is of particular importance because they became effective on January 1, 1992.

In general, we believe the Proposed Regulations do an excellent job of providing guidance under the REMIC rules. They serve as an excellent example of regulations that deal clearly, fairly, and comprehensively with an important, though specialized, area. In most cases, the Proposed Regulations respect market practice. Particularly helpful in this regard is the prospective application of the Proposed Regulations. As we said in our earlier report on the REMIC rules[3] the tax bar has

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[1] This report was drafted by members of the Committee on Pass-Through Entities. The principal authors of the report were Thomas A. Humphreys and Bruce Kayle. Other authors were Charles M. Adelman, Micah Bloomfield, Loretta J. Finger, Nicholas L. Gunther, Douglas Jacobs, Lisa Levy, Terence B. Meyers and David Z. Nirenberg. Helpful comments were received from Peter C. Canellos, Dale S. Collinson, John A. Corry, Kenneth Gerstenfeld, Andrew S. Mason, James M. Peaslee, Thomas R. Popplewell and Michael L. Schler.

[2] All section references are to the Code or the Treasury regulations thereunder.

[3] Report on the Federal Income Tax Treatment of Real Estate Mortgage Investment Conduits by the Committee on Financial Instruments, December 30, 1988 (the "1988 REMIC Report").

spent the years since 1986 making a good faith attempt to apply the REMIC statute and sparse legislative history to increasingly complex mortgage-backed securities transactions. The prospective application of the Proposed Regulations acknowledges that some of the conclusions they contain were not known or knowable and should be applied on a prospective basis only.

Although there are some defects in the Proposed Regulations, we believe they generally are minor. As suggested below, these defects can be cured without major revisions. Among our suggestions for changes to the Proposed Regulations are the following:

(i) certain aspects of the "reasonable arrangements test" should be clarified;

(ii) in applying the "significant value requirement", the test based on the anticipated life of the REMIC should be modified and based on - the weighted average life of the REMIC;

(iii) safe harbors should be provided whereby the transferor of a residual interest would not be treated as having the impeding of the assessment or collection of tax as any significant purpose of its transfer;

(iv) the procedures for payment of any tax imposed on the transfer of a residual interest to a disqualified organization should be clarified;

(v) the treatment of unrecognized gain or loss upon the exchange of mortgages for residual interests should be modified more closely to reflect economic reality;

(vi) the types of permissible "interest only regular interests" should be expanded;

(vii) additional safe harbors should be provided for types of loan modifications that would not result in disqualification of a REMIC;

(viii) final regulations should address two areas of great practical importance not otherwise addressed in the Proposed Regulations – the treatment of a payment made to a transferee of a residual interest and the numerous questions arising from the “taxable mortgage pool” rules; and

(xi) “negative accruals” of OID should be allowed in appropriate cases and determination of the accrual of market discount and certain other computational issues should be clarified.

II. TAXATION OF HOLDERS OF RESIDUAL INTERESTS (PROPOSED REGULATION SECTION 1.860C-1)

A. Background

Section 860C addresses the taxation of holders of residual interests. In general, section 860C provides that a REMIC calculates its taxable income as if it were an entity and proportionate shares of that taxable income are passed through as ordinary income to holders of residual interests. Section 860C provides specific rules for determining the taxable income of the REMIC, generally treating the REMIC as an individual, with certain modifications. The most notable modification is that the REMIC is given a deduction for interest expense determined as if its regular interests were debt obligations. Section 860C also provides mechanical rules for calculating the pass-through of income on a quarterly basis to the residual holder and for adjustments to the basis of a residual interest to reflect income taken into account and distributions made.

B. Discussion

1. Treatment of Payments to Transferees of Residual Interests

Proposed Regulation sections 1.860C-1 and 1.860C-2 address well the more mechanical aspects of the taxation of holders of residual interests. However, no guidance is given with respect to what is perhaps the most difficult theoretical and practical issue regarding the tax treatment of the holder of a residual interest. That issue is the residual holder's treatment of a payment, usually from the sponsor, received in connection with the transfer of the residual interest. Typically, such a payment would be made where the residual interest itself does not entitle the holder to much, if any, in the way of cash distributions,[4] yet will cause the holder of the interest to suffer (at least on a present value basis) tax liability as residual holder over the life of the transaction.

The treatment of such a payment for federal income tax purposes is not entirely clear. Without guidance in the regulations, the most likely possibility is that the payment is immediately includible in the recipient's taxable income. Alternatively, the payment might be properly amortized into

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[4] The Proposed Regulations provide that a residual interest need not entitle the holder to any distributions from the REMIC. Prop. Reg. S1.860G-l(c). See also Staff of the Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 416 (Comm. Print 1987) ("Blue Book").

taxable income based on some reasonable schedule.[5]

The first alternative, immediate inclusion, would find support in the ample case law relating to prepaid income.[6] Justification for the second alternative, amortization of the initial payment into income, would be based on the rationale of Notice 89-2l[7] and the recently proposed regulations under section 446. Although a payment made to induce the acquisition of a residual interest is not a nonperiodic payment on a notional principal contract within the meaning of Notice 89-21 and proposed regulation section 1.446-3, there is a great deal of similarity between the two. Each involves the receipt of

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[5] A third but remote possibility is that the payment should not be taxable income at all. The third alternative would be based on the theory that the transfer is a fiction. The transferor has simply made an advance of cash to the transferee, who will pay the transferor's ongoing tax liability in an agency capacity. Any investment earnings that the transferee is entitled to keep and cash remaining when all liabilities have been paid would be taxable income to the residual holder as a payment in the nature of an agency fee. This analysis is unpersuasive because it is inconsistent with the basic facts of the transaction. The typical transfer of a residual interest shifts to the transferee all burdens and benefits of ownership, including the obligation to pay taxes on income realized from the residual.

[6] See e.g., Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto Ass'n v. United States, 367 U.S. 687 (1961).

[7] 1989-1 C.B. 651.

definite payment(s) by one party in exchange for that party's undertaking to pay estimable but not certain amounts in the future. In this respect, the ongoing payments of tax liability relating to the residual interest are analogous to the obligation of a party to a notional principal contract to pay amounts based on, for example, a floating interest rate. The fact that tax payments are not deductible does not seem to be significant. The key factors are that the initial payment is allocable economically to the required tax payments, and those payments are due in a predictable way over time. Although tax payments are contingent on changes in rates or tax laws (differences among taxpayers are limited due to the excess inclusion rules), swap payments also can be quite contingent.

It also should be noted that an initial payment for a residual interest in many cases could be transformed into a series of distributions from the REMIC, simply by contributing the payment to the REMIC on the startup date and investing it in a qualified mortgage with the desired characteristics. In that event, the “principal” of the mortgage would be taxable to the residual holder only as distributions are made to it by the REMIC, and then only to the extent those distributions exceed the holder's basis in the residual interest. As a practical matter, however, providing a separate mortgage investment having the desired cash flows would be clumsy in many cases.

For the reasons stated above, and because the initial payment relates to an ongoing obligation over the life of the residual interest, we believe that the income of the recipient is more clearly reflected where the payment is amortized.[8] Amortization or exclusion also arguably is preferable to

[8] But see RCA Corp. v. United States, 664 F.2d 881 (2d Cir. 1981).

immediate inclusion because the significant tax cost associated with immediate taxation of the payment will tend to cause noneconomic residual interests to be transferred virtually exclusively to entities that have net operating losses. Such a rule would give these loss companies an advantage over other taxpayers who would suffer a tax cost upon receipt of the residual interests. It also will tend to distort the market for noneconomic residual interests by limiting the persons to whom residual interests can be transferred.

If an amortization approach is adopted, the method of amortization must be addressed. We recommend that the portion of the payment amortized into income each period equal the excess of (1) the residual holder's income from the residual determined as if the REMIC's tax basis in the assets it holds were reduced at the outset by the amount of the initial payment over (2) the residual holder's income without adjustments. The reason for recommending this approach is in part that it achieves the proper measure of the REMIC's basis in its assets, as discussed in the next section.

Even if the Service disagrees with our recommendation, and, specifically, believes that initial payments should be included in income upon receipt, it would be helpful to have a clear rule to that effect, so that transactions in residuals can be accurately priced.[9]

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[9] A related question of some interest is whether upfront payments made to non-U.S. investors are subject to U.S. withholding tax. Such payments generally would not be subject to withholding tax if they were distributed by the REMIC and exceeded the accrued excess inclusions.

2. Basis of the REMIC’s Assets

An issue that is closely related to and must be considered in connection with the treatment of a payment to the recipient of a residual interest is the determination of the REMIC's basis in its assets. Proposed Regulation section 1.860F-2 addresses this issue. Under Proposed Regulation section 1.860F-2, the REMIC's basis in its assets is the aggregate of the issue prices of the regular and residual interests in the REMIC. The preamble to the Proposed Regulations makes it clear that a noneconomic residual would not have a “negative issue price” or a “negative basis”. Thus, for a REMIC that has a noneconomic residual that is transferred by the sponsor, the Proposed Regulations will tend to overstate the REMIC's basis in its assets relative to the aggregate fair market value of its mortgages. All other things being equal, an overstatement of basis of this nature would tend to understate the income of the holder of the residual interest.

An illustrative example would be helpful in exploring this issue. Suppose that a sponsor owns mortgages with a basis and fair market value of $100, and transfers the mortgages to a REMIC in exchange for regular interests and a residual interest that provides for no cash distributions. Assume further that the regular interests are sold to investors for $102 in cash, and the residual interest, because of its tax characteristics, has a value of minus $2.[10]

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[10] Although there may be an “arbitrage” profit causing the aggregate value of the regular and residual interests (net of issuance expenses) to exceed the value of the mortgages, if the markets are efficient, which they generally are for mortgages, that profit should be quite small and is ignored for purposes of this analysis.

The statute appears to answer this question in a straightforward way. Section 860F(b)(2) states that “The basis of any property received by a REMIC in a transfer [in exchange for regular or residual interests in such REMIC] shall be its fair market value immediately after such transfer.” Thus, based on the statute, the answer in the example (i.e., the tax basis of the REMIC's qualified mortgages) is $100. However, in the context of discussing the issue price of regular interests received in exchange for property, the legislative history suggests a different answer by stating that the fair market value of property exchanged for regular interests will be determined based on the fair market value of those regular interests.[11] In the case of regular interests issued for cash, their fair market value presumably would equal their issue price as determined under section 1273 (in the example, $102).[12]

Given these somewhat confusing signals, it is worth looking to basic principles of tax accounting for guidance as to the best answer. The holder of a residual is in many respects in the same position as if it owned the underlying REMIC assets subject to the liability represented by the regular interests. If in the example above the holder simply owned the mortgages,

11 H. Rep. No. 99-841, 99th Cong. 2d. Sess. II-232, n.14 (1986) (“Conference Report”).

12 Technically, the issuance of REMIC regular interests for cash is always analyzed as an exchange of mortgages for those interests followed by a sale of the interests. Nonetheless, the issue price of regular interests issued for cash is always determined based on the rules governing debt instruments issued for cash. This practice is consistent with the analysis of the issuance as involving an initial exchange of mortgages for regular interests if the fair market value of the regular interests is considered to be their issue price determined based on the cash price.

borrowed $102 and received the proceeds, it would not recognize $2 of income, and accordingly the basis in the mortgages would not be stepped up. However, in more complex cases where the holder does recognize $2 of income as a result of the borrowing, the tax system would allow a step up.[13] This could occur, for example, if the holder transferred the mortgages to a third party, subject to the debt of $102, or, in the case of a borrowing through a partnership, received a distribution in excess of basis (perhaps because the debt was held by, and therefore allocated to, another partner) and made a section 734/754 adjustment. Thus, in the elementary case, where a sponsor sells the regular interests for $102 and recognizes gain of $2, basic tax accounting principles support a basis for the mortgages of $102.[14]

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[13] The borrowing analogy is not perfect. In the case of a normal nonrecourse borrowing, the borrowing will exceed the tax basis of property only where the property's value is greater than that basis. To the extent the proceeds of the borrowing exceed cost, an economic gain is realized analogous to a gain on sale. It is entirely appropriate, then, to reflect any such gain in the basis of the collateral, at least if the gain is recognized. In the case of a REMIC, by contrast, the excess of the value of regular interests over the original value of the contributed mortgages does not reflect appreciation of the mortgages, but rather a rearrangement of the value of the mortgages among different classes, some having positive and some negative values. As a result, it could be argued that a step up in the basis of the mortgages is inappropriate. However, we believe this argument is outweighed by the tax accounting and policy arguments set forth in the text.

[14] A closely related argument concerns the policy underlying the REMIC rules. The reason for creating a residual interest and taxing the holder on net income of the REMIC even in cases where the residual is noneconomic is to ensure that the tax system collects the same tax from the mortgages that it would have collected if they had not been divided up into multiple classes of securities. However, if the creation of multiple classes of securities itself causes the recognition of a taxable profit of $2 that would not have been realized if the mortgages had been sold directly, stepping up the basis in the mortgages to $102 for purposes of computing income from the residual is appropriate.

That basis of $102 is the correct result in this case and can be seen by examining the computation of income on the residual interest. The initial basis in the residual interest is zero, and because no distributions ever will be made on the residual, the sum of the income and loss attributable to the residual over its life also should be zero. If the REMIC is required to compute deductions with respect to the regular interests based on a issue price of $102 (i.e., offsetting $2 of premium against interest expense), then the income of the REMIC will be zero over its life, matching the economics of the residual, only if the mortgages have a basis of $102.

To complete the analysis of the basis issue, three variations on the basic example need to be analyzed: where the residual is sold, where the regular interest is retained, and where the residual has positive or zero value. First, if the residual is “sold” (in the example, by having the sponsor make a payment of $2 to the buyer), the sponsor would have no net income, because the deduction of $2 would offset the income. However, if the recipient of the payment has immediate income of $2, the net effect for all parties is again positive income of $2, and the same step-up that would occur if there were no transfer of the residual would seem appropriate. (The tax treatment of initial payments is discussed in the preceding section of this report.) If, however, the residual holder's income of $2 is recognized only over time, it would not seem appropriate immediately to step up the REMIC's basis in the mortgages. Rather, in a theoretically pure system, the step-up basis for the REMIC's mortgages should be afforded only as the residual holder's $2 of income is recognized.[15]

In the second case, where the sponsor retains the regular as well as the residual interests, a basis of $102 in the mortgages again is the appropriate result, notwithstanding the absence of immediate gain recognition by the sponsor. In this case because the sponsor is required to recognize over time the difference of $2 between the issue price of the regular interests and their $100 basis (which $2 difference would not be recognized by a purchaser of the regular interest for $102). Therefore, a step-up of $2 in the basis of the REMIC's mortgages (which would reduce by $2 over time the aggregate amount of income the sponsor recognizes) is necessary to offset the additional $2 of income attributable to the regular interest.[16]

Finally, suppose a right to cash distributions having a value of $2 is shifted in our example from the residual interest to the regular interest. In that event, the residual interest and regular interests would be worth zero and $100, respectively, and there would be no argument for assigning a basis to the mortgages of $102. However, eliminating the negative value of the residual would result in each class of interests having a basis equal to

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[15] Because the REMIC's mortgages are relatively fungible in most cases, this type of periodic step-up can be administered without a great deal of complexity simply by setting up a single “adjustment account”. Amounts would be added to the adjustment account to reflect a gain recognized by the residual holder. Amounts in the adjustment account can be amortized as an offset to the REMIC's income over the remaining life of the REMIC, presumably in proportion to remaining principal payments received on the mortgages (or some other reasonable method).

[16] Because this case is analogous to the case of the transferee of a residual interest who is allowed to recognize income attributable to the transfer over time, a periodic step-up in the REMIC's basis in the manner suggested may be appropriate.

its initial value, so that a sale of one or both would not produce taxable gain. The absence of gain justifies the lower basis for the mortgages.

In summary, the Proposed Regulations provide appropriate results with respect to the basis of the REMIC's mortgages in most cases. Because of the theoretical linkage between a step-up in basis and gain recognition with respect to the mortgages, modifications to the basis rule might be appropriate if the Service adopts a rule allowing amortization of gain to the transferee of a residual interest. Because the resulting timing difference between an immediate step-up and a step-up over time is likely to be relatively small, the Service should weigh the benefit of a somewhat more accurate basis rule against the rough justice and relative simplicity of using the single stated basis rule.

III. DEFINITION OF A REMIC (PROPOSED REGULATION SECTION 1.860D-1

A. Rights and Interests That Are Not Treated as Interests in a REMIC

All interests in a REMIC must be either regular interests or residual interests.[17] Consequently, it is crucial to the qualification of a REMIC that various contractual rights not be treated as “interests” in the REMIC.

[17] §860D(a)(2). A REMIC must have a single class of residual interests but need not have any regular interests outstanding. The final regulations should make it clear that a REMIC can continue in existence with only a residual class after all regular interests have been retired.

The Proposed Regulations include a nonexclusive list of several common contractual rights that will not be treated as disqualifying interests in a REMIC. The list of items that will not be treated as interests in a REMIC generally is quite helpful. These include a right of reimbursement arising from a credit enhancement contract (e.g., a right of subrogation pursuant to a guarantee), and a right (or obligation) to acquire mortgages on conversion of a convertible adjustable rate mortgage, or pursuant to a clean-up call or qualified liquidation. Another item, outside reserve funds, although not listed, is treated similarly elsewhere.[18]

Particularly helpful is the treatment of servicing fees and stripped interest. Servicing compensation per se is treated as not an interest in a REMIC only to the extent that it is reasonable. Nonetheless, determining reasonable servicing compensation can be an uncertain undertaking. Recognizing that fact, and the absence of good technical or policy reasons for REMIC qualification to depend on a determination that servicing compensation is reasonable, the Proposed Regulations also treat the right of a mortgage servicer to retain a servicing fee out of interest payments it collects not as an interest in a REMIC even if that right exceeds reasonable compensation.[19] Rather, the “excess” portion would be treated as an interest in the REMIC's mortgage loans that is not part of the REMIC.[20] Presumably, a transfer of the right to receive the servicing compensation subject to the servicer's continued performance would not cause

[18] Prop. Reg. §1.860G-2(h). This confirms the regular market practice prior to the issuance of the Proposed Regulations whereby outside reserve funds have been permitted.

[19] Prop. Reg. §1.860D-l(b)(2)(ii).

[20] See Rev. Rul. 91-46, 1991-34 I.R.B. 5.

the right to become an ineligible interest in the REMIC. Nor should a transfer of the “excess” portion result in the creation of an ineligible interest at least where that excess portion is represented by the right to receive “stripped coupons” from the REMIC's mortgages. Final regulations should clarify that the status of servicing compensation in excess of reasonable compensation in these circumstances does not depend on the servicer retaining the servicing.

The Proposed Regulations also provide that certain de minimis interests used to facilitate creation of an entity that elects REMIC status are not treated as interests in the REMIC.[21] For example, to form a trust under state law it is necessary to have the trust issue an initial trust certificate for a nominal amount of cash (e.g., $10). Such an interest would not be treated as an interest in the REMIC under the Proposed Regulations. The final regulations should clarify, however, that the de minimis rule does not apply to an interest actually designated as a residual or regular interest. For example, in some cases the sponsor may want to designate the trust certificate described above as a residual interest. In this case, it should not be disregarded as de minimis.

The Proposed Regulations provide that a right of reimbursement against a REMIC arising out of a credit enhancement contract (as defined in Proposed Regulation section 1.860G-2(c)(2)) is not an interest in the REMIC. In some cases, the credit enhancer will require the REMIC to pay interest on the amount advanced. We believe that the right of a credit enhancer to receive interest on the amounts advanced reflect only normal commercial practice in providing credit enhancement should not be

[21] Prop. Reg. §1.860D-l(b)(1)(ii).

viewed as creating an interest in the REMIC. Accordingly, we believe that final regulations should clarify that a right of reimbursement can include interest on the amount advanced.

B. Reasonable Arrangements Designed to Ensure That Residual Interests Are Not Held by Disqualified Organizations

1. Background

To qualify as a REMIC, a REMIC must make reasonable arrangements designed to ensure that residual interests are not held by "disqualified organizations".[22] This test is satisfied if the residual interest is in registered form, the REMIC's organizing documents prohibit a disqualified organization from acquiring beneficial ownership of a residual interest, and notice of the prohibition is provided to potential transferees through a legend on the ownership certificate or through a conspicuous statement in the offering document.[23] If, despite these arrangements, a residual interest is transferred to a disqualified organization, a tax is imposed on the transferor, or if the transfer is to an agent for the disqualified organization, on the agent. In addition, a tax is imposed on certain pass-

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[22] §860D(a)(6)(A). The term "disqualified organization" is defined in section 860E(e)(5) as the United States, any state or political subdivision thereof, any foreign government, any international organization, any agency or instrumentality of any of the foregoing (excluding any instrumentality all of whose activities are subject to tax and a majority of whose board of directors is not selected by any such governmental entity), any cooperative organization furnishing electric energy or providing telephone service to persons in rural areas as described in section 1381(a)(2)(C), and any organization (other than a farmers' cooperative as described in section 521) that is exempt from taxation unless the organization is subject to the tax on unrelated business income imposed by section 511.

[23] Prop. Reg. §l.860D-l(b)(5)(i).

through entities that hold residual interests and in which a disqualified organization holds an interest.[24]

The REMIC must make reasonable arrangements to provide information needed to compute the tax imposed on transfers to disqualified organizations and on pass-through entities to the person liable for that tax and to the Service.[25] These provisions were added to the Code by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") apparently to address the concern that a governmental entity could be used to avoid taxation of excess inclusion income.

2. Discussion

The test for arrangements designed to ensure that a disqualified organization does not hold a residual interest is clear and helpful. However, the extent of a REMIC's obligation to provide information relating to the tax on transfers to disqualified organizations should be clarified.

The transferor of a residual interest to a disqualified organization, or a pass-through entity in which a disqualified organization holds an interest, generally is liable for the tax imposed by section 860E(e). The transferor or (pass through entity) can protect itself from liability by obtaining an affidavit from the transferee (or interest holders in the pass through entity) stating that it is not a disqualified organization.[26] The Proposed Regulations do not appear to require or otherwise contemplate that the REMIC itself will obtain such

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[24] See Part V., infra.

[25] Prop. Reg. §1.860D-l(b)(5)(ii).

[26] §860E(e)(4).

affidavits upon the original issuance of residual interests. Even though residual interests must be issued in registered form, a REMIC will not necessarily know if a disqualified organization is a transferee. Accordingly, the final regulations should make it clear that information relating to the tax on transfers to disqualified organizations need be supplied by a REMIC only upon request, without an obligation to determine whether there has been a transfer to a disqualified organization.[27]

IV. TREATMENT OF TAXABLE INCOME OF A RESIDUAL INTEREST HOLDER IN EXCESS OF DAILY ACCRUALS (PROPOSED REGULATION SECTION 1. 860E-11

A. Treatment of Thrifts

1. Background

In general, section 860E reflects extraordinary efforts by Congress to assure that so-called “excess inclusion” income is not easily sheltered. Specifically, Proposed Regulation section 1.860E-l(a)(1) follows the statutory rule of section 860E(a)(1) and provides that, except in the case of financial institutions to which section 593 applies,[28] the taxable income of a holder of a residual interest for any taxable year can never be less than the total excess inclusions attributable to the residual interest for that taxable year. In addition, section 860E(a)(5) provides

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[27] Proposed Regulation section 1.860E-2(a)(5) requires the REMIC to furnish such information upon request. Proposed Regulation section 1.860D-l(b)(5)(ii) should state that the obligation of the REMIC to provide information is satisfied if the REMIC complies with requests that it receives.

[28] Section 593 generally applies to certain thrift institutions.

that under section 172(b)(2), a taxpayer's excess inclusions will not reduce the taxpayer's net operating loss carryovers.[29] Section 860E(a)(3) provides that, for purposes of applying the excess inclusion rules, an affiliated group filing a consolidated tax return is treated as one taxpayer. Proposed Regulation sections 1.860E- 1(a)(1) and (2) implement these rules and provide helpful clarifying examples.

Section 860E(a)(2) provides a special rule for thrift institutions (the “thrift exception”) that generally allows such institutions to offset excess inclusions with unrelated losses. Proposed Regulation section 1.860E-l(a)(3)(i) provides rules for a thrift institution that is a member of an affiliated group, and Proposed Regulation section 1.860E-l(a)(3)(ii) requires that in calculating its taxable income, a thrift institution must use its allowable deductions to offset first its taxable income that is not an excess inclusion and then, to the extent of any remaining deductions, its excess inclusions. Section 860E(a)(2) authorizes regulations that deny the thrift exception “where necessary or appropriate to prevent avoidance of tax”. The legislative history of the REMIC rules suggests that the thrift exception was not intended to apply in the case of a residual interest that does not have “significant value”.[30] Accordingly, Proposed Regulation section 1.860E-1(a)(3)(i) requires that the residual interests held by a thrift institution have significant value in order for the thrift exception to apply (this requirement, the “significant value requirement”).

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29 No rule similar to section 860E(a)(5) is provided with respect to section 382, presumably because section 382(b)(2) renders such a residual interest specific rule unnecessary.

30 See Conference Report at II-236.

Under Proposed Regulation section 1.860E-l(a)(3)(iii), a residual interest satisfies the significant value requirement if (i) the aggregate of the issue prices of the residual interests in the REMIC is at least two percent of the aggregate of the issue prices of all regular and residual interests in the REMIC and (ii) the anticipated weighted average life of the residual interests is at least 20 percent of the anticipated life of the REMIC (the “20 percent test”). The anticipated weighted average life of a residual interest is the sum of the products of each anticipated principal payment on the residual interest (determined using the prepayment and reinvestment assumption used in accruing original issue discount (“OID”)) and the number of years (including fractions thereof) from the startup day to the related principal payment date, divided by the total anticipated principal payments on the residual interest. If a residual interest has no specified principal amount or a disproportionately high interest rate, the anticipated weighted average life of the residual interest is calculated using all anticipated distributions on the residual interest. Under Proposed Regulation section 1.860G-1(b)(5)(i), a residual interest is considered to have a disproportionately high interest rate if its issue price exceeds 125 percent of its specified principal amount (this test, the “disproportionate interest test”). Proposed Regulation section 1.860F-2(b)(5) provides that the anticipated life of the REMIC is the period of time during which the REMIC is expected to exist, determined based on the prepayment and reinvestment assumptions used in accruing OID.

2. Discussion

We believe that the thrift exception (with the significant value condition) was provided to allow thrift institutions to use net operating losses to offset the “phantom income” generated in REMIC transactions in roughly the same manner as they did prior to the enactment of the REMIC rules by issuing collateralized mortgage obligations (“CMOs”) through consolidated subsidiaries or pass-through entities. The issuance of non-REMIC CMOs generally required a significant equity investment in the issuer to ensure that the CMOs were respected as debt. Thus, although it was possible for a thrift institution to use its net operating losses to shelter any “phantom income” derived from an issuance of CMOs, the thrift institution effectively was required to make a significant investment in the transaction by holding that equity. Similarly, a significant value requirement constitutes an appropriate and effective way to ensure that thrift institutions make a meaningful capital investment in a REMIC in order to be able to offset “phantom income” with losses.

A significant value requirement that measures the value of a residual interest only as of the startup day would, however, permit a thrift institution to make an investment that, because it is returned quickly, is not substantial in any true sense. To prevent an abuse of this nature, regulations could take two possible approaches. One approach would be to require testing of the relative value of a residual interest from time to time. Such an approach would be very difficult to administer and would cause a thrift institution to be uncertain when it acquired the residual interest whether it would be allowed to use its net operating losses to offset its excess inclusions over the life of the interest. The alternative and far more practical approach adopted in the Proposed Regulations is to require testing of a residual interest for significant value only at its issue date, when information regarding its relative value is easily available and to prevent “temporary” significant investments by requiring that the investment is expected to be maintained for a minimum time period.

We believe, however, that Proposed Regulation section 1.860E-1(a)(3)(iii), which implements the minimum time period requirement, should be modified in two respects. First, the weighted average life of a residual interest should always be calculated using all the anticipated distributions thereon, regardless of whether denominated as principal or interest.[31] Otherwise, two residual interests with identical cash flows may be treated differently, depending on how payments are denominated. All other things being equal, because residual interests are not taxed as debt, holders of residual interests generally are indifferent to the characterization of distributions.

To illustrate the problem, assume that a residual interest in a REMIC with an anticipated life of 30 years is structured as a zero coupon bond with an issue price of $614.45 and a specified principal amount of $1000 payable in installments of $100 per year over ten years. This residual interest would have a weighted average life of 5 1/2 years and would thus fail to meet the 20 percent test. However, a residual interest that provides for cash flows identical in timing and amount, structured as a self-amortizing bond paying $100 per year with an issue price and principal amount of $614.45 and an interest rate

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31 Because sponsors of REMICs and purchasers of residual interests will have relied on the Proposed Regulations as issued, such a modification should be applied prospectively only.

of 10 percent, would have a weighted average life of 6.2 years and would meet the significant value test.[32] This type of difference provides both opportunities for abuse and traps for the unwary.

The second significant manner in which we believe the significant value requirement should be modified relates to its reliance on the “anticipated life” of the REMIC. We assume that the drafters of the Proposed Regulations intended that the weighted average life of the residual interest have some relationship to the economic life of the REMIC; the use of the prepayment and reinvestment assumptions supports this presumption. Nevertheless, even if prepayment and reinvestment assumptions are taken into account, the anticipated life of the REMIC is not a fair measure of the REMIC's true economic life because of the methods typically used to define prepayment speeds. Almost without regard to the composition of the mortgage pool or the assumed prepayment speed, the anticipated life of the REMIC generally will approximate the term of the latest maturing mortgage held by the REMIC. For example, the anticipated life of a pool of newly originated 8.75 percent, 30-year mortgages would be approximately 30 years whether at prepayment speeds of 100

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[32] The cash flow on a residual interest can often be manipulated to increase the weighted average life of a residual interest in more dramatic ways. A residual interest may, for example, be structured with high interest rates in early years and lower interest rates in later years without having a disproportionate interest rate. High interest rates in the early years would permit decreasing the principal paid in the early years, effectively backloading principal payments and thereby increasing the weighted average life of the residual interest. The lower interest rates in the later years would however ensure that the residual interest's issue price would not exceed 125 percent of its specified principal amount.

percent, 200 percent and 300 percent of PSA.[33] The weighted average lives of that pool of mortgages at those prepayment speeds, however, would be 12.0 years, 8.0 years and 5.9 years, respectively.[34] Thus, under the Proposed Regulations as written, all residual interests based on 30-year mortgages are required to have a weighted average life of approximately five and one half to six years in order to have significant value, even though that weighted average life may range from a small but significant percentage to nearly 100 percent of the weighted average life of the mortgage pool. Thus, the final regulations should also provide that, for purposes of the 20 percent test, the weighted average life of a residual interest be compared with the REMIC's weighted average life, rather than its anticipated life. Although there may be other ways to measure a REMIC's economic life, the weighted average life of the REMIC (that is the weighted average life of all classes of interests in the REMIC or possibly of the qualified mortgages) is a more appropriate measure than its anticipated life because weighted average life will reflect how long capital is invested in the REMIC.

It may appear that using the weighted average life of the REMIC will permit fairly short-lived residual interests to be treated as having significant value. But, this will be true only when the REMIC itself is short-lived. Also, the distributions on

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[33] PSA is a commonly used standard prepayment assumption proposed by the Public Securities Association under which it is assumed that (1) each mortgage loan in a pool prepays in the first month after issuance at an annual rate of 0.2 percent of its outstanding principal balance, (2) this prepayment rate increases each month thereafter at an annual rate of 0.2 percent through the thirtieth month after origination and (3) the prepayment rate remains constant in each month thereafter at an annual rate of 6.0 percent.

[34] Moreover, it is possible under the Proposed Regulations to have a residual interest that has a principal amount paid proportionately with principal payments on the underlying pool and yet fails the 20 percent test.

many non-REMIC CMO residuals often were substantially front-loaded.[35]

B. Transfers of Noneconomic Residual Interests

1. Background

Proposed Regulation section 1.860E-l(c)(1) disregards for all federal tax purposes any transfer of a “noneconomic” residual interest to a U.S. person, “unless no significant purpose of the transfer was to impede the assessment or collection of tax.” If the transfer of a residual interest is disregarded, the transferor would continue to be treated as the owner of the residual interest and would be required to include in gross income its pro rata share of the REMIC's taxable income. A residual interest is considered “noneconomic” unless at the time of the transfer:

> (i) the present value of the expected future distributions on the residual interest at least equals the product of the present value of the anticipated excess inclusions and the highest corporate tax rate for the year in which the transfer occurs, and
>
> (ii) the transferor reasonably expects that the transferee will receive distributions from the REMIC at or after the time at which the taxes accrue on the anticipated excess inclusions in an amount sufficient to satisfy the accrued taxes.[36]

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35 A substantial portion of the cash flow on many pre-1987 non-REMIC CMO residuals consisted of the difference between the interest rate on the collateral and the various interest rates on the CMOs, and this difference typically was greatest with respect to the shortest-lived CMO classes.

36 Prop. Reg. §1.860E-l(c)(2).

The calculation under (i) above must be based on events that have occurred up to the time of the transfer and the prepayment (and, if appropriate, reinvestment) assumptions adopted in determining the rate of accrual of OID on the related regular interests. Under this definition, even residual interests that have a positive fair market value or provide for significant distributions could be considered “noneconomic”. Further, because its status is determined at the time of transfer, a residual interest could be economic at certain points during its life and noneconomic at other points.

2. Discussion

We believe that further guidance is necessary regarding the meaning of “[impeding] the assessment or collection of tax”. Presumably, the Proposed Regulations are concerned about the collectability of taxes due, and not about the dollar amounts of the transferor's and transferee's respective tax liabilities arising from holding the residual interests. Thus, for example, the fact that the transferee is in a lower tax bracket than the transferor, or has losses that can be offset against income from a residual interest, subject to the excess inclusion rules, would be irrelevant. This, however, should be clarified.

Further, the final regulations should indicate whose purpose -- that of the transferor or the transferee -- is relevant in determining whether there is no significant tax avoidance purpose. In this regard, we believe the final regulations should look to the transferor's purpose because it is the transferor's tax liability that would be decreased if a transfer were respected.

The final regulations also should describe the measures a transferor could take to demonstrate that the transferor is not motivated by a tax avoidance purpose. For example, the transfer should be deemed not to have a tax avoidance purpose unless the transferor knows (or, perhaps, has reason to know) that the transferee does not intend to pay the taxes due on its share of the taxable income of the REMIC. In this regard, the transferor should be permitted to rely on written representations and covenants from the transferee regarding the transferee's intention and ability to pay any tax liability arising from the transferee's holding the residual interest. Absent knowledge of improper motives by the transferee, the transferor should not be charged with any duty to investigate the financial capacity of the transferee to make tax payments.[37] One objective fact to consider is whether amounts paid to the transferee for taking the residual interest are so low (or the price paid by the transferee is so high), taking into account expected distributions and expected taxable income, that the transaction would not be economically justifiable unless that transferee intended not to pay the taxes due on the income from the residual interest. Finally, the final regulations should indicate that these rules apply to transfers of residual interests to foreign persons engaged in a U.S. trade or business where the transferee's income is effectively connected to the trade or business. Such transfers are not subject to the special rules for transfers of noneconomic residuals to foreign persons (discussed in Part X), and thus should be covered here.

[37] Investigation of a transferee's financial status is likely to be a practical impossibility. Moreover, because the investigation would only reveal information about the transferee's current financial situation and not its future situation, such an investigation is unlikely to have any realistic predictive value with regard to whether tax payments will be made.

V. TAX ON TRANSFERS OF RESIDUAL INTERESTS TO CERTAIN ORGANIZATIONS (PROPOSED REGULATION SECTION 1.860E-2)

A. Background

Section 860E(e) addresses the consequences of the transfer of a residual interest to a disqualified organization notwithstanding the reasonable arrangements made to prevent such a transfer.[38] Under section 860E(e), a tax is imposed on the transferor (or if the transfer is through an agent of the disqualified organization, on the agent of the transferee) equal to the product of the highest corporate tax rate and the present value of the total anticipated excess inclusions with respect to the residual interest for periods after the transfer. Under section 860E(e)(7), the tax described above may be waived if, within a “reasonable time” after discovery that a disqualified organization holds a residual interest, such holding is terminated and “such amounts as the Secretary may require” are paid.

If one of an enumerated group of entities whose taxable income generally is reportable by its owners (a “pass through entity”[39]) holds a residual interest, and a disqualified

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[38] See Part III.B., supra.

[39] “Pass-through entities” include any regulated investment company (“RIC”), real estate investment trust (“REIT”), common trust fund, partnership, trust or estate and certain corporations operating on a cooperative basis. Except as may be provided in Treasury regulations, any person holding an interest in a pass-through entity as a nominee for another will, with respect to such interest, be treated as a pass-through entity. §860E(e)(6)(B).

organization is the record holder of an interest in the pass through entity, the entity is taxed at the highest corporate rate on the disqualified organization's pro rata share of the excess inclusions for any period during which the disqualified organization held the interest. The tax paid by the pass-through entity is treated as an expense.[40]

Both transferors (or agents) and pass-through entities may avoid inadvertently becoming subject to the tax by having each transferee or interest holder, respectively, provide an affidavit, under penalties of perjury, that the transferee or interest holder is not a disqualified organization.[41]

B. Discussion

1. Waiver of Tax on Transferor to, or Agent of, a Disqualified Organization

Proposed Regulation section 1.860E-2(a)(7)(ii) specifies the amount required to be paid pursuant to section 860E(e)(7) (i.e., when holding of a residual interest is terminated within a "reasonable time" after discovery) as the product of the highest corporate tax rate and the accrued excess inclusions allocable to the disqualified organization during its ownership of the interest. Neither section 860E(e)(7) nor Proposed Regulation section 1.860E-2(a)(7)(ii) mentions who is responsible for paying the "amount". The legislative history of the provision, however, interprets the statutory language as providing for "the transferor (or agent) [to pay] such amount as the Secretary of

[40] §860E(e)(6)(C).

[41] §§860E(e)(4) (pertaining to transferees), 860E(e)(6)(D) (pertaining to interest holders).

the Treasury may require”.[42] This is logical, since presumably it would be the transferor or agent who would seek to avoid the larger tax on the present value of all excess inclusions. Nonetheless, since the alternative payment is not mandatory, and the Service presumably does not care who pays it, the approach in the Proposed Regulations is not objectionable.

The use of the term “amount” leaves open the question whether the amount is or is not a nondeductible tax. The answer may depend on who makes the payment. For example, if the payment is made by the party otherwise liable for the tax owing on the transfer of the residual interest to the disqualified organization, then the amount properly could be viewed simply as a substitute for such tax. On the other hand, if the payment is made by someone else, the right analysis might be that it represents a payment to the transferor, who then pays the amount as a tax. Perhaps the final regulations should state that any amount paid under the provision will be treated for federal income tax purposes as if it were a payment of tax imposed on the transferor.

2. Taxation of Pass-Through Entities

Unlike the case of a disqualified organization owning a residual interest directly, there is no specific prohibition against indirect ownership of a residual interest through a pass through entity. Instead, the pass-through entity incurs the tax that would have been imposed on the disqualified organization with respect to the residual interest had such organization been a taxpayer. This mechanism is designed to prevent use of the

[42] Staff of the Joint Committee on Taxation, Description of the Technical Corrections Act of 1988 (H.R. 433 and S. 2238), at 83 (Comm. Print 1988) (the “TCA Description”).

effective tax exemption for disqualified organizations for avoiding all tax liability with respect to residual interests.

The legislative history states that a pass-through entity seeking to assure holders of its interests that it will not incur the tax might either adopt measures "preventing it from acquiring residual interests" or "prohibiting ownership of its interests by disqualified organizations (or, where possible, allocating the tax to such entities)".[43] With certain pass through structures (e.g., a partnership) an allocation to particular holders is feasible. With others (e.g., a RIC), such allocation is impossible in the absence of special regulations.[44] The Proposed Regulations make no mention of an allocation, neither affirming nor rejecting the possibility.

We believe that final regulations should facilitate special allocation of the tax burden to disqualified organizations by stating that such an allocation and corresponding distributions would be deemed not to lack "substantial economic effect" for a partnership, or to result in a "preferential dividend" for a REIT or a RIC under section 562(c), or otherwise be impermissible for other pass-through entities. The reason why a reduction in the distribution to a disqualified organization is not preferential is that tax specially allocated to a disqualified organization is in substance a withholding tax imposed on the disqualified organization; thus, a reduced distribution could be analogized to a pro rata gross distribution net of a withholding tax. Pass

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[43] The parenthetical suggestion assumes that the pass-through entity is aware that the holder is a disqualified organization. This suggests that the affidavit safeguard discussed above is more for the purpose of facilitating this allocation than preventing ownership by a disqualified organization.

[44] See §562(c).

through entities can identify disqualified organization owners either by using the affidavit procedure or inquiring as to the reason for the lack of a taxpayer identification number or foreign holder certification. We believe that this approach minimizes market distortions and protects the objective of imposing at least one tax on excess inclusions.

VI. QUALIFIED LIQUIDATIONS (PROPOSED REGULATION SECTION 1.860F-1)

A. Background

Section 860F(a)(2)(A)(iv) states that the disposition of a qualified mortgage by a REMIC pursuant to a "qualified liquidation" is not a prohibited transaction. To effect a qualified liquidation, section 860F(a)(4)(A) requires the REMIC to adopt a plan of complete liquidation and specifies a 90-day period beginning on the date of adoption of such plan within which the REMIC must sell all of its assets (other than cash) and credit or distribute all proceeds (plus cash), less assets retained to meet claims, to holders of regular or residual interests. The Proposed Regulations provide only that a REMIC is considered to adopt a plan of complete liquidation when the plan is signed by a person authorized under Regulation section 1.860F-4(c) to sign the REMIC's income tax return.

B. Discussion

It is not clear whether the rule in the Proposed Regulations is intended to be exclusive, and this point should be clarified. If the rule is exclusive, the Proposed Regulations take an unnecessarily restrictive view of when a plan of liquidation is adopted and, by extension, even what constitutes a "plan". By contrast, the term "plan" of reorganization as used in section 368(a) is defined broadly in regulations to refer to exchanges and distributions that are directly part of the transaction defined as a reorganization in the statute.[45] By requiring a "plan" to be signed on the first day of the 90-day liquidation period, the Proposed Regulations apparently contemplate the signing of a formal document containing the plan as the initial step in liquidation.

Apart from tax law requirements, different procedures may be used for terminating REMIC interests depending on their form, e.g., whether REMIC interests are represented by CMOs or multiple class pass-through certificates. For example, a CMO liquidation typically involves the mailing of a notice by the bond trustee (as distinguished from an officer or owner-trustee of the issuer) to bondholders (who may be both regular and residual interest holders) describing the date and place for submitting bonds in final payment. Typically, the indenture itself prescribes the conditions for sending such notice, such as the direction to do so by the issuer, administrator or residual holder and the deposit of, or sale of the collateral for an amount equal to, the greater of the redemption price of the bonds or the fair market value of the collateral. On the other hand, since a pass-through transaction does not involve the retirement of debt, there may be a greater likelihood that there will be a termination plan describing the actions to be taken by the trustee.

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[45] Reg. §1.368-2(g).

Although either such a document, a CMO redemption notice, or any other document describing the steps in the plan, might be signed, the signature is not necessarily by the person required to sign the REMIC's tax return. Moreover, the presence or absence of such a signature is less important than the fact that the document evidencing the plan was promulgated with due authorization under the REMIC's organizational documents as of a given date. In addition, since the principal significance of the adoption of a plan of qualified liquidation is to allow sales of assets to take place without incurring prohibited transactions taxes, it is important that parties be permitted flexibility to determine when a plan becomes effective, and in particular to condition the adoption on the occurrence of a sale of assets. In a similar vein, if a REMIC attempts to sell assets but is unsuccessful, it should be permitted to revoke any plan it has adopted in anticipation of the sale.

Accordingly, we recommend the Proposed Regulation be clarified to provide that (i) the plan of liquidation need not be in any particular form and may be adopted in any manner specified in the REMIC's organizational documents, (ii) the document evidencing the plan may, but need not, be signed as long as it is issued under the authorization of such documents, (iii) the plan document will be deemed effective as of the date specified in the plan (which may be conditioned upon a sale or other disposition of property or other events specified in the plan), or if no date is specified in the plan, on the date it is adopted in accordance with the REMIC's organizational documents. More generally, it is difficult to see what risk the Service would run in allowing the date of adoption of a plan of liquidation to be determined simply by stating a date on the REMIC's final tax return, provided the REMIC was actually liquidated within 90 days following such date. The requirement that the REMIC liquidate and that sales be spread over a period of only 90 days insures that the qualified liquidation rules cannot be used to allow a REMIC to engage in an active business. Using the tax return to designate the liquidation period is not inconsistent with this goal.

Although the issue is not addressed in the Proposed Regulations, we also believe that final regulations should permit a REMIC to distribute its assets in-kind in connection with a qualified liquidation, rather than be required to sell its assets prior to liquidation. Gain or loss would be recognized by the REMIC and allocated to the holder of the residual interest with respect to assets distributed in satisfaction of regular interests. That gain or loss would be measured by the difference between the adjusted basis of the assets distributed and adjusted issue price of the regular interests. No gain or loss should be recognized by the REMIC with respect to assets distributed to the holder of the residual interest, and the residual interest should be treated as having been redeemed for an amount equal to the REMIC's basis in its assets distributed to the residual holder. The residual holder should take a carryover basis in the distributed assets.[46] Permitting in-kind liquidations would allow more flexibility for the REMIC, allowing it to wind up its affairs without increasing the potentially significant transaction costs that would be involved in a sale of its assets.

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[46] Gain or loss recognition with respect to assets distributed to the residual holder would not affect the total income recognized by the residual holder because any gain would be reflected in an increased basis and reduced gain or increased loss on redemption, with the same effect for any losses recognized. Because of the possible character mismatch (i.e. ordinary loss on disposition of assets, capital gain on redemption of residual interest and vice versa), we believe the recommended approach will yield less arbitrary results.

VII. TRANSFERS TO A REMIC (PROPOSED REGULATION SECTION 1.860F-2)

A. Background

A transferor does not recognize gain or loss on the transfer of property to a REMIC in exchange for regular or residual interests in the REMIC.[47] The aggregate adjusted bases of the regular and residual interests received in the exchange equal the aggregate adjusted bases of the property transferred, and is allocated among the interests based on their respective fair market values.[48] As discussed in Part II., above, the REMIC's aggregate basis for the property received in that exchange equals the property's fair market value immediately after the exchange.[49] Sections 860F(b)(1)(C) and (D) provide rules for inclusion in income of, and allowance of deductions for, unrecognized gain and unrecognized loss, respectively, with respect to REMIC regular and residual interests retained by the transferor, or any other person whose basis is determined by reference to the basis of such interests in the hands of the transferor.

In general, the model adopted by section 860F for the formation of a REMIC is a contribution of assets by a “sponsor” to the REMIC in exchange for regular and residual interests in the REMIC. The Blue Book does not expressly embrace the concept of a “sponsor” but indicates that the tax consequences associated with the formation of a REMIC should be the same if the REMIC, instead of issuing regular and residual interests in exchange for assets, issued those interests for cash and used that cash to

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47 §860F(b)(1).

48 §860F(b)(1)(B).

49 §860F(b)(2).

purchase the assets.[50] The Proposed Regulations confirm that a transaction in which a REMIC issues some or all of its regular and residual interests for cash, after which interests in mortgages and related assets are sold to the REMIC, will be recharacterized as an exchange by the sponsor of assets for regular and residual interests, followed by a sale of some or all of those interests. This treatment ensures that the tax consequences associated with the formation of a REMIC are not affected by the actual steps taken.[51] The uniform treatment of REMIC formation under the Proposed Regulations is consistent with our interpretation of the language in the legislative commentary. In general, the sponsor takes a carryover basis in the regular and residual interests received in the exchange. Unrecognized gain and loss with respect to a retained REMIC regular interest is included in the income of the sponsor under rules similar to those governing market discount, or deducted by the sponsor under rules similar to those governing amortizable bond premium, respectively.[52] Unrecognized gain and loss with respect to a retained REMIC residual interest is included in income or deducted ratably over the anticipated period the REMIC is expected to be in existence.[53] For purposes of the rules governing the treatment of unrecognized gain and loss, a holder of a REMIC regular or residual interest is treated in the same manner as the REMIC's sponsor if that holder's basis is determined in whole or in part by reference to its basis in the hands of the sponsor.[54]

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[50] Blue Book at 417; see also Conference Report at II-230 n.8.

[51] Prop. Reg. §1. 860F-2(a)(1).

[52] §§860F(b)(1)(C) and (D).

[53] Id.

[54] Prop. Reg. §1.860F-2 (b)(7).

Under the Proposed Regulations, the sponsor of a REMIC takes an aggregate tax basis in the regular and residual interests it receives on the formation of the REMIC equal to the sum of (i) the aggregate adjusted basis of the property it transfers to the REMIC, plus (ii) the amount of “organizational expenses”.[55] The aggregate tax basis is allocated among the regular and residual interests based on their fair market values on the “pricing date”, or if there is no pricing date, on the startup day. “Organizational expenses” are defined as expenses incurred by the sponsor or the REMIC directly related to the REMIC's creation and incurred in a period beginning a reasonable time before the start-up day and ending before the filing date for the REMIC's first tax return (determined without regard to any extensions).[56] Organizational expenses include legal fees for services related to the formation of the REMIC, such as the preparation of a pooling and servicing agreement or trust indenture, and accounting fees and other administrative costs.[57]

By contrast, “syndication expenses” are expenses incurred in marketing the interests in the REMIC.[58] These expenses offset the amount realized by the sponsor on the sale of the REMIC interests. Syndication expenses include brokerage fees, registration fees, fees of an underwriter or a placement agent, and printing costs of the prospectus, private placement memorandum and other selling or promotional material.

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55 Prop. Reg. §1.860F-2(b)(3).

56 Generally, the REMIC's first tax return is due April 15 of the calendar year following the year that includes the startup day. Reg. §1.860F-4(b)(1).

57 Prop. Reg. §1.860F-2(b)(3)(ii)(A).

58 Prop. Reg. §1.860F-2(b)(3)(ii)(B).

The "pricing date" is defined as the date the terms of all the regular and residual interests are fixed and the prices at which a substantial portion of the regular interests will be sold are fixed.[59] The term startup day means the day on which the REMIC issues all of its regular and residual interests, subject to a special rule permitting the sponsor to elect any one day in a defined ten day period as the startup day in certain cases.[60]

The use of "multiple-tier" REMICs has become a popular structure for certain transactions. To ensure that each tier is treated as a separate REMIC, some practitioners have required that each tier be represented by a distinct entity under state law, and be organized under separate sets of documents, creating additional administrative expense. The Proposed Regulations indicate that two or more REMICs may be created pursuant to a single set of organizational documents, even though for state law and federal securities law purposes, those documents create only a single organization.[61] However, the documents must clearly and expressly identify the assets of and the interests in each REMIC, and each REMIC must satisfy all the requirements of section 860D and the related regulations.[62]

B. Discussion

1. Definition of Pricing Date

Although the use of the pricing date concept is helpful, we believe some modification of the definition of "pricing date"

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59 Prop. Reg. §1.860F-2(b)(3)(iii).

60 Prop. Reg. §1.860G-2(j).

61 Prop. Reg. §1.860F-2(a)(2).

62 Id.

would be appropriate. In general, the pricing date is relevant in that it fixes the time for allocating the aggregate basis of the regular and residual interests in a REMIC among those interests and determining the issue prices of any REMIC interests retained by the sponsor.[63] With respect to a substantial number of REMICs that issue multiple classes of regular interests, determination of the "pricing date" may be difficult, if not impossible.[64] Because there is no clear definition of "substantial portion", it often will be the case that the pricing date is uncertain, and it is entirely possible that there will be no pricing date. Although in the absence of a pricing date, the relevant date for these purposes would be treated as the startup day, this might be too late for indicating in a selling document (such as a prospectus or private placement memorandum) whether or not a residual interest has "significant value" under Proposed Regulation section 1.860E-1(a)(3)(iii). Accordingly, we recommend that the pricing date be defined to include any date or dates within 10 days after the first date on which a significant portion of any class of regular interests in the REMIC has been sold,[65] which date is designated by the REMIC as the pricing date.[66] This would

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[63] Prop. Reg. §§1.860F-2(b)(3) and 1.860G-l(d). <u>See</u> pp. 67-68.

[64] There is no one "pricing" date in the typical REMIC offering. Thus, a REMIC sponsor will typically announce (via an interdealer network such as Telerate) a transaction when it has decided on the material terms for the bulk of the regular interests. Beginning immediately before the announcement, the sponsor will call customers some of whom will commit to pay a particular price for a particular amount of regular interests of a particular class. When the "pricing" announcement is made, however, not all regular interests will necessarily have been committed. In addition, it may take several days for other investors to commit to other regular interests (or investors may not commit in which case the sponsor would purchase the regular interests at closing).

[65] We believe that in determining whether a significant portion of any class of regular interests has been sold for this purpose, all sales on a cumulative basis should be taken into account.

[66] It would be even more helpful if a specified percentage of the class of REMIC interests were deemed significant for this purpose. We would recommend 20 percent.

be consistent with the special rule for the REMIC's startup day contained in Proposed Regulation section 1.860G-2(j). Although taxpayers can be anticipated to choose the most favorable date in the proposed 10- day window, we believe that such a short period of time should not lead to material distortion in the allocation of basis to the regular and residual interests received by the sponsor.

2. Treatment of Unrecognized Gain or Loss

The Proposed Regulations regarding the treatment of unrecognized gain or loss are generally helpful. However, a few points merit clarification. With regard to regular and residual interests that are transferred basis property, the final regulations should clarify that a subsequent transferee of a REMIC interest is treated in the same manner as the REMIC's sponsor only to the extent that the holder's basis in that interest is not more or less than the basis the interest would have in the hands of the sponsor if it had not been transferred. In other words, adjustments should be made for gain or loss recognized in partially taxable transfers.

With respect to a REMIC residual interest, the Proposed Regulations require the sponsor to include unrecognized gain in its income, and permit the sponsor to deduct unrecognized loss, ratably over the “anticipated life of the REMIC”.[67] As is the case with the “significant value” test, discussed in Part IV., above, use of anticipated life is problematic. In most cases, the anticipated life of the REMIC as defined will not reflect the true economic life of the transaction. We believe the

[67] Prop. Reg. §§1.860F-2(b)(4)(iii) and (iv).

unrecognized gain or loss would be measured better by treating the unrecognized gain or loss as an adjustment to the tax basis of the REMIC in its qualified mortgages. This approach would be consistent with our recommendation regarding the treatment of an upfront payment to the transferee of a noneconomic residual interest. On the other hand, it could be argued that such an approach is not compatible with the statute, which requires, in section 860F(b)(1)(C)(ii), that "in the case of a residual interest, [the excess of issue price over basis] shall be included in gross income ratably over the anticipated period during which the REMIC will be in existence." Although perhaps this is a minor point, an adjustment to the basis of a REMIC's assets would generally be taken into account under a level yield (rather than straight-line) method.

If it is thought to be necessary under the statute to amortize premium or unrecognized gains or losses under a straight-line method over a specified period, then we would recommend that such period be the expected weighted average life of the REMIC, determined as discussed above in our comments on the substantial value rule.

Finally, the REMIC legislative history provides that for purposes of determining the REMIC's anticipated life, account should be taken of "any binding agreement regarding liquidation of the REMIC".[68] The final regulations should include a reference to such a binding agreement.

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[68] Conference Report at II-236.

3. Two-Tier REMICs

We think the recognition of the Proposed Regulations that two REMICs can be created in a single document is an appropriate approach to satisfy the Service's interest in assuring proper tax accounting without unduly increasing administrative expense associated with transactions. Presumably, the requirement of clear and express identification would be met by any form of description that allows for an unambiguous determination of the cash flows associated with the regular and residual interests in each tier. For example, a schedule of principal and interest allocation rules for the two tiers that would each, standing by itself, be sufficient to instruct the trustee how distributions should be made for that tier clearly should satisfy the requirement.

VIII. DEFINITION OF REGULAR AND RESIDUAL INTERESTS (PROPOSED REGULATION SECTION 1.860G-1)

The Proposed Regulations clarify what types of “interest only” and “variable rate” REMIC regular interests are permissible. The Proposed Regulations also provide a number of significant clarifying special rules relating to the qualification and treatment of regular interests.

A. Permissible 10 Regular Interests

1. Background

Section 860G(a)(1)(B)(ii) was added to the Code by TAMRA to broaden the definition of a REMIC regular interest. Under section 860G(a)(1)(B)(ii), a regular interest includes an interest that entitles the holder to interest payments consisting of “a specified portion of the interest payments on qualified mortgages [provided that] such portion does not vary during the period [the regular interest] is outstanding.” Regular interests qualifying under this provision commonly are referred to as “IO'S” or “IO strips”. The TAMRA legislative history provides that “[t]he broadening of the definition [was] intended to permit such interests in a REMIC to qualify as [REMIC] regular interests even if the amount of interest is disproportionate to the specified principal amount”.[69]

The Proposed Regulations adopt a relatively narrow interpretation of the “specified portion” requirement. Under the Proposed Regulations, the requirement is met only if the portion can be expressed as (i) a fixed percentage of the interest payable on some or all of the qualified mortgages, or (ii) a fixed number of basis points of the interest payable on some or all of the qualified mortgages.[70] Nonetheless, the preamble to the Proposed Regulations indicates that the Service is considering an expanded specified portion definition to permit other 10 structures. Specifically, the Service is reviewing the following two IO structures: (i) a right to receive interest payments expressed as all interest payable on qualified mortgages in excess of a fixed number of basis points, or in excess of a qualified variable rate, (e.g., a REMIC that held a pool of fixed rate mortgages could issue as a regular interest a variable 10 expressed as the excess of the fixed pool rate over LIBOR); and (ii) “squeezable” 10's under which the right of the interest holder to receive payments may be reduced or eliminated as interest rate changes. In the preamble, the Service expressed

[69] TCA Description, at 84, 85.

[70] Prop. Reg. §l.860G-l(a)(2).

its concern that an expanded definition of specified portion may result in some IO's more closely resembling options than debt instruments.

The Proposed Regulations provide that the specified portion must be established as of the startup day and cannot vary over the period that begins on the startup day and ends on the day that the holder of the interest is no longer entitled to receive payments.[71] The Proposed Regulations also clarify that a specified portion is not treated as varying over time if an interest holder’s right to a portion of the interest on some or all of the qualified mortgages is dependent on the absence of defaults or delinquencies on those mortgages.[72] The Proposed Regulations provide that a specified principal amount includes a zero principal amount, thereby allowing an IO to be issued providing only for payments based on interest.[73]

2. Discussion

We believe the definition of specified portion should be expanded to specifically include a right to receive interest payments expressed as all interest payable on qualified mortgages in excess of (or up to) a fixed number of basis points, or up to or in excess of a qualified variable rate. For example, a REMIC that held a pool of fixed rate mortgages should be allowed to issue as a regular interest a variable 10 strip expressed as the excess of the fixed pool rate over LIBOR. More generally, we do not see any reason why any right to interest on a qualified mortgage that would constitute a good fixed or variable rate with

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[71] Prop. Reg. §1.860G-l(a)(2)(ii).

[72] Prop. Reg. §1.860G-l(a)(2)(iii).

[73] Prop. Reg. §1.860G-l(a)(2)(iv).

respect to a REMIC regular interest should not be a qualified specified portion. The word “specified” is broad enough to include any allocation based on a formula known in advance. It might be noted that the tax system will need to contend with interests of this type in any event, since regular interests can easily be separated into principal-only and interest-only components.

The principal policy objection to expanding the definition of specified portion appears to be that it would permit taxpayers to create interests taxed under the REMIC rules that are economically similar to other financial instruments (specifically, options) that are subject to different tax regimes. Apparently the concern is that this development would allow tax arbitrage opportunities. For example, a taxpayer might buy a regular interest representing a right to receive interest at LIBOR in excess of 8 percent and write an economically similar cap. If the cap premium received was required, under proposed regulation section 1.446-3, to be allocated among different periods over the life of the cap based on the relative values of a series of options, whereas the investment in the regular interest is amortized under a section 1272(a)(6) constant yield method, then the transaction could produce a net loss.

There are a number of reasons why we believe this concern should not prevent the adoption of an expanded definition of specified portion. First, the “arbitrage problem” would be avoided, for example, if REMIC regular interests that resemble caps or floors were taxed under the same principles that apply to notional principal contracts. However, to the extent that this results in an acceleration of income recognition on such an interest by investors, there would be an exactly matching deferral of income by the REMIC, which would translate into a deferral of income by the residual holder. In light of the excess inclusion rules, deferring the income of a residual interest holder is quite likely to result in deferred or reduced tax payments to the government. Stating the point somewhat differently, to the extent that taxpayers were able to take account of timing differences on specified portion regular interests to their advantage, a correspondingly larger tax would be collected from the residual interest holder.

Second, the Service's concern arises particularly with respect to IO regular interests that are economically similar to other financial instruments. However, hedging mortgage-backed securities is not that easy given the uncertainty relating to the timing of principal payments. While it is possible to allocate principal payments among different classes of REMIC interests so as to stabilize somewhat the principal payments on a particular class and thus reduce the effect of timing uncertainties, the vast majority of mortgage-backed securities have substantial timing uncertainties.

Third, taxpayers seeking tax arbitrage must contend with proposed regulation section 1.446-3(e)(4)(ii), which provides that where a taxpayer, either directly or through a related party, hedges a notional principal contract by purchasing, selling, or otherwise entering into other notional principal contracts, futures, forwards, options or other financial instruments, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole. As we said in our recent report on the proposed regulations on accounting for notional principal contracts ("Swap Report"),[74] a notional principal contract offset with another financial instrument could be integrated by the Service into a tax nullity.

Fourth, the mismatch in timing arises only if it is assumed that a different tax accounting method will be used with respect to notional principal contracts and REMIC regular interests having substantially identical terms. We proposed in the Swap Report that cap or floor premiums be amortized under a straight-line or, alternatively, a constant-yield method, rather than based on the values of a series of options. If this suggestion were adopted, the discrepancy between the two types of instruments would be reduced.

Finally, as noted above, most regular interests have as a significant economic feature uncertainty regarding the timing of prepayments. Section 1272(a)(6) of the Code provides a system for taking account of such uncertainties. There is no comparable rule for notional principal contracts based on notional principal amounts subject to prepayment. Thus, it might well be argued that the REMIC rules provide a more coherent and accurate system of measuring income for mortgage-related securities than the rules that currently exist for notional principal contracts. If so, it would be paradoxical to eliminate the security that is more accurately taxed.

In the event that IO regular interests representing rights to floating interest in excess of a fixed amount are permitted, it will be necessary to develop special rules for applying section 1272 to those interests. Specifically, a

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74 New York State Bar Association, Section of Taxation, Committee on Financial Instruments, Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts, January 6, 1992, at 73.

floating rate should be assumed that is sufficiently high so that there will always be some future payments on the interest; otherwise, yield calculations are not possible. We suggest that future payments be calculated assuming an index value such that the initial yield on the interest equals the average yield of all qualified mortgages held by the REMIC on the startup day (or pricing date).

B. Variable Rate Regular REMIC Interests

1. Background

Pursuant to section 860G(a)(1), a REMIC regular interest is defined in part as any interest in a REMIC that meets certain conditions, including that the REMIC regular interest will pay interest "based on a fixed rate (or to the extent provided in regulations, at a variable rate)." In Notice 87-41 and Notice 87-67,[75] the Service announced that regulations would be issued permitting variable rate regular interests that meet specified criteria.

Notice 87-41 indicated that regulations would permit a REMIC regular interest to bear a variable rate that (i) would be a permissible rate for a variable rate debt instrument under the proposed regulations addressing the original issue discount provisions of the Code (the "OID Regulations"),[76] i.e., a rate based on current values of an objective interest index,[77] or

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

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

[77] For example, interest based on the prime rate of a designated financial institution, LIBOR, the applicable federal rate or the average yield on Treasury securities.

(ii) was expressed as a fixed multiple of an objective index plus or minus a constant number of basis points. Notice 87-41 also indicated that an otherwise qualifying regular interest would not fail to qualify merely because it was subject to a maximum or a minimum rate.

Notice 87-67 indicated that regulations would permit a REMIC regular interest to bear a variable rate based on a weighted average of the interest rates on qualified mortgages held by the REMIC, provided that the interest on each qualified mortgage was payable during each accrual period at a fixed rate or a permissible variable rate. In addition, Notice 87-67 stated that a mortgage could have a fixed interest rate for one or more accrual periods and a permitted variable interest rate for other accrual periods. Notice 87-67 specifically approved a rate reflecting the average cost of funds of one or more financial institutions as an objective interest index, e.g., the Eleventh District Cost of Funds Index.

The Proposed Regulations affirm, expand and clarify Notices 87-41 and 87-67, and otherwise contain highly flexible provisions regarding permissible variable rates for REMIC regular interests. The Proposed Regulations provide the following clarifications:

(a) Under the Proposed Regulations, a rate equal to the highest, lowest, or average of two or more objective interest indices is a rate based on an objective interest index.

(b) A rate based on a weighted average of the interest rates on some, but not all, of the REMIC’s qualified mortgages may be a qualified variable rate provided that the qualified mortgages taken into account bear interest at a fixed rate or at a rate otherwise described in the Proposed Regulations. The Proposed Regulations also clarify the commonly held view that an interest rate is regarded as based on a weighted average rate even if in determining that rate, the interest rate on some or all of the qualified mortgages is first reduced by a fixed number of basis points (which may vary from mortgage to mortgage) or a fixed percentage of the interest on underlying mortgages. The Proposed Regulations also provide that a rate determined by taking a weighted average of the interest rates on the qualified mortgage loans net of any servicing spread, credit enhancement fees, or other expenses of the REMIC is a rate based on a weighted average rate.

(c) The Proposed Regulations also clarify that a periodic cap or floor is a permissible cap or floor. The Proposed Regulations provide that a permissible cap or floor is one that establishes (i) a maximum or minimum rate, or (ii) a maximum or minimum number of basis points by which the rate may decrease or increase from one accrual or payment period to another or over the term of the interest.

(d) Perhaps the most significant expansion of the definition of a qualifying variable rate is the ability to combine various permissible variable rates. Specifically, under the Proposed Regulations, a rate is a permissible variable rate if it is based on a fixed or qualifying variable rate described in the Proposed Regulations during one or more accrual or payment periods and a different fixed or qualifying variable rate during other accrual or payment periods.

2. Discussion

The Proposed Regulations expand on and clarify the Notices and generally contain highly flexible provisions regarding the types of variable rates that REMIC regular interests are permitted to bear. However, we have a few comments on these rules.

First, the Proposed Regulations do not provide that REMIC regular interests will be treated as variable rate debt instruments under proposed regulation section 1.1275-5(a) for purposes of applying the OID rules to those interests. If they are not so treated, they may, as discussed in the 1988 REMIC Report, be treated under the rules governing contingent payments.[78] That result would be counter to the expectation of most market participants and would serve arbitrarily to shift the incidence of taxation from regular to residual interest holders, or vice versa, from one period to the next. Accordingly, we urge that final regulations provide that permitted variable interest rates for REMIC regular interests described in the Proposed Regulations be considered to be rates “based on current values of an objective interest index” for purposes of proposed regulation section 1.1275-5.

Second, the final regulations should clarify that a cap or floor based on a weighted average of rates on the mortgages or some other varying amount (such as funds available in the REMIC or available from a specific pool of mortgages to which the regular interest relates) are permissible. Third, as currently drafted, in determining a weighted average, the Proposed Regulations only permit a reduction in the interest rate on some

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[78] Prop. Reg. §§1.1275-5(a) and 1.1275-4.

or all of the qualified mortgages by a number of basis points or a fixed percentage of interest.[79] Final regulations should permit a weighted average formula where a separate cap or floor is first applied to the interest rate on a qualified mortgage before the weighted average is computed. For example, assume that a REMIC has two qualified mortgages, each with an Interest rate that floats based on LIBOR. The mortgages have a lifetime interest cap of 14 percent and a floor of 6 percent. The sponsor may want to sell regular interests with an interest rate equal to the weighted average of the interest rates on the qualified mortgages, in each case subject to a cap of 13 percent and a floor of 4 percent. In other words, to compute the weighted average the interest rate on each loan would be determined but such amount could not be less than 4 percent or greater than 13 percent. The interest rate on both loans as so determined would then be used to compute a weighted average rate. Such a rate should be considered “based on” a weighted average of the underlying mortgage rates and should be permitted.[80]

C. Special Rules

1. Background

The Proposed Regulations also provide special rules relating to the qualification and treatment of regular interests. One special rule is noteworthy. The Proposed Regulations provide that an interest in a REMIC may qualify as a regular interest where the terms of the regular interest provide that customary prepayment penalties received with respect to qualified mortgages

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[79] Prop. Reg. §1.860G-l(a)(3)(ii)(B).

[80] If this sort of rate is not permitted, a two-tier REMIC can be used to accomplish the same result.

are to be passed through to the holders of that interest.[81] However, an interest in a REMIC may not qualify as a regular interest if the terms of the regular interest provide for the payment of any premium determined with reference to the length of time that the regular interest is outstanding.[82]

2. Discussion

The Proposed Regulation provisions relating to prepayment penalties are helpful but are limited in usefulness. These provisions clearly permit a single class pass-through structure where prepayment penalties are passed through on a pro rata basis. An allocation of prepayment penalties on other than a pro rata basis, however, may also be desirable. For example, in a multiple class structure, it may be desirable to pass through prepayment penalties based on a formula that takes into account the length of time that the interest is outstanding. Alternatively, where an IO interest is issued, it may be desirable to pass through all or substantially all of the prepayment penalties on the qualified mortgages to the IO interest holder because that interest is most significantly affected by prepayments. We interpret the rule allowing prepayment penalties received to be “passed-through” to allow considerable flexibility in allocating prepayment premiums among different classes of regular interests. However, this point should be stated more clearly in the final regulations, perhaps through examples.

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81 Prop. Reg. §1.860G-l(b)(2).

82 Prop. Reg. §1.860G-1(b)(1).

D. Contingencies on Regular Interests

1. Background

Section 860G(a)(1) provides that a regular interest must be issued with fixed terms on the startup day and must unconditionally entitle the holder to receive a specified principal amount. A regular interest does not fail to meet this requirement merely because the timing (but not the amount) of the principal payments may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.

The Proposed Regulations provide that except for certain specified contingencies, the regular interest's principal amount and the latest possible maturity date must not be contingent.[83] The specified contingencies that are disregarded include (i)(x) where timing of principal payments is contingent on prepayments on some or all of the qualified mortgages or (y) where timing of interest or principal is contingent on payments of expenses incurred by the REMIC, (ii) where the timing or amount of payments of principal or interest is contingent upon the absence of defaults on qualified mortgages and permitted investments, or on the amount of income generated by permitted investments, (iii) where payments on a regular interest are contingent because it bears all, or a disproportionate share of losses stemming from cash flow shortfalls due to defaults or delinquencies on qualified mortgages or permitted investments, lower than reasonably expected returns on permitted investments, expenses incurred by the REMIC, or prepayment interest shortfalls, before

[83] Prop. Reg. §1.860G-l(a)(5).

other regular interests or the residual interest[84] bear losses occasioned by such shortfalls, (iv) solely because the regular interest provides for deferral of interest payments, or (v) solely because the amount of interest payments is contingent upon prepayments made on the underlying mortgages.

2. Discussion

The listing of permitted contingencies on regular interests is quite helpful because these sorts of contingencies are the ones commonly required from an economic standpoint in structuring almost any mortgage-backed security. We think the Proposed Regulations could be improved, however, by providing that “remote and incidental contingencies” on interest and principal would be disregarded. For example, it is possible to structure a mortgage-backed security such that there are certain prepayment speeds which if sustained would mean that principal on a regular interest would not be paid. This interest can be sold to investors with a AAA rating from a rating agency because the sponsor of the transaction demonstrates to the rating agency that such prepayment speeds for the necessary period are extremely unlikely to occur.[85] Although the risk of non-payment on the regular interest would be disclosed in the offering document, it is done so on the basis that the prepayment speed is extremely unlikely to be reached for the necessary period of time. In addition, there may be other circumstances where payment of interest and principal on a regular interest is technically

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84 This rule permits a residual interest to be senior in terms of credit priority to a regular interest.

85 We do not mean to suggest that we are addressing only remote and incidental contingencies that would be taken into account by a rating agency or that rating agency approval would be required for a particular contingency to be treated as remote. Rather, we only suggest that a rating of AAA should be considered prima facie evidence that all risks are remote.

contingent but where the risk of any shortfall is remote. None of these situations should present any significant policy issue because the remote contingency presumably would be ignored for all tax accounting purposes unless the contingency actually came to pass.[84] We also note that as a general proposition, remote contingencies that would excuse payment are properly ignored in determining whether an instrument is treated as debt,[85] the general model for regular interests. Accordingly, we think that the list of permitted contingencies in the Proposed Regulations should be expanded to include a contingency that is remote and incidental.

Proposed Regulation section 1.860G-l(b)(3)(i)(A) prevents disqualification of a regular interest where the timing of principal amounts is contingent on the amount of income from permitted investments. Proposed Regulation section 1.860G-1(b)(3)(ii) permits the amount or timing of payments of principal and interest to be contingent "on the amount of income generated by permitted investments." These references should be clarified. For example, it seems clear that Proposed Regulation section 1.860G-l(b)(3)(i)(A) would permit all earnings on a cash flow or qualified reserve asset to be used to pay down principal on a regular interest. Proposed Regulation section 1.860G- 1(b)(3)(H), however, could be read to permit a regular interest's principal amount to be contingent on income earned on cash flow or qualified reserve fund assets. If this was intentional, it should be stated clearly. Additionally, Proposed Regulation section 1.860G-l(b)(3)(ii) could be read to permit interest on a regular

84 Cf. Prop. Treas. Reg. §1.1275-2(b) (Service entitled to ignore remote and incidental contingencies with respect to debt obligations).

85 See Anchor National Life Insurance Co. v. Commissioner, 93 T.C. 382 (1989).

interest based on earnings on a reserve fund. As we said in our 1988 Report this is a useful rule because it would permit sponsors to put up cash as a reserve and earn interest on the reserve without being required to hold the REMIC residual interest. Again, the Proposed Regulation should be clarified, perhaps through examples, to illustrate that this was the intended rule.

Proposed Regulation section 1.860G-l(b)(3)(iii) refers to cash flow short falls attributable to expenses incurred by the REMIC. Presumably, expenses should also be mentioned in paragraph (ii). In addition, a description of this paragraph in the preamble to the Proposed Regulations refers to “unanticipated” expenses. This seems an appropriate qualification, and should be reflected in the text of the regulation.

E. Issue Prices of Regular and Residual Interests

Proposed Regulation section 1.860G-l(d) provides rules for determining the issue price of a regular interest. While the regulation addresses publicly offered regular interests, it ignores privately placed regular interests. The final regulations should clarify that the issue price of a privately placed regular interest is the price paid by the first buyer as provided in section 1273(b)(2) and proposed regulation section 1.1273-2(b)(2). Also, the last sentence of Proposed Regulation section 1.860G-l(d) provides that if a regular or residual interest is retained by the sponsor then the issue price of the retained interest is its fair market value on the pricing date (as defined in Proposed Regulation section 1.860F-2(b)(3)(iii)), or if there is no pricing date, the startup day, whether or not the interest or the property exchanged there for is publicly traded. It would seem, however, that if the sponsor retains a portion of a class of publicly-traded regular or residual interests then the issue price should be determined under the normal rule, i.e., the offering price at which a substantial amount of the class was sold. In this case, there is no benefit to the fair market value rule because an easily ascertainable price exists in the public market.

IX. OTHER RULES (PROPOSED REGULATION SECTION 1.860G-2)

A. Definition of Qualified Mortgages

1. Background

A loan may be a qualified mortgage only if it is an “obligation (including any participation or certificate of beneficial ownership therein) principally secured by an interest in real estate”.[86] Proposed Regulation section 1.860G-2 defines the key terms “obligation”, “principally secured” and “real estate”, and also provides guidance on issues such as the consequences of an assumption or modification of a qualified mortgage. In addition, Proposed Regulation section 1.860G-2 defines “defective obligation”.

a. Principally Secured

Proposed Regulation section 1.860G-2(a)(1) provides that an obligation is treated as principally secured by an interest in real property if the fair market value of the real property securing the obligation was at least 80 percent of the adjusted issue price of the obligation either (i) at the time the obligation was originated or (ii) at the time the sponsor

[86] §860G(a)(3)(A).

contributed the obligation to the REMIC. The fair market value of the property, for this purpose, is reduced by the amount of any senior liens and by the proportionate amount of any liens of equal seniority.[87]

Proposed Regulation section 1.860G-2(a)(3) provides a safe harbor under which an obligation that does not meet the foregoing test nevertheless is deemed to be principally secured by an interest in real property if the sponsor “reasonably believed” at the time of contribution that the obligation was so secured. For this purpose, a reasonable belief could be based on representations and warranties made by the originator of the obligations.[88] However, if it were later discovered that an obligation was not principally secured by an interest in real property, it would be treated as a “defective obligation” as of the date of discovery. The mortgage would continue to be treated as a qualified mortgage for 90 days from that date and would be subject to the rules for defective obligations discussed below.

b. Real Property

Proposed Regulation section 1.860G-2(a)(4) defines “real property” in the same way as the term is used in the regulations pertaining to REITs.[89] Real property is broadly defined as land or improvements thereon. Local law definitions are not controlling. The term, however, does not include assets accessory

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[87] So long as the obligation is secured by real property of sufficient value, there is no restriction on having other non-real property security as well.

[88] It does not appear that the Proposed Regulations require that the sponsor make any representations and warranties to the REMIC regarding the status of the mortgages in order to take advantage of the safe harbor.

[89] Reg. §1.856-3(d). See Section I.A. of the Preamble to the Proposed Regulations.

to the operation of a business, such as, among other items, the furnishings of a motel, hotel or office. The Proposed Regulations do not define an "interest" in real property.

c. Obligations

The Proposed Regulations describe the types of obligations that are considered to be secured by real property;[90] these include (i) mortgages, deeds of trust and installment land contracts, (ii) GNMA, FNMA, or FHLMC pass through certificates, or other grantor trust interests that represent undivided beneficial ownership in a pool of real estate mortgages, and (iii) obligations secured by manufactured housing (provided the manufactured housing would qualify as single family residences under section 25(e)(10)).[91] Obligations other than REMIC regular interests that are secured by other debt obligations, such as CMOs, are not considered secured by real property.[92]

d. Defeasance

Proposed Regulation section 1.860G-2(a)(7) provides that an obligation will continue to be considered to be a qualified mortgage notwithstanding that the REMIC releases its lien on the underlying real property provided that: (i) the mortgagor pledges substitute collateral consisting solely of government securities, (ii) the mortgage documents allow for such a substitution, (iii) the lien is released to facilitate the disposition of the real

[90] Prop. Reg. §1.860G-2(a)(5).

[91] Section 25(e)(10) provides that a "single family residence" includes "any manufactured home which has a minimum of 400 square feet of living space and a minimum width in excess of 102 inches and which is of a kind customarily used at a fixed location."

[92] Prop. Reg. §1.860G-2(a)(6).

property and (iv) the defeasance does not occur within two years of the startup day.

e. Assumptions and Modifications of Qualified Mortgages

Proposed Regulation section 1.860G-2(b) provides that, in general, any “modification” of a mortgage is treated as an acquisition of the modified mortgage (the “new mortgage”) in exchange for the unmodified mortgage (the “old mortgage”) on the date the modification occurs. Under Proposed Regulation section 1.860G-2(b)(2), a modification occurs if the new terms of a mortgage differ materially either in kind or in extent from its old terms within the meaning of regulation section 1.1001-l(a). A mortgage that is deemed to be newly acquired under this rule would be a qualified mortgage only if it is a “qualified replacement mortgage”, which would be impossible if the deemed acquisition occurred more than two years after the REMIC's startup day. The deemed disposition of the old qualified mortgage would be a prohibited transaction, unless there were an applicable exception.

Proposed Regulation section 1.860G-2(b)(3) affords substantial relief from this broad rule by providing that a mortgage is not considered modified for purposes of determining its status as a qualified mortgage in the case of: (i) a change in the terms of the mortgage occasioned by a default or a reasonably foreseeable default, (ii) an assumption of the mortgage, (iii) a waiver of a due-on-sale clause, or (iv) a conversion of an interest rate by a mortgagor pursuant to the terms of a “convertible adjustable rate mortgage”. In addition, if a REMIC holds pass-through certificates issued by a grantor trust, modifications of the mortgage loans underlying the certificates are not treated as modifications of the pass-through certificates, as long as the grantor trust was not created to avoid the prohibited transactions rules of section 860F(a).

f. Defective Obligations

Proposed Regulation section 1.860G-2(f) contains a fairly broad definition of defective obligation, which will result in REMICs having greater latitude in substituting or disposing of qualified mortgages. A defective mortgage is defined as a qualified mortgage that:

(i) is in default, or with respect to which default is reasonably foreseeable,[93]

(ii) was fraudulently procured by the mortgagor,

(iii) was not in fact "principally secured" by real property, or

(iv) was transferred to the REMIC in violation of a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage or pool of mortgages of which the mortgage is a part.

The Proposed Regulations state that a customary representation does not include a representation that payments on qualified mortgages will be received at a rate no less than a specified minimum or no greater than a specified maximum.

The Proposed Regulations also state that upon discovery that an obligation is defective, a REMIC must dispose of the obligation or cause the defect to be cured within 90 days of discovery, if the defect would have prevented the obligation from being a qualified mortgage had it been discovered before the

93 Thus, qualified replacement mortgages can be substituted for mortgages in or near default within the two-year period beginning on the start-up date.

startup day (for example, because it affects the security for the obligation). Otherwise, the defective obligation will cease to be a qualified mortgage. Until the expiration of the 90-day period, however, the defective obligation will continue to be treated as a qualified mortgage. Thus, until that time, income earned on the defective mortgage will not be considered income from a prohibited transaction.

2. Discussion

a. Definition of Qualified Mortgages-Basic Definitions

We believe that the definitions of “obligation”, “principally secured” and “real estate” are appropriate, conform to the expectations of most market participants and raise few significant issues. A few technical issues, however, should be addressed in the final regulations.

One issue that should be clarified is whether a qualified mortgage can be secured by improvements on leased land or by a lease of real property itself. Regulation section 1.856-3(b), applicable for REITs, provides that real estate assets include “interests in mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon). . . .” Also, regulation section 1.856-3(c) provides that interests in real property include “fee ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon.” We think a similar definition is appropriate for the qualified mortgage definition.[94]

The definition of “obligation” includes pass-through certificates and interests in trusts holding real estate mortgages, provided the trust is taxable as a trust under regulation section 301.7701-4(c). We believe that the definition of qualifying “private label” trusts was meant to be descriptive rather than limiting. Thus, a private label trust designed to hold mortgages and that also may hold property similar to cash flow investments and foreclosure property should qualify as an obligation and the indirectly-owned investment assets and real estate should not be treated as non-permitted investments. That would be the case with FNMA and FHLMC pass-through certificates since they literally qualify without meeting any other criteria under Proposed Regulation section 1.860G-2(a)(5). We are aware of no policy reason to distinguish between “agency” and private label certificates. In the case of private label trusts, we believe the final regulations should make this point clear.

The Proposed Regulations do not indicate whether pass-through certificates backed by obligations secured by stock in a cooperative housing corporation qualify as obligations secured by real property. Although the failure to include such pass-through certificates does not imply that they do not qualify, we believe that such certificates should be specifically enumerated.

[94] For purposes of section 593, an obligation that is secured by a leasehold interest in real property is considered secured by real property only if the term of the leasehold is at least 30 years or exceeds the term of the mortgage by at least 10 years. Reg. §l.593-ll(b). As a general matter we see no principled reason for favoring this more restrictive definition in the context of REMICs. We note that the suggested rule would not be subject to abuse because REMIC interests would not qualify under section 593 if the REMIC's mortgages did not so qualify.

The Proposed Regulations defining qualified mortgages should clarify when the 80 percent test is applied to a mortgage that has been modified after origination and before the time the mortgage is contributed to the REMIC. Because certain modifications of mortgages constitute a reissuance of the mortgages for Federal income tax purposes, (e.g., a voluntary reduction in interest rate), it might be thought that the 80 percent test is measured either at the time the mortgage was modified or at the time the mortgage was contributed to the REMIC. It is common market practice, however, that no formal appraisal is made at the time a mortgage is modified; as a result, the value of the real property securing the related mortgage is not known with certainty. Accordingly, the 80 percent test for a qualified mortgage should be measured either at the time the mortgage was initially originated, i.e., without regard to any modification that would constitute a reissuance, or at the time the modified mortgage was contributed to the REMIC.

The Proposed Regulations defining qualified mortgage should also clarify when the 80 percent test is applied to a qualified replacement mortgage, as defined in section 860G(a)(4). Because the definition refers to a mortgage that “would be a qualified mortgage if transferred on the startup day in exchange for regular or residual interests”, it might be thought that a qualified replacement mortgage is subject to the general rule in Proposed Regulation section 1.860G-2(a)(1) that the 80 percent test is measured on either the origination date or the startup day. The startup day, however, may be as much as two years before the replacement mortgage is contributed to the REMIC and may not bear much relevance to whether the mortgage, upon contribution, is adequately secured by real estate. The 80 percent test for a qualified replacement mortgage, therefore, should be measured either on origination or at the time the mortgage is contributed to the REMIC.

Proposed Regulation section 1.860G-2(a)(3) provides a safe harbor which deems a mortgage to be principally secured by real property if the sponsor reasonably believes the mortgage meets the 80 percent test. A reasonable belief may be based on representations and warranties made by the originator of the obligations. We think that a reasonable belief could also be based on representations from the REMIC sponsor or the former owner of the mortgages. Thus, the originator of the obligations may not be a party to the REMIC transaction. It is impossible to trace back to find the originator (who may not still be in existence). Additionally, even if found, the originator has no motivation to supply the necessary representation. Permitting the sponsor or owner to make the representation is also consistent with Proposed Regulation section 1.860G-2(f)(1)(iv) which, in the context of defining a defective obligation, contemplates a representation by the sponsor or the prior owner of the mortgages regarding the mortgage's characteristics.

b. Defeasance

We believe that there is no policy reason for disqualifying (or excluding from REMICs) mortgages that permit the obligor to substitute collateral for the mortgaged real estate, provided the substitution is consistent with reasonable commercial practices and is not part of plan to use the REMIC rules to securitize obligations other than real property mortgages. In this regard, Proposed Regulation section 1.860G-

2(a)(7) is a useful rule.[95] Its usefulness would be somewhat enhanced, however, if the third requirement, that the lien be released to facilitate the disposition of the real property, were deleted. Although mortgagors typically defease mortgages to sell the underlying real property, the REMIC may not be able to ensure that selling the underlying property is the mortgagor's real purpose for defeasing the mortgage. Further, if the lien is released prior to a contemplated disposition in order to facilitate the disposition, but the property is not actually sold for any number of legitimate reasons, it may appear that there was some other reason for the release. In lieu of the third requirement, we believe that a requirement that the release not be part of a plan to use the REMIC rules to securitize obligations other than real property mortgages would be appropriate. Further, a REMIC may not anticipate a defeasance that would violate the rule, because, for example, it may not be expected that a defeasance permitted within two years of the startup day would actually take place within that time period. Therefore, the rule should provide that the obligation ceases to be a qualified mortgage 90 days after the lien on the real property is released.

c. Assumptions and Modifications

Because the consequences of a deemed substitution of a new non-qualified mortgage for a qualified mortgage are so severe, we believe that certainty as to whether a modification of a mortgage loan is a permitted modification is extremely

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[95] The Proposed Regulations contemplate the complete release of the lien on the real property. Presumably, the release of the lien on a portion of the real property, where the real property remaining would by itself have permitted the obligation to meet the requirements of Proposed Regulation section 1.860G-2(a)(1), would not (without regard to the defeasance safe harbor) cause the obligation to fail to continue to be considered a qualified mortgage.

important.[96] In this regard the Proposed Regulations fall short. Whether a modification will be considered to cause the mortgage to have terms differing materially in kind or extent within the meaning of regulation section 1.1001-1(a) (such a modification, a “section 1001 event”) will in many cases be uncertain because the breadth of regulation section 1.1001-l(a) is uncertain and the interpretation of that regulation is continuously changing.[97] Thus, a general rule to the effect that any section 1001 event (with limited exceptions) is considered a substitution will either (i) cause entities to fail unintentionally to maintain their REMIC status or (ii) cause REMICs to refuse to consent to externally initiated and commercially reasonable requests for modifications. Accordingly, we believe that (subject to the safe harbors provided in Proposed Regulation section 1.860G-2(b)(3) and the section 1001 event safe harbor mentioned above) a more appropriate standard would be to treat a modification as a substitution if, and only if, the amount or timing of interest or principal payments would be changed to any material extent or other terms would be changed in such a manner that the likelihood

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96 For example, assuming that one of the safe harbors in Proposed Regulation section 1.860G-2(b)(3) is not met, (i) any income earned on the disposition of the old mortgage, which may include the difference between the REMIC's basis in the old mortgage and the fair market value of the new mortgage, would be subject to a 100 percent prohibited transactions tax, (ii) any income earned on the new mortgage, including interest and discount accrued thereon, would be subject to the 100 percent prohibited transactions tax and (iii) if the new mortgage represented more than a _de minimis_ amount of the REMIC's assets, the entity would be disqualified as a REMIC.

97 _See Cottage Savings Ass’n v. Commissioner_, 90 T.C. 372 (1988), _rev'd_. 890 F.2d 848 (6th Cir. 1989), _rev'd and remanded_, 111 S.Ct. 1503 (1991), _aff'd_, 934 F.2d 739 (6th Cir. 1991). See the discussion of _Cottage Savings_ and the reissuance question in general in our report entitled “Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges”, reprinted in _Tax Notes_ April 8, 1991, pp. 79-111.

of full payment on the obligation were materially reduced.[98] Such a rule is appropriate because the “static” asset requirement for a REMIC is modeled after the prohibition on a fixed investment trust that neither the trustee nor the certificate holders can have any power to vary the trust's investment to take advantage of market fluctuations.[99] The key issue under those rules is whether the trustee has discretion to substitute a new investment for an old one in order to take advantage of market fluctuations and maximize investment returns. In the case of a qualified mortgage where the payment terms are not materially altered, there is no ability to take advantage of market fluctuations. Therefore, a slightly more relaxed, but clearer, standard than that under section 1001 is appropriate. Further, we believe that if a new obligation is created under this standard, the new obligation should be treated as a qualified mortgage for 90 days in order to permit a REMIC to dispose of the new obligation in an orderly manner.

Even if our proposed rule is not adopted, the final regulations should make clear that a partial prepayment of a mortgage that is not provided for in the original terms does not give rise to a deemed exchange so long as the original terms apply to the portion of the mortgage that remains outstanding. The uncertainty arises because Proposed Regulation section 1.1274- l(c) provides that a payment from or to the lender not provided for in the debt instrument is automatically treated as a

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[98] It should be noted that this standard would permit the substitution of new real estate collateral for old. Assuming that the 80 percent test in Proposed Regulation section 1.860G-2(a) is met at the time of substitution, we believe this to be appropriate. As noted above, we also think it would be appropriate to permit release of a portion of the real estate securing a qualified mortgage, again assuming the 80 percent test is met at the time of the release.

[99] Reg. §301.7701-4(c), Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941).

modification of the debt instrument. Such a rule in the REMIC context is unreasonably harsh considering that the effect would be to create a nonqualifying asset, possible REMIC disqualification and income subject to the prohibited transactions tax.

The safe harbors of Proposed Regulation section 1.860G-2(b)(3) provide that no substitution will be deemed to occur upon the conversion of a "convertible adjustable rate mortgage", although that term is not defined. The term "convertible mortgage" is defined in Proposed Regulation section 1.860G-2(d)(4); this might imply that a convertible adjustable rate mortgage is a "convertible mortgage" (as defined) that starts as an adjustable rate mortgage. We believe that such a safe harbor is too narrow. If a mortgage can be a qualified mortgage even though the interest rate may be convertible in some manner, we find no policy reason for requiring the REMIC to dispose of such a mortgage upon the conversion (which is the effect of construing the conversion safe harbor narrowly).[100] Examples of mortgages that would not qualify under a narrow rule are mortgages that begin bearing interest at a fixed rate, but allow a conversion to a floating rate[101] or mortgages that permit the mortgagee rather than the mortgagor to change the interest rate. Another example would be an adjustable rate mortgage where the obligor has the right to change to another adjustable rate formula, where the adjustment would not be "intended to approximate a market rate

[100] The ability of a wide variety of convertible mortgages to be qualified mortgages is implied by the treatment under Proposed Regulation section 1.860G-2(d).

[101] This would be the case if such a conversion were a section 1001 event, which it would not necessarily be. Compare Rev. Rul. 87-19, 1987-1 C.B. 249. ("An adjustment to the interest rate on an issue of bonds pursuant to an interest rate adjustment clause does not result in an exchange under section 1001 of the Code."). As noted in the text above, however, the test for determining whether there has been a section 1001 event is uncertain and ever-changing.

for newly originated mortgages . . .” While such a market rate requirement may be sensible in the case of the right to acquire a mortgage from a REMIC, it makes no sense for determining whether a REMIC can retain such a mortgage. Accordingly, we believe that clause (iv) of Proposed Regulation section 1.860G-2(b)(3) should be changed to permit the change of an interest rate (whether by the mortgagor or the REMIC) pursuant to the terms of the mortgage so long as the new rate (or a formula for setting the new rate) is set forth in the mortgage.

Mortgages (“extendable mortgages”) sometimes provide the mortgagor with an option to extend the term of the mortgage, at the same interest rate, or in some cases at a new interest rate. We believe that a safe harbor should be provided indicating that the extension of the maturity of an extendable mortgage will not be considered a substitution.[102]

d. Defective Obligations

Certain technical issues relating to defective obligations should be clarified in the final regulations. First, an obligation should be considered defective, and thus subject to the 90-day discovery rule, if the obligation is reasonably believed to be secured by stock in a cooperative housing corporation as defined in section 216(b)(1), but it is later discovered that the obligation did not meet that test.[103]

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[102] Such a rule would be consistent with the treatment of such mortgages under the OID Regulations which generally treat a loan with an option to extend as a loan with a maturity equal to its latest maturity with a prepayment option. See Prop. Reg. §1.1272-1(f)(4)(v).

[103] A cooperative housing corporation could have, for example, failed to meet the 80 percent of income test of section 216(b)(1)(1). Further, the final regulations should clarify whether a REMIC must dispose of a loan secured by stock in a cooperative housing corporation which qualified under section 216(b) at the issuance of the loan (or its transfer to the REMIC), but then fails to qualify thereafter.

Although a representation as to status of collateral as co-op stock probably could fit under the Proposed Regulation section 1.860G-2(f)(1)(iv) general rule regarding representations, a specific statement would still be helpful. Second, the right or obligation of the sponsor or third party to purchase defective mortgages should not be considered an interest in or an asset of the REMIC. Third, it is important to determine when the 90-day period referred to in this paragraph expires. The Proposed Regulation does not make clear whose discovery of a defect counts. For example, suppose the original seller discovers the defect but does not inform either the servicer or the trustee of that fact for 120 days. Alternatively, suppose the servicer becomes aware of a problem, but does not inform the trustee, or vice versa. When does the 90-day period start to run? Ordinarily, it would make sense to start the period running when the servicer acquires knowledge of the defect since it is ordinarily the servicer who would be responsible for disposing of a defective obligation. On the other hand, if the sponsor is obligated to repurchase a defective loan, and is not informed of a problem promptly by the servicer, then under this rule it could be required to purchase a loan on very short notice. Perhaps the parties should be able to designate some person whose knowledge will start the clock running, provided there is an obligation on the part of the servicer, sponsor and if applicable, trustee to inform that person promptly of any defects that are discovered. In addition, any payment received upon the disposition of any defective mortgage should be treated as a payment in full on the mortgages (and thus not income from a prohibited transaction).[104] Finally, we believe that the final regulations should permit a new mortgage exchanged for a obligation that ceased to be a qualified mortgage because of the lapse of more than 90 days

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[104] Compare Prop. Reg. §1.860G-2(d)(2).

following the discovery of a defect to be treated as a qualified replacement mortgage. Absent regulatory relief, such a mortgage might fail to so qualify because the mortgage for which it was exchanged was not at the time of exchange a qualified mortgage.

B. Definition of Permitted Investments

1. Background

In addition to qualified mortgages, the assets of a REMIC may consist of “permitted investments”, which include “cash flow investments”, “qualified reserve assets” and “foreclosure property”. The Proposed Regulations provide definitions for the first two terms, but do not define foreclosure property.

a. Cash Flow Investments

A cash flow investment is defined as an investment of payments received on qualified mortgages for a temporary period between the receipt of those payments and the regularly scheduled date for distributions to REMIC interest holders. For this purpose, a payment received on a qualified mortgage includes:

(i) payments of interest and principal, including prepayments and payments under credit enhancement contracts,

(ii) proceeds from the disposition of qualified mortgages,

(iii) cash flows from foreclosure property and the proceeds from its disposition,

(iv) a payment by a sponsor or prior owner of a defective obligation in lieu of a repurchase of the obligation, where the obligation was transferred in breach of a customary warranty, and

(v) prepayment penalties required to be paid under the terms of the qualified mortgage upon its prepayment.[105]

Cash flow investments must be passive investments that earn a return in the nature of interest, and amounts are considered temporarily invested if the period from the receipt of a payment to the time that payment is distributed does not exceed 13 months. The temporary period for any one mortgage payment is not terminated because of the distribution of other mortgage payments to interest holders.

If a REMIC is formed with a contribution of cash that will be used to purchase mortgages (pursuant to a fixed price contract) within three months,[106] any investment of that cash for the period prior to purchase is unlikely to qualify as a cash flow asset. Accordingly, the receipt of investment earnings during that period literally can be treated as a prohibited transaction to which the 100 percent tax would apply.[107]

b. Qualified Reserve Assets

The Proposed Regulations define a qualified reserve asset as an intangible asset that is both held for investment (although it need not actually earn a return) and held as part of a "qualified reserve fund". A qualified reserve fund, in turn, is any reasonably required reserve used to provide for full payment of expenses of a REMIC or amounts due on regular and residual interests, in the event of: (i) defaults on qualified mortgages,

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105 In determining the extent to which REMIC interests held by REITs and thrift institutions qualify as real property loans or real estate assets, cash flow investments are treated as qualifying assets. See Prop. Reg. §§1.593(e)(2)(ii) and 1.856-3(b)(2)(ii)(B).

106 See §860G(a)(3)(A)(ii).

107 See §860F(2)(B).

(ii) prepayment interest shortfalls or (iii) lower than expected returns on cash flow investments.

The Proposed Regulations also provide a rebuttable presumption that the amount of a reserve is reasonably required and is promptly and appropriately reduced, if it does not exceed (i) the amount required by a nationally recognized independent rating agency to give the desired rating, or (ii) the amount required by a third party insurer or guarantor, who does not directly or indirectly own an interest in the REMIC, to provide credit enhancement.

c. Foreclosure Property

Foreclosure property is defined in section 860G(a)(8) as property that would be foreclosure property under section 856(e) (without the requirement of an election being made) if acquired by a REIT and that is acquired in connection with a default or imminent default of a qualified mortgage held by the REMIC. Under section 856(e)(1), foreclosure property is real property acquired as a result of having bid on such property at foreclosure or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default (or default was imminent) on a mortgage loan which such property secured. Regulation section 1.856-6(b)(3) provides, however, that property will not qualify as foreclosure property if the loan with respect to which the property was acquired itself was acquired either with an intent to foreclose or where there was actual knowledge or reason to know that default on the loan would occur. The Proposed Regulations do not elaborate on the definition of foreclosure property for REMICs.

The consequences are severe if property that is acquired by a REMIC fails to qualify as foreclosure property. If assets of this nature comprise more than one percent of the REMIC's total assets, the REMIC will be disqualified. Moreover, any income realized from that property would be treated as income from a prohibited transaction and would be subject to a one hundred percent tax.

2. Discussion

a. Cash Flow Investments

When investments are commingled, the Proposed Regulations are not clear on when the 13-month temporary period expires. A REMIC should be permitted to use any reasonable accounting method for determining when the 13-month period expires. For example, if a commingled account is used, a reasonable method would be a FIFO method so long as that method was used consistently by the REMIC.

Where a REMIC is formed through a contribution of cash that will be used to purchase mortgages within three months, we believe that the tax on prohibited transactions was not intended to apply to earnings on those assets. As a general matter, the prohibited transaction rules are designed to confine the REMIC's activities only to those contemplated as incident to passive ownership of mortgages. Because the statute specifically contemplates that the REMIC could hold such temporary investments of cash during the initial three month period, it would be inappropriate to confiscate any potential earnings for that period. As a result, we recommend that final regulations include in the definition of cash flow investment temporary investments in the initial three month period. Although such investments are not literally within the statutory definition of cash flow investment, we believe that the functional similarity would justify extending the definition in regulations.

b. Qualified Reserve Assets

Allowing reserves to protect residual interests and to meet prepayment interest shortfalls as well as the creation of the rebuttable presumptions provided by in the Proposed Regulations are all new and appropriate. We are concerned, however, that the definitions of a credit enhancement contract (see below), mortgage servicer advances and qualified reserve funds, will effectively require a REMIC to provide for differing contingencies in particular ways when no policy reason exists for the differences.[108] Accordingly, we believe that the list of permitted purposes for which a reserve fund may be used should be expanded to include advances and credit enhancements of any nature that could be provided under a credit enhancement contract, including a mortgage servicer advance (each as defined in Part IX.C.I.b., below).[109]

The Proposed Regulations do not indicate whether a reserve fund that provides funding for more than one purpose will be considered entirely not a “qualified reserve fund” if one of those purposes is impermissible. We believe that it would be more

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108 Some examples of the needless differences are: (i) credit enhancement contracts contemplate partial payment guarantees while reserve funds literally may be read to apply only to “full payments”, (ii) credit enhancement contracts may provide for unanticipated losses of the REMIC but a reserve fund cannot and (iii) a reserve fund can provide for lower than expected returns on cash flow investments but a credit enhancement contract may not.

109 Another approach is to ensure that each definition is broad enough to cover items covered in the others.

appropriate to treat such a reserve fund as qualifying in part and not qualifying in part.

c. Foreclosure Property

We believe that the limitation on the definition of foreclosure property contained in regulation section 1.856-6(b)(3) should not be applied with respect to property that a REMIC acquires by foreclosure.[110] The restrictions in that regulation section are designed to insure that a REIT could not acquire and operate property on terms that otherwise would not be permissible. In general, no similar concern should exist for REMICs. It is difficult to imagine that the sponsor of a REMIC would seek to use the REMIC vehicle as a means of acquiring and operating property through the foreclosure of loans, and thereby avoiding a corporate level tax on income from those operations. To the extent a concern of this nature exists, it can be addressed in one of two ways, either of which would be preferable to the severe limitation of regulation section 1.856-6(b)(3). The first approach would be to substitute for the standard based on knowledge of likely default, a test based on a specific intent to acquire the foreclosed upon property that was the security for the qualified mortgage. If a test along these lines is formulated, safe harbors should be required whereby the requisite intent can be demonstrated to be lacking. We believe an appropriate safe harbor with respect to single family residential real estate loans would be the absence of knowledge that a loan is delinquent in payment by more than six months as of the

[110] A REMIC often may acquire loans on which payments are somewhat delinquent and technically in default. Nonetheless, the REMIC is acquiring those loans with no intention of foreclosing. Accordingly, at a minimum, property should not fail to be treated as foreclosure property with respect to a loan that was technically in default when acquired by the REMIC unless there is reason to believe the REMIC specifically intended to acquire the foreclosed upon property.

formation of the REMIC, and with respect to commercial or multifamily mortgage loans the absence of actual knowledge of the commencement of foreclosure proceedings.

Alternatively, the test could be formulated based on the REMIC's overall intention, measured by the extent to which loans that it holds may be near a default and foreclosure. For example, it is difficult to maintain that a REMIC is designed for abuse where less than a very significant percentage of its mortgage loans could be considered candidates for default and foreclosure. Accordingly, the final regulations might apply the REIT standard only if some substantial percentage of the REMIC's loans on the startup day (e.g., 25 percent) were in material default (giving effect to applicable grace periods).

C. Treatment of Certain Items as REMIC Assets

1. Background

Since substantially all of the assets of a REMIC must be qualified mortgages or permitted investments, it is important to ensure that the REMIC does not hold more than a de minimis amount of other assets. The Proposed Regulations clarify that certain items, such as “outside reserve funds” and “credit enhancement contracts”, will not be treated as assets (or at least will not be treated as separate assets) of a REMIC if certain requirements are met.

a. Outside Reserve Funds

The Proposed Regulations provide a safe harbor rule under which a reserve fund will be treated as “outside” the REMIC and not an asset of the REMIC if certain tests are met. Under this safe harbor, a reserve maintained to pay expenses of a REMIC, or to make payments on regular interests in the event that the REMIC experiences cash flow shortfalls due to defaults or delinquencies on qualified mortgages or cash flow investments (or lower than expected cash flow investment returns), is considered outside the REMIC if the REMIC's organizational documents clearly and expressly:

> (i) provide that the reserve fund is an outside reserve fund and not an asset of the REMIC;
>
> (ii) identify the owner(s) of the reserve fund, either by name, or by description of the class whose membership comprises the owners of the fund; and
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> (iii) provide that, for all federal tax purposes, amounts transferred by the REMIC to the fund are treated as amounts distributed by the REMIC to the designated owners(s) or their transferees.

b. Credit Enhancement Contracts

Frequently a REMIC will enter into credit enhancement arrangements under which payments will be made to the REMIC to replace defaulted or delinquent payments on qualified mortgages and to ensure timely payments to REMIC interest holders. One issue that had existed prior to the Proposed Regulations was whether the right to receive such payments, and any collateral pledged to guarantee that such payments will be made, is an asset of the REMIC.

The Proposed Regulations provide generally that “credit enhancement contracts” are not REMIC assets. Further, any collateral supporting such a contract is not a REMIC asset solely because it supports the guarantee represented by that contract. Instead, a credit enhancement contract is treated as part of the mortgage or pool of mortgages to which it relates. A credit enhancement contract is defined as any arrangement whereby a person agrees to guarantee (i) full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or (ii) full or partial payment on one or more classes of regular interests, in the event of defaults or delinquencies on qualified mortgages, or unanticipated losses or expenses incurred by the REMIC. Credit enhancement contracts include, for example, mortgage pool insurance contracts, certificate insurance contracts, third party guarantee arrangements, guarantees by either the REMIC sponsor or a third party and bank letters of credit.

Certain agreements providing for “servicer advances” (whether obligatory or optional) also are treated as credit enhancement contracts.[111] These agreements include an agreement to pay taxes and hazard insurance premiums on the property underlying the qualified mortgages or other expenses incurred to protect the REMIC's security interest, in each case in the event the mortgagor fails to pay such taxes, insurance premiums or expenses.

c. Agreements to Purchase Convertible Mortgages

Proposed Regulation section 1.860G-2(d) provides that a “purchase agreement” to purchase a “convertible mortgage” is incidental to the mortgages and thus not a separate asset of the REMIC and payments made thereunder are treated as made pursuant to the mortgages. A “purchase agreement” is a contract pursuant

[111] The Proposed Regulations do not specifically indicate that the right of a servicer to be reimbursed for advances with interest is not an interest in the REMIC; this, however, must be the case. Proposed Regulation section 1.860D- 1(b)(2)(iii) provides that the right to reimbursement on a credit enhancement contract (which would include servicer advances) would not be treated as an interest in the REMIC and letters of credit (which are permissible credit enhancement contracts) typically provide for reimbursement with interest.

to which a REMIC is obligated to sell, and a third party to buy, a convertible mortgage at par (plus accrued interest) upon conversion. A “convertible mortgage” is a mortgage that permits the mortgagor from time to time to convert the interest rate on the mortgage from one interest rate to another, provided that the new rate of interest is determined in a manner set out in the mortgage documents and is intended to approximate the interest rate on newly originated mortgages at the time of conversion.

d. Non-Integration of REMICs and Grantor Trusts

The Proposed Regulations clarify that two entities electing to be taxed as REMICs are not integrated in determining whether either entity qualifies as a REMIC.[112] Similarly, the Proposed Regulations indicate that a wide variety of rights vis-a-vis a REMIC are not interests in the REMIC (without regard to their state law characterizations).[113] The Proposed Regulations imply without stating that a REMIC and a grantor trust the equity interests of which are qualified mortgages are not integrated.[114]

2. Discussion

a. Outside Reserve Funds

This rule states the standards for treating a reserve fund as outside of a REMIC in a case where the purposes of having the reserve fund are ones that would have permitted it to be inside the REMIC. Thus, the usefulness of this safe harbor will be limited; the only obvious benefits of the rule are that a

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112 See Prop. Reg. §1.860F-2(a)(2).

113 See Prop. Reg. §§1.860D-1(b)(2) and 1.860G-2(c).

114 See Prop. Reg. §1.860G-2(a)(5).

reserve fund will not be disqualified if it is not promptly reduced, the income on the reserve can be allocated to a person other than the residual holders and contributions can be made to the reserve fund other than in cash and by a person other than the holder of the residual interest.

We think the safe harbor should be extended to reserve funds used for purposes other than those currently described in the Proposed Regulations. As long as the parties treat the reserve fund as a separate asset, and are required to pay tax on income from the reserve fund (either by treating the reserve fund as a taxable entity or, more often, determining that it would not be classified as a separate entity), it seems the reserve fund should be recognized as being outside the REMIC. Thus, a REMIC can consist of segregated assets of a single legal entity; the logical extension of this principle is that a REMIC can be segregated from an outside reserve fund so long as a mechanism exists to ensure that all parties respect the entity created under the REMIC rules.

b. Credit Enhancement Contracts

We generally support the broad approach taken by the Proposed Regulations with respect to credit enhancement contracts, but have two significant concerns. First, the definition does not appear to permit a guaranty of full or partial payment on a residual interest. This omission is curious, since many guarantees that are clearly contemplated, such as a typical pool mortgage insurance policy, will clearly indirectly protect the residual interest. Further, if a residual interest is senior to a regular interest, any credit enhancement contract that protects the subordinate regular interest will indirectly support the residual interest. Second, more broadly, as described above, we see no policy reason why a contingency can be protected against in one of two permissible ways -- credit enhancement contract (including, a mortgage servicer advance) or reserve fund, but not the other. Accordingly, we believe that the definition of a credit enhancement contract should include agreements to provide for payment on a residual interest and contracts to cover any shortfall in a qualified reserve fund (but obviously, not an outside reserve fund) or to make payments that could have been made out of a reserve fund. It should be noted that to the extent the final regulations permit credit enhancement contracts to substitute for reserve funds, it will be less likely that excess funds will be invested inside the REMIC.

In addition, although the definition of credit enhancement contracts generally is written to provide examples and does not purport to be an exclusive list, it would be better if a few more common arrangements were clearly permitted. For example, advances by third parties other than the mortgage servicer are common. Further, commercial practice sometimes provides for a servicer to pay expenses on behalf of the REMIC or to advance amounts payable by any mortgagor in respect of expenses prior to the mortgagor's requirement to pay such amount. The servicer then reimburses itself when the mortgagor actually pays or is reimbursed by the REMIC on the next distribution date. Such an advance mechanism provides for an orderly administration of the REMIC and ensures that such amounts are never delinquent to the payee. We are unaware of any policy reason to prohibit such an advance mechanism, provided that the advance is made (and reimbursed) within a reasonable time relative to when such expenses are due.

A few technical concerns should also be addressed in the final regulations. In the case of a servicer advance of delinquent payments of principal and interest, we believe that, for purposes of determining whether a payment is delinquent, the due date specified in the loan documents should be controlling, so that the servicer may advance funds on such due date even if the mortgagor has a grace period to cure a payment default before a penalty is levied or before the REMIC has a right to foreclose. It would be preferable, however, if this were made clear in the final regulations.[115]

Further, the Proposed Regulations' definition of servicer advance provides for expenses incurred to protect the “REMIC's security interest in the collateral”. Presumably, what was intended was to cover expenses incurred to protect the property that comprises the collateral for the qualified mortgage, not merely to protect the security interest. The final regulations should clarify this point.

c. Convertible Mortgages

We believe that the Proposed Regulations have adopted a generally appropriate approach to the treatment of convertible mortgages. However, final regulations should clarify and to some extent liberalize the requirement relating to the rate into which the mortgage may be converted. Final regulations should make it

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115 One question that arises is whether an advance is permitted where the payment of principal and interest is not yet due. Suppose, for example, that all but two mortgages in a pool have due dates of the first of each month, but two mortgages provide for payments on the twentieth of each month. Would it be permissible for the servicer to advance on the fifteenth day of each month all payments for such month not yet received? We are unaware of any policy reason why the servicer should not be permitted to advance funds in respect of those two mortgages, or more generally, in respect of any principal or interest payment due in the immediate future, provided the purpose of the advance is to provide for an orderly administration of the REMIC and not to effectively substitute an obligation of the servicer for an obligation of the mortgagors.

clear that if the interest rate on a mortgage converts pursuant to a fixed formula to an interest rate that as of the issuance of the mortgage is expected to approximate market rates of interest on newly originated mortgages at the time of conversion, changes in the mortgage market that cause the formula rate to not reflect market rates of interest at the time of conversion will not cause the mortgage to fail to qualify as a convertible mortgage. One possible approach is to provide a safe harbor that an interest rate will be considered to approximate market rates if it does not differ from a market rate by more than .25 percent, per remaining year of life on the mortgage.

d. Non-Integration of REMICs and Grantor Trusts

The Proposed Regulations do not specifically indicate that a REMIC and a grantor trust holding interests in the REMIC will not be integrated in determining whether either one satisfies the requirements for its particular status.[116] We believe that there would be no such integration, although it would be best if this were clarified in the final regulations. Such a no-integration rule should not be controversial -- if a REMIC can be a segregated pool of assets, and thus not integrated with the assets of the legal owner of the REMIC, then it would make no sense to integrate it with assets owned by a trustee in an entity that is separate for non-tax purposes. More generally phrased, if the REMIC rules are designed specifically to permit entities (and interests in entities) that meet specified requirements to qualify as REMICs (and regular and residual interests) without meeting the generally accepted tests for qualifying as separate entities (and debt and equity,

[116] This situation could arise, for example, if a REMIC regular interest were held in a grantor trust along with a swap contract or other asset that the REMIC could not hold itself.

respectively), then applying a substance over form analysis to integrate such entities (and such interests) and disqualify them would frustrate the intention of the statute.

X. TREATMENT OF FOREIGN PERSONS (PROPOSED REGULATION SECTION 1.860G-3)

A. Background

Section 860G(b) contains two special rules for foreign holders of REMIC residual interests (whose income is not effectively connected with a U.S. trade or business). Section 8606(b) also gives the Service the authority to modify one of those rules.

The first rule is that no reduction in rate or exemption will apply to the “excess inclusion” income. The second rule is that income from a residual will be taken into account only “when paid or distributed (or when the [residual] interest is disposed of).” The legislative history to the REMIC provisions suggests that withholding on income from a residual at the time the residual is disposed of is to be similar to withholding on the disposition of debt obligations that have OID.[117]

[117] See Conference Report at II-236, n.18; although regulations concerning withholding on the disposition of an OID obligation have not been adopted, the tax that applies on the disposition of an OID obligation is determined by applying the 30 percent tax rate to the OID which accrued while the obligation was held by the foreign person (to the extent not previously taken into account) whether or not there is gain on the disposition. See §871(a)(1)(C)(1).

The Service was given the authority to provide by regulations that “amounts [of gross income from a residual] shall be taken into account earlier than [when paid or distributed or when the residual is disposed of] where necessary or appropriate to prevent the avoidance of tax . . . .”[118] The legislative history indicates that the regulatory authority may be exercised when the residual does not have significant value.[119]

In the Proposed Regulations, the Service did not use this regulatory authority to require a foreign person to include excess inclusions in income before they are paid (or the residual is disposed of).[120] Instead, Proposed Regulation section 1.860G-3 provides that the transfer of a residual to a foreign person will be disregarded for all Federal tax purposes if it has “tax avoidance potential”, unless the income from the residual is effectively connected with a U.S. trade or business of the transferee. If the transfer is disregarded, the transferor will be considered to continue to hold the residual and will be required to recognize the income from the residual. A residual will have tax avoidance potential unless each of two tests is met.

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118 §860G(b) (flush language).

119 See Conference Report at II-236.

120 The regulatory authority to require the recognition of income by a foreign person before it is paid is not limited to excess inclusion income. However, when the collateral of a REMIC is an agency pass-through certificate, income from the residual which is not excess inclusion income will generally be “portfolio interest” which is not taxable to a foreign holder unless its income is effectively connected with a U.S. trade or business. See Reg. §35a.9999-5(e) (Q & A 21).

The first test is that the "expected future distributions . . . equal at least 30 percent of the anticipated excess inclusions. ..." Anticipated excess inclusions are determined as of the date of transfer, taking into account events which have occurred up to the time of transfer, but based on the original prepayment and reinvestment assumptions.[121] The second test is that the transferor "reasonably expects that the transferee will receive sufficient distributions from the REMIC at or after the time at which the excess inclusions accrue". The Proposed Regulation do not specify what the distributions must be "sufficient" for. The analogous provision dealing with transfers to U.S. persons provides that the distributions must be anticipated to be sufficient to pay the accrued taxes.[122] Presumably the same thing is meant here.

The Proposed Regulations also have a special rule relating to transfers by foreign persons. A transfer by a foreign person of a residual to a U.S. person will be disregarded if it has the effect of allowing the transferor to avoid tax on excess inclusions.[123]

B. Discussion

The Proposed Regulations do not cover the transfer of residuals to foreign persons whose income would be effectively connected with a U.S. trade or business. As discussed above, such transfers should be treated in the same manner as transfers to U.S. persons.

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121 See Prop. Reg. §1.860E-2(a)(4).

122 See Prop. Reg. §1.860E-l(c)(2)(ii).

123 See Prop. Reg. §1.860G-3(a)(4).

The Proposed Regulations apparently assume that the amount of excess inclusions attributable to a cash distribution equals the lesser of the amount of the distribution and the aggregate amount of excess inclusions that have accrued prior to the distribution but have not previously been taken into account. This should be made explicit.

The second prong of the test for a residual that does not have tax avoidance potential is that it be reasonably expected that the distributions at or after the time the excess inclusions accrue will be sufficient to pay the tax liability. There is no indication in the Proposed Regulations how this reasonable expectation is to be determined. It is unclear, for example, whether it would be sufficient to test the results using just the pricing speed. Whereas projections based on the pricing speed reflect the parties best expectation of future results, it is quite unlikely that the mortgages will prepay at the pricing speed. Further, the distribution and excess inclusion consequences in some cases could differ drastically at slightly different prepayment speeds (e.g., if there are so-called “jump” classes, which prepay at different rates depending on slight changes in prepayment speeds). There should perhaps be a rebuttable presumption that the reasonable expectation test is met if the distribution and excess inclusion results meet the test of the Proposed Regulations at all prepayment speeds between 1/2 and twice the pricing speed.[124] The presumption might be rebutted by showing that the allocation of prepayments was designed to take advantage of the presumption (e.g., by changing the allocation of prepayments if prepayments are outside of the 50-200 percent range) so as to avoid tax on the residual.

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124 Any test of this nature should be made prospective, since market participants cannot be expected to have anticipated its details.

It is unclear when the rule disregarding a transfer by a foreign person to a U.S. person having the effect of allowing the transferor to avoid tax on excess inclusion income would apply. It is clear that the tax on all accrued excess inclusions not previously taken into account will be imposed on the foreign person when it disposes of the residual and it therefore cannot escape tax.[125]

XI. TAXABLE MORTGAGE POOLS

A. Background

Along with the REMIC provisions, section 7701(i) was added to the Code by the Tax Reform Act of 1986 (“1986 Act”) but generally became effective on January 1, 1992. It provides that a taxable mortgage pool (“TMP”) is treated as a corporation for federal income tax purposes that cannot consolidate with any other corporation, thereby ensuring a corporate level tax on the deemed corporation's taxable income.[126]

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[125] See §860G(b).

[126] Section 7701(1) provides that a TMP is

> any entity (other than a REMIC) if ––
>
> (i) substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein),
>
> (ii) such entity is the obligor under debt obligations with 2 or more maturities, and
>
> (iii) under the terms of the debt obligations referred to in clause (ii) (or underlying arrangement), payments on such debt obligations bear a relationship to payments on the debt obligations (or interests) referred to in clause (i).

The reasons for the TMP rules are not clearly articulated. The Conference Report simply provides that:

> The conferees intend that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of taxation.[127]

The Conference Report gives as an example of an entity that would be a TMP an "Owner Trust".[128]

There is not, however, any clear statement why Congress wanted a REMIC to be the exclusive means of issuing multiple class mortgage-backed securities. Several reasons are possible. First, where a taxpayer took advantage of the increased economic efficiency of issuing multiple class securities, Congress may have wanted to ensure that the taxpayer could not choose between the nonrecognition treatments afforded a borrowing secured by mortgages and the recognition treatment afforded a REMIC transaction. Second, Congress may have wanted to ensure that "phantom" or excess inclusion income created when multiple-class mortgage-backed debt is issued would be taxed in all events and that the excess inclusion rules could not be circumvented simply by forming a non-REMIC Owner Trust. Third, Congress may have wanted to ensure that holders of multiple class mortgage-backed debt were taxed under the special rules applicable to REMIC regular interests.

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[127] Conference Report at II-239.

[128] Id., at II-240, n.25. Under pre-1987 practice an "Owner Trust" typically would hold mortgage collateral and issue multiple classes of pay-through debt. The trust agreement was drafted so that the trust, if not treated as a trust for federal income tax purposes, was treated as a partnership.

B. Discussion

The Proposed Regulations do not address the treatment of TMPs. Because the effective date of the TMP rules is January 1, 1992, we believe that regulations under section 7701(i) should be issued promptly. A number of points that should be covered in regulations are spelled out below.

1. Asset Tests

The first requirement for an entity to be classified as a TMP is that “substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein)”.[129]

It would be helpful for regulations to establish a safe harbor for the portion of an entity's assets that must be non-debt obligations in order for the entity to fail the “substantially all” requirement. The safe harbor should be consistent with precedent under other Code sections which generally interpret “substantially all” to mean at least 80 percent.

There is no guidance in the statute that describes when the asset tests are measured. It is unclear whether the tests are to be applied to the entity at the time of the acquisition of the assets, the entity's issuance of the debt obligations or on a continual basis. For example, suppose that a pool of loans originally fails the 50 percent test but then meets it. This could occur, for example, where mortgage collateral prepays

129 §7701(i)(2)(A)(i).

slower than non-mortgage collateral. Because of the significant amount of non-mortgage collateral, the pool could not be a REMIC. To avoid this sort of problem, it may be appropriate to test the pool once beginning 90 days after what would have been the startup day had the pool been REMIC-eligible. If the pool does not meet the asset requirements at that time, it would not be a TMP. To prevent abuse, the tests would be reapplied whenever new debt was issued or substantial new capital contributed. In addition, the regulations should provide that assets should be disregarded under the 50 percent test if the principal purpose for including the assets is to keep the entity for qualifying as a TMP. For example, such a rule would apply where an entity's assets consisted of 60 percent six-month trade receivables and 40 percent 30-year mortgages and cash flow on the receivables was used to pay a short-term class of debt. The six-month receivables would be disregarded in making the 50 percent determination.

Another question is whether the asset tests are measured on a gross asset basis or a net asset basis. We think that gross assets should be the measure, primarily because this is the way asset tests are uniformly measured under subchapter M.[130] In order to make the test easy to apply, however, basis rather than fair market value should be used.

The regulations should also define the term "real estate mortgage" under the 50 percent test. We would recommend that this term be defined as any "qualified mortgage" as defined in section 860G(a)(3)(A), (i.e., "any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured, by an interest in real property,)"

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130 §851(b)(4); §856(c)(5).

but without regard to the further requirements in section 860G(a)(3)(A)(i) and (ii).[131] For this purpose, the provisions of the Proposed Regulations that determine whether a mortgage is “principally secured” by an interest in real estate should apply.

We think that construing the term “real estate mortgage” under the 50 percent test consistently with the term “qualified mortgage” under section 860G(a)(3) makes sense from a policy standpoint. Thus, the TMP rules should not apply where a loan could not be contributed to a REMIC because it is not a qualified mortgage. On the other hand, if a loan could be contributed to a REMIC, it should not be able to be contributed to a proscribed non-REMIC multiple class entity. This approach has the added advantage that the body of developing law regarding the “qualified mortgage” definition would automatically be incorporated by reference into the definition of “real estate mortgage” under the TMP rules.

Although the basic definition of “qualified mortgage” should be used to define the term “real estate mortgage”, we do not believe the tests in the Proposed Regulations for determining whether a loan is “principally secured” by real estate should be applied for purposes of determining real estate mortgage status for purposes of the TMP rules. If the 80 percent test is applied under the TMP rules in the manner described in the Proposed Regulations, then a loan could be a “real estate mortgage” if it met the 80 percent test either upon origination or upon contribution. This would, in effect, require revaluation of security when any loan secured by both real and personal property

[131] Section 860G(a)(3)(A)(i) and (ii) require that a qualified mortgage must be transferred to the REMIC on the startup day in exchange for regular and residual interests or purchased by the REMIC within the three-month period beginning on the startup day if such purchase is pursuant to a fixed-price contract in effect on the startup day.

is contributed to an “entity”. Such a requirement would be extremely cumbersome at a minimum. In addition, by looking to either origination date or contribution date values, such a rule would result in entities being classified as TMPs even though upon formation none of the loans were principally secured (within the meaning of the Proposed Regulations) by real estate. We think that while the regulations should use the 80 percent threshold in determining whether a loan is “principally secured”, the taxpayer should be able to pick either the origination date or the contribution date as the date on which to measure the 80 percent test. Such a rule would avoid the necessity of having to test loans as of the contribution date if it was clear that as of the origination date the real estate collateral did not meet the 80 percent test. It would also have the benefit of excluding from TMP status entities holding loans with real estate collateral not meeting the 80 percent test as of the contribution date.

The regulations should also exclude from the “real estate mortgage” definition any loan secured by all or substantially all of the assets of an active trade or business. In this case, the lender may be looking to real estate as collateral but is also looking to future operating income and goodwill to make the loan. Treating such a loan as a “real estate mortgage” would mean that the real estate would have to be valued independently from the business which may be a difficult, if not impossible, task. In order to avoid abuse, the exception could exclude from the active trade or business exception real estate development or management activities.

The regulations should also exclude from the “real estate mortgage” definition any loan secured by all or substantially all of the assets of an active trade or business.

In this case, the lender may be looking to real estate as collateral but is also looking to future operating income and goodwill to make the loan. Treating such a loan as a “real estate mortgage” would mean that the real estate would have to be valued independently from the business which may be a difficult, if not impossible task. In order to avoid abuse, the exception could exclude from the active trade or business exception real estate development or management.

2. Two or More Maturities

The second requirement for TMP status is that the entity must be the obligor “under debt obligations with 2 or more maturities”. Additionally, there is regulation authority in section 7701(i)(2)(D) to treat as debt “equity interests of varying classes which correspond to the maturity classes of debt”. The regulations need to address several issues.

First, the regulations should make it clear that an entity with one class of debt outstanding is not a TMP merely because there is a residual interest in the mortgages. For example, suppose a mortgage originator owns $100 million of mortgages. In order to raise capital, the originator issues a single class of pay-through debt secured by the mortgages for $90 million. Principal payments on the debt “bear a relationship” to principal payments on the mortgages. The mortgages should not be treated as a TMP merely because the mortgage originator is entitled to all the cash flow on the mortgages after debt service has been paid. This is because the outstanding debt does not have “2 or more maturities”. A similar rule should apply even if the debt is issued by an owner trust which has a class of residual certificates that are retained by the mortgage originator or sold to third parties.

Second, it is not clear whether two "classes" of debt instruments exist when the debt has the same maturity date but different features. Thus, suppose that in the previous example, the mortgage originator issues $45 million of debt with an interest rate equal to three-month LIBOR and $45 million of debt with an interest rate equal to 10 percent minus three-month LIBOR. Both the floater and inverse floater classes have the same maturity date. The TMP rules should not apply because they require "varying" maturities and both classes of debt share principal payments and prepayments pro rata.

Third, the TMP rules should also not apply where the debt instruments have the same maturities but where one debt instrument is subordinated to one or more other debt instruments. If there are no defaults on the underlying mortgages then each debt instrument would have an equal right to cash flow on the collateral and there would not be different maturities. If there were losses on the collateral, however, the debt instruments would bear the losses beginning with the most subordinated debt instrument first. Again, such debt instruments do not have the "varying maturities" required by the TMP rules. This rule is consistent with the basic REMIC principle that defaults are ignored in measuring the terms of a regular interest against the statutory requirements in section 860G(a)(1).[132]

Fourth, a rule should be included to clarify that the "entity" described in the statute should be considered the "indenture trust" in the case of corporate entities that issue single-class securities. For example, if a corporation issued, through different series with different indenture trusts (each

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[132] See, for example, Prop. Reg. §1.860G-1(b)(3).

with a discrete and separate interest in its own pool of mortgages), a number of single-class pay-through mortgage-backed securities each indenture trust viewed above would fail the two or more maturities tests. However, the corporation would have debt obligations with two or more maturities and the debt obligations, in the aggregate, would bear a relationship to payments on all the underlying mortgage loans, although there would be no cross- collateralization. The simplest example of this is a corporation that issues single-class retail mortgage-backed bonds. Here each indenture trust, rather than the corporation, should be considered the entity referred to in the statute.

Fifth, and finally, the regulations should clarify that the right of an issuer to redeem some of the bonds of a single class, where the bonds are selected through a procedure that gives each bond the same potential right to be redeemed does not result in multiple maturities. Such a right is very common in single-class retail mortgage-backed bond structures.

3. “Bear a Relationship” Test

The third requirement for TMP status is that payments on the multiple class debt instruments “bear a relationship” to payments on the real estate mortgages. We think that further clarification of the “bears a relationship” language is necessary. We believe this language was intended to cover transactions in which the timing of payments on the debt (or equity) is connected to the timing of payments (as distinguished, for example, from proceeds of sale) on the underlying mortgages.[133] Thus, for example, multiple classes of balloon maturity debt would not raise a TMP issue merely because the debt was secured by mortgages.

In addition, payments on debt should not be considered to “bear a relationship” merely because payments on mortgages may be used in certain unexpected circumstances to repay the debt. For example, suppose that commercial paper is secured by a pool of mortgages. If the commercial paper cannot be “rolled over” because of a decline in credit quality of the issuer, cash from mortgage principal payments (including prepayments) would be used along with sales proceeds from the mortgages to repay the commercial paper. The “bear a relationship” test should not be met merely because the terms of the transaction require the use of all available cash to pay the commercial paper. Similarly, a mortgage-backed bond may provide for acceleration upon decline in value of the underlying mortgage collateral. Payment upon acceleration can be made from mortgage principal payments plus proceeds from sale of the mortgages. Payments on the debt, however, do not “bear a relationship” to payments on the mortgages and the regulations should clarify that such an acceleration provision does not meet the “bear a relationship test”.

4. The Portion Rule

Section 7701(1)(2)(B) provides that any portion of an entity which meets the definition of a TMP shall be treated as a

[133] The Conference Report states that “Typically, the relationship between the assets of the entity and its debt obligations would be such that payments on the debt obligations must be made within a period of time from when payments on the assets are received”. Conference Report at II-240.

TMP. The only guidance in the legislative history on the application of this provision is the following example:

> [i] if an entity segregates mortgages in some fashion and issues debt obligations in two or more maturities, which maturities depend upon the timing of payments on the mortgages, then the mortgages and the debt would be treated as a TMP, and hence a separate corporation.
>
> The TMP provisions are intended to apply to any arrangement under which mortgages are segregated from a debtor's business activities (if any) for the benefit of creditors whose loans are of varying maturities.[134]

It is not clear from this example in the legislative history when the portion rule will be applied, and regulations should be issued to clarify the application of this provision.

There is some uncertainty concerning how the portion rule would apply when an entity owns a portfolio of assets which includes property other than debt securities. For example, suppose an entity acquires a pool of assets which is comprised of one third real estate and two thirds real estate mortgages and the entity issues two classes of pay through debt obligations with different maturities secured by the entire pool of assets. Although the entire entity would not be a TMP because “substantially all” of the entity's assets are not debt obligations, one possible application of the portion rule could classify the portion of the entity which is the real estate mortgages as a TMP. We believe that regulations interpreting the portion rule in this manner should not be issued because this would effectively eliminate the statutory “substantially all” requirement.

Regulations should be issued which clarify that the portion rule will be applied to a portion of an entity only when

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[134] Blue Book at 427.

the debt obligations issued by such entity are pay through and recourse only to the assets in that portion of the entity. Also, the portion rule could apply to prevent the avoidance of the TMP rules by including assets in a pool of real estate mortgages for the specific purpose of failing the “substantially all” requirement of the TMP rules. For example, a newly formed partnership acquires a pool of real estate mortgages from a distressed financial institution for $750. At the same time, the partnership acquires raw land for $250 which it intends to sell. The partnership then issues two classes of debt obligations which are pay through and recourse to all of the partnership's assets (i.e., the real estate mortgages and the land, although the debt will be repaid only with cash flow from the real estate mortgages). Even though the partnership's assets are not “substantially all” debt obligations, the portion rule could apply to classify the pool of mortgages as a TMP.

5. Treatment of Real Estate Investment Trusts

Section 7701(1)(3) provides an important exception for certain REITs. It says:

> If --
>
> A. a real estate investment trust is a taxable mortgage pool, or
>
> B. a qualified REIT subsidiary (as defined in section 856(i)(2)) of a real estate investment trust is a taxable mortgage pool,
>
> under regulations prescribed by the Secretary, adjustments similar to the adjustments provided in section 860E(d) shall apply to the shareholders of such real estate investment trust.

Regulations should clarify what it means to say that “adjustments similar to the adjustments provided in section 860E(d) shall apply to the shareholders of such real estate investment trust”. For example, for these purposes, is the REIT permitted to compute the income of a qualified REIT subsidiary as if it were a REMIC or, is it required to do so? Thus, when a REMIC is formed, the mortgages and other assets contributed to the REMIC receive a stepped-up or stepped-down basis in the REMIC's hands. This basis then affects the computation of the REMIC's excess inclusion income. In order to compute the amount of the REIT's income that must be reported to shareholders as excess inclusions, it is probably appropriate to treat the mortgage assets as though they were contributed to a REMIC. In some cases, this will result in increased excess inclusions; in others, the excess inclusions will be decreased. Nevertheless, such treatment seems necessary in order to not apply different standards to a REIT than are applied to a REMIC. On the other hand, a REIT should not be required to compute income on its mortgages or interest expense on its debt as though it were a REMIC. The regulations should also clarify that whatever special accounting is required is only necessary for purposes of computing and allocating excess inclusion income and that there is no statutory authority for requiring a REIT to compute income as if it were a REMIC (and in fact, there is statutory authority to the contrary). In this circumstance, the regulations should clarify whether the other special REMIC accounting rules would apply to the computation of excess inclusion income. For example, does mandatory market discount accrual apply? There is also a need to clarify what the “residual” is in a REIT or qualified REIT subsidiary for purposes of applying the 120 percent test in measuring excess inclusions, since there is no separate instrument issued to identify it. Furthermore, in this regard, clarification of the “issue price” of the “residual” is necessary for purposes of applying the percentage computation in determining the excess inclusion income. In the REMIC rules, the “issue price” is the fair market value of the residual interest. The same rule should apply in the REIT area, notwithstanding that the difference between the issuer's adjusted basis in the “residual” and its fair market value is not required to be amortized into income as is required with respect to a REMIC residual interest.

Another problem relates to administrative expenses. If a REIT issues a mortgage-backed bond, it will have various administrative costs associated with the issuance such as trustee’s fees, costs of preparing tax returns, attorneys and accountants fees, etc. If a REMIC issued regular and residual interests, these expenses would reduce the REMIC's excess inclusion income as they are taken into account in determining the REMIC's net income. The regulations should permit a reasonable allocation of administrative and overhead expenses to the income from the REIT's mortgage pool in computing what “would have been” the REIT's excess inclusions if the mortgage pool was a REMIC.

6. Certain Entities That Should Not Be TMPs

Section 7701(i)(2)(D) provides that “to the extent provided in regulations, equity interests of varying classes which correspond to maturity classes of debt shall be treated as debt for purposes of this subsection.” The regulations should make it clear that certain entities are not TMPs under this authority. Thus, the regulations should exempt from the TMP rules any fixed investment trust as defined in Regulation section 301.7701-4(c). This would include senior-subordinated grantor trusts, trusts that issued interests representing stripped bonds and stripped coupons, as well as other multiple class trusts where the multiple classes of interest are “merely incidental” and facilitate a direct investment in the underlying assets. Such trusts do not meet the statutory requirement that the entity be the obligor on debt “with 2 or more maturities”. Thus, in each case, the investor is treated as owning an interest in the underlying assets of the trust directly. Moreover, it is unlikely that the regulation authority under section 7701(1)(2)(D) was meant to permit the Service to treat a fixed investment trust with two equity classes as an entity with two debt classes but no equity. Furthermore, there is no evidence that Congress intended to change the treatment of these sorts of trusts, and it would be appropriate to make this clear in regulations under section 7701(i)(2)(D).

7. Effective Date of the TMP Rules

The 1986 Act provides that section 7701(i) is effective on January 1, 1992. It further provides that the TMP rules shall not apply to any “entity in existence on December 31, 1991”. This “grandfather” rule, however, does not apply “with respect to any entity as of the first day after December 31, 1991 on which there is a substantial transfer of cash or other property to such entity”.

The “substantial transfer” exception was apparently intended to prevent the formation of shell entities for future transactions which might otherwise be grandfathered due to technical formation prior to January 1, 1992 and to prevent the re-use of non-shell entities. However, read literally, the exception to the grandfather rule might eliminate the grandfather rule almost entirely. For example, suppose that an owner trust in existence on December 31, 1991 borrows money after such date to pay expenses such as legal fees, accounting fees, etc. It expects to repay the borrowing out of future residual income. Does the "transfer" of cash by the lender constitute a transfer that could void the grandfather protection? Obviously, it should not. To cure this problem the regulations should first define what is meant by substantial. At a minimum the phrase might be interpreted consistently with the phrase "substantially all" in the Proposed Regulations so that a transfer would not be substantial if it did not exceed 20 percent of the value of the entity's assets. Additionally, transfers of cash pursuant to borrowings in the ordinary course of operations should be exempted entirely from the transfer definition. An example could be provided to show that this rule is limited to money transferred to the entity to pay expenses of the entity such as legal, accounting or trustee's fees.

In some cases, entities have been created which involve revolving pools of mortgage loans. In one standard structure, an originator of home equity loans will transfer the loans to a trust. The trust issues multiple classes of certificates backed by the mortgage loans. The arrangement is treated for federal income tax purposes as a financing by the loan originator.

When the trust receives principal payments on the home equity loans, it will use the principal to purchase new loans from the mortgage originator for a predefined period (the "nonamortization period"). At the end of the nonamortization period all principal payments and prepayments are passed through to the certificate holders.

If such an entity is formed before January 1, 1992, the regulations should provide that it is entitled to the grandfather rule even though new mortgages would be transferred on or after January 1, 1992 to the trust. This rule could be limited to purchases of mortgages by the trust out of existing cash flow to prevent expansion of a pre-1992 trust.

The regulations should also clarify that transfers of cash made in satisfaction of obligations held by the entity on December 31, 1991 should not result in a “substantial transfer” for purposes of the TMP effective date. For example, the Conference Report makes it clear that receipt of payments on mortgages would not be considered a transfer after December 31, 1991.[135] Another example is contributions to the entity required by guarantee or indemnity agreements. It is possible that the word “transfer” was actually intended to mean contribution to the REMIC, i.e., an addition to net worth that could support future borrowings. Alternatively, a “transfer” could be defined in the regulations as any transfer representing contributions or the proceeds of borrowings not made to pay ordinary course of business expenses. Such a rule would solve many of the technical issues but at the same time prevent post- 1991 borrowings based on old equity.

The “substantial transfer” rule should not apply to deemed transfers under the Code. For example, it should not apply if a partnership formed before January 1, 1992 is constructively terminated under the rules of section 708(b) if there is a sale or exchange of 50 percent or more of the total interests in

[135] Conference Report at II-241.

partnership capital or profits. To treat the recontribution of assets as a post-1991 “transfer” does nothing to further the purposes of the TMP rules described above and should be exempted from the “transfer” definition.

Finally, it would be desirable to clarify the entity concept used in the effective date rule. If the post-1991 transfer can be treated as a separate mortgage pool under section 7701(1)(2)(B), it should not be treated as a transfer to some broader entity that transforms pre-1992 transactions into TMPs. We have in mind certain SEC shelf registrations for an issuer whose debt may consist of separate series of bonds secured by separate mortgage pools.[136]

XII. OID COMPUTATIONS, REMIC REPORTING REQUIREMENTS AND OTHER ADMINISTRATIVE RULES

A. Background

1. OID Computations - Negative OID

Section 1276(a)(6) provides a formula to determine the amount of OID with respect to regular interests in a REMIC. As we discussed in the 1988 REMIC Report, when applying section 1276(a)(6) to certain regular interests, the formula produces an amount of OID that is negative.[137] However, the Conference Report to the 1986 Act provides:

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136 We are aware of concerns that certain types of tax-exempt debt financings (generally involving revenue bonds) may literally fall within the definition of a TMP but have not addressed those concerns because the result seems clearly unintended and we understand the Service may resolve those concerns administratively other than by regulations under section 7701(1).

137 See 1988 REMIC Report at 65-66.

> The conferees intend that in no circumstances, would the method of accruing OID prescribed by the conference agreement allow for negative amounts of OID to be attributed to any accrual period. If the use of the present value computations prescribed by the conference agreement produce such a result for an accrual period, the conferees intend that the amount of OID attributable to such accrual period would be treated as zero, and the computation of OID for the following accrual period would be made as if such following accrual period and the preceding accrual period were a single accrual a period.[138]

2. Reporting and Administrative Requirements

In March, 1988, the Service issued proposed and temporary regulations relating to the various information reporting requirements REMICs must fulfill under sections 860F, 67(c) and 6049(d)(7). For a variety of reasons, the Service concluded that the system of information reporting created by these regulations was for the most part ineffective.[139] In the fall of 1989, the Service issued revised regulations,[140] outlining a more manageable approach to the information reporting process. The rules streamlined the flow of information from issuer to investor and established more realistic due dates for providing the information. Although the revised regulations went

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138 Conference Report at II-239. See also Blue Book at 426.

139 The Service received many comments regarding the ineffectiveness of the regulations as well as the need for additional guidance. Of the rules provided by the regulations, those dealing with information reporting to regular interest holders were found to be the most unwieldy. This was due in large part to the fact that each person in the chain of ownership depended upon the person immediately above him to furnish the required tax information. This process caused extensive delays in furnishing the information to the ultimate holder and either delayed the filing of the holder's tax return or required the holder to file an amended tax return.

140 Treasury Decision 8186 (September 6, 1989).

a long way towards resolving earlier concerns, the comments received suggested that further guidance would be necessary.

Final and temporary regulations issued along with the Proposed Regulations (collectively, “the Regulations”) address various aspects of REMIC information reporting and substantially adopt the 1989 version. In general, the Regulations address effectively certain of the concerns expressed with respect to the previously issued regulations. Nonetheless, some unanswered questions remain, particularly with regard to computations that are required with respect to market discount and acquisition premium.

B. Discussion

1. Negative OID

As discussed in detail in the 1988 REMIC Report, we believe there is no reason to prohibit section 1272(a)(c) from producing negative amounts of OID.[141] We continue to believe that in certain circumstances, a deduction should be allowed to the holder for negative amounts of OID and that the rule recommended in the 198.8 REMIC Report be adopted.[142] There appears to be no principal policy objections to adopting such a rule.

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[141] See 1988 REMIC Report at 65-68.

[142] See 1988 REMIC Report at 68.

2. Market Discount--Floating Rate Instruments

Under section 6049(d)(7), the "market discount fraction" must be provided to assist regular interest holders in computing their accrual of market discount.[143] The Regulations provide one method of determining the market discount fraction for instruments issued without OID (the "stated interest method") and another method for instruments issued with OID (the "OID method"). Under the stated interest method, the numerator of the market discount fraction is the interest allocable to the accrual period and the denominator is the sum of the interest allocable to the accrual period and the remaining interest as of the end of the accrual period. Under the OID method, the numerator of the market discount fraction is the OID allocable to the accrual period and the denominator is the sum of the OID accrued allocable to the accrual period and the remaining OID at the end of the accrual period.[144]

Additional guidance is needed concerning the method for determining the market discount fraction for a floating rate instrument. Specifically, clarification is required regarding the interest rate to be used in determining the interest/OID allocable to the accrual period (the "current period amount") and the remaining interest/OID at the end of the accrual period. In practice, the current period amount is typically based upon the

[143] The amount of the market discount attributable to a particular accrual period equals the product of the market discount remaining at the beginning of the period and the market discount fraction for the accrual period.

[144] Reg. §§1.6049-7(f)(2)(i)(G) and (ii)(K). Although the numerator is the same as was provided under the temporary regulations, the clarification of the denominator highlights a desire on the part of the Service for consistency between the two.

interest rate in effect prior to the close of the accrual period (the “current rate”). The remaining interest/OID is an amount projected based upon assumptions in effect at the startup day generally including the interest rate used in determining the original yield to maturity (the “settlement rate”). Using the settlement rate in this manner can result in either an over/under accrual of market discount for each accrual period. We believe the interest rate used in determining the market discount fraction should be the same for current and future periods. Arguably the current rate should be used for all related calculations.[145] However, use of the settlement rate in the same fashion should produce similar results. The following example illustrates the desirability of requiring consistent rates:

> Assume a floating rate REMIC regular interest (or collateralized debt obligation) issued without OID has a settlement rate of 10 percent and a current rate of 8 percent. The current period amount and the remaining interest at the end of the accrual period using the current rate are $10,000 and $1,300,000, respectively. The same amounts determined using the settlement rate are $12,500 and $1,625,000, respectively. The market discount remaining at the beginning of the accrual period is $200,000.

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145 Reg. §§ 1.6049-7(f)(2)(i)(G) and (ii)(K) state that both the interest/OID allocable to each accrual period and the remaining. interest/OID are calculated by taking into account events which occurred before the close of the accrual period. A reasonable reading of this rule suggests that the use of the actual interest rate in effect prior to the close of the accrual period for purposes of determining the amount of interest/OID remaining would be appropriate.

The three possible methods of calculating the current period and remaining interest amounts, to be used in the determination of the related market discount fraction are:

Method:	Current Period Amount	Remaining Interest
A	Current Rate	Settlement Rate
B	Current Rate	Current Rate
C	Settlement Rate	Settlement Rate

The market discount fractions and accrued market discount determined under each of these methods would be:

Method:	Market Discount Fraction	Accrued Market Discount
A	.6116208 Percent (10,000/ (1,635,000))	1,223.24
B	.7633588 Percent (10,000/ (1,310,000))	1,526.72
C	.7633588 Percent (12,500/ (1,637,500))	1,526.72

These results demonstrate the over/under accrual that can result when Method A is used in determining the market discount fraction. The use of either Method B or C results in an identical market discount fraction. Consequently, it would seem that the use of either Method B or C should be acceptable, if consistently employed. Therefore, the regulations should clarify the interest rate to be used in calculating the market discount fraction and eliminate the use of inconsistent rates.

3. Acquisition Premium

The preamble to the Proposed Regulations clarifies that the market discount fraction may be used for amortizing bond premium, by its reference to the legislative history under section 1276(b)(3).[146] Additional guidance is necessary regarding the reduction in OID that occurs when a subsequent holder of a debt instrument that has OID pays acquisition premium.[147] The method of calculating this reduction provided in section 1272(a)(7) is deficient as it relates to certain REMIC regular interests and CMOs. In general, section 1272(a)(7) requires OID otherwise accrued for a period to be reduced by a fixed fraction. Where the aggregate amount of OID is a fixed amount, the use of a fixed fraction will result in the reduction of aggregate OID accruals by the exact amount of the acquisition premium. Nonetheless, the aggregate amount of OID to be accrued is not fixed for any REMIC regular interest or CMO that does not

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[146] The preamble refers the reader to the Conference Report, at II-842, for the application of the market discount rules to amortizing amortizable bond premium within the meaning of section 171.

[147] Section 1272(a)(7) provides that in the case of any purchase of a debt instrument after its original issue, the daily portion of OID shall be reduced by an amount equal to the product of the daily portion of OID and a fraction -

a. the numerator of which is the excess (if any) of -

   1. the cost of such debt instrument incurred by the purchaser, over

   2. the issue price of such debt instrument, increased by the portion of OID previously included in the gross income of any holder (“revised issue price”), and

b. the denominator of which is the sum of the daily portions for such debt instrument for all days after the date of such purchase and ending on the stated maturity date (“OID remaining”).

have qualified periodic interest.[148] Applying a fixed fraction to an aggregate amount of OID that is virtually certain to vary from any originally assumed amount inevitably will result in the recovery of too much or too little of the acquisition premium. In order to overcome this problem we recommend that the regulations provide the market discount fraction may be used to calculate the amount of reduction due to acquisition premium.

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148 A similar problem exists for any other floating rate instrument where the OID fluctuates based upon the interest rate.